The latest news from the Delaware courts: decisions of interest to insolvency and restructuring professionals

Norman L Pernick, member
Michael F Bonkowski, member
J Kate Stickles, member
Patrick J Reilley, associate
Cole Schotz Meisel Forman & Leonard PA

Over the past year the Delaware courts have issued several opinions addressing important issues such as zone of insolvency litigation, corporate governance, shareholder rights and waivers of attorney-client privilege. This chapter discusses select decisions which may be of interest to directors and senior management of companies, insolvency professionals and shareholders.

Creditors' right to direct claims against directors for breaches of fiduciary duties: *NACEPF v Gheewalla*

Since 1991, when the Delaware Court of Chancery first considered the broadened constituency of a corporation in the zone of insolvency in *Credit Lyonnais Bank Nederland, NV v Pathe Communications Corp* (1991 WL 277613 (Del Ch Dec 30 1991)), courts in Delaware and elsewhere have generated a sizeable body of 'zone of insolvency' jurisprudence. However, notwithstanding the many cases addressing insolvency-related issues, including so-called 'deepening insolvency' claims, the zone of insolvency jurisprudence provided few markers by which directors and officers could navigate while in the zone. In *North American Catholic Educational Programming Foundation, Inc v Gheewalla* (930 A 2d 92 (Del 2007)) the Delaware Supreme Court seized the opportunity to provide some much-needed guidance to directors who face the inevitable creditor claims that arise in the zone of insolvency.

The zone of insolvency divide: creditors v shareholders

The issue presented to the court in *Gheewalla* was whether creditors of an insolvent corporation, or a corporation operating in the zone of insolvency, could bring direct claims against a corporation's officers and directors for breach of fiduciary duties. Delaware has long required directors and officers to satisfy the triad of fiduciary duties (ie, due care, loyalty and good faith) owed to shareholders. However, Delaware courts have traditionally been reluctant to expand these fiduciary duties beyond shareholders to creditors.

The reason for the difference in treatment between shareholders and creditors derives from the relative positions of the parties and the ability of each to protect its interests. Shareholders stand clearly in a fiduciary relationship with their directors and officers, and therefore rely on their fiduciaries to protect their interests. Creditors, on the other hand, are the beneficiaries of the contracts that they have struck with corporations. As such, their ability to protect their interests derives from the contractual agreements by which they are bound, general commercial law and corollary sources of creditor rights (eg, fraudulent conveyance law). Accordingly, the longstanding general rule holds that officers and directors of a corporation are not fiduciaries charged with the duty to protect the interests of creditors and owe no duties to creditors beyond the governing contractual terms. This general rule changes when a corporation becomes insolvent.

In *Credit Lyonnais* the Delaware Court of Chancery recognised 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"(*id* at *34). The court explained that a corporation's board has an "obligation to the community of interests that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity" (*id*). When a corporation is insolvent, creditors take the place of shareholders as "the residual beneficiaries of any increase [or decrease] in value" (*Gheewalla*, 930 A 2d at 101). Their recovery is wholly dependent on the business decisions of the officers and directors.

Direct v derivative

The key component of the zone of insolvency debate is whether creditors can pursue their own claims (direct claims) based on alleged fiduciary breaches by directors whose company is in the zone or rather are limited to pursuing their claims on behalf of the corporate constituency as a whole (derivative claims). Prior to *Gheewalla*, creative creditor counsel had argued that upon insolvency, derivative claims were transformed into direct claims. The courts rejected that argument, stressing that such claims remain purely derivative as they "injure the firm in the first instance by reducing its value, injuring creditors only indirectly by diminishing the value of the firm" (*id* at 102). *Gheewalla* is the first decision to address this issue and its implications head on.

The Gheewalla *decision*

In *Gheewalla* the plaintiff North American Catholic Educational Programming Foundation, Inc (NACEPF), in its capacity as a creditor and not as a shareholder, filed a complaint against the directors of Clearwire Holdings, Inc alleging direct, not derivative, fiduciary duty claims against them. The complaint alleged that:

- Clearwire was insolvent or in the zone of insolvency;
- the defendants owed fiduciary duties to NACEPF as a creditor of Clearwire; and
- the defendants had breached those duties by not preserving the assets of Clearwire for its benefit and that of its creditors when it became apparent that Clearwire would be unable to continue as a going concern and would need to be liquidated (*id* at 95).

