



## Delaware court of chancery issues significant ruling on the ability of creditors to assert fiduciary duty claims against directors: key takeaways

### Corporate Litigation Alert

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In *Quadrant Structured Products Co. v. Vertin*, 2015 WL 2062115 (Del. Ch. May 4, 2015), the Delaware Court of Chancery (Vice Chancellor J. Travis Laster) announced a bright-line standard governing the threshold inquiry of when a creditor can maintain a derivative suit against directors for breach of fiduciary duty. The court held that a creditor need only establish that the company was balance sheet insolvent at the time the suit was filed and that the creditor's standing will not be extinguished if the company rides back into solvency during the litigation.

The opinion is perhaps more important, however, for its comprehensive historical review of Delaware law on the relationship between creditors and a board of directors. There has been so much confusion in this area that the opinion is a "must read." What you think you know may be wrong – and questions remain.

### Background

Athilon Capital Corporation sells credit protection to large financial institutions and its subsidiary writes credit default swaps on collateralized debt obligations. After formation, the company secured \$700 million in financing (\$600 million of which was debt, in the form of notes of variously tiered preferences, all of which would mature in

the year 2035 or after) and, on that basis, had guaranteed more than \$50 billion in credit default swaps. After the financial crisis struck, Athilon's GAAP financial statements showed a net worth of negative \$513 million in 2010 and it suffered substantial downgrades of its securities.

Noting the opportunity, EBF & Associates, L.P. acquired a substantial number of Athilon's notes at fire sale rates (e.g., par value of \$149.7 million for \$37 million). EBF later acquired all of Athilon's equity and reconstituted the board to two EBF executives, the CEO of Athilon and two independent directors (one of whom was a former EBF employee).

Quadrant, an Athilon creditor, filed a derivative action in the Court of Chancery in October 2011, asserting numerous claims, including a derivative claim that the board breached its fiduciary duties by making interest payments on the junior subordinated notes owned by EBF. Quadrant also had alleged the Athilon board transferred value from Athilon to EBF by causing the Company to pay excessive fees to another EBF-controlled entity.

Following significant motion practice, two decisions appealed to the Delaware Supreme Court and a certification of a question of law to the New York Court of Appeals, only the two aforementioned claims survived.

Defendants then made two arguments in support of judgment in their favor as a matter of law. First, that the court should apply a "continuous insolvency" requirement, *i.e.*, that a creditor's standing to prosecute a derivative action is extinguished upon the company becoming solvent again. Second, to be successful, Quadrant must establish, in addition to balance sheet insolvency, that Athilon had no reasonable prospect of returning to solvency, *i.e.*, that the Company was "irretrievable insolvent."

### **Myths debunked; current state of the law explained**

Before addressing the defendants' arguments, the court reviewed in detail the modern evolution in Delaware law concerning whether and what fiduciary duties directors owe to the company's creditors, and therefore, when and under what circumstances creditors could enforce those duties. The court noted that the apex of this area of the law was the Delaware Supreme Court's decision in *North American Catholic Education Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007). Specifically, before *Gheewalla*, the following was believed to be true:

- "The fiduciary duties owed by directors extended to creditors when the corporation entered the vicinity of insolvency."
- "Creditors could enforce the fiduciary duties that directors owed them through a direct action for breach of fiduciary duty."
- "Under the trust fund doctrine, the directors' fiduciary duties to creditors included an obligation to manage the corporation conservatively as a trust fund for the creditors' benefit."
- "Because directors owed fiduciary duties both to creditors and stockholders, directors faced an inherent conflict of interest and would bear the burden of demonstrating that their decisions were entirely fair."
- "Directors could be held liable for continuing to operate an insolvent entity and incurring greater losses for creditors under a theory known as 'deepening insolvency.'"

*Gheewalla* essentially eliminated these principles. After *Gheewalla*, Delaware courts have applied the following rules:

- "There is no legally recognized 'zone of insolvency' with implications for fiduciary duty claims. The only transition point that affects fiduciary duty analysis is insolvency itself."
- "Regardless of whether a corporation is solvent or insolvent, creditors cannot bring direct claims for breach of fiduciary duty. After a corporation becomes insolvent, creditors gain standing to assert claims derivatively for breach of fiduciary duty."
- "The directors of an insolvent firm do not owe any particular duties to creditors. They continue to owe fiduciary duties to the corporation for the benefit of all of its residual claimants, a category which now includes creditors. They do not have a duty to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgment that this is indeed the best route to maximize the firm's value."
- "Directors can, as a matter of business judgment, favor certain non-insider creditors over others of similar priority without breaching their fiduciary duties."
- "Delaware does not recognize the theory of 'deepening insolvency.' Directors cannot be held liable for continuing 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."

- “When directors of an insolvent corporation make decisions that increase or decrease the value of the firm as a whole and affect providers of capital differently only due to their relative priority in the capital stack, directors do not face a conflict of interest simply because they own common stock or owe duties to large common stockholders. Just as in a solvent corporation, common stock ownership standing alone does not give rise to a conflict of interest. The business judgment rule protects decisions that affect participants in the capital structure in accordance with the priority of their claims.”

