

Counseling the Board of Directors of a Delaware Corporation in Distress

E. Norman Veasey*

Directors of a Delaware corporation have a statutory duty to direct the management of the business and affairs of the corporation.¹ That is a proactive mandate that contemplates full engagement by directors.² In carrying out that duty, directors are generally protected by the business judgment rule if they are not found to have violated their fiduciary duties of care and loyalty.³ The duty of loyalty embraces the principle that directors must act in good faith.⁴

The applicable standards of review determine whether a director may be held liable or a transaction set aside when the standards of conduct are not met.⁵ We begin with the business judgment rule.

* Retired Chief Justice of Delaware (1992-2004), Senior Partner of Weil, Gotshal & Manges LLP, Wilmington and New York. Chief Justice Veasey has served as President of the Conference of Chief Justices and is a Fellow of the American College of Trial Lawyers.

¹ DEL. CODE ANN. tit. 8, § 141(a).

² E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance From 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1418 (2005).

³ *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006).

⁴ *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

⁵ Veasey & Di Guglielmo, *supra* note 2, at 1416-39.

1. *The Business Judgment Rule*

The conduct of directors of Delaware corporations in their decisionmaking role continues to be reviewed under the business judgment rule, which is alive and well in Delaware corporate jurisprudence. Because of the mandate that directors manage or direct the management of the business and affairs of the corporation, the focus of the business judgment rule remains on the process that directors use in reaching their decisions. The business judgment rule will normally protect the decisions of a board of directors reached by a careful, good faith process.⁶ The rule itself has been restated numerous times. In *Brehm v. Eisner*, the Supreme Court provided the following formulation:

The business judgment rule has been well formulated by *Aronson* and other cases. See, e.g., *Aronson [v. Lewis]*, 473 A.2d 805, 812 (Del. 1984)] (“It is a presumption that in making a business decision the directors ... acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation.”). Thus, directors’ decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.⁷

⁶ See *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (explaining the deference courts give a director’s decision). In *Brazen v. Bell Atlantic Corp.*, the court explained:

The business judgment rule is a presumption that directors are acting independently, in good faith and with due care in making a business decision. It applies when that decision is questioned and the analysis is primarily a process inquiry. Courts give deference to directors’ decisions reached by a proper process, and do not apply an objective reasonableness test in such a case to examine the wisdom of the decision itself.

695 A.2d 43, 49 (Del. 1997) (footnotes omitted).

⁷ *Brehm*, 746 A.2d at 264 n.66.

Delaware's emphasis on responsible corporate governance practices⁸ as a standard of conduct is intended to promote good decisionmaking by directors, thereby obviating the specter of judicial second-guessing. Good governance practices permit the time-honored business judgment rule regime to operate with integrity by checking self-interest and sloth while permitting valuable and prudent risk taking.

The goal is to promote good governance and avoid the need (or the temptation) for courts and regulators to second-guess directors. By encouraging sound structures and processes, good disclosure, and fair elections, the courts can continue to accord directors wide discretion, because sound practices of internal corporate governance limit the potential for abuse.⁹

2. *Standard of Review Issues*

As noted above, the standards of conduct are the goals and aspirations to which directors should aspire. Standards of review are the standards that courts apply in judging the conduct of directors.¹⁰

The standards of review include various gradations of judicial scrutiny. If the business judgment rule applies, courts will not second-guess directors or even question whether a business decision is "reasonable." But the takeover era of the 1980s, culminating in the watershed year of 1985, led to more and increasingly complicated

⁸ For an excellent primer on good corporate governance practices by directors in aspiring to high standards of conduct, see THE CORPORATE DIRECTORS GUIDEBOOK (5th ed. 2007), available from the ABA Section of Business Law and reproduced at 62 BUS. LAW. 1482 (2007).

⁹ Veasey & DiGuglielmo, *supra* n.2 at 1406.

