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North American Catholic Educational Programming Foundation, Inc. v. Gheewalla: The Twilight for the Zone of Insolvency

Recently, the Supreme Court of the State of Delaware (the "Court") had the opportunity to settle once and for all whether creditors have standing to bring direct claims for breach of fiduciary duty against directors of corporations that either are insolvent or operating in the enigmatic "zone of insolvency." In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, No 521-2006, slip op. (Del. May 18, 2007) ("NACEPF"), a creditor asserted claims against certain directors of Clearwire Holdings, Inc. ("Clearwire") for, among other things, breach of fiduciary duty for failing to preserve the asset values of certain Federal Communications Commission ("FCC") licenses. Siding with management, the Court held that sufficient legal and contractual remedies were already in place to safeguard the interests of creditors and therefore creditors did not have standing to bring direct fiduciary duty claims regardless of whether the corporation was insolvent or merely operating within the "zone of insolvency."

Background

North American Catholic Educational Programming Foundation, Inc. ("NACEPF") is an independent lay organization that holds certain radio wave spectrum licenses regulated by the FCC. In 2000, NACEPF joined together with certain other spectrum license holders to form the ITFS Spectrum Development Alliance, Inc. (the "Alliance"). Collectively, the Alliance owned a significant percentage of FCC-approved spectrum licenses used for one-way educational programs known as Instruction Television Fixed Services ("ITFS") licenses.[1]

In March 2001, the Alliance entered into a Master Use and Royalty Agreement (the "Master Agreement") with Clearwire, a Delaware Corporation formed to develop and operate fixed-wireless broadband Internet access across the United States. Under the terms of the Master Agreement, Clearwire was to acquire the Alliance members' ITFS spectrum licenses as they became available for approximately $24.3 million.

Unfortunately, in June of 2002, following the collapse of WorldCom, the market for wireless spectrum licenses plummeted. Clearwire then began negotiations with the individual members of the Alliance to terminate its obligations under the Master Agreement. However, after paying nearly $2 million to settle its claims with the other Alliance members, Clearwire was unable to obtain any further financing to settle with NACEPF. Thereafter, NACEPF filed suit against certain Clearwire directors (the "Defendants") alleging claims of fraudulent inducement, tortious interference, and breaches of fiduciary duties. Clearwire moved to dismiss the claims for lack of personal jurisdiction and failure to state a claim under Court of Chancery Rule 12(b)(6). The Court of Chancery granted the Defendants' motion, and NACEPF appealed.

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1 *NACEPF*, slip op. at 4-5.

The Defendants were employees of Goldman Sachs & Co. ("Goldman Sachs") who served on the Clearwire Board of Directors at the behest of Goldman Sachs. As Goldman Sachs was Clearwire's only source of funding, NACEPF alleged that the Defendants effectively controlled Clearwire and they used this power and influence to favor Goldman Sachs' agenda in derogation of their fiduciary duties. More precisely, the Complaint set forth direct (not derivative) claims[2] against the Defendants for breaches of fiduciary duties and alleged that because, at all relevant times, Clearwire was either insolvent or in the "zone of insolvency," the Defendants owed fiduciary duties to NACEPF "as a substantial creditor of Clearwire," and that the Defendants breached those duties by:

> (1) not preserving the assets of Clearwire for its benefit and that of its creditors when it became apparent that Clearwire would not be able to continue as a going concern and would need to be liquidated and (2) holding on to NACEPF's ITFS licensing rights when Clearwire would not use them, solely to keep Goldman Sachs's investment "in play."[3]

Thus, the Court was presented with two legal questions: (1) whether, as a matter of law, a corporation's creditors could assert direct claims against directors for breach of fiduciary duty when a corporation was within the "zone of insolvency"; and (2) whether, as a matter of law, a corporation's creditors could assert direct claims against directors for breach of fiduciary duty when a corporation was actually insolvent.

Direct Creditor Claims for Breach of Fiduciary Duty With Respect to Corporations in the Zone of Insolvency

In addressing this matter of first impression, the Court held that "the need for providing directors with definitive guidance compels us to hold 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." The Court reasoned that while shareholders rely on directors to act as fiduciaries on their behalf to protect their interests, creditors do not share this same reliance as they are afforded a variety of other sources of protection, such as 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. [4]

Moreover, the Court agreed with the Court of Chancery's reasoning that any benefits derived in permitting creditors of a corporation operating in the "zone of insolvency" from asserting direct claims against directors would be significantly outweighed by the costs to efficiency. The Court of Chancery stated:

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2 The fundamental difference between a derivative suit and a direct suit is that in a derivative suit, a plaintiff shareholder brings a claim on behalf of the corporation and seeks recovery for the corporation, whereas, in a direct suit, the plaintiff shareholder asserts his or her own cause of action and seeks recovery individually. Because a derivative suit is brought by the shareholder on behalf of the corporation, any proceeds from the suit are put back into the corporate treasury, which benefits the shareholder indirectly through an increase in the value of his or her shares. Unlike direct suits, derivative suits require a shareholder to comply with certain specific pleading requirements, such as written demands and waiting periods. *See* Jason M. Tanguay, *Minority Shareholders and Direct Suits in Closely Held Corporations Where Derivative Suits are Impractical: Durham v. Durham*, 5 Pierce L. Rev. 469, 47071 (2007).