### **Creditors maintain standing despite a corporation’s return to solvency**

The court held that when a corporation becomes insolvent, “the creditors replace the stockholders as the equitable owners of the firm’s assets and the initial [residual] beneficiaries of any increases in value.” Thus, “[t]he corporation’s insolvency makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value.”

With these principles in mind, the court rejected the Defendants’ assertion that creditors should be subject to a continuous insolvency requirement and held that a creditor retains standing to sue derivatively on behalf of an insolvent company for so long as it remains a creditor of the company. Just like the continuous ownership rule applicable to stockholder plaintiffs, this is a bright-line test because a creditor either owns a company debt or it does not. The court noted that, “whether the corporation is solvent or insolvent is not a bright-line inquiry” because “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.” This, the court noted, could result in a “failure of justice.”

The court also addressed a practical consequence of its ruling: that during the course of the same litigation, both stockholders and creditors could gain standing to sue on behalf of the corporation. Creditors (whether senior or junior) and stockholders often will have competing theories as to how aggressive a board’s business strategy should have been. Thus, if both bring derivative claims simultaneously, the court is left with multiple adverse plaintiffs. However, the court observed that, post-*Gheewalla*, Delaware courts have applied the business judgment rule to directors of “solvent, barely solvent, and insolvent corporations” alike. Because that standard applies across the board, the court can adequately referee the competing theories that might be asserted by creditors and stockholders in a given case.

### **Irretrievable insolvency is not the standard**

The “irretrievably insolvent” standard derives from the court’s exercise of discretion in appointing a receiver. Specifically, Delaware courts will not appoint a receiver unless there is “no reasonably prospect that the business can be continued,” because such appointment is a “‘drastic’ act that displace[s] the corporation’s board of directors.” Here, the court noted that neither *Gheewalla* nor other Delaware cases have eliminated the balance sheet test in favor of “irretrievable insolvency” in the context of a creditor derivative fiduciary duty claim.

### **The balance sheet test**

The court then clarified the “balance sheet” test in the context of creditor-derivative claims. Specifically, the court noted that Delaware courts have held on numerous occasions that the “balance sheet” test “is not a bright-line rule based on GAAP figures.” That is, keeping in mind that book value of assets often differ from market value, “a corporation is insolvent under that test when it ‘has liabilities in excess of a *reasonable market value* of assets held.’” This approach, the court opined, “takes into account ‘the realities of the business world in which corporations incur significant debt in order to seize business opportunities.’”

The court also noted that the continued application of the balance sheet test in this context will aid in maintaining consistency among the related legal doctrines relating to state law fraudulent transfer claims, the comparable Bankruptcy Code fraudulent transfer provisions and the “standard[s] for determining whether a Delaware corporation has a cause of action against its directors for declaring an improper dividend or improperly repurchasing stock,” all of which apply a similar form of the balance sheet insolvency test.

Applying these legal principles, the court denied the defendants’ motion for judgment in its favor. In October 2011, Athilon’s balance sheet showed a \$300 million deficit in stockholders equity under GAAP. The court noted that although these GAAP figures were not dispositive of insolvency, “[t]he deficit [] is sufficiently large to create an

issue of fact.” Moreover, keeping in mind that a company is insolvent “‘if the total debt discount’ – *i.e.*, the difference between the amount of its debt claims and the fair market value of those debts – is greater than the fair market value of its equity,” because the “total debt discount on three outstanding issues of Athilon notes it then held was \$215.2 million, while the fair value of Athilon’s equity . . . was \$45.5 million,” *Quadrant* had established that there remained a genuine issue that Athilon was insolvent.

### Key takeaways

- The court reaffirmed the post-*Gheewalla* principle that the “transition point that effects [the] fiduciary duty analysis [in the context of the company’s creditors] is insolvency itself.”
- Solvency achieved during the course of a litigation will not *ipso facto* deprive a creditor plaintiff of its standing to prosecute derivative claims.
- The balance sheet insolvency test probably will apply as the threshold showing a creditor must establish to pursue derivative claims on behalf of an insolvent corporation.
- The balance sheet insolvency test is not a black-and-white test. That is, book value is not the only means of determining whether a company’s debts exceed its assets: the court may assess an asset’s reasonable market value.
- An important question that remains post-*Quadrant* is, as a company slides in and out of insolvency, who actually speaks for the corporation? That is, as the company’s financial health moves along the spectrum, and considering that directors of distressed companies still are protected by the business judgment rule, whose interests trump whose and when? The court recognized dual standing for stockholders and creditors, but whose interests or views should be given the greater weight when assessing the board’s “business judgment”?
- It also remains to be seen if the Delaware Supreme Court will uphold an extension of equitable standing that permits both creditors and shareholders to sue derivatively even when an insolvent corporation returns to solvency. In *Schoon v. Smith*, 953 A.2d 196, 208 fn. 46 (Del. 2008) the Delaware Supreme Court explained that “because *Gheewalla* merely substitutes creditors for shareholders” in the “limited setting” of insolvency, “it does not represent an extension or enlargement of the scope of the equitable standing doctrine.” The Court of Chancery’s decision in *Quadrant* does extend the equitable standing doctrine by recognizing dual standing for shareholders and creditors. Dual standing is different than one constituency being “substituted” for the other.

Find out more about this ruling and its impact on your business by contacting partner John L. Reed and former Delaware Supreme Court Justice Henry DuPont Ridgely.

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