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New Decision Clarifies Rules Regarding Derivative Standing for Creditors in Delaware Court of Chancery

On May 4, 2015, the Delaware Court of Chancery issued an important decision regarding creditor standing to maintain a derivative action on behalf of an insolvent corporation. In *Quadrant Structured Products Company v. Vertin et al.*, C.A. No. 6990-VCL, Vice Chancellor Laster, in denying defendants' motion for summary judgment on plaintiff's breach of fiduciary duty and fraudulent transfer claims, held (i) that a creditor-plaintiff must plead and later prove that the corporation was insolvent *only at the time the suit was filed*, and not thereafter, rejecting the defendants' "continuous insolvency" theory; and (ii) that a creditor-plaintiff need not satisfy the heightened "irretrievable insolvency" standard that applies in cases seeking the appointment of a receiver, but instead need only plead and later prove insolvency under the traditional balance sheet or cash flow tests. The opinion also provides a cogent and comprehensive summary of the evolution of the law of fiduciary duty (reaffirming that duties are owed not to creditors or shareholders but to the enterprise as a whole) and becomes the first published opinion to adopt a test of insolvency developed by Kramer Levin partner Gregory Horowitz.

Athilon, the corporation on whose behalf the derivative suit was brought, was a provider of credit default swaps to large financial institutions. Following the 2008 financial crisis, Athilon took huge losses on certain positions. As a result, in 2010 Athilon's financial statements showed a net worth of negative $513 million and the company's credit ratings reflected virtual certainty that Athilon would default on debt obligations. Under these circumstances, defendant EBF & Associates ("EBF") acquired over $270 million in face amount of Athilon's debt for between 10 and 25 cents on the dollar before ultimately acquiring all of Athilon's equity as well. EBF used its control over Athilon to reconstitute the board.

In October 2011, Quadrant, a creditor of Athilon, filed a derivative action against EBF and others, alleging, among other things, breaches of fiduciary duties. As relevant to the current opinion, Quadrant alleged that Athilon, while insolvent, had improperly made payments on certain subordinated notes held by EBF rather than exercising its option to defer such payments without penalty. In February 2015, defendants moved for summary judgment to dismiss Quadrant's derivative claim, arguing that the company had returned to solvency following institution of Quadrant's lawsuit.[1]

Judge Laster's analysis began with an overview of the nature of a creditor's claim for breach of fiduciary duty, considering whether it should be viewed as:

> "(i) an easily invoked theory that a creditor can assert directly as the firm approaches insolvency, (ii) a powerful cause of action that defendant directors will struggle to defeat because of an inherent conflict between their duties to creditors and their duties to stockholders, and (iii) a vehicle for obtaining a judicial remedy that would involve a forced liquidation of a firm that otherwise might continue to operate and return to solvency."

or

> "(i) something creditors only can file derivatively once the corporation actually has become insolvent, (ii) subject by default to the business judgment rule and not facilitated by any inherent conflict between duties to

[1] Construing the evidence in favor of the non-movant, Quadrant, Vice Chancellor Laster noted that Athilon had achieved balance-sheet solvency by engaging in transactions with EBF.

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creditors and duties to stockholders, and (iii) only a vehicle for restoring to the firm self-dealing payments and other disloyal wealth transfers."

In the Court's view, the latter description - under which a creditor derivative claim is "less potent and more closely aligned with the interests of the firm as a whole" - was the proper view. As such, "the need for additional hurdles [to such a suit] recedes."

With these background principles in mind, Judge Laster turned to Athilon's specific arguments. The Court first addressed the contention that to pursue the derivative action, Quadrant must prove Athilon's insolvency from initiation of the suit all the way through judgment -- that is "continuing insolvency." As the ultimate beneficiaries of a corporation's assets (including litigation assets), stockholders can generally pursue derivative claims. One requirement for pursuing a derivative suit is that the shareholder own stock at the time of the filing of the suit and throughout the litigation. When a corporation becomes insolvent, creditors become beneficiaries of the corporation's assets and thus have an equitable entitlement to pursue derivative claims as well. This was the theory upon which Quadrant proceeded. Athilon argued, however, that because the right to pursue the claim stems from insolvency, a creditor-plaintiff's equitable entitlement to pursue a derivative suit against an insolvent corporation should cease to exist if the corporation becomes solvent at any point during the litigation.Vice Chancellor Laster rejected this, ruling that the proper comparison to continuing ownership was to a requirement that the creditor own a claim continuously all the way through judgment, not continuous insolvency. He favored a rule that established insolvency as the clear point at which a creditor may pursue a derivative action and saw no reason to inject an additional element of uncertainty and subjectivity into the process by requiring that insolvency be proven throughout.

Next, Athilon argued that establishing insolvency under the traditional balance sheet or cash flow tests was insufficient; instead a showing that the corporation was irretrievably insolvent (the standard use for appointing a receiver) should be required. The Court traced the origins of the irretrievable insolvency standard and looked at its application in cases seeking appointment of a receiver. Determining that irretrievable insolvency was too harsh a test and should be reserved for the drastic remedy of seeking appointment of a receiver, Vice Chancellor Laster ruled that the traditional balance sheet or cash flow tests for insolvency were appropriate here, emphasizing that Delaware fraudulent transfer law, Delaware law on shareholder suits for improper dividends or share repurchases, and Bankruptcy Code provisions on fraudulent transfers all utilized the traditional tests.

Turning from the law to the facts, the Court assessed whether Quadrant had presented sufficient evidence to show that a dispute existed regarding whether, under the traditional balance sheet test, Athilon was insolvent at the time the suit was filed. In making this assessment the Court first took note of Athilon's balance sheet, which showed negative stockholders equity and Athilon's poor credit ratings. Ultimately, the Court relied heavily on the evidence regarding the discount at which EBF was able to purchase Athilon's debt as compared to the fair market value of the company's equity. Citing an article written by Kramer Levin partner Gregory Horowitz, the Court noted that EBF had paid $55.9 million for $271.1 million in face amount of Athilon debt and determined that this "debt discount" of $215.2 million was far greater than the fair market value of the company's equity - a measure of insolvency.[2]

Vice Chancellor Laster's opinion establishes that Delaware courts are wary of placing increased burdens on plaintiff-creditors in pursuing derivative actions for breach of fiduciary duties. The opinion recognizes that Delaware courts provide great latitude to directors of insolvent corporations and therefore the oversight provided by creditor derivative suits is of significant value and such suits should not be discouraged. Additionally, the case is significant because it recognizes a clear, efficient, and market-based approach to determining whether a corporation is balance sheet insolvent, a test that can serve as a blueprint for conducting this type of analysis going forward.

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[2] Gregory A. Horowitz, *A Further Comment on the Complexities of Market Evidence in Valuation Litigation*, 68 Bus. Law. 1071, 1077 (2013).

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