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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

What Distressed Cos. Can Take Away From Quadrant V. Vertin


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On May 4, 2015, the Delaware Court of Chancery issued an opinion in Quadrant Structured Products Co. Ltd. v. Vertin that provides important guidance to those counseling distressed Delaware corporations and their stakeholders. The issue in Vertin was whether a creditor suing derivatively on behalf of an insolvent corporation loses standing to maintain that lawsuit if the corporation becomes solvent while the lawsuit is pending. In a matter of first impression, the Court of Chancery held that the creditor does not lose standing, but rather standing is determined as of the date the suit was filed.

In addition to rejecting this “continuous insolvency” requirement, the Court of Chancery also rejected an “irretrievable insolvency” requirement for standing purposes. The court’s analysis of an “irretrievable insolvency” requirement contains a discussion that, while dicta, provides guidance for corporations and their advisers in performing a solvency analysis. Last, but not least, Vertin also provides a concise analysis of the developments in Delaware fiduciary duty law with respect to insolvent corporations over the years and where that law currently stands.

Background

Quadrant Structured Products Co. Ltd., a creditor of Athilon Capital Corp., filed a derivative action against the directors of that corporation on Oct. 28, 2011. Through its complaint, Quadrant alleged that the Athilon directors breached their fiduciary duties by transferring value preferentially to Athilon’s controller, EBF & Associates, and to EBF’s affiliate.

Athilon, which was in the business of selling credit protection to large financial institutions and funded its operations through approximately $100 million in equity capital and $600 million in long-term debt, in the form of senior notes, subordinated notes and junior subordinated notes.

While Athilon's debt securities were initially given investment-grade ratings, damage wrought by the financial crisis of 2008 resulted in the debt being downgraded to junk grade by 2010. In 2010, EBF acquired significant amounts of Athilon's debt, and later the same year, it acquired all of Athilon's equity and reconstituted Athilon's board to comprise three directors with ties to EBF or Athilon and two ostensibly independent directors. According to Quadrant, Athilon's board then began to engage in conduct favorable to EBF, but detrimental to Athilon's general creditors, such as continuing to pay interest on junior subordinated notes held by EBF despite the ability to defer interest payments and changing Athilon's business model to make speculative investments for the benefit of EBF, all while Athilon was insolvent on a balance sheet basis.

After Quadrant filed suit, Athilon engaged in a series of transactions with EBF that helped it achieve balance sheet solvency. With Athilon's newly achieved solvency, the defendants moved for summary judgment on Quadrant's breach of fiduciary duty claim, arguing that even if Athilon was insolvent when the suit was filed, it had since reached balance sheet solvency, thereby cutting off Quadrant's creditor derivative standing. In the alternative, the defendants urged summary judgment in their favor because Quadrant could not prove that Athilon was "irretrievably insolvent" with no reasonable prospect of returning to solvency. The court rejected both arguments as a matter of law, and held that to bring a derivative action, the creditor-plaintiff must plead and later prove insolvency under the traditional balance sheet test, and that insolvency is measured at the time of suit.

Fiduciary Duties Owed to Creditors

Before reaching the merits, the court recounted the doctrinal transition that, in the court's words, "significantly altered the landscape for evaluating a creditor's breach-of-fiduciary-duty claim." The cases cited by the court as ushering in this doctrinal decision included cases decided by current Chief Justice Leo Strine while a member of the Court of Chancery and the Delaware Supreme Court's decision in North American Catholic Educational Programming Foundation Inc. v. Gheewalla. For ease, we refer generally to this doctrinal shift as the "pre-Gheewalla" era and "post-Gheewalla" era.

Pre-Gheewalla

Before Gheewalla, many believed that directors of Delaware corporations owed fiduciary duties to creditors once the corporation entered the "vicinity" or "zone" of insolvency, a concept that was notoriously hard to define for practitioners and courts alike. Further, before Gheewalla, many believed that creditors could bring direct or derivative claims on behalf of the corporation, as directors were obligated to "manage the corporation conservatively as a trust fund for the creditors' benefit."