¹⁰ *Id.* at 1416-1435.

standards of review. For example, the Delaware Supreme Court has articulated differing review mechanisms to be applied in various contexts, ranging from testing the reasonableness and proportionality of the directors' resistance to a takeover under the *Unocal*¹¹ standard, to the "entire fairness" test applying to controlling stockholder transactions under *Weinberger*,¹² to the "best price on sale of control" standard under *Revlon*¹³ and *QVC*.¹⁴

3. "Vicinity" or "zone" of insolvency

For many years there has been a very challenging and debatable issue of whether (and to what extent) directors, in making their business decisions when the corporation is in the vicinity or zone of insolvency, may be required to consider the interests of creditors—a different constituency from that to which their duties normally extend, namely stockholders. In his 1991 opinion in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, then-Chancellor Allen stated that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."¹⁵ The Chancellor then provided, in his famous footnote fifty-five, an example of how the

¹¹ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985).

¹² See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (holding that in a transaction involving conflicted insiders, those who are conflicted have the burden to satisfy the court that the transaction is entirely fair to stockholders or the corporation, both as to fair price and fair process).

¹³ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1985).

¹⁴ *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 43 (Del. 1994).

¹⁵ No. 12150, 1991 Del. Ch. LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991).

possibility of insolvency can alter the incentives facing directors in their decisionmaking processes.¹⁶

The key here is that directors, in these and all circumstances, must act in the honest belief that they are carrying out the best interests of the corporate entity. In *Production Resources Group, LLC v. NCT Group, Inc.*,¹⁷ a creditor of NCT Group sought to have a receiver appointed for NCT under title 8, section 291 of the Delaware General Corporation Law (DGCL), and also alleged certain breaches of fiduciary duty. The Court of Chancery largely denied a motion to dismiss the action, allowing the section 291 claims and some of the fiduciary duty claims to proceed. In his decision, Vice Chancellor Strine stated that the plaintiff had sufficiently pleaded:

a suspicious pattern of dealing that raises the legitimate concern that the NCT board *is not pursuing the best interests of NCT's creditors as a class with claims on a pool of insufficient assets*, but engaging in preferential treatment of the company's primary creditor and de facto controlling stockholder (and perhaps of its top officers, who are also directors) without any legitimate basis for the favoritism.¹⁸

I cite *Production Resources* not because it announces anything new. Rather, it reaffirms what, in my view, has always been the law—that directors who make good faith, careful

¹⁶ In that footnote, former Chancellor Allen stated:

The directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

Id. at *108 n.55.

¹⁷ 863 A.2d 772, 775 (Del. Ch. 2004).

¹⁸ *Id.* at 800 (emphasis added).

judgments in the honest belief that they are acting in the best interests of the corporation should not fear liability.

Nevertheless, there is an issue here that should be heeded. Directors facing a collapsing enterprise in the vicinity of insolvency may be under some constraints to take action and prudent risks to preserve the enterprise and attempt to get the best transaction available that will benefit the entity, and thus stockholders and creditors.

For example, directors may flirt with the idea of locking up a “saving” merger transaction in a way similar to that which the directors of NCS Healthcare attempted to do in the famous and controversial *Omnicare* case.¹⁹ There, in a highly unusual split decision of the Delaware Supreme Court in which I and Justice (now Chief Justice) Steele dissented, the Court enjoined a lockup of a merger. In our view and the view of Vice Chancellor Lamb, the lockup was permissible. In the vernacular, the merger was the “only game in town” for directors who had searched diligently and in good faith for the best transaction for the corporation, but were “between a rock and a hard place.” In *Omnicare*, we said, in dissent:

The process by which this merger agreement came about involved a joint decision by the controlling stockholders and the board of directors to secure what appeared to be the only value-enhancing transaction available for a company on the brink of bankruptcy. . . .

. . . . The essential fact that must always be remembered is that this agreement and the voting commitments of Outcalt and Shaw concluded a lengthy search and intense negotiation process in the context of insolvency and creditor pressure where no other viable bid had emerged. Accordingly, we endorse the Vice Chancellor’s well-reasoned

¹⁹ *Omnicare v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

analysis that the NCS board's action before the hostile bid emerged was within the bounds of its fiduciary duties under these facts.²⁰

I believe it is likely (but not certain) that the Delaware Supreme Court in the future would uphold director action in circumstances that may be comparable to (if not substantially the same as) those present in *Omnicare* and give conscientious directors in such a predicament the benefit of the doubt.