The defendants filed a motion to dismiss the complaint for failure to state a claim. The Delaware Court of Chancery dismissed the action.

On appeal, the Delaware Supreme Court first addressed whether, as a matter of Delaware law, a creditor of a corporation that is operating within the zone of insolvency can bring a direct action against its directors for an alleged breach of fiduciary duty (*id* at 99). Recognising the "need for providing directors with definitive guidance" in this burgeoning field of law, the court engaged in a detailed review of insolvency issues before holding that "no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency" (*id* at 101).

The Delaware Supreme Court extended its analysis to consider whether creditors of a corporation that is in fact insolvent, and not just operating in the zone of insolvency, have the right to bring a direct claim for breach of fiduciary duty against the corporation's directors. The court reached the same conclusion, holding that "individual *creditors* of an insolvent corporation have *no right to assert* direct claims for breach of fiduciary duty against corporate directors" (*id* at 103 (italics in original)). The court's ruling sets out its concern for the freedom that directors of solvent corporations must have to act for the corporate constituency as a whole: "Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. 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 for the benefit of the corporation." (*Id*.)

Creditors retain derivative rights of action

Considering the unique contractual platforms from which the rights of shareholders and creditors spring, the court's ruling would seem not just logical but incontrovertible. Importantly, however, *Gheewalla* speaks to direct claims only. *Gheewalla* does not deny creditors the right to protect their interests by bringing derivative claims on behalf of an insolvent corporation against the officers and directors. A creditor retains the right to bring an action on behalf of the corporation when the corporation is insolvent.

Practical concerns in the wake of Gheewalla: *the shift of the litigation playing field*

The *Gheewalla* decision affords directors the freedom to pursue courses of action that they believe are in the best interests of the corporation and its stockholders and to be protected by the business judgement rule without exposure to direct liability suits brought by dissatisfied creditors. Under Delaware law, a court will not substitute its own business judgement for that of the corporation if "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company" (*Aronson v Lewis*, 473 A 2d 805, 812 (Del 1984)). This is true even if the result of the directors' ultimate course of action is not successful and lessens the return to creditors. As such, directors should be more secure making decisions – assuming that such decisions are in good faith, informed and reasoned – to maximise the value of a corporation, regardless of whether the corporation is in the zone of insolvency.

By eliminating the creditor's right to file a direct claim against directors, the *Gheewalla* decision arguably weakens individual creditors' leverage since creditors can no longer threaten or pursue direct claims against directors. However, creditors are not without options. First, creditors may protect their interests through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy and creditors' rights (*id* at 99). Second, creditors can assert derivative breach of fiduciary duty claims on behalf of the insolvent corporation. Even armed with the bright-line rulings of *Gheewalla*, corporations are still exposed to the vagaries of aggressive creditors whose target must perforce shift now to breaching the insolvency divide, albeit in a derivative context. However, pursuit of a derivative action presents greater procedural obstacles than a direct suit – namely, the requirement that a shareholder make a demand on the directors before having standing to sue on behalf of the corporation. In addition, even if a creditor successfully pursues a derivative suit against directors, the recovery is shared by all the corporate constituents. Nevertheless, directors retain the full protection of the business judgement rule. Thus, these hurdles may deter creditors from pursuing derivate claims.

Delaware rejects deepening insolvency claims: the *Trenwick* decision

In *Trenwick America Litigation Trust v Ernst & Young LLP* (906 A 2d 168 (Del Ch 2006); affirmed 931 A 2d 438 (Del 2007)) the Delaware courts were presented for the first time with the progeny of 'in the zone of insolvency' litigation: the so-called 'deepening insolvency' claim. The complaint was brought by a litigation trust against former directors of Trenwick America, its parent and a number of third-party advisers. Most noteworthy among the legion of claims raised in the complaint was a claim that company directors had, through breaches of their fiduciary duties, damaged Trenwick America by deepening its insolvency. In granting the defendants' motion to dismiss, the Delaware Court of Chancery offered a detailed, cogent analysis of deepening insolvency claims and why they fail under Delaware law.

