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What of direct creditor claims after "Gheewalla"?

Viability of such claims may depend on factors such as jurisdiction

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THE STRATEGY occurs in bankruptcy cases around the country. Trustees or committees look to recover funds for creditors of a bankrupt debtor. Potential targets are the debtor's former officers and directors, especially if a directors and officer sinsurance policy exists that is available to satisfy a judgment, or to fund a possible settlement.

To avoid either possible affirmative defenses to a debtor/company claim, or problems quantifying the damages suffered by the debtor, trustees often obtain assignments from creditors of claims the creditors themselves have against third parties, including those against the directors and officers for breach of fiduciary duty. Many observers anticipated that the Delaware Supreme Court's decision in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007), would stop or curtail that practice. Yet, *Gheewalla* may not have slammed the door shut. Whether direct creditor claims for breach of fiduciary duty can be brought may depend on several factors, including the jurisdiction in which the lawsuit is filed, the debtor's state of incorporation, and the location of the debtor's and the creditors' business operations.

The *Gheewalla* court confronted the issue of whether individual creditors could sue former directors for breach of a direct fiduciary duty owed to creditors. The court held that "individual creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors." Id. at 103. Rather, creditors could only assert derivative claims on behalf of the corporation. The court was not presented with, nor did it address, the issue of whether corporate officers owe a fiduciary duty to creditors when the company is insolvent.

In so holding, the court examined earlier Delaware decisions and analyzed the policy considerations and the potential impact on directors if it permitted direct creditor claims. It reasoned that creditors' interests, unlike those of shareholders, are protected "through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, [and] general commercial law..." Id. at 99.

According to the court, directors must have clear guidance as to whom duties are owed, because "[r]ecognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors." Id. at 101, 103. Furthermore, regardless of whether a company was insolvent, directors need to maintain their fiduciary duties "to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners." Id. at 101. The court reasoned that if there was a direct duty to creditors, directors would face a conflict between that new duty and their existing duty to shareholders.

Nevertheless, the court noted that when a company is insolvent, creditors – not shareholders – are the residual beneficiaries, and they "are the principal constituency injured by any fiduciary breaches that diminish the firm's value." Id. at 102 (quoting *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 794 n. 67 (Del. Ch. 2004). Therefore, creditors can maintain derivative claims against directors of an insolvent corporation.

‘Gheewalla’ as a precedent

Several courts have already followed *Gheewalla*. See, e.g., *Jetpay Merch. Svs., LLC v. Miller,* No. 3: 07-CV-0950-G, 2007 WL 2701636 (N.D. Tex. Sept. 17, 2007)(applying Delaware law); *In re I.G. Svs., Ltd.*, No. 04-5041-C, 2007 WL 2229650 (Bankr. W.D. Tex. July 31, 2007)(applying *Gheewalla* to liquidating trustee’s causes of action of assigned creditor claims for breach of fiduciary duty); *In re Vartec Telecom, Inc.*, No. 04-81694-HDH-7, 2007 WL 2872283 (Bankr. N.D. Texas Sept. 24, 2007)(permitting trustee to assert creditor based derivative breach of fiduciary duty claims as to a Texas company and a Delaware business trust); *In re Mooney*, No. 05-13392, 2007 WL 2403774, *2 (Bankr. D.N.H. Aug. 17, 2007)(in a §523(a)(4) action, court held that Massachusetts and Delaware law were the same; creditor “has no standing to bring an individual claim against the Defendant for breach of fiduciary duty” when the company was insolvent); *In re Felt Mfg., Inc.*, 371 B.R. 589 (Bankr. D. N.H. 2007)(New Hampshire law same as Delaware); *Metcoff v. Lebovics*, No. X06CVO55000521S, 2007 WL 2570410, *4 (Conn. Super. Ct. Aug. 16, 2007)(under Delaware or Connecticut law, regardless of whether company is insolvent, “directors...do not owe a fiduciary duty to a corporate creditor that would expose them to personal liability to the creditor”).

Yet at least one court has held that *Gheewalla* does not establish the law everywhere. In *Jetpay*, the plaintiff provided transaction processing services to its clients that in turn accepted credit cards from their own customers. The plaintiff commenced an action against the officers and directors of a client, alleging that they had conspired to mislead the plaintiff into providing merchant services to the client. The complaint included, inter alia, claims for breach of fiduciary duty of care under Delaware law, and breach of duty of loyalty under Colorado law. The claims were premised on the plaintiff’s creditor status as to its client and its client’s insolvency.

Applying *Gheewalla*, the court dismissed the claim for breach of fiduciary duty under Delaware law. However, the court refused to dismiss the count for breach of the duty of loyalty, reasoning that under Colorado law, “‘[o]fficers and directors of an insolvent corporation owe creditors a duty to avoid favoring their own interests over creditor’s claims.” 2007 WL 2701636, at *7. The court concluded that although this duty to creditors was limited, it “still presents a valid avenue for the plaintiff to pursue.” Id.

Other courts will need to analyze their own state’s law. For example, in *Skinner v. Hulsey*, 138 So. 769, 773 (Fla. 1931), the Florida Supreme Court held that “[d]irectors are not liable to the creditors on the theory of their being fiduciaries.” In light of Skinner and *Gheewalla*, a court applying Florida law might hold that direct creditor claims for breach of fiduciary duty are barred. In fact, following *Gheewalla* would appear consistent with the 11th Circuit U.S. Court of Appeals’ reasoning that “Florida courts [rely] upon Delaware corporate law to establish their own corporate doctrines.” *International Ins. Co. v. Johnson*, 874 F.2d 1447, 1459 n.22 (11th Cir. 1989); see also *Mullen v. Academy Life Ins., Co.*, 705 F.2d 971, 973 n.3 (8th Cir. 1983)(“courts of other states commonly look to Delaware law...in fashioning rules of corporate law”).

