

New Delaware Decision Clarifies the Duties of and Protections Afforded to Directors of Insolvent Companies

The Delaware Court of Chancery has addressed key questions involving the obligations of and protections afforded to directors of insolvent corporations. In *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. Nov. 17, 2004), Vice Chancellor Strine of the Court of Chancery articulated several important concepts:

- ▶ The Court of Chancery's landmark 1991 decision in *Credit Lyonnais*, which established the principle that the beneficiaries of a director's fiduciary duty expand to include creditors if the corporation is insolvent or in the "vicinity of insolvency," was actually intended to be a shield to protect directors from claims by shareholders that they acted too conservatively in managing the corporation's affairs;
- ▶ The expansion of a director's fiduciary duty when a corporation is insolvent or in the zone of insolvency does not create a new body of creditor's rights law, but simply gives creditors of an insolvent corporation standing to assert a claim for a director's breach of fiduciary duty, which duty continues to be owed to the corporation itself;
- ▶ A breach of fiduciary duty claim brought by a creditor of an insolvent corporation remains a derivative claim owned by the corporation, not a direct claim owned by the creditor;
- ▶ The business judgment rule applies to claims brought by creditors of an insolvent corporation, as well as those brought by shareholders; and

- ▶ Exculpatory provisions in the certificates of incorporation of most Delaware corporations protecting directors from claims for monetary damages for breaches of the fiduciary duty of care, included under authority of Delaware General Corporation Law Section 102(b)(7), apply to derivative claims brought by creditors of an insolvent corporation as well as by shareholders.

What does the decision mean to directors?

The *Production Resources* decision is good news for directors of Delaware corporations. The Court rejects a trend among some courts and commentators of imposing a new set of fiduciary duties on directors in favor of creditors of insolvent corporations or those in the zone of insolvency in reliance on the 1991 Chancery Court decision in *Credit Lyonnais (Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.)*, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

How did the *Production Resources* Court reach that conclusion?

The Court noted that directors of a solvent corporation are expected to undertake economic activities to maximize the value of the corporation's cash flows primarily for the benefit of the shareholders—the residual risk-bearers. When a corporation is insolvent, the creditors become the residual risk-bearers. Even so, directors must attempt "to maximize the economic value of the firm." While the insolvency causes the creditors to "become exposed to substantial

risk as the entity goes forward," a risk that directors must consider, the Court clarified that the "fact of insolvency does not change the primary object of the director's duties, which is the firm itself."

Did the *Production Resources* Court address duties of directors on the boards of directors of corporations that are not yet insolvent but are only in the "zone of insolvency"?

Yes. The *Production Resources* Court held that the *Credit Lyonnais* case provided directors with a "shield against claims by shareholders who claimed that the directors had a duty to undertake extreme risk so long as the company would not technically breach any legal obligations" since a

Key Attorney Contacts

Creditor's Rights & Bankruptcy

Bob Eisenbach 415/693-2094
reisenbach@cooley.com

Michael Kelly 415/693-2076
kellyjm@cooley.com

Corporate

Eric Jensen 650/843-5049
ejensen@cooley.com

Nancy Wojtas 650/843-5819
nwojtas@cooley.com

This information is a general description of the law and is not intended to provide specific legal advice.

Copyright © 2005 Cooley Godward LLP, 3000 El Camino Real, Palo Alto, CA 94306. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley Godward LLP as the author. All other rights reserved.

director's duty is to the "corporate enterprise itself." Directors have an obligation "to preserve and, if prudently possible, to maximize the corporation's value to best satisfy the legitimate claims of all its constituents, and not simply to pursue the course of action that stockholders might favor as best for them."

Did the *Credit Lyonnais* case create a new set of duties owed directly to creditors of an insolvent corporation?

While some courts and commenters believed that to be the case, the *Production Resources* Court held that the *Credit Lyonnais* decision did not create a new set of duties owed directly to creditors beyond those already owed to the corporation.

Doesn't our charter contain an exculpatory provision that protects us from these types of claims?

Most if not all Delaware charters contain exculpatory provisions authorized by Section 102(b)(7) of the Delaware General Corporation Law. The exculpatory provision protects directors from claims for monetary damages for most breaches of the fiduciary duty of care. The *Production Resources* decision held that this exculpatory provision also applies to claims for breach of the fiduciary duty of care brought by creditors, and not just those brought by shareholders. The *Production Resources* Court is an important decision for directors because it held that the claims brought by creditors of an insolvent corporation are derivative claims, which are owned by the corporation.

What impact will the decision have on other courts?

While the *Production Resources* decision marks one of the first decisions of the Court of Chancery hopefully to reverse a trend of increased liability for directors of insolvent corporations, the *Production Resources* decision is not binding on all courts. The decision was made by one of the Vice Chancellors of the Court of Chancery, and therefore does not have the same legal precedent as

if the Delaware Supreme Court had made this ruling. While the Court of Chancery is very influential on matters of Delaware corporate law, the question remains whether other members of the Court of Chancery and other judges will follow the decision.

If the corporation has filed for protection under the federal bankruptcy laws, will the federal judges follow this holding?

Since many lawsuits against directors of insolvent corporations are brought by bankruptcy trustees or creditors committees in federal bankruptcy courts, the true impact of the decision is unknown until the bankruptcy courts decide whether, and to what extent, to follow the *Production Resources* decision. ■