The court approached the deepening insolvency issue from a traditional fiduciary duty and business judgement rule perspective. Formatively, the decision makes clear that from the liability perspective insolvency is of itself a static condition for which deepening has no independent significance: "[U]nder Delaware law, 'deepening insolvency' is no more of a cause of action when a firm is insolvent than a cause of action for 'shallowing profitability' would be when a firm is solvent" (*id* at 174); "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" (*id* at 205). Although the court rejected deepening insolvency as an independent cause of action, it recognised that deepening insolvency may well be relevant to the issue of good faith in the fiduciary analysis or as a necessary component of the damages for which a board could be held accountable, the latter point taking on more significance in light of *Gheewalla*'s recognition of creditors' right to pursue derivative actions against insolvent companies.

The court tied its analysis to the traditional contractual underpinnings that distinguish creditor and shareholder rights, discussed in detail in *Gheewalla*. While stressing that "[r]efusal to embrace deepening insolvency as a cause of action is required by settled principles of Delaware law", the court noted that the distinct legal position held by creditors compels "a refusal to extend to creditors a solicitude not given to equityholders. Creditors are better placed than equityholders and other corporate constituencies (think employees) to protect themselves against the risk of firm failure" (*id* at 174).

The holding in *Trenwick* tracks the Delaware courts' recent opinions in their resort to traditional contract and fiduciary principles for resolution of insolvency-related issues. No doubt sensitive to the uneven footing that the zone of insolvency jurisprudence had so far offered directors, it also strived to sketch for directors the extent to which they can rely on the protections of the business judgement rule in this area. Throughout *Trenwick*, the court paused to reassure directors that, even when the company is insolvent, the board may pursue strategies to maximise the value of the firm under the umbrella of the business judgment rule: "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 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." (*Id* at 205.)

At the same time, the court reminded creditors that they are not without protection. However, the court made plain that those rights are outside insolvency, entirely creatures of the contracts "by which creditors protect themselves – through the negotiations of toothy contractual provisions securing their right to seize on the assets" of their obligor (*id* at 173).

Trenwick is noteworthy because it squarely rejected a cause of action for deepening insolvency, effectively limiting efforts to expand the liability of directors of corporations that are insolvent or in the zone of insolvency. In conjunction with *Gheewalla*, the *Trenwick* decision represents a further clarification of both creditor rights and causes of action in insolvency litigation, as well as the continued applicability of the business judgement rule to directors forced to navigate in those waters.

Delaware Court of Chancery prevents corporation from using bankruptcy laws to circumvent state corporate law requirements

In *Esopus Creek Value LP v Hauf* (913 A 2d 593 (Del Ch 2006)) Metromedia International Group, which had not filed for protection under Chapter 11 of the Bankruptcy Code, wanted to sell its principal asset, Magticom, in a transaction that would require shareholder approval under Delaware law because the proposed transaction constituted a "sale of all or substantially all" of Metromedia's assets. Advised that it was prohibited by federal regulation from calling a meeting of stockholders to vote on the proposed transaction because it was delinquent in its financial reporting requirements, Metromedia moved to circumvent the vote requirement by adoption by its board of a plan to effectuate the transaction under Section 363 of the code. Specifically, Metromedia planned to execute an agreement providing for the sale of Magticom, then file a voluntary bankruptcy petition, obtain bankruptcy court approval of the sale under Section 363 and seek confirmation of a Chapter 11 plan (*id* at 600). To this end, and with the understanding that the Bankruptcy Code required the support of the sale and plan from the holders of two-thirds of the company's preferred stock, Metromedia entered into a voting and lock-up agreement with approximately 80 per cent of the preferred shareholders. Metromedia then publicly announced its execution of the lock-up agreement and a letter of intent with the buying group. Following the announcement, plaintiff common stockholders sought to enjoin Metromedia from executing the agreement with the buying group without an affirmative vote of the common stockholders pursuant to Chapter 8, Section 271(a) of the Delaware Code.

At oral argument the defendants retreated from their position and suggested that the parties stipulate that:

- any agreement entered into by the company for

the sale of Magticom would be subject to a vote of the common stockholders;
- the board would seek relief from the Securities and Exchange Commission (SEC) to permit the company to solicit proxies and provide shareholders with financial information regarding Magticom;
- regardless of the success of the request for relief from the SEC, the company would distribute all information required under Delaware law to ensure that the Section 271 vote was informed;
- the company would encourage common stockholders to attend the Section 271 meeting and vote on the proposed transaction; and
- the court reserved jurisdiction over the dispute (*id* at 601).

The plaintiff and court were amenable to the stipulation and the court entered the order. The court also issued an opinion discussing the foundations of the order (*id*).