Yet, prudent counseling today suggests the following. First, the courts are likely to limit and not expand the reach of *Omnicare*. Second, practitioners should not count on the Court to overrule the decision—not only because of stare decisis but also because, if the transaction that is to be tested provides legitimate distinctions from *Omnicare*, the reach of the Court's decision on review, will be limited. So, it should not become necessary or practical for the Court to overrule *Omnicare*.

Finally, the Delaware Supreme Court is a practical institution and has expertise in business law. A deal protection measure that makes good business sense, particularly if the transaction appears to the board to be necessary to save the corporation, should pass muster if the board has followed a best practices process in good faith. I caution, however, that a disingenuous attempt to use some transparently artificial measure that is too-clever-by-half in order to try to get around *Omnicare* in a superficial way while maintaining an ironclad lockup with no realistic wiggle room may be too aggressive and may result in the practitioner taking an unnecessary risk that *Omnicare* will be

²⁰ *Id.* at 940 (Veasey, CJ, and Steele, J. dissenting).

overruled.²¹ Moreover, unless and until the Delaware Supreme Court is presented with a case that raises questions about the application of *Omnicare*, other courts must treat it as the law of Delaware.

4. The Delaware Supreme Court in 2007 Clarified the Standing of Creditors to Bring Fiduciary Duty Claims

Today, as a result of the 2007 decision of the Delaware Supreme Court in *National American Catholic Educational Programming Foundation, Inc. v. Gheewalla*,²² the law of Delaware concerning the standing of creditors to sue has been clarified. In *Gheewalla*, creditors brought a direct claim for breach of fiduciary duty in the Delaware Court of Chancery against directors of a Delaware corporation operating in the zone of insolvency. The Court of Chancery dismissed the action for failure to state a claim. The Supreme Court affirmed.

Observing that this was a case of first impression, Justice Holland, writing for the Supreme Court *en banc*, held that: (a) creditors may not assert *direct* claims for breach of fiduciary duty against directors of a solvent corporation, whether or not it is operating in the “zone of insolvency;”²³ and (b) creditors may not assert *direct* claims for breach of fiduciary duty against directors of an insolvent corporation.²⁴ *Gheewalla* also states (in

²¹ Veasey & DiGuglielmo at 1461-6; see also *Orman v. Cullman*, No. 18039, 2004 Del. Ch. LEXIS 150.

²² 930 A.2d 92 (Del. 2007).

²³ *Id.* at 101.

²⁴ *Id.* at 103; see also *Nelson v. Emerson*, C.A. No. 2937-VCS, 2008 WL 1961150, at *6 n.29 (Del. Ch. May 6, 2008) (acknowledging that creditor had agreed that his direct claims for breach of fiduciary duty should be dismissed in light of the Delaware Supreme Court’s decision in *Gheewalla* “holding that creditors cannot bring direct actions for breach of fiduciary duties”).

dicta, because the plaintiff did not raise, in the Court of Chancery or on appeal, any derivative claim) that creditors of an insolvent corporation have standing to assert derivative claims on behalf of the corporation for breach of fiduciary duty.²⁵ The Court does not address, even in dicta, whether creditors of a solvent corporation in the “zone of insolvency” may assert derivative claims.²⁶ Moreover, the Court in *Gheewalla* also declined to set forth a precise definition of “zone of insolvency.”

The relevant language of the Court follows:

It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders. While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights. Delaware courts have traditionally been reluctant to expand existing fiduciary duties. Accordingly, “the general rule is that directors do not owe creditors duties beyond the relevant contractual terms.”

* * *

... When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners. Therefore, we hold the Court of Chancery properly concluded that ... the ... Complaint fails to state a claim, as a matter of Delaware law, to the extent that it attempts to assert a direct claim for breach of fiduciary duty to a creditor while Clearwire was operating in the zone of insolvency.

