

## message from partner in charge

This issue features recent Delaware corporate decisions that may affect corporate law cases across the county. If the onslaught of litigation claims many of us expect to see in bankruptcy cases occurs, these cases will be of particular interest.

These are just a few of the issues Pepper attorneys have on their minds, so be sure to visit [www.pepperlaw.com](http://www.pepperlaw.com) for a variety of articles and podcasts on topics of interest.

As always, if you have any questions about any legal issue you or your company are experiencing, or would like further information about the topics discussed in this newsletter, give us a call. We're here to listen.

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## Delaware Supreme Court and the Court of Chancery Offer Obligation Guidance for Financially Troubled Entities

*Fiduciary Duties While a Company is in "Zone of Insolvency" or Insolvent*

Many practitioners believe that the next wave of large commercial bankruptcy cases will generate a substantial number of complex litigation claims asserted by creditors who otherwise would recover little or nothing from the debtor's hard assets.

The Delaware Supreme Court, however, recently took a step toward stemming that tide by clarifying - and in most respects, narrowing - those claims that might otherwise be directly available to creditors who believe they have been wronged by a debtor's management.

In a case of first impression, the Delaware Supreme Court in *North American Catholic Educational Programming Foundation Inc. v. Rob Gheewalla, et al.*, 2007 WL 1453705 (Del. Ch. May 18, 2007), not only affirmed a Delaware Court of Chancery ruling that creditors of a corporation operating in the "zone of insolvency" may not bring a direct cause of action against its directors for breach of fiduciary duty, but further held that even when that corporation is insolvent, its creditors have nothing more than derivative standing to assert breach of fiduciary duty claims against directors of the insolvent corporation.

The Supreme Court affirmed the Court of Chancery's decision holding that as a matter of law, no right exists for a plaintiff to assert a direct claim for breach of fiduciary duty against a defendant operating in the "zone of insolvency." The Court reasoned that when a corporation is in the "zone of insolvency" the focus for directors in Delaware does not change; directors must continue to discharge their fiducia-

ry duties to the corporation and shareholders in exercising their business judgment.

Of greater importance, however, the Court also held that creditors do not have the right to assert direct claims for breach of fiduciary duty against directors of insolvent corporations. The Court recognized that if directors of an insolvent corporation owe a direct fiduciary duty to creditors, it would create uncertainty for such directors and create a conflict between those directors' duty to maximize the value of the insolvent corporation and its newly recognized direct fiduciary duty to individual creditors.

The Court reasoned that directors of insolvent corporations must retain the freedom to engage in vigorous good faith negotiation with individual creditors for the benefit of the corporation. When a corporation is insolvent, the shareholders are replaced by the creditors who then have standing to only maintain derivative claims as against directors on behalf of the corporation for breach of fiduciary duty.

For ease of reference, the current status of Delaware law regarding fiduciary duty claims by creditors against a corporation's directors is summarized below.

	<b>Creditors' Direct Claims</b>	<b>Creditors' Derivative Claims</b>
<b>Insolvent Corporation</b>	<b>No</b> – “creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors.”	<b>Yes</b> – “creditors of an <i>insolvent</i> corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.”
<b>Corporation in the “Zone of Insolvency”</b>	<b>No</b> – “the need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency.”	<b>Uncertain</b> – The Court of Chancery commented that a creditor may bring a derivative claim where the corporation is in the zone of insolvency. The Delaware Supreme Court did not squarely address the issue in <i>Gheewalla</i> .

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## Court of Chancery Refuses to Recognize Independent Claim for “Deepening Insolvency”

In an August 2006 opinion, titled *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.* (which preceded the Delaware Supreme Court’s *Gheewalla* decision), the Court of Chancery explicitly ruled that the business judgment rule applies where a corporation’s directors owe fiduciary duties to creditors.

The Delaware Supreme Court recently issued a ruling without an opinion, affirming the holding, and adopting the reasoning, of the Delaware Court of Chancery in *Trenwick America Litigation Trust v. Ernst & Young, LLP*, 906 A.2d 168 (Del. Ch. 2006). *Trenwick America Litigation Trust v. Billett*, 2007 WL 2317768, at \*1 (Del. August 14, 2007).

The *Trenwick* case involved multiple claims brought by a litigation trust formed after a subsidiary and its parent corporation filed for bankruptcy. In explicitly rejecting that a litigant may bring an independent claim for deepening insolvency, Vice Chancellor Strine of the Court of Chancery held the following:

*If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation’s value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy’s success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law.*

The Court of Chancery espouses the view that while directors of an insolvent or near-insolvent corporation must consider creditors’ interests when making a business decision, that decision will be protected by the business judgment rule so long as the decision was made with due care, loyalty and good faith.

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### WEBINAR

## Key Delaware Court of Chancery Summary Proceedings to Obtain Information and to Contest Control of Boards

Delaware corporations and their stockholders have legal tools at their disposal that help define what information corporations are required to share with their stockholders and what to do if there is a dispute about membership on the board of directors, and which may help ensure that shareholder value is protected. Oftentimes, these tools are overlooked, underused and misunderstood.

