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Delaware Court Clarifies Creditor-Derivative Standing And Directors' Fiduciary Duties To An Insolvent Corporation And Its Creditors

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June 1, 2015 - In what may become a precedential analysis of the cardinal principles of Delaware corporate and bankruptcy law, the Delaware Court of Chancery recently issued a decision in *Quadrant Structured Products Co., Ltd. v. Vertin*, extensively discussing the rights of an insolvent company's creditors to pursue derivative claims against the company's directors and provided guidance to directors of distressed companies on the fiduciary duties they owe to the corporation and its stakeholders.

As a result of the financial crisis, Athilon Capital Corp, which guaranteed credit default swaps on collateralized debt obligations, suffered severe financial distress and became insolvent. A former note holder, EBF & Associates LP, subsequently acquired all of Athilon's equity and as a result also gained control of Athilon's board. Following this acquisition, Quadrant Structured Products Company, a creditor and note holder of Athilon, filed a derivative lawsuit in the Delaware Court of Chancery against Athilon's directors alleging that they had breached their fiduciary duties by adopting a high risk investment strategy for the sole benefit of EBF at the expense of Athilon's other creditors. After the filing, Athilon structured several financial transactions with EBF, which, according to the defendants, returned Athilon to balance-sheet solvency. The directors then moved for summary judgment and argued that Quadrant could only have standing to bring a derivative lawsuit if it could show that (i) Athilon was insolvent at the time the lawsuit was commenced and continuously thereafter, and (ii) Athilon was "irretrievably insolvent," *i.e.*, with no reasonable prospect of returning to solvency.

Noting that the question was one of first impression under Delaware law, the court rejected continuous insolvency as a requirement for creditor standing. The court explained that a continuous insolvency requirement was ill-advised because, during the course of litigation, "a troubled firm could move back and forth across the insolvency line such that a continuing insolvency requirement would cause creditor standing to arise, disappear, and reappear again." Further, to require continuing insolvency for creditor standing would allow conflicted directors to prevent the corporation and its creditors from pursuing valid claims by restoring the corporation back to solvency and would result in a "failure of justice." Therefore, to have standing to sue derivatively, a creditor need only establish that a corporation was insolvent at the time the creditor filed suit; whether the corporation was continuously insolvent thereafter is irrelevant.[1] The court also rejected the more onerous "irretrievable insolvency" requirement because the great weight of Delaware authority uses the traditional "balance sheet test," which deems an entity insolvent when it has liabilities in excess of a reasonable market value of assets. The court noted that the balance sheet test was also consistent with both the test under the Bankruptcy Code for recovery of allegedly preferential or fraudulent transfers,[2] and Delaware's statutory standard for determining whether a Delaware corporation has a cause of action against its directors for declaring an improper dividend or improperly repurchasing stock.[3]

The ruling in *Quadrant Structured Products Co., Ltd. v. Vertin* should be of interest for board members whose company is already, or faces the prospect of, insolvency. Although the Delaware Court of Chancery rejected the continuous insolvency and "irretrievable insolvency" requirements, the ruling does not significantly expand derivative plaintiffs' rights—they still may not bring direct claims to enforce fiduciary duties against an insolvent corporation, do not have a "deepening insolvency" cause of action, may only gain standing to derivatively sue the board when the corporation is insolvent rather than in the "zone of insolvency" and enjoy the broad protections of the business judgment rule. *Quadrant* may have removed a single arrow from the quiver of a director defending against derivative suits, but the quiver still remains full.

Footnotes

[1] In reaching these conclusions, Vice Chancellor Laster elaborated on the legal principles underpinning the regime for creditor-derivative litigation in light of the Delaware Supreme Court's 2007 decision in *North American Catholic Educational Programming Foundation v. Gheewalla*, 930 A.2d 92 (Del. 2007), and its progeny, namely that:

- Creditors do not gain derivative standing when a corporation operates in a "zone of insolvency." The corporation's "insolvency itself" is the only factor conferring standing to creditors.
- Regardless of the corporation's solvency or insolvency, creditors may only bring derivative claims – as opposed to direct claims – to enforce fiduciary duties.
- The directors of an insolvent corporation do not owe any particular duties to creditors and continue to owe fiduciary duties to the corporation for the benefit of its residual claimants, which includes creditors. Therefore, the directors (a) may continue to operate the insolvent entity and refuse to transfer or distribute all of its assets to the creditors, and (b) may exercise their good faith judgment to favor non-insider creditors over other creditors of similar priority.
- There is no theory of "deepening insolvency" in Delaware. Directors may continue to operate an insolvent entity in the good faith belief that they may achieve profitability even if their decisions ultimately lead to greater losses for creditors.

[2] See 11 U.S.C. § 101(32)(A) (defining insolvency as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of–(i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and (ii) property that may be exempted from property of the estate under section 522 of [the Bankruptcy Code].").

[3] See 8 Del. C. § 160(a)(1); *SV Inv. P'rs, LLC v. ThoughtWorks, Inc.*, 7 A.3d 973, 982 (Del. Ch. 2010) ("[T]he [net assets] test operates roughly to prohibit distributions to stockholders that would render the company balance-

sheet insolvent, but instead of using insolvency as the cut-off, the line is drawn at the amount of the corporation's capital."), *aff'd*, 37 A.3d 205 (Del. 2011).

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