Fiduciary Duties of Directors to Creditors

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In times of financial distress, do directors of companies owe fiduciary duties to creditors? It has long been the case that directors owe fiduciary obligations to the corporation for which they serve and the stockholders of such corporation. There had been some debate as to whether, in the case of financial hardship, the fiduciary obligations of directors of a trouble corporation would shift or expand to include creditors. The Supreme Court of Delaware, in the case *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007)("Gheewalla"), held that the fiduciary duties of the directors do not extend to creditors when a corporation is insolvent or in the zone of insolvency.

Prior to this decision, it had become common practice to advise boards of directors that their fiduciary obligations might run to creditors where a corporation is insolvent or about to become insolvent. In prior decisions, Delaware courts had left the door open for speculation. In *Gheewalla*, the Delaware Supreme Court emphatically slammed the door shut.

In *Gheewalla*, North American Catholic Educational Programming Foundation ("NACEPF"), a putative creditor of Clearwire Holdings, Inc. sought to bring direct actions against several of Clearwire's directors alleging, among other things, a claim for breach of fiduciary duty. NACEPF argued that because Clearwire was either insolvent or in the zone of insolvency, the fiduciary obligations of the directors were owed to the creditors of the corporation. While acknowledging that Clearwire was either insolvent or in the zone of insolvency, the Delaware Supreme Court rejected NACEPF's argument that it was entitled to bring a direct action against the Clearwire directors for breach of fiduciary duty. The Court noted: "[w]hen 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 the shareholder owners." Id. at 101. The Court noted that creditors have a plethora of remedies available for their protection including negotiated contacts, security agreements, the implied covenant of good faith and fair dealing, fraudulent conveyance law and bankruptcy. Id. at 99. Further, the Delaware Supreme Court did not find a distinction based on a finding of insolvency. Accordingly, the Delaware Supreme Court held that "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 the corporation's directors." Id. at 103. The holding did not preclude creditors from bringing derivative claims on behalf of the insolvent corporation.

The Delaware Supreme Court has provided a safe harbor to corporate directors to exercise their business judgment in the best interests of the corporation and its shareholders without fear of a direct action brought by creditors of a corporation faced with insolvency. This will permit directors to freely negotiate with the insolvent corporation's individual creditors for the benefit of the corporation. Meanwhile, creditors of insolvent corporations are not left without other recourse — creditors may pursue claims against the corporation based on contract and tort liability and may bring derivative claims on behalf of the insolvent corporation. As a result,

directors of an insolvent corporation still must be mindful of their obligations to act in the best interests of the corporation in distressed circumstances.

For more information on fiduciary duties, please contact the author **Joseph C. Marrow**.