* * *

It is well settled that directors owe fiduciary duties to the corporation. When a corporation is *solvent*, those duties may be enforced by its

²⁵ *Gheewalla*, 930 A.2d at 101.

²⁶ *See Production Resources*, 863 A.2d at 790 n. 56.

shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.

Consequently, the creditors of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. The corporation's insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value." Therefore, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation. Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.

* * *

... To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation. Accordingly, we hold that individual *creditors* of an *insolvent* corporation have *no right to assert direct* claims for breach of fiduciary duty against corporate directors. Creditors may nonetheless protect their interest by bringing derivative claims on behalf of the insolvent corporation or any *other* direct nonfiduciary claim, as discussed earlier in this opinion, that may be available for individual creditors.

* * *

The creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against its directors.²⁷

So, it is clear that creditors have no *direct* fiduciary duty claims against directors of an insolvent corporation or a solvent one, whether or not it is in the "zone of

²⁷ *Id.* at 99-103 (footnotes omitted; some alterations in original).

insolvency.” If the corporation is actually insolvent, they may have derivative claims to make on behalf of the corporate entity, if the facts support such a claim.²⁸ Whether creditors may bring derivative claims against directors of a corporation that is solvent but in the zone of insolvency is unclear, but doubtful as a practical matter, in my view.

5. *Authorities Before Gheewalla*

As the opinion in *Gheewalla* catalogues, there were a number of cases after *Credit Lyonnais* that either contributed to the confusion or to the clarity of the law relating to directors’ fiduciary duties in these areas. Justice Frankfurter’s 1943 quote about fiduciary duties is a good starting point:

But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as fiduciary? In what respects has he failed to discharge these obligations? And what are the consequences of his deviation from duty?²⁹

In *Production Resources v. NCT Group*³⁰ Vice Chancellor Strine presented a discursive analysis of the subject of directors’ fiduciary duties. Although he assumed *arguendo* that there could be a direct creditor claim for violation of fiduciary duty, he did

²⁸ *Cf. Nelson*, 2008 WL 1961150, at *8-9 (holding that derivative claim that directors breached their fiduciary duty of loyalty by filing for bankruptcy in a bad faith effort to frustrate a creditor’s secured claims against the company failed to state a claim because “the directors of a Delaware corporation do not commit a breach of fiduciary duty if they have the corporation file a non-frivolous claim, seeking to recharacterize certain debt as equity in order to protect the interests of the company’s equity holders”); *id.* at *2 (“an insolvent company is not required to turn off the lights and liquidate when that company’s directors believe that continuing operations will maximize the value of the company”).

²⁹ *Securities and Exchange Commission v. Chenery Corp.*, 318 U.S. 80, 85-6, 87 L. Ed. 626, 63 S. Ct. 454 (1943).

³⁰ *Supra* n.17.

not decide that question.³¹ He decided only that directors of an *insolvent* corporation have fiduciary duties to the corporation that creditors may have standing to pursue on behalf of the corporation unless those claims are merely due care claims that are barred by the Delaware director exoneration statute.³²

In *Trenwick America Litigation Trust v. Ernst Young, L.L.P.*,³³ Vice Chancellor Strine clarified further the import of the *Credit Lyonnais* language. He stated in *Trenwick*, as he had in *Production Resources*, that the language in *Credit Lyonnais* was not intended as a sword hanging over the heads of directors. Rather, it was more in the nature of a shield. That is, to the extent that directors of a corporation in the zone of insolvency may consider the rights of creditors in the context of their duties in serving the corporate entity, they may not be breaching their duty to stockholders.

So, *Credit Lyonnais* is not a case that endorses a theory of liability based on “deepening insolvency” of an insolvent Delaware corporation. Rather, in *Trenwick*, the Court explicitly rejected the notion that there is a viable fiduciary duty claim of “deepening insolvency,” in the following language:

If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation’s value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy’s success. That the strategy results in continued insolvency and an even more insolvent entity

³¹ Id. at 800. Other cases employing the “arguendo” assumption include the Court of Chancery decision in *Gheewalla* and *Big Lot Stores, Inc. v. Bain Capital Fund VI LLC*, 922 A.2d 1169 (Del. Ch. 2006).

