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Delaware Speaks to Directors of Troubled Companies

In a welcome note of reassurance to directors of financially troubled companies, the Delaware Court of Chancery has held that director exculpation charter provisions adopted under Delaware's § 102(b)(7) protect directors from due care/mismanagement claims brought by creditors who are accorded standing to pursue fiduciary duty claims when the firm is insolvent. More broadly, the opinion is an important dilation on the same court's often-cited 1991 decision in *Credit Lyonnais* addressing the degree of discretion afforded directors when the firm is in the "zone of insolvency," and makes clear that there is no "new body of creditor's rights law." *Production Resources Group, L.L.C. v. NCT Group, Inc.*, Del. Ch., C.A. No. 114-N (Nov. 17, 2004).

Vice Chancellor Strine's opinion makes several significant points concerning fiduciary duty claims asserted by creditors against directors of troubled firms:

- *Credit Lyonnais* is a "shield" for directors, not a sword for creditors. Most fundamentally, the opinion makes clear that directors of financially troubled firms are not exposed to a new set of fiduciary duty claims by creditors. In the *Credit Lyonnais* decision by then-Chancellor Allen, the Court of Chancery rebuffed the charge of a 98% stockholder that directors had disregarded its interests, famously stating that "at 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" — a statement some had interpreted as implying that directors in such circumstances owe a duty to creditors. The opinion in *Production Resources* explains that *Credit Lyonnais* recognizes that the protection of creditors lies in shielding directors from stockholder claims that directors are duty-bound to undertake extreme risk which might benefit stockholders so long as the company does not breach any legal obligations. At the same time, directors of troubled firms need not act solely in the interests of creditors. Rather, at bottom, the board of such a firm may chart a course with an eye to its duty to "the corporate enterprise" and thereby "to the community of interest that sustained the corporation." *Credit Lyonnais* thus provides a "shield" against stockholder claims that redounds to the benefit of creditors, but does not suggest that directors' duties change profoundly as the firm approaches insolvency or that there is some "magic dividing line" that signals the end to risk-taking that directors may lawfully undertake.

In this regard, the *Production Resources* opinion squarely, and forcefully, rejects the contention of some commentators and courts that directors of a company in the "zone of insolvency" are exposed to a new set of creditor challenges to their business judgment as violative of fiduciary duties to creditors, as well as the holdings of certain federal cases that a due care claim belonging to the corporation is transformed into something beyond the reach of charter exculpation provisions when the claim is asserted by a bankruptcy trustee. Undoubtedly, as the proportion of a firm's enterprise value comprised of debt increases, directors can and should bear that circumstance in mind as they exercise their business judgment. But the directors' duties do not profoundly change. Directors remain fully capable in the exercise of

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business judgment to chart a course that seeks to maximize the value of the firm, and are not required to choose a less risky alternative in order to protect the claims of creditors.

- *Creditors of insolvent firms have standing to pursue fiduciary duty claims, but the claims remain derivative claims, not direct claims.* In the case of an insolvent firm, creditors are granted standing to pursue fiduciary claims against directors, as the residual claimants to an inadequate pool of assets, but the claims continue to be derivative claims asserted in the right of the corporation as opposed to direct claims owned by the creditors. Whether the wrongful acts occur before or after insolvency, the claims of fiduciarily improper conduct continue to belong to the corporation, which is the recipient of any recovery that benefits the derivative plaintiffs — be they creditors or stockholders — only indirectly via their respective claims on the firm’s assets. “[T]he fact of insolvency does not change the primary object of the director’s duties, which is the firm itself. The firm’s insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value and logically gives them standing to pursue these claims to rectify that injury.”

- *Directors of insolvent companies are protected from personal liability under charter exculpation provisions.* Directors of insolvent firms are protected from personal liability for due care/mismanagement claims brought by creditors, including derivative claims, under charter exculpation provisions adopted pursuant to Delaware’s § 102(b)(7). The decision notes that a primary purpose of the exculpation statute is “to encourage directors to undertake risky, but potentially value maximizing, business strategies, so long as they do so in good faith,” and that when the firm has become insolvent, “the possibility of hindsight bias about the directors’ prior ability to foresee that their business plans would not pan out is at its zenith and when the exculpatory charter provision is most useful.” Accordingly, although § 102(b)(7) does not mention creditors, its protection extends to directors of insolvent firms even when creditors are accorded derivative standing, given the legislative purpose of “encouraging capable persons to serve as directors of corporations by providing them with the freedom to make risky, good faith business decisions without fear of personal liability.” To withdraw exculpation merely because creditors are accorded standing to pursue fiduciary duty claims against the directors would “hollow § 102(b)(7) of much of its intended utility.”

Directors of financially troubled companies often face incompatible demands by stockholder and creditor constituencies. Vice Chancellor Strine’s opinion thoughtfully addresses that context and dispels the spectre that directors of troubled companies operate in a legal straitjacket obliging them to act solely in the interests of creditors. Directors’ choices remain difficult ones, but under *Production Resources* it is clear that those choices, if made in the good faith exercise of business judgment as to the best interest of the firm itself, ought not give rise to any threat of personal liability at the behest of either stockholders or creditors.

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