The Delaware Court of Chancery initially determined that the board's decision to structure the transaction as a Section 363 sale did not trigger the 'compelling justification' standard of review set forth in *Blasius Indus, Inc v Atlas Corp* (564 A 2d 651 (Del Ch 1988)), but rather was subject to the business judgement rule (Esopus, 913 A 2d at 603). The court found that the board's decision was not motivated to disenfranchise stockholders, but resulted from its belief that it was impossible to obtain a favourable vote from the common stockholders due to the company's failure to comply with reporting requirements. However, the court determined that the board's decision to structure the transaction as a Section 363 sale "offended fundamental notions of equitable conduct" and thus was inequitable (*id*).

In reviewing the facts and the underlying rehabilitative purpose of the Bankruptcy Code, the court was persuaded that the proposed transaction "though technically within the letter of the law, works a profound inequity upon the company's common stockholders and is thus prohibited" (*id* at 604). The court emphasised that it was "an abuse of the bankruptcy process for a robust and healthy company, encumbered by virtually no debt, to seek out the vast and extraordinary relief a bankruptcy court is capable of providing" (*id*). Further, the court determined that in structuring the transaction the board expanded the rights of the preferred shareholders, which was a "theoretically legal, yet undeniably inequitable, reallocation of control over the corporate enterprise" (id at 605). Although the court recognized that it could not prevent Metromedia from filing a bankruptcy petition, it was within the court's power to prevent the board from binding the company to a transaction without first complying with the requirements of Chapter 8, Section 271 of the Delaware Code. Lastly, the court criticised the board's failure to explore exemptive relief from the SEC (Id at 605-606).

At the most basic level, the *Esopus* decision supports the longstanding view that the Delaware Court of Chancery will exercise its power to enjoin inequitable conduct. Corporate advisers, including legal counsel, should be sensitive to the potential inequities of a transaction that is otherwise technically legal, especially when the transaction appears designed to elude specific requirements of the Delaware General Corporation Law or otherwise to interfere with the voting rights of shareholders. Clearly, in the case at hand the court perceived a healthy company's resort to the Bankruptcy Code as an end run around statutory tenets of corporate governance. The *Esopus* decision reflects that the Court of Chancery will not allow the bankruptcy court to serve as a safe harbour for conduct fundamentally contrary to the Delaware General Corporation Law.

Delaware Court of Chancery orders shareholders' meeting despite imposition of Section 362 automatic stay

In *Fogel v US Energy Systems, Inc* (2008 WL 151857 (Del Ch Jan 15 2008)) the Delaware Court of Chancery compelled a corporation to schedule a shareholders' meeting, despite the company's invocation of the automatic stay imposed under Section 362 of the Bankruptcy Code.

Following the court's entry of an order directing that a shareholders' meeting be held, but prior to setting the date, the company filed for bankruptcy protection in the Southern District of New York. The company argued that the automatic stay barred the court from scheduling the meeting. The court rejected that authority and ordered the shareholders' meeting to be scheduled.

In reaching its decision, the court reaffirmed the widely held maxim that "absent other compelling legal or equitable factors, insolvency alone, irrespective of degree, does not divest the stockholders of a Delaware corporation of their right to… corporate democracy" (*id* at *1). Relying on the "well-settled rule that the right to compel a shareholders' meeting for the purpose of electing a new board subsists during reorganization proceedings", the court ruled that "[t]o interfere with this right, a challenger must show that a shareholder is 'guilty of clear abuse,' a determination that turns on 'whether rehabilitation [of the debtor] will be seriously threatened, rather than merely delayed'" (*id* at *2). Finding that the company made no showing whatsoever of the abuse required to forestall the meeting, the court ordered the meeting set, reminding all that the "passage into bankruptcy does not sound the death knell for the shareholders' role in corporate governance" (*id*).

For these reasons, the court emphasised that it, and not the bankruptcy court, was the proper forum for resolution of this issue.

Like *Esopus*, *Fogel* stands starkly and simply for the proposition that in the absence of compelling reasons, Delaware courts will uphold the corporate democracy that its laws impose even in the face of bankruptcy. Under appropriate circumstances, and despite the automatic stay, the Court of Chancery will ensure proper corporate governance.

Ryan v Gifford pierces attorney-client privilege asserted by special committee

In *Ryan v Gifford* (2007 WL 4259557 (Del Ch Nov 30 2007)) the Delaware Court of Chancery ordered a special committee and its counsel to produce information related to an investigation despite the invocation by the company and the special committee of attorney-client privilege. In a subsequent opinion denying certification of an interlocutory appeal, the court further discussed its ruling (*Ryan v Gifford*, 2008 WL 43699 (Del Ch Jan 2 2008)).

