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Delaware Decision Reviews Directors' Fiduciary Duty to Creditors

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In *Quadrant Structured Products Company, Ltd. v. Vertin* (May 4, 2015), the Delaware Court of Chancery once again addressed the issue of the fiduciary duties of the board of directors to creditors of an insolvent company. In this case, the plaintiff (Quadrant) argued that Athilon Capital Corp. ("Athilon") was insolvent and brought derivative claims for breach of fiduciary duty against the members of the board of directors of Athilon. The defendants moved for summary judgment, arguing that Athilon was no longer insolvent and therefore the plaintiff no longer had standing. The Court of Chancery denied the defendant's motion for summary judgment for the reasons set forth below.

<u>Background of Creditor Fiduciary Duty Claims</u>

A long line of case law analyzes directors' fiduciary obligations to creditors. The 2007 case *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla* established new authority on this issue. Prior to Gheewalla, case law suggested the following:

- Directors owed a fiduciary duty to creditors when a company entered the vicinity of insolvency.
- Courts would permit creditors to enforce the director fiduciary duties through a direct breach of fiduciary duty claim.
- Directors owed fiduciary duties to creditors and stockholders, therefore creating an inherent conflict of interest, which would require directors to demonstrate that their decisions were entirely fair.
- Directors faced risk for continuing to operate an insolvent entity which might result in more significant losses to the creditors.

In the *Quadrant* decision, the Court of Chancery summarized the current state of the law after *Gheewalla* and a new line of cases:

- The concept of a "zone of insolvency" no longer exists. Fiduciary duties to creditors can only be implicated by an actual insolvency.
- Creditors are not permitted to bring direct claims against directors for breach of fiduciary duty. Once a company becomes insolvent, creditors can only gain standing to bring a claim by asserting a derivative action for breach of fiduciary duty.
- Directors of an insolvent company do not owe a specific duty to creditors. Instead, they "continue to owe fiduciary duties to the corporation for the benefit of all of its residual claimants, a category which now includes creditors."
- Delaware courts do not recognize the concept of "deepening insolvency". Directors will not be

held liable for continuing to operate an insolvent entity if they believe in good faith that the company may become profitable again.

- Directors do not have a conflict of interest simply because they own common stock.

Further Clarifications by Quadrant Decision

Several questions remained unanswered after the *Gheewalla* decision, many of which the *Quadrant* court has now addressed. First, the defendants argued that Quadrant must prove not only had Athilon been insolvent at the time the claim was initiated, but that Athilon remained insolvent from the beginning of the claim through the time of judgment. The defendants suggested that the Court should compare a continuous insolvency requirement to the contemporaneous ownership requirement (pursuant to which if a plaintiff stockholder no longer owns equity in a company, then the plaintiff loses standing). In order to bring an action, a creditor must have a debt claim against the company and the company must be insolvent. The defendants therefore argued that both of these prerequisites must remain in order for the creditor to continue to have standing. The Court of Chancery disagreed with this analysis, and instead stated that "the proper analogy to the continuous ownership requirement is a continuous creditor requirement." The Court concluded that a creditor must simply show that the company was insolvent at the time the claim was brought, but is not required to establish that the company remained insolvent through the date of judgment.

The defendants also requested summary judgment by alleging that the creditor must show Athilo was "irretrievably insolvent", meaning that "there is no reasonable prospect that the corporation, if left alone, will soon be placed, by the efforts of its managers, in a condition of solvency." The Court of Chancery analyzed prior Court decisions on this issue and concluded that a traditional balance sheet test as opposed to an "irretrievably insolvent" test should control.

Conclusion

The Court of Chancery reaffirmed many of the existing doctrines set forth in the *Gheewalla* decision, and clarified that a creditor (i) must show that the corporation was insolvent at the time the suit was brought pursuant to a traditional balance sheet test; (ii) need not prove that the corporation remained insolvent through the lawsuit; and (iii) need not prove that the corporation was "irretrievably insolvent". While the *Quadrant* decision seems to broaden a creditor's ability to continue to have a claim, it still serves as a reminder of how the fiduciary duty doctrine as applied to creditors has narrowed in the past decade to the benefit of board members.

For further information on this topic, please contact **Mary Beth Kerrigan**.