3 *NACEPF*, slip op. at 7.

4 *Id*. at 15-19. While this issue was a matter of first impression before the Court in Delaware, the issue of whether to recognize a direct fiduciary duty claim of a creditor where a corporation was in the "zone of insolvency" had previously been discussed, although not decided, in *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 790 (Del. Ch. 2004). The *Production* Court similarly suggested, however, that the need to create an additional direct cause of action for breach of fiduciary duty "would be extremely small, *if extant*" with the numerous avenues already available to protect creditors from inequitable conduct by directors. *NACEPF*, slip op. at 17 (quoting *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d at 790).

> "[A]n otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership—as well as the ability to negotiate in good faith with its creditors—goals which would be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors."[5]

Whatever the rationale, the Court was crystal clear in its holding: "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 shareholder by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."[6]

Direct Creditor Claims for Breach of Fiduciary Duty With Respect to Insolvent Corporations

The issue of whether creditors may bring direct fiduciary duty claims against directors of an insolvent corporation, however, was more problematic. It is well settled that directors owe fiduciary duties to a corporation; and when a corporation is *solvent*, these duties are owed to a corporation's shareholders. When a corporation is *insolvent*, however, the scope of a corporate directors' fiduciary duties expand to include a duty to creditors. As a result, creditors of an insolvent corporation routinely have been granted standing to bring *derivative* claims for breaches of fiduciary duties against directors on behalf of insolvent corporations. The issue of whether such creditors had standing to bring *direct* claims, however, had yet to be answered.

Recent Delaware decisions such as *Credit Lyonnais*[7] and *Production Resources*[8] have suggested *in dicta* that such direct causes of action brought by creditors for breaches of fiduciary duties might be viable. The *NACEPF* Court, however, seemingly put the issue to rest. The Court reasoned that recognition of a direct claim of creditors for breach of fiduciary duty "would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation" and "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." Accordingly, the Court held that "individual *creditors* of an *insolvent* corporation have *no right to assert direct* claims for breach of fiduciary duty against corporate directors."[9]

Conclusion

The recent decision by the Court in *NACEPF* has brought much needed clarity to an area of the law that, until now, has been murky. While the decision does not bind other jurisdictions, it is now clear that under Delaware law, creditors do not have standing to bring direct actions for breach of fiduciary duty against a corporation's directors regardless of whether the company is in the "zone of insolvency" or is actually insolvent. Although creditors still have access to protections found in contractual agreements, fraudulent conveyance law and the like, their leverage in distressed situations has been significantly reduced.

While theoretically directors should act according to their business judgment regardless of whether their company is insolvent or in the zone of insolvency, as a practical matter, the threat of a direct lawsuit by creditors during the course of workout negotiations can sometimes sway the decisions ultimately made by

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[5] *NACEPF*, slip op. at 18 (quoting *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 2006 WL 2588971, at *13 (Del. Ch. Sept. 1, 2006)).

[6] *Id.* at 19.

[7] *Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp.*, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

[8] *Production Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004).

[9] *NACEPF*, slip op. at 23-24 (emphasis in original).

directors. The *NACEPF* decision removes this external pressure while the company is operating in the zone of insolvency. Even when the corporation is actually insolvent, creditors will only have standing to sue the directors derivatively. Since the proceeds of a derivative action belong to the insolvent corporation, a creditor who does not hold a very substantial claim may find that the time, effort, procedural hurdles and cost required to bring a derivative action outweigh any potential benefit to that creditor personally.

As a result, creditors who are dissatisfied with management may want to consider their bankruptcy options — such as filing an involuntary bankruptcy petition or enforcing their contractual rights in order to force the filing of a voluntary bankruptcy case. Once in bankruptcy, the debtor in possession is under much closer court and creditor scrutiny. The creditors can oppose out-of-the-ordinary-course business transactions, can seek the appointment of a trustee, and can seek to pursue derivative claims against the directors or otherwise press for the assignment of litigation rights pursuant to a plan of reorganization.

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