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GOOD NEWS AND BAD NEWS FOR CORPORATE MANAGERS DEALING WITH INSOLVENCY ISSUES

THE GOOD NEWS: DIRECTORS AND OFFICERS OF DELAWARE CORPORATIONS ARE FREE FROM CREDITORS' DIRECT BREACH OF FIDUCIARY DUTY CLAIMS

Directors and officers of Delaware corporations face no liability to corporate creditors from direct claims for breach of fiduciary duty, under the Delaware Supreme Court's recent ruling in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, (May 18, 2007) ("*North American Catholic*"). Although management's fiduciary duties to shareholders have been clear for many years, the issue of whether, and in what circumstances, a director or officer might bear fiduciary duties to corporate *creditors* has been the subject of considerable uncertainty, litigation, and commentary. Several lower court decisions from Delaware suggested that directors and officers assumed fiduciary duties to creditors immediately upon the corporation's insolvency – or even earlier when the corporation entered the vaguely-defined "zone of insolvency." These duties to creditors usually entailed a prohibition on insiders' diversion of corporate assets for their own benefit, to the detriment of outside creditors. Nevertheless, attempts were made to extend to creditors the entire panoply of Delaware fiduciary duties of due care, loyalty, and good faith. Directors and officers (and their insurers) were understandably concerned when faced with uncertainty regarding what types of fiduciary duties might be owed to creditors and when those duties arose.

In *North American Catholic*, the Delaware Supreme Court held as a matter of law, "The creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against its directors." Since creditors can gain protection through strong covenants in their negotiated agreements, security interests in corporate assets, fraudulent conveyance law, and bankruptcy law, the Court deemed unnecessary the crafting of additional protections through direct claims for breach of fiduciary duty. When a corporation is solvent or merely in the zone of insolvency,

THE BAD NEWS: TRADING ON INSIDE INFORMATION OBTAINED WHILE ON A CREDITORS COMMITTEE COULD RESULT IN SIGNIFICANT DAMAGES

Barclays Bank and Steven J. Landzberg, a former trader for Barclays, recently agreed to settle charges brought against them by the Securities and Exchange Commission arising from allegations that they illegally traded bond securities while aware of nonpublic information they had received while sitting on the creditors committees for six bankrupt companies (*SEC v. Barclays Bank PLC, S.D.N.Y., Civil Action no. 07-CV-04427, May 30, 2007*). The SEC alleged that Barclays and Landzberg engaged in a pattern of illegal insider trading between March 2002 and September 2003. In particular, the SEC alleged that Landzberg simultaneously served as Barclays' representative on the six creditors committees and as its proprietary trader. In no instance did Barclays or Landzberg disclose the material nonpublic information received from their involvement with the creditors committees to their bond trading counterparties. As is usually the case, Landzberg allegedly signed confidentiality agreements and committee bylaws on behalf of Barclays in connection with sitting on the creditors committees and received material nonpublic information about the financial condition and prospects of the issuers, their most recent business plans, detailed management projections, contemplated financing alternatives, proprietary adviser analyses, and the timing and terms of the proposed plans of reorganizations of the bankruptcy entities.

Without admitting or denying fault, Barclays and Landzberg agreed to pay a total of $11.69 million to settle the SEC's charges that Barclays and Landzberg engaged in a pattern of illegal insider trading based upon information received while sitting on the creditors committee of six bankruptcy debtors. While the SEC's case was premised on insider trading allegations, it does illustrate the tension often encountered by companies sitting on creditors committees. Bankrupt debtors, as required by bankruptcy law, must disclose significant information to creditors committees. Often that information is

fiduciary duties are enforced through shareholders' rights to bring derivative actions; similarly, *North American Catholic* instructed that creditors of an insolvent corporation can only bring derivative fiduciary duty claims on behalf of the corporation. Because a particular creditor will be able to sue directors and officers of a Delaware corporation only on behalf of the corporation and all of its creditors, and cannot recover individually, *North American Catholic* brings greater certainty to an area of confusion and risk and reduces the likelihood that creditors will seek leverage by asserting breach of fiduciary duty claims against corporate management.

In contrast, the Colorado Supreme Court recently held that directors and officers of Colorado corporations owe both statutory and common law duties to creditors when a corporation becomes insolvent (*Alexander v. Anstine*, February 20, 2007). Statutory duties allow creditors, as a group, to directly sue directors and officers who authorize shareholder distributions when the corporation is either insolvent or rendered insolvent. Under common law, when a Colorado corporation becomes insolvent, directors and officers assume a duty to the corporation's creditors that prohibits management from self-dealing and favoring their own interests over outside creditors' claims. Effective July 1, 2006, Colorado enacted a statute (C.R.S. § 7-108-401(5)) stating that directors and officers of corporations owe no fiduciary duties to the corporation's creditors. However, the Colorado Supreme Court expressly declined to comment on whether that statute applies when a corporation is insolvent. It is also unclear whether this statutory protection "trumps" Colorado's common law fiduciary duties of officers and directors to creditors. Unfortunately, directors and officers of Colorado corporations will have to wait to receive the same type of clarification, along with freedom from creditors' direct claims, that directors and officers of Delaware corporations received in *North American Catholic*.

confidential and contains proprietary information, business plans, projections, and other nonpublic information. Companies (and individuals) sitting on creditors committees must always be mindful that any nonpublic and/or confidential information they receive as a result of participating on a creditors committee can only be used for the benefit of all unsecured creditors.

The lawyers in HRO's Bankruptcy, Creditors' Rights and Financial Restructuring Group are experienced in helping clients navigate their way through the numerous duties and laws relating to insolvency that affects companies and those that they do business with. We would welcome the opportunity to explain how these risks, when managed strategically, can be turned into opportunities.

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