In addition, there was concern that directors' decisions could be reviewed under the more exacting "entire fairness" standard (rather than the deferential business judgment standard) because of what some viewed as an inherent conflict of interest resulting from concurrent fiduciary duties owed to creditors and stockholders. Directors also possibly ran the risk of incurring liability to creditors for continuing to operate an insolvent entity and amassing greater losses under the theory of "deepening insolvency."

Post-Gheewalla

Post-Gheewalla, the concept of a "vicinity" or "zone" of insolvency has been dispelled; instead it is now clear that Delaware law charges directors with fiduciary duties to creditors only once the corporation is actually insolvent. Further, in a departure from pre-Gheewalla thinking, creditors may only bring derivative (and not direct) actions for breach of fiduciary duty. Similarly, post-Gheewalla, it is clear that directors do not owe any particular duties to creditors, but rather directors' fiduciary obligations run "to the corporation for the benefit of all of its residual claimants" — a class that includes creditors.

Moreover, post-Gheewalla, it is clear that directors of an insolvent entity are entitled to the protection of the business judgment rule, even if their decisions further deteriorate the firm's financial position, so long as the board was disinterested, reasonably prudent and acted in good faith. In rejecting the idea of "deepening insolvency," Gheewalla and its forebears also granted directors the ability to "favor certain non-insider creditors over others of similar priority" for valid business reasons. And, post-Gheewalla, directors' ownership of common stock alone "does not give rise to a conflict of interest" under any of these scenarios.

Creditor Derivative Standing is Not Lost if the Corporation Subsequently Becomes Solvent

With these teachings in mind, the Court of Chancery in Vertin held that a creditor must only establish insolvency at the time it files a derivative suit and does not lose standing if the corporation subsequently achieves solvency. In other words, Delaware law does not impose a "continuous insolvency" condition in order for creditors to maintain derivative actions. The court also rejected "any requirement that the creditor establish that the corporation is "irretrievably insolvent," with no reasonable prospect of returning to solvency. The court found that the irretrievable insolvency test only applies in receivership proceedings for reasons unique to that remedy. Instead, a creditor can establish derivative standing if it can demonstrate insolvency under the traditional "balance sheet" test.

The Balance Sheet Test Must Account for Reasonable Market Value of the Corporation's Assets

The court's decision also contains a discussion that, while dicta, provides important guidance on the balance sheet test. Specifically, in distinguishing a prior opinion that addressed the solvency of a startup company by focusing solely on the "cash flow" solvency test, the court quoted approvingly of "authorities establishing that the traditional balance sheet test is not a bright-line rule based on [generally accepted accounting principles]," but instead requires an analysis of the "reasonable market value" of assets held. "Reasonable market value," in turn, takes into account "the realities of the business world in which corporations incur significant debt in order to seize business opportunities." As such, to the extent a corporation can finance those opportunities, it may have "prospect value," which would exceed the amount of any borrowed funds and may be considered an asset of the corporation for purposes of determining solvency under the balance sheet test.

Conclusion

The Vertin opinion offers important guidance to distressed corporations, and their directors, creditors and advisers, including on issues of first impression to the Delaware Court of Chancery. As the court observed, however, the opinion is "of one trial judge" and the "Delaware Supreme Court may well disagree." Accordingly, the issues discussed await further development.

—By Eric Klinger-Wilensky and Matthew B. Harvey, Morris Nichols Arsht & Tunnell LLP

Eric Klinger-Wilensky is a partner with Morris Nichols' Delaware corporate counseling group. He is the vice chairman of the American Bar Association Section of Business Law Committee on Venture Capital and Private Equity. He also currently serves on the Delaware Supreme Court's Access to Justice Commission and is an adjunct professor at the University of Pennsylvania Law School.

Matthew Harvey is an associate with the firm's business reorganization and restructuring practice.