On the other hand, Florida’s corporate statutory scheme appears to contemplate monetary liability against directors of a Florida corporation for actions brought by or in the right of someone other than the company or shareholder. In Florida, a breach of a duty alone is not enough to impose monetary liability upon a director. Rather, there must be a breach of a traditional fiduciary duty (i.e. care, loyalty, or good faith), and something more. See Fla. Stat. §607.0831(1). The “something more” contemplated by the statute distinguishes between an action “by or in the right of the corporation… or by in the right of a shareholder…” see, id. at §607.0831(1)(b)(4), and a proceeding “by or in the right of someone other than the corporation or a shareholder” Id. at §607.0831(1)(b)(5).

Since the Florida Legislature saw fit to pass a law suggesting that an action against a director may be instituted by or in the right of “someone other than the corporation or a shareholder,” it might mean that a creditor has its own right to bring a direct action because a creditor is a member of a constituency to whom directors owe a duty under Florida law when the corporation becomes insolvent. *See Guar. Trust & Sav. Bank v. United States Trust Co.*, 103 So. 620, 622 (Fla. 1921)(“directors...of an insolvent corporation occupy toward the creditors of the corporation a fiduciary relation in that the properties of the corporation constitute a fund for the payment of the corporation’s debts, which fund the directors are charged with managing to the best interests of the creditors.”). Also, the law in other states (like Colorado) may, too, be different, thereby enabling creditors (and perhaps bankruptcy trustees through assignments) to pursue direct creditor claims against directors.

Additionally, courts outside Delaware may conclude that they are not required to follow *Gheewalla*, even if the debtor is incorporated in Delaware. It is true that many courts utilize the "internal affairs doctrine," applying the law of the state of incorporation to a breach of fiduciary duty claim brought by a company or its shareholders. *See, e.g., Walton v. Morgan Stanley & Co,. Inc.*, 623 F.2d 796, 798 (2d Cir. 1980); *In re Ontos, Inc.*, 478 F.3d 427, 432 (1st cir. 2007); A*skanse v. Fatjo,* 130 F.3d 657, 670 (5th Cir. 1997).

But the internal affairs doctrine might not lend itself to the company-creditor relationship. As to that relationship, the law of the place where the creditor's or the debtor's business operations is located may apply to a breach of fiduciary duty claim because those contacts may establish which state has "the most significant relationship." *See, e.g., Trumpet Vine Inv., N.V. v. Union Capital Partners I, Inc*., 92 F.3d 1110, 1115-16 (11th Cir. 1996)("[A]s to tort claims, the Florida Supreme Court has abandoned the traditional lex loci delicti rule in favor of the 'most significant relationship' test."); *Carris v. Marriott Int'l, Inc*., 466 F.3d 558, 560 (7th Cir. 2006)(Illinois law uses the most significant relationship test)(citing *Esser v. McIntyre*, 661 N.E.2d 1138, 1141 (Ill. 1996)); Restatement (Second) of Conflict of Laws, § 188 (1971). Essentially, the court where the lawsuit is filed will need to perform a conflicts of laws analysis to determine which state's substantive law applies.

Of course, applying the law of a state other than the state of incorporation means that directors may have no idea what duties, if any, they owe to creditors because the scope of the duties to one creditor could be different from the duties owed to another creditor based simply on where each creditor is located. More importantly, whether a director has any liability to those creditors would likewise be unknown. The likelihood that creditors are located in different states means that the laws of multiple jurisdictions would determine the scope of the duties, whether a cause of action exists, or if a director can be monetarily liable to creditors.

Given *Gheewalla*'s desire for director certainty, applying the internal affairs doctrine would be preferable. On the other hand, while the most significant relationship test is contrary to *Gheewalla*'s desire for certainty, it would protect creditors who are likely unaware of the debtor's state of incorporation.

While *Gheewalla* may preclude trustees from asserting direct creditor claims against directors, even under Delaware law, trustees might still obtain assignments of assignable derivative claims from creditors. The benefit of doing so might be outcome determinative because the assignment may enable the trustee to avoid a commonly raised affirmative defense: in pari delicto; i.e. wrongdoing on the part of both parties, thus denying relief to the claimant. See, e.g., *In re I.G. Services Inc.*, *Ltd.*, 2007 WL 2229650 at *12 n. 3 (noting that direct versus derivative distinction may impact application of in pari delicto defense; "the equitable defense ought not be available when innocent strangers to the wrongful conduct bring the action derivatively")(citing *In re Adelphia Communications Corp*., 365 B.R. 24, 46-57 (Bankr. S.D. N.Y. 2007)). However, for a derivative claim, a trustee would be required to quantify the damages to the debtor corporation rather than utilizing a more simplistic analysis of the assigned creditor's damages, i.e. the amounts owed to the creditor(s). Also, *Gheewalla* leaves unanswered, even under Delaware law, whether creditors may assert a direct claim against officers as distinct from directors.

Many people thought that *Gheewalla* slammed the door shut on direct creditor breach of fiduciary duty claims against officers and directors. As noted above, that is not necessarily the case. While the door may have been closed, the window may still be open. Only time will tell whether that window, too, is shut. ■

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