³² Del. Code Ann. tit. 8, § 102(b)(7). He also declined to decide the application of derivative pleading standards under Court of Chancery Rule 23.1.

³³ 906 A.2d 168 (Del. Ch. 2006), *aff’d sub nom Trenwick America Litigation Trust v. Billett*, No. 495 2007 WL 23 17768 (Del. Aug. 14, 2007).

does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law.

The rejection of an independent cause of action for deepening insolvency does not absolve directors of insolvent corporations of responsibility. Rather, it remits plaintiffs to the contents of their traditional toolkit, which contains, among other things, causes of action for breach of fiduciary duty and for fraud. The contours of these causes of action have been carefully shaped by generations of experience, in order to balance the societal interests in protecting investors and creditors against exploitation by directors and in providing directors with sufficient insulation so that they can seek to create wealth through the good faith pursuit of business strategies that involve a risk of failure. If a plaintiff cannot state a claim that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, it may not cure that deficiency simply by alleging that the corporation became more insolvent as a result of the failed strategy.

Moreover, the fact of insolvency does not render the concept of “deepening insolvency” a more logical one than the concept of “shallowing profitability....”³⁴

For an incisive and scholarly analysis of *Gheewalla* and *Trenwick*, see the upcoming article by Michelle M. Harner and Jo Ann J. Brighton, *The Implications of North American Catholic and Trenwick: Final Death Knell for Deepening Insolvency? Shift in Directors’ Duties in the Zone of Insolvency?*³⁵

So, in Delaware, at least, directors are not guarantors that insolvency will not “deepen.” Their fiduciary duties to the corporation are the general duties of care and loyalty, to be measured, of course, by the financial and other circumstances in which the corporation finds itself. If a prudent, good faith and deliberative corporate decision

³⁴ *Id.* at 205.

³⁵ Brighton, Jo Ann J., Harner, Professor Michelle “Deepening Insolvency & Zone of Insolvency” – Nortons Annual Survey of Bankruptcy Law 2007 (West Publishing, 2008).

results in a “deepening insolvency,” there should be no valid claim against them solely because, in hindsight, the decision was unsuccessful.

6. *Post-Gheewalla Bankruptcy Court Cases*

Judge Leif Clark of the Bankruptcy Court of the Western District of Texas in the *Medlin* case in July 2007 provided a succinct overview of the development of the law from *Credit Lyonnais* to *Gheewalla*. Although the adversary proceeding there was recommended³⁶ to be dismissed on grounds of *res judicata*, the Court noted that the *Gheewalla* decision held that no *direct* fiduciary duty claims may be maintained by creditors, but indicated that derivative claims and “any other nonfiduciary claims” may be asserted by creditors. Judge Clark went on to add:

The Delaware courts’ decisions have proved to be immensely influential in the national debate over the shape of causes of action that have their genesis in breach of fiduciary duties on the part of officers and directors.³⁷

In September 2007, District Judge Harlin Hale of the Northern District of Texas in the *Vartec Telecom* case³⁸ also discussed the impact of *Gheewalla*:

Prior to the Delaware Supreme Court’s decision, an open question had existed as to what fiduciary claims creditors could bring against directors of an insolvent corporation or a corporation operating in the “zone of insolvency.” However, in *Gheewalla* the court clarified that directors owe fiduciary duties to the corporation When a corporation is solvent, those duties may be enforced by its shareholders, who have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation’s growth and increased value. When a corporation is insolvent, however, its creditors take the place of

³⁶ Judge Clark’s decision is a recommendation to the District Court. There is no record that the District Court acted on this recommendation.

³⁷ *Medlin v. Wells Fargo Bank, N.A.*, 2007 Bankr. LEXIS 3329 (W.D. Tex. July 31, 2007).

³⁸ *Mims v. Fail*, 2007 Bankr. LEXIS 3240 (N.D. Tex. Sept. 18, 2007).

the shareholders as the residual beneficiaries of any increases in value, and consequently the creditors of an insolvent corporation have standing to maintain *derivative* claims against debtors on behalf of the corporation for breaches of fiduciary duties....