Pepper Hamilton partners M. Duncan Grant, Edmond (Ted) Johnson, and Albert H. Manwaring, IV discuss why the Delaware Court of Chancery has the unique ability to provide quick and accurate guidance that balances the needs of investors and management in Delaware corporations.

To listen and view a recording of this or other Pepper webinars, visit [www.pepperlaw.com](http://www.pepperlaw.com) and select the Webinars tab.

## Court of Chancery Offers Guidance on Use of “Majority-of-the-Minority” Provisions in Going-Private Transactions

In *In re PNB Holding Co. S’Holder Litig.*, 2006 WL 2403999 (Del. Ch. Aug. 18, 2006), the Court of Chancery ruled that departing shareholders, who did not return a proxy, did not assent to the merger, and their abstentions must be included in the mathematics of ratification.

Clarifying an ambiguous area of Delaware law, the court thus found that to ratify the decision by an interested board to proceed with the merger, and to subject that decision to the deferential business judgment rule (and not entire fairness), an interested transaction, like that involved in *PNB*, must be approved by a majority of *all* of the minority shareholders entitled to vote. Because only 48.8 percent of the cashed-out stockholders had voted in favor of the merger, the merger was not ratified and the merger price was subject to entire fairness review, a very difficult burden for the defendants to overcome.

Of similar importance, the court also held that the approval by the majority of the disinterested stockholders may be sufficient to invoke the protections of the business judgment rule even in the event that the challenged transaction was not subject to a non-waivable “majority-of-the-minority” condition. The fact that “an informed, non-coerced majority of the disinterested stockholders approved an interested transaction has the effect of invoking business judgment rule protection for the transaction,” and the lack of a “majority-of-the-minority” provision is insignificant when such an informed vote has occurred.

The Court of Chancery’s ruling contains some important points. First, in certain transactions where a board is deemed interested, a vote by the majority of the disinterested shareholders to approve the transaction will result in review under the business judgment rule, which frequently results in a dismissal of the plaintiff’s lawsuit at the pleadings stage, thus avoiding an expensive and lengthy discovery process. Second, in calculating a “majority-of-the-minority” vote, the court will look to all minority shares outstanding, not just those shares that voted. Finally, absent a controlling shareholder, an interested transaction

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does not need to be subject to a non-waivable “majority-of-the-minority” condition to gain business judgment protection so long as such a vote is actually obtained by a majority of all minority shareholders entitled to vote.

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## Court of Chancery Scrutinizes Private Equity Fund Transactions

In two recent opinions issued by Vice Chancellor Strine in June 2007, the Court of Chancery found fault with two transactions involving the sale of public companies to private equity funds. The opinions demonstrate that although private equity companies are relatively new to large merger and acquisition activity, Delaware courts will nevertheless hold private equity funds to the same standards applied to traditional players in such transactions.

In *In re The Topps Company Shareholders Litigation*, 926 A.2d 58 (Del. Ch. June 14, 2007), the Court of Chancery issued an injunction enjoining a vote by the shareholders of The Topps Company concerning a merger of Topps into two private equity funds. The injunction required the baseball card and bubble gum company to make additional disclosures about the merger prior to a shareholder vote.

Upper Deck, a competing bidder for Topps that also sells baseball cards, filed suit claiming that the proposed merger by Topps and the equity funds was unfair and that Topps failed to make necessary public disclosures.

The Court of Chancery ordered Topps to release Upper Deck from a standstill agreement so that Upper Deck could communicate publicly about a competing bid and make a non-coercive tender offer to Topps shareholders. The court explained that “the injunction that issues is warranted to ensure that the Topps stockholders are not irreparably injured by the loss of an opportunity to make an informed decision and to avail themselves of a higher-priced offer that they might find more attractive.”

In *In re Lear Corporation Shareholder Litigation*, 926 A.2d 94 (Del. Ch. June 15, 2007), the Court of Chancery once again issued a preliminary injunction enjoining a going-private merger between a public company and a private equity fund. Although the injunction was far less severe than that issued in *Topps*, the court ordered Lear to make additional disclosures to its shareholders prior to a vote on the merger. The injunction required Lear to publicly disclose that its CEO’s interest in securing his own retirement package created a potential incentive for the CEO to pursue a going-private deal.

*This attention is related in part to the concerns attendant to going-private transactions, which often result in the cashing out of a company’s public stockholders.*

*Topps* and *Lear* both demonstrate the willingness of the Court of Chancery to give close scrutiny to transactions involving private equity firms. This attention is related in part to the concerns attendant to going-private transactions, which often result in the cashing out of a company’s public stockholders. In these situations, the Court of Chancery places significant emphasis on whether a company has sufficiently informed its constituents prior to a shareholder vote seeking approval of a merger or similar transaction.

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