

## Delaware Supreme Court:

### Directors of Insolvent Corporations Do Not Owe Direct Fiduciary to Creditors

In addition to their well recognized fiduciary duties to shareholders, many recent decisions in the Delaware Court of Chancery have suggested that directors of Delaware corporations also owed a fiduciary duty to creditors of the corporation if the corporation was insolvent or operating in the “zone of insolvency.”

However, a recent case decided by the Delaware

Supreme Court has made it clear that there is no fiduciary duty owed by the directors of a Delaware corporation directly to the creditors of the corporation, even where the corporation is insolvent.

In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla et al.*, a creditor of Clearwire Holdings, Inc. sued three of the company’s directors on the grounds

that they had breach their fiduciary duties to the plaintiff while the company was insolvent. The court dismissed the plaintiff’s claims against the directors.

The court’s opinion noted that corporations which are insolvent or in the “zone of insolvency” need effective

and proactive leadership and the ability to negotiate in good faith with creditors.

According

to the court, the ability of the corporation to do this would be undermined if directors of the corporation were subject to lawsuits by creditors for breach of fiduciary duties.

The court explained that expanding the fiduciary duties of directors as proposed by the plaintiff would create uncertainty for directors who have fiduciary duties to exercise their business judgment in the best interest of an insolvent corporation.



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Although it held that there are no direct fiduciary duties owed by directors to creditors, the court in *Gheewalla* reconfirmed that creditors of an insolvent corporation are able to maintain a “derivative” claim against directors for breaches of fiduciary duties owed to the corporation.

In that scenario, explained the court, creditors step into the shoes of shareholders as the “residual beneficiaries of any increase in value of the corporation” and become the “principle constituency injured by any fiduciary duty breaches that diminish the firm’s value.”

## SEC Approves NASD and NSYE Regulatory Consolidation

On July 26, the SEC approved the consolidation of the member firm regulatory functions of the National Association of Securities Dealers, Inc. and the New York Stock Exchange into a new consolidated self regulatory organization to be known as the Financial Industry Regulatory Authority or “FINRA.”

According to the SEC, the consolidation is intended to help streamline the broker-dealer regulatory system, combine technologies and permit the establishment of a single set of rules governing membership

matters, with the aim of enhancing oversight of U.S. securities firms and assuring investor protection.

In its press release announcing the creation of FINRA, the SEC indicated that one of its goals is to eliminate the unnecessarily duplicative regulation and enforcement systems that previously existed.

FINRA will operate under SEC oversight and will be responsible for regulating all securities firms doing business with the public.

Along with other procedures, FINRA will administer professional training,

testing and licensing of broker/dealers as well as arbitration and mediation proceedings.

FINRA will also be responsible for regulating The Nasdaq Stock Market, the American Stock Exchange and the International Securities Exchange as well as operating trade-reporting facilities and other over-the-counter operations.

NYSE Regulation, Inc. will continue to be responsible for the regulatory oversight of trading on the New York Stock Exchange.

## Are 10b5-1 Plans the Next Big Scandal?

The SEC issued Rule 10b5-1 in 2000 to provide company insiders with a way to protect themselves from liability for insider trading resulting from trading their shares of company stock.

In general, the rule provides that if the insider's trades are made under a predetermined trading plan over which the insider does not exercise influence, no liability for trading on material nonpublic information can be imposed on the insider even if he or she had knowledge of such information at the time the trade was executed.

The key to the effectiveness of the rule is that trades are to take place on "automatic pilot" without any influence

over how, when and whether purchases or sales are made.

These plans are supposed to be established or terminated at times when the company insider does not have actual knowledge of material nonpublic information regarding his or her company.

However, a recent study by a Stanford University professor has found that many plans seemed to be established immediately prior to adverse news disclosures and terminated prior to positive news disclosures.

As a result, the study suggests that some corporate insiders were still taking advantage of material nonpublic information when making trades of their

company's stock, even though they made the trades through 10b5-1 plans. The flexibility to start and stop plans, amend plans or employ multiple plans simultaneously provides an opportunity to continue to make trading decisions based on inside information despite the "prearranged" nature of the plans.

The SEC has taken note of this study and recent press coverage of the issue and has suggested that this is an area that the Division of Enforcement will be reviewing.

The SEC has stated that if corporate executives are, in fact, trading on inside information and using 10b5-1 plans "for cover," they should not expect the rule to provide a defense against charges of insider trading. This may also become an area of increased scrutiny by underwriters of directors' and officers' liability insurance.

## Recent Case Makes it Easier for Patent Licensee to Challenge Underlying Patents

It is widely acknowledged that the large volume of patent applications has overwhelmed the resources of the Patent and Trademark Office and led to the issuance of patents of somewhat questionable validity.

However, companies often enter into royalty-bearing license agreements with the holders of questionable patents that may apply to their products in order to avoid costly litigation, especially an injunction or the imposition of treble damages.

While a patent licensee could challenge the validity of the underlying patent, a federal court decision in 2004 provided that, in order to do so, the licensee must create a "case or controversy" over which a court will have jurisdiction by stopping the payment of royalties to the patent licensor.

This created a dilemma for the licensee since it would be in breach of its license agreement and, therefore, risked losing its license if the patent were found to be valid and could be found liable for treble damages for intentional infringement of the patent.

However, in *MedImmune v. Genentech*, the U.S. Supreme Court held that it was not necessary for a patent licensee to breach or terminate its

license agreement in order to challenge the validity of the licensed patent.

In this case, MedImmune had received a letter from Genentech stating that one of MedImmune's new products (which accounted for 80% of its revenues) was covered by a patent license granted to MedImmune by Genentech and requested that royalties be paid.

MedImmune felt the patent was invalid, but rather than risk such a large portion of its business, it began paying royalties "under protest" and filed an action to invalidate the patent.

A lower court ruled that there was no "case or controversy" due to the fact that royalties were being paid. However, the Court reversed this ruling and allowed MedImmune's suit to proceed since there was a sufficient threat of litigation by the licensor.

In the Court's view, the letter from Genentech was sufficient to establish the threat of litigation if MedImmune failed to pay the royalties and, therefore, created a case or controversy.

The case leaves several questions unanswered, including whether the licensee can recover the royalties it has paid under protest if it is successful in invalidating the patent.

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**To learn more, contact**

**Steve Amen 402.231.8721  
[Steven.Amen@KutakRock.com](mailto:Steven.Amen@KutakRock.com)**

**Mark Ellis 402.231.8744  
[Mark.Ellis@KutakRock.com](mailto:Mark.Ellis@KutakRock.com)**

**Mike Bydalek 402.231.8807  
[Michael.Bydalek@KutakRock.com](mailto:Michael.Bydalek@KutakRock.com)**

**Lisa Sarver 402.231.8347  
[Lisa.Sarver@KutakRock.com](mailto:Lisa.Sarver@KutakRock.com)**

**Lyneth Rhoten 402.231.8613  
[Lyneth.Rhoten@KutakRock.com](mailto:Lyneth.Rhoten@KutakRock.com)**