

Delaware Offers New Guidance on Enforcing Fiduciary Duties Owed to Insolvent Corporations

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*On May 4, 2015, Vice Chancellor Travis Laster of the Delaware Court of Chancery issued a decision in *Quadrant Structured Products Co., Ltd. v. Vertin*,¹ analyzing creditors' standing to bring derivative claims against directors and officers of Delaware corporations. Building on the Delaware Supreme Court's jurisprudence regarding fiduciary duties owed to creditors,² Vice Chancellor Laster's opinion has two primary holdings. First, creditors' standing to bring derivative claims does not require that the corporation be "irretrievably insolvent." Second, even if the corporation becomes solvent during the litigation process, the creditors' standing is not revoked.*

This Alert summarizes the decision and highlights some considerations that directors of an insolvent, or possibly insolvent, corporation should keep in mind.

Procedural Background

Quadrant Structured Products, which holds debt issued by Athilon Capital Corp., sued Athilon's board of directors in 2011. Quadrant alleged that Athilon was insolvent and asserted derivative claims for breach of fiduciary duty against the individual members of Athilon's board. Following a long and tortured litigation history, Athilon and its directors moved for summary judgment, arguing that Quadrant lacked standing for two reasons. First, the defendants asserted that when Quadrant filed its suit, Athilon was not "irretrievably insolvent." In other words, Athilon could plausibly have returned to solvency, and the defendants argued that being "irretrievably insolvent" is a necessary condition for a creditor to have standing to maintain a derivative

¹ Case No. 6990-VCL (Del. Ch. May 4, 2015).

² *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

action. Second, the defendants argued that even if Athilon had been insolvent in the past, it had become solvent in the interim, thereby depriving creditors of the ability to bring a derivative claim.

The Court denied summary judgment, rejecting both arguments made by the defendants. On the first argument, the Court held that there is no requirement that a corporation be “irretrievably insolvent” before creditors can bring derivative claims. The Court emphasized that only the traditional tests for insolvency apply (i.e., the balance-sheet test and the cash-flow or equitable insolvency test). As for the defendants’ second argument, the Court concluded that there is no requirement for a corporation to be continuously insolvent from time of filing the complaint and throughout the litigation process. Rather, the Court concluded, the only requirement for continued standing is that the plaintiff remain a creditor.

Legal Background

As the court in *Quadrant* explained, the Delaware Supreme Court decision of *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*,³ “significantly altered the landscape for evaluating a creditor’s breach-of-fiduciary duty claim.” As summarized by the *Quadrant* decision, *Gheewalla* established the following principles:

1. The “zone of insolvency” has no implications for fiduciary duty claims. “The only transition point that affects fiduciary duty analysis is insolvency itself.”⁴
2. Derivative actions are the only means for creditors to bring fiduciary duty claims against the debtor corporation. Creditors cannot bring direct claims for breach of fiduciary duty.
3. Directors of an insolvent corporation do not owe any particular duties to creditors. Rather, directors owe fiduciary duties to the corporation itself, for the benefit of all of its residual claimants. When the corporation is insolvent, the category of residual claimants includes the corporation’s creditors.
4. Shareholders do not lose their right to bring derivative claims as the corporation becomes insolvent. Insolvency only expands the pool of potential plaintiffs to include both shareholders and creditors.

Analysis

Gheewalla rejected the idea that the beneficiaries of the fiduciary duties of a Delaware corporation’s directors shift from shareholders to creditors once the corporation enters the “zone of insolvency” and held that creditors may bring derivative claims only after the corporation is, in fact, insolvent. The reality is, however, that the difference between solvency and insolvency is not always obvious at the time. As the *Quadrant* court recognized, “whether the corporation is solvent or insolvent ... often is determined definitively only after the fact, in litigation, with the benefit of hindsight.”⁵ Notwithstanding *Gheewalla*’s apparent move toward a bright-line rule, a corporation’s solvency status may not be clear, and may only be determined later, after the directors have taken the action about which creditors are complaining. As a result, the directors still need to consider whether the corporation *might* be insolvent when making their decisions.

The *Quadrant* court’s rejection of the “irretrievable insolvency” standard proposed by the defendants is a positive development for creditors. This concept, which is borrowed from receivership proceedings, would have introduced considerable uncertainty into the determination of insolvency, as it requires predictions about the corporation’s future performance. Instead, *Quadrant* firmly embraced the familiar standards for

³ *Id.*

⁴ *Quadrant*, Case No. 6990-VCL (Del. Ch. May 4, 2015).

⁵ *Id.*

determining insolvency: (1) balance-sheet insolvency, meaning whether the entity's liabilities exceed the reasonable market value of its assets, and (2) cash-flow (or equitable) insolvency, which asks whether the entity is able to pay its debts as they come due.

Conversely, the Court's conclusion that there is no requirement that the corporation be continuously insolvent throughout the litigation process is less welcome for directors. The theory behind allowing creditors to bring a derivative suit is that they stand in the shoes of shareholders as the residual beneficiaries when the corporation is insolvent—at that point, shareholders' residual claim to the corporation's assets is, by definition, valueless. If the corporation is no longer insolvent, however, this logic no longer holds. The Court focused on the easily determined status of the plaintiff as a creditor, analogizing to the requirement in a shareholder derivative suit that the plaintiff beneficially own stock continuously during the litigation process (a similarly straightforward determination). But this embrace of bright-line rules is misplaced when the key initial determination—whether or not the company is solvent—is not always a simple matter, as the Court itself acknowledged. Determining whether a creditor has obtained standing to bring a derivative suit is done in litigation by a backwards-looking determination of the corporation's solvency at the time of filing. There would seem to be little benefit in skipping the same analysis when determining whether a creditor has lost standing because the corporation is no longer insolvent.

Conclusion and Practical Application

The *Quadrant* ruling makes it easier for creditors of insolvent corporations to bring and maintain derivative suits. The standard for establishing a corporation's insolvency is not the higher standard that is applicable to the appointment of a receiver. Rather, the tests that apply are those that are familiar from bankruptcy-related litigation: the balance-sheet and cash-flow tests. The Court's adoption of a bright-line test for standing based on whether the plaintiff is continuously a creditor—instead of whether the corporation is continuously insolvent—is troubling for directors. Although directors might previously have assumed that returning to sound fiscal health would remove any risks that arose during a period of insolvency, this rule creates the possibility that once a creditors' derivative suit is brought, it will continue to be prosecuted (and continue to impose costs on the corporation) even after the corporation is no longer insolvent. This risk of continuing litigation reinforces the need for directors to exercise caution when the corporation is, or might be, insolvent.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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