Delaware Courts Affirm Guidance for Directors in Distressed Situations

By Matthew B. Harvey and Nathan P. Emeritz

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The Delaware Supreme Court and the Court of Chancery recently issued guidance for directors navigating the complex fiduciary issues that arise around insolvency. That guidance, outlined in a series of decisions in *Quadrant Structured Products Co., Ltd. v. Vertin*, should give directors a measure of comfort in understanding the who, what, when, and how of fulfilling fiduciary duties in these situations.

The question of who may bring a breach of fiduciary duty claim was central to these decisions. Quadrant, a creditor of credit protection company Athilon Capital Corp., sued Athilon's directors on several grounds, including breach of fiduciary duty, after the company allegedly became insolvent in 2010. The Court of Chancery ruled that the plaintiff lacked standing because that claim was added to the plaintiff's complaint after Athilon regained solvency. The Supreme Court's decision affirms that while the company is solvent, only stockholders may bring fiduciary duty claims.

Likely of greater interest to directors is what fiduciary duties they must fulfill while the company is insolvent. The Court of Chancery, in an earlier opinion, held that directors' fiduciary duties are always to the company and its residual claimants. While the company is solvent, only stockholders are residual claimants. Should the company become insolvent, creditors also become residual claimants.

The Supreme Court's ruling neither controverted these principles nor questioned the earlier statements by the Court of Chancery. Thus, directors would be well-advised to follow the Court of Chancery's earlier decision and proceed carefully in exercising their fiduciary duties when additional stakeholders with different interests than stockholders may become residual claimants of the corporate assets.

The issue of when this subtle shift in fiduciary obligations happens may give directors pause. The Supreme Court affirmed that Athilon's solvency should be determined based on a judicial evaluation in hindsight of "whether the sum of the debtor's debts is greater than all of the debtor's assets, with both sides of the balance sheet given a fair valuation."

In the *Quadrant* decision affirmed by the Supreme Court, the Court of Chancery acknowledged that the "line is often fuzzy and dim" in a solvency analysis. The Court of Chancery also explained that generally accepted accounting principles do not automatically determine solvency and carry decreasing evidentiary weight in showing a company's insolvency at later stages of litigation.

In an earlier decision, the Court of Chancery also noted that there is no "zone of insolvency" that might create new fiduciary duties for directors. In addition, deepening insolvency, continuous insolvency, or irretrievable insolvency is not required to establish insolvency, and solvency must be determined on the basis of the market value of the company's assets.

As a company approaches insolvency, its board should tread cautiously: a court may find that the board owed fiduciary duties to a larger group of stakeholders.

The Court of Chancery's earlier decision held that directors are not conflicted when the company becomes insolvent simply by the fact of their stock ownership. If the company is insolvent, directors may decide to take action that favors one constituency, such as "certain non-insider creditors over others of similar priority," so long as they make an informed determination in good faith that such an action is in the best interests of the company as a whole.

These opinions provide comfort to directors in contexts where they often must accept uncertainty. Although directors' decisions, and the legal advice that informs them, will turn on the facts of each situation, the *Quadrant* decisions offer salient guideposts.