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Can Creditors Directly Sue Company Directors for Breaches of Fiduciary Duties? The Delaware Supreme Court Says “No.”

In a groundbreaking, and somewhat surprising decision, the Delaware Supreme Court recently held that creditors of a company that is either in the zone of insolvency or actually insolvent cannot, as a matter of law, *directly* sue directors of the company for breaches of the directors’ fiduciary duties.

The case—*North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 2007 Del. LEXIS 227 (Del. May 18, 2007)—arose out of a motion to dismiss a complaint filed by a creditor of a company against former directors of that company claiming (i) fraudulent inducement to enter into, and perform, a contract with the company; (ii) breach of the directors’ fiduciary duties to the creditor; and (iii) tortious interference with the creditor’s business opportunities.

North American Catholic Educational Programming Foundation, Inc. (“North American Catholic”) held FCC-approved licenses for the microwave transmission of educational programs. The defendants were employees of Goldman Sachs & Co. who served on the Clearwire Holdings, Inc. (“Clearwire”) board of directors (the “Directors”) at the behest of Goldman Sachs. In March 2001, Clearwire and North American Catholic entered into a Master Use and Royalty Agreement (the “Master Agreement”) providing for the licensing by North American Catholic to Clearwire of its FCC licenses.

Under the Master Agreement, Clearwire was obligated to acquire the FCC licenses when they became available for more than \$24.3 million. When the Master Agreement was entered into, Clearwire allegedly had only \$29 million in cash but financial obligations including those under the Master Agreement of \$134 million and a “burn” rate of \$2 million per month with no significant revenues. The Directors allegedly knew but did not tell North American Catholic that Goldman Sachs did not intend to carry out its business plan to create a national wireless Internet connection system (which allegedly was Clearwire’s stated rationale for entering into the Master Agreement) by further funding of Clearwire.

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In June 2002, the market for wireless spectrum collapsed when WorldCom announced its accounting problems and it appeared that there would be a surplus of spectrum available from WorldCom. By October 2003, Clearwire allegedly had been unable to obtain any further financing and effectively went out of business.

North American Catholic was not a shareholder of Clearwire, but filed the complaint (the “Complaint”) as a putative creditor claiming that the Directors had breached their fiduciary duties to it while Clearwire was in the zone of insolvency and while actually insolvent. The Complaint alleged *direct*, rather than derivative, fiduciary duty claims against the Directors. In particular, the Complaint alleged that (i) the Directors, although less than a majority of the Board, were able to control Clearwire because its only source of funding was Goldman Sachs; and (ii) the Directors used that power in derogation of their fiduciary duties to North American Catholic. They breached those duties, the Complaint alleged 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 [North American Catholic]’s . . . license rights when Clearwire would not use them, solely to keep Goldman Sach’s investment “in play.”

The Directors moved to dismiss the Complaint for lack of personal jurisdiction and failure to state a claim upon which relief could be granted. The Chancery Court ruled that, notwithstanding that the Complaint adequately pled facts that permitted a reasonable inference that Clearwire had been in the zone of insolvency and actually insolvent during the relevant periods alleged in the Complaint (1) creditors of a Delaware corporation in the “zone of insolvency” can not assert *direct* claims for breach of fiduciary duty against the corporation’s directors; (2) the Complaint failed to state a claim for the narrow, “if extant,” cause of action for *direct* claims involving breach of fiduciary duty brought by creditors against directors of insolvent Delaware corporations; and (3) with dismissal of North American Catholic’s fiduciary duty claims, it had not provided any basis for the court to exercise personal jurisdiction over the Directors with respect to the fraudulent inducement and tortious interference claims.

With respect to the argument that the Delaware Supreme Court should recognize a new *direct* right for creditors to challenge directors’ exercise of their business judgment as breaches of the fiduciary duties owed to them while the company is in the zone of insolvency, the court adopted the reasoning of the Chancery Court that (i) because 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, creditors do not need an additional layer of protection through direct claims for breach of fiduciary duty; (ii) any benefit to be derived from recognition of such claims appeared minimal at best and significantly outweighed by the costs to economic efficiency; and (iii) “an 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 likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct

claims by creditors.” The high court went on to state: “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.”

As for the argument that a creditor has a right to assert a *direct* claim for breach of fiduciary duty against directors of an insolvent corporation, the court first noted in *dicta* that creditors of an insolvent corporation can make *derivative* claims against directors on behalf of the corporation for breaches of fiduciary duties just as shareholders can when a corporation is solvent. This is because when a corporation is insolvent, its creditors take the place of shareholders as the residual beneficiaries of the corporation. But, the court reasoned, allowing maintenance of *direct* claims by creditors would create uncertainty for directors because the duty to creditors would conflict with the directors’ duties to shareholders to maximize value. And, the court stated in reaching its holding, “Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.”

This is a groundbreaking decision because prior to it there had been suggestions in various judicial opinions passing on Delaware law and journal articles that creditors might have a right to maintain *direct* claims for breaches of fiduciary duties against directors of a corporation either in the zone of insolvency or actually insolvent. Indeed, because of these suggestions, it was impossible to say definitively that no such rights existed, and thus, directors and their advisors had to consider them as distinctly possible actionable rights of creditors--and many assumed as much. With *North American Catholic*, the Delaware Supreme Court has made clear that no such rights exist.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Bankruptcy & Corporate Reorganization Department.

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