

Delaware Court of Chancery Issues Significant Opinion on Corporate Creditors; Addresses Fiduciary Duties, Standing, and Measure of Insolvency

Client Alert

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In an opinion issued on May 4, 2015, *Quadrant Structured Products Co., Ltd. v. Vertin*, the Court of Chancery provided important guidance to distressed Delaware corporations and their creditors. Among other things, the Court:

1. summarized directors' fiduciary duty to creditors,
2. held that a creditor has standing to bring a derivative suit if the corporation is insolvent at the commencement of the suit, even if the corporation subsequently becomes solvent, and rejected an "irretrievably insolvent" element to establishing insolvency for standing purposes and
3. discussed the measure of "assets" for purposes of determining solvency under the balance sheet test.

BACKGROUND

After plaintiff filed a creditor-derivative suit on behalf of Athilon Capital Corp., Athilon engaged in a series of transactions that helped it achieve balance-sheet solvency. The director defendants then moved for summary judgment on the breach of fiduciary duty claim, arguing that since Athilon became solvent, plaintiff lost its creditor-derivative standing. In the alternative, the defendants argued that plaintiff should be required to prove that Athilon was "irretrievably insolvent" with no reasonable prospect of returning to solvency in order to have creditor-derivative standing in the first place. The Court rejected both arguments as a matter of law.

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FIDUCIARY DUTIES OWED TO CREDITORS

Before reaching the merits, the Court provided a summary of what it described as a “significantly altered landscape for evaluating a creditor’s breach-of-fiduciary-duty-claim” following the Delaware Supreme Court’s 2007 decision in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*. As summarized by the Court, that altered landscape includes the following.

CREDITOR-DERIVATIVE STANDING IS NOT LOST IF CORPORATION BECOMES SOLVENT AFTER LITIGATION FILED AND DOES NOT REQUIRE “IRRETRIEVABLE INSOLVENCY”

With these teachings in mind, the Court addressed defendants’ key legal arguments. In a matter of first impression, the Court observed that, although a creditor must establish that a corporation is insolvent at the time the creditor files a derivative suit, the creditor does not lose standing if the corporation subsequently becomes solvent. Having made that determination, the Court turned to defendants’ alternative argument that, to establish “insolvency,” a creditor-derivative plaintiff must demonstrate that the corporation is “irretrievably insolvent,” *i.e.*, it has no reasonable prospect of returning to solvency. The Court rejected this argument, holding that the irretrievable insolvency test only applies in receivership proceedings for reasons unique to that remedy. Instead, a creditor can maintain derivative standing if it can show insolvency under the traditional “balance sheet” test.

THE BALANCE SHEET TEST MUST ACCOUNT FOR REASONABLE MARKET VALUE OF THE CORPORATION’S ASSETS

Finally, the Court’s analysis of an “irretrievably insolvent” requirement contains a discussion that, while *dicta*, provides guidance for businesspersons and their advisors in performing a solvency analysis. While distinguishing a prior opinion that addressed the solvency of a start-up company by focusing solely on the “cash-flow” test for insolvency as opposed to both that test and the balance sheet test, the Court quoted approvingly “authorities establishing that the traditional balance sheet test is not a bright-line rule based on GAAP,” 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.” The Court suggests that, to the extent a corporation can finance those opportunities, those opportunities have “prospect value” which would exceed the amount of any borrowed funds and may be considered an asset of the corporation for purposes of the balance sheet test.

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CONCLUSION

The *Quadrant* opinion offers important guidance to distressed corporations, their creditors, and advisors, including on issues of first impression to the Court. As observed by the Court, however, the opinion is “of one trial judge” and the “Delaware Supreme Court may well disagree.” As such, the issues discussed in the opinion await further development.

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