In *Ryan* a shareholder derivative suit was filed alleging options backdating at Maxim Integrated Products, Inc. Thereafter, Maxim established a special committee of the board of directors, consisting of a single director, to undertake an internal investigation. The special committee engaged legal counsel to conduct an investigation into the alleged options backdating. Special committee counsel retained an accountant for forensic accounting services. In the course of the investigation, the special committee's legal and accounting advisers identified, preserved and collected approximately 13 terabytes of electronic data, and reviewed and conducted 32 interviews of current and former employees, members of Maxim's board and auditing professionals for Maxim. The special committee and its counsel orally presented a final report to the board. In attendance at the meeting were members of Maxim's board of directors, the special committee's counsel and counsel for the director defendants in the shareholder derivative suit. No written report of the special committee's findings and recommendations was ever prepared, submitted or published, and board members were not allowed to leave the presentation with documents or notes discussing the investigation.

The plaintiffs in the shareholder derivative suit moved to compel production of the report and communications concerning the investigation between the special committee's counsel and the special committee or Maxim. Special committee counsel and Maxim asserted the attorney-client privilege. The court granted the motion, finding that the plaintiff had overcome the privilege, having established "good cause" to access the information (*Ryan*, 2007 WL 4259557 at *3, citing *Garner v Wolfinbarger*, 430 F 2d 1093 (5th Cir 1970)).

More saliently, the court found that the privilege had been waived by the disclosure of the report to the full board of directors, including directors who were not members of the special committee and who were defendants in the derivative suit that was the subject of the investigation, and outside attorneys who represented defendant directors. By disclosure of the information to third parties who lacked a common interest with the special committee, the special committee waived the privilege (*id*).

The *Ryan Case* counsels strongly that in complex litigation involving layers of competing interests, all parties must adhere to rigid privilege protocols. Presentation of a final report to a full board of directors may result in the waiver of the attorney-client privilege on the theory that the members of the board and the special committee do not share a common interest.

Non-Delaware lawyer and non-Delaware law firm which provided corporate advice to Delaware corporation can be sued in Delaware courts

Non-Delaware lawyers representing Delaware corporations came under scrutiny in *Sample v Morgan* (935 A 2d 1046 (Del Ch 2007)). The Delaware Court of Chancery addressed whether a non-Delaware corporate attorney and his non-Delaware law firm could be sued in Delaware for claims arising out of their advice and services to a Delaware public corporation in matters of Delaware corporate law. The attorney and his firm, which had advertised themselves as able to provide "coast-to-coast legal services", advised the corporation on Delaware corporate law matters and caused a certificate amendment to be filed with the Delaware secretary of state. As a result, the court found that the lawyer and the firm both were subject to personal jurisdiction in Delaware under the Delaware Long-Arm Statute (10 Del C § 3104).

The court concluded that "[w]hen well-pled facts support the inference that a person caused a corporation to take jurisdictionally-significant conduct in Delaware and that conduct is an element in a scheme by corporate fiduciaries to unfairly advantage themselves at the expense of a Delaware corporation and its stockholders, our case law has consistently held that the long-arm statute may be used to serve that person" (*id* at 1060). The court also noted that their conduct – namely, the filing of the certificate amendment which facilitated transactions under dispute in the court – injured a Delaware corporation and fell within the Delaware long-arm statute (*id* at 1057).

The court rejected the defendants' argument that it would offend notions of due process to require them to defend the suit in Delaware given "sophisticated" counsel's actions in providing advice on Delaware law to the Delaware corporation (*id* at 1063).

Finally, the court set forth the public policy interest supporting its decision, stating that: "Delaware has no public policy interest in shielding corporate advisors from responsibility for consciously assisting the managers of Delaware corporations in breaching their fiduciary duties. If well-pled facts can be pled that support the inference that a corporate advisor knowingly assisted corporate directors in breaching their fiduciary duties, Delaware has a public policy interest in ensuring that its courts are available to derivative plaintiffs who wish to hold that advisor accountable to the corporation." (*id* at 1065.)

In sum, non-Delaware counsel providing Delaware corporate law advice to Delaware corporations may be subject to the jurisdiction of the Delaware courts.