DELAWARE SUPREME COURT LIMITS CREDITORS' RIGHTS TO ASSERT DIRECT CLAIMS FOR BREACH OF FIDUCIARY DUTY AGAINST A CORPORATION'S DIRECTORS

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The Supreme Court of Delaware has held that under Delaware law, creditors of a corporation that is either insolvent or in the "zone of insolvency" have no right to assert direct claims against the corporation's directors for breach of fiduciary duty.[1] This decision is important because it limits the fiduciary duties owed to creditors by directors. Other courts have expanded those fiduciary duties to instances where the corporation was not necessarily insolvent, but was in the "zone" or "vicinity" of insolvency.[2] Although the decision is binding only on those corporations who operate under Delaware law, it may signal a new trend away from expanding creditors' rights which courts in other jurisdictions may follow.

The general rule is that directors owe fiduciary duties to the corporation and its shareholders. Directors do not typically owe any fiduciary duty to creditors because the relationship between debtor and creditor is contractual in nature, and creditors already have remedies under state law if the debtor breaches the contract. Creditors are protected not only by contracts, but also by fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, and general commercial law. However, when a corporation becomes insolvent, its creditors take the place of its shareholders and it is the creditors, not the shareholders, who benefit if any value is realized from the insolvent corporation.

If a corporation is solvent, its shareholders may bring derivative actions against directors whom they believe are breaching their fiduciary duties. If the corporation is insolvent, the creditors step into the shareholders' shoes, and may bring derivative actions against directors whom they believe are breaching their fiduciary duties. But Delaware had not decided whether shareholders or creditors had the right to bring derivative actions if the corporation was operating in the "zone of insolvency." (Although the term "zone of insolvency" has not been precisely defined, it exists where a corporation cannot generate and/or obtain enough cash to pay for its projected obligations and fund its business requirements for working capital and capital expenditures with a reasonable cushion to cover the variability of its business needs over time.[3])

The *Gheewalla* Court held that creditors could not bring derivative actions when the corporation was in the "zone of insolvency." It agreed with the reasoning of the lower court, which had explained "'an otherwise solvent corporation operating in the zone of

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[1] *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92 (Del. 2007) (hereinafter, *Gheewalla)*.
[2] See, e.g., *Pereira v. Cogan*, 294 B.R. 449 (S.D.N.Y. 2003).
[3] *Id.* at pp. 520-521.

insolvency is one in most need of effective and proactive leadership—as well as the ability to negotiate in good faith with its creditors—a goal which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors.'"[4]

Gheewalla is an important decision for both directors and shareholders. It gives broader protection to the former and one less remedy to the latter. Though it only affects corporations operating under Delaware law, directors and shareholders in other jurisdictions must be mindful of the decision, as other courts may decide to follow its reasoning.

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[4] *Gheewalla, supra,* at pp. 100-101.