The guidance offered by *Gheewalla* helps to resolve our issue in this case. The essence of a derivative action is that it is brought in the stead of a direct action brought by the corporation itself. Consistent with the holding in *Gheewalla*, the Chapter 7 Trustee in this case is bringing such a derivative action on behalf of the corporation's creditors. Thus, it appears that Delaware law also recognizes the cause of action brought by the Trustee in this case.

* * *

Both Texas and Delaware law recognize a cause of action for breach of fiduciary duty against the directors or officers of a corporation may be brought by the creditors of a corporation when the corporation is either insolvent or in the "zone" or "vicinity of insolvency" which is what the Trustee has pled in this case.

Although Judge Hale flatly stated that, under Delaware law, a derivative suit could be asserted by a trustee bankruptcy against directors of a corporation in the "zone of insolvency," Delaware Courts have not explicitly so held. Nor have they defined "zone of insolvency," as expressly noted in *Gheewalla*.³⁹ So, not only does that term defy definition and has no judicial gloss in Delaware, but also it is unclear how it would apply as a practical matter to the standing of a creditor or trustee to assert a derivative claim on behalf of a Delaware corporation in that status. My own view is that the assertion of such a claim would be highly problematic.⁴⁰

³⁹ See *Gheewalla*, 930 A.2d at 99 n.26 (citing Veasey & DiGuglielmo, *supra* note 2, at 1432). The Court noted further regarding the "zone of insolvency" that the "subject has been discussed, however, in several judicial opinions and many scholarly articles," and cited a number of such authorities and writings. *Id.* at 99 n.27, 99 n.28.

⁴⁰ But see *Stanziale v. Dalmia (In re Allserve Systems Corp.)*, 379 B.R. 69, 79 (Bank D. N.J. 2007) in which the Bankruptcy Court sitting in the District of New Jersey, departed

It makes sense to me that Vice Chancellor Strine is correct in his analysis in *Production Resources* and *Trenwick* that the *Credit Lyonnais* dictum is not a sword in the hands of *creditors* to make fiduciary duty claims against directors of a corporation in the “zone of insolvency” for “deepening insolvency” or to provide them with standing to sue derivatively while the corporation is solvent.⁴¹ Rather, it is a shield against *stockholder* claims that permit directors to consider the interests of creditors when evaluating their business decisions on behalf of the corporation.⁴²

A recent decision by Vice Chancellor Strine in *Nelson v. Emerson*⁴³ further reinforces the view that *Credit Lyonnais* did not create a new duty to creditors, independent of the duty to the corporation. In *Nelson*, the Court of Chancery dismissed a creditor’s claims for breach of fiduciary duty because the creditor was collaterally estopped from bringing them by a decision by the Bankruptcy Court for the Northern District of Illinois. But Vice Chancellor Strine opined that the claims also failed to state a claim upon which relief could be granted. The creditor asserted that the company’s

from the normal rule that the law of the state of incorporation governs fiduciary duty claims against directors. There, Bankruptcy Judge Michael Kaplan applied New Jersey law to claims by a Chapter 7 trustee against fiduciaries of a Delaware corporation on the ground that New Jersey had “substantial and more significant interests.” Indeed he held that the New Jersey contacts meant that it had the “paramount interest,” trumping the interests of Delaware, the state of incorporation. Although the Court also said that the claims are not limited to those involving internal affairs of the corporation, I believe that the law of the state of incorporation should control the fiduciary duty claims.

⁴¹ *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) (“[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms.”).

⁴² See also *The Ins and Outs for Ds and Os: In the Zone: Fiduciary Duties and the Slide Toward Insolvency*, 5 DePaul Bus. & Com. L.J. 667, 676-82 (2007) (to the same effect).

