dentons.com

DENTONS

# Insights and Commentary from Dentons

The combination of Dentons US and McKenna Long & Aldridge offers our clients access to 1,100 lawyers and professionals in 21 US locations. Clients inside the US benefit from unrivaled access to markets around the world, and international clients benefit from increased strength and reach across the US.

This document was authored by representatives of McKenna Long & Aldridge prior to our combination's launch and continues to be offered to provide our clients with the information they need to do business in an increasingly complex, interconnected and competitive marketplace.

**July 10, 2007**

## Delaware Supreme Court Limits Remedies Against Directors to Derivative Claims

**Creditors may not bring direct claims for breach of fiduciary duty against directors of insolvent or near-insolvent corporations, the Delaware Supreme Court announced recently.** The landmark decision is immediate good news for directors of distressed corporations based in Delaware, and since many states look for guidance to Delaware corporate law, the precedent could eventually be helpful for boards of directors nationwide.

The defendants in the recent case, NACEPF v. Gheewalla, were directors of a holding company, Clearwire Holdings, Inc., and employees of Goldman Sachs & Co. The plaintiffs, who were Clearwire creditors, alleged that Clearwire was either insolvent or in the "zone of insolvency," and that the defendant directors breached a fiduciary to the creditors directly by running Clearwire for the benefit of Goldman Sachs instead of preserving Clearwire's assets for creditors.

The plaintiffs' claim attempted to expand upon the remedies available for creditors in dealing with an insolvent company. As a general principle, directors owe fiduciary duties to shareholders and to the corporation itself, not to creditors. When a corporation slides toward insolvency, it begins to owe a fiduciary duty to creditors. It has become well-established in Delaware, as well as other states, including Georgia and New York, that directors of insolvent companies owe duties to other constituencies, including creditors.

The legal question in this case is related to the nature and scope of the rights of creditors against directors of an insolvent business. Based on *Gheewalla*, creditors must bring a derivative suit against the directors of the insolvent company in order to assert their rights. In *Gheewalla*, the creditors chose not to bring a derivative suit. Instead, they asked the Delaware court to recognize a new, direct right for creditors to challenge directors' exercise of business judgment.

Derivative lawsuits must be brought on behalf of the corporation with any recoveries shared among various constituencies. Alternatively, direct claims would allow creditors to recover their particular damages without any such sharing. The economic benefits to a successful litigant are theoretically much different, therefore, this litigation has the potential to significantly impact the volume of creditor claims that could be expected.

The Delaware Supreme Court rejected the creditors' claims and upheld the lower court's dismissal of the case for its failure to state a claim. "Creditors already have protections," the Court said. Creditors of a near-insolvent corporation can rely on "their negotiated agreements, their security instruments, the

**CONTACTS**

If you would like more information, please contact any of the McKenna Long & Aldridge attorneys or public policy advisors with whom you regularly work. You may also contact:

**Michael Cochran**
404.527.8375

**Ann-Marie McGaughey**
404.527.8354

implied covenant of good faith and fair dealing, fraudulent conveyance law, and bankruptcy law." Creditors of a fully insolvent company can rely on all of these, with the additional option of a derivative lawsuit if necessary. On the other hand, the Court argued, directors of distressed corporations need unfettered freedom to negotiate with creditors on behalf of their shareholders, to whom the most important fiduciary duty is owed. The prospect of individual director liability arising from such negotiations would impermissibly restrict this freedom, the Court reasoned.

**The upshot: The Delaware Supreme Court's ruling does not change the status quo, but does turn back a claim that, if successful, would have opened the door to a potential flood of direct creditor lawsuits against directors of distressed companies.** The text of the decision is available by clicking here. For more information on corporate services offered by McKenna Long & Aldridge, visit our website.

**About Us**

McKenna Long & Aldridge LLP is an international law firm of more than 430 lawyers and public policy advisors. The firm provides business solutions in the areas of corporate law, government contracts, intellectual property and technology, complex litigation, public policy and regulatory affairs, international law, real estate, environmental, energy and finance.

**Subscription Info**

If you would like others to receive future mailings of the Buying Trouble Advisory, please email their contact information to us at information@mckennalong.com

If you would like to be removed from the Buying Trouble Advisory mailing list, please email information@mckennalong.com

*This Buying Trouble Advisory is for informational purposes only and does not constitute specific legal advice or opinions. Such advice and opinions are provided by the firm only upon engagement with respect to specific factual situations. This message is intended as a transactional message for clients of the Firm. If you are not a client of the Firm, you have received it for informational purposes only and should not consider it an advertisement or solicitation.