⁴³ C.A. No. 2937-VCS, 2008 WL 1961150 (Del. Ch. May 6, 2008).

directors had breached their fiduciary duties by filing for bankruptcy in a bad faith effort to frustrate the creditor's efforts to collect on his secured claims against the company.⁴⁴

Rejecting that claim, the court observed:

the directors of a Delaware corporation do not commit a breach of fiduciary duty if they file a non-frivolous claim, seeking to recharacterize certain debt to equity in order to protect the interests of the company's equity holders. In such a circumstance, the non-frivolous, good faith nature of the lawsuit makes filing that lawsuit a decision that is protected by the business judgment rule.⁴⁵

The decision in *Nelson* thus highlights the longstanding principle that directors' duties run to the company and that directors' disinterested, independent, and good faith business decisions will be protected by the business judgment rule.

Moreover, in my view, the "zone of insolvency" might lie within such a narrow and ambiguous band that it has little practical application when considering the standing of a creditor or trustee to assert a derivative claim. If it means uncertainty about whether the corporation is, in fact, insolvent, then the directors need the best financial and legal advice obtainable in order to determine on which side of the solvency line the corporation is sitting. But I don't think the concept of the zone of insolvency should give creditors standing to sue derivatively if the corporation is, in fact, solvent but close to the line of insolvency. Nevertheless, directorial focus on the best interests of corporate viability and a skeptical view of the wisdom of aggressive risk-taking would seem to be the best advice for fiduciaries of a corporation that is close to the line.

7. Summary and Conclusion

⁴⁴ *Id.* at *9.

⁴⁵ *Id.*

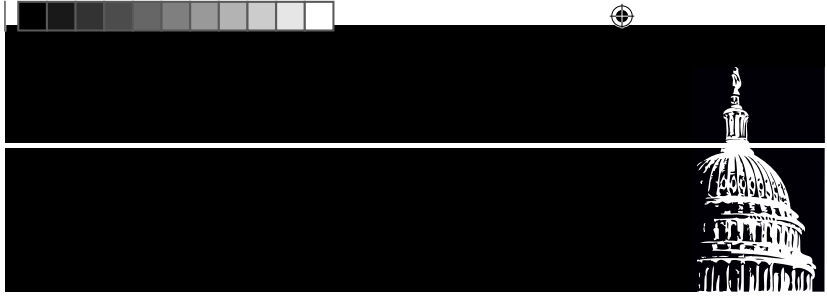
Directors owe fiduciary duties of due care and loyalty to the enterprise. And stockholders, having supporting facts, may sue either derivatively or, if applicable, directly.⁴⁶ Creditors have no standing to bring a direct fiduciary duty claim but do have standing to sue derivatively if the corporation is insolvent. I doubt that creditors have standing to sue derivatively if the corporation is solvent but close to insolvency. The main counseling lesson is that directors should always follow best practices in the interests of the corporate enterprise, particularly those articulated in the 2007 version of *The Corporate Directors Guidebook*.⁴⁷

Those best practices should tend to guide directors in avoiding derivative or direct stockholder claims for violation of the duties of care and loyalty in a solvent corporation.⁴⁸ Similarly, they should help directors to avoid liability to an insolvent corporation in a derivative action brought by a creditor.

⁴⁶ See *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004) (setting forth standards for distinguishing between direct and derivative stockholder claims).

⁴⁷ THE CORPORATE DIRECTORS GUIDEBOOK, *supra* note 8.

⁴⁸ It is to be noted that Section 102(b)(7) of the DGCL permits a corporation in its charter to exonerate directors from personal liability “to the corporation or its stockholders” for due care violations but not loyalty or good faith violations. Most states have comparable provisions and most public corporations have enshrined the exoneration provision in their charters. Following *Production Resources* and *Trenwick*, Section 102(b)(7) is applicable to due care claims in the case of derivative suits brought by creditors on behalf of a corporation that is insolvent or in the “zone of insolvency.”



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Retailing: Market Developments and Restructuring Issues Including Brand Valuations

Thomas J. Allison, Moderator
Mesirow Financial Consulting, LLC; Chicago

Jeffrey C. Bloomberg
Gordon Brothers Group LLC; Boston

Cory Lipoff
Hilco Merchant Resources, LLC; Northbrook, Ill.

Pamela M. O'Neill
AlixPartners, LLP; New York