Bankruptcy & Litigation Alert

# Business Judgment Rule Protects Board's Decision to Maximize the Value of an Insolvent Delaware Corporation Even If It Puts Creditors at Risk; But It Does Not Protect Transfers of Value from the Corporation to a Controlling Shareholder or Related Party

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Directors of an insolvent corporation face a host of difficult questions. Should they wind up operations or file for bankruptcy to preserve assets for creditors, or chart a riskier course that could lead the company back to profitability and possibly create value for shareholders? If they choose the riskier course and it fails, will the directors be potentially liable to creditors? The opinion issued by Vice Chancellor Laster of the Delaware Court of Chancery earlier this month in *Quadrant Structured Products Co., Ltd. v. Vertin*, C.A. No. 6990-VCL, slip op., 2014 Del. Ch. LEXIS 193 (Del. Ch. Oct. 1, 2014), *reconsideration denied*, 2014 Del. Ch. LEXIS 214 (Del. Ch. Oct. 28, 2014), addresses these issues in depth and makes it clear that directors' strategic decisions about how best to maximize the value of an insolvent Delaware corporation are protected by the business judgment rule, even though they benefit the corporation's shareholders while putting creditors at risk. Where directors approve direct transfers of value from an insolvent corporation to a controlling shareholder or related party, however, they risk liability to creditors.

## Background

Quadrant, a creditor of Athilon Capital Corp., sued Athilon's directors, its controlling shareholder EBF & Associates, and EBF's affiliate Athilon Structured Investment Advisors, LLC (ASIA), for alleged breaches of fiduciary duty and preferential transfers. Athilon had been created to sell credit protection to large financial institutions, writing credit default swaps on senior tranches of collateralized debt obligations. Following the 2008 financial crisis, Athilon paid hundreds of millions of dollars to unwind two swaps involving mortgage-backed securities. In the wake of the crisis, financial institutions were unwilling to enter into credit swaps with entities such as Athilon that lacked substantial capital. Athilon could no longer engage in the only business that it was permitted to pursue under its charter and operating guidelines, which had been narrowly limited to meet requirements imposed by the credit rating agencies.

EBF acquired Athilon's junior subordinated notes and the rest of its equity, gaining control of the company and its board. The board then sought permission from the rating agencies to amend Athilon's operating guidelines to loosen its investment restrictions and allow it to invest in riskier securities. The board also continued to pay interest to EBF on the junior notes, even though it could have deferred these payments, and paid allegedly excessive service and license fees to ASIA.

Quadrant asserted derivative claims for breach of fiduciary duty against the directors and EBF, alleging that they had improperly taken on more risk to benefit EBF at the expense of Quadrant and engaged in transactions that had transferred value preferentially to EBF and its affiliate ASIA. Quadrant also asserted fraudulent transfer claims directly against EBF and ASIA. Ruling on the defendants' motion to dismiss the complaint, the court dismissed Quadrant's breach of fiduciary duty claims insofar as those claims challenged the directors' decision to take on greater risk, but allowed Quadrant to pursue its remaining claims.

## When is a corporation insolvent?

Delaware law recognizes that a corporation can be found insolvent under the balance sheet test or the cash flow test. Under the balance sheet test, an entity is insolvent if it has liabilities in excess of the reasonable market value of its assets. Alternatively, under the cash flow test, a company is insolvent if it is unable to pay its debts as they fall due in the usual course of business.

## Do the directors of an insolvent corporation owe fiduciary duties to its creditors?

No. In *North American Catholic Educational Programming Foundation v. Gheewalla*, 930 A.2d 92 (Del. 2007), the Delaware Supreme Court held that creditors of an insolvent corporation have *standing* to pursue breach of fiduciary duty claims derivatively on behalf of the corporation.[1] But that does not mean that directors of an insolvent corporation owe direct fiduciary duties to its creditors. As the court noted in a passage cited by Vice Chancellor Laster, recognizing a direct fiduciary duty to creditors "would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation" and "create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors." *Id.* at 103.
After analyzing *Gheewalla*, Vice Chancellor Laster concluded in *Quadrant* that, "I do not believe it is accurate any longer to say that the directors of an insolvent corporation owe fiduciary duties to creditors…. The fiduciary duties that creditors gain derivative standing to enforce are not special duties to creditors, but rather the fiduciary duties that directors owe to the corporation to maximize its value for the benefit of all residual claimants."

## Can the directors of an insolvent corporation properly take actions that benefit shareholders while putting creditors at risk?

Yes, if they involve strategic decisions about maximizing the value of the enterprise, rather than direct transfers of value to a controlling shareholder or related parties. The board's general strategic decisions are protected by the business judgment rule even if they benefit shareholders while putting creditors at risk – even where the board is controlled by a single shareholder such as EBF. This conclusion follows from the previous point that even in insolvency, corporate directors do not owe any special fiduciary duty to creditors under Delaware law.

Quadrant alleged that Athilon's directors breached their fiduciary duties by amending its operating guidelines to permit speculative investments instead of preparing the company for liquidation. EBF would reap nearly all the benefit of this strategy while incurring no downside, since its stock would be worthless in a liquidation, while creditors such as Quadrant were put at greater risk. Quadrant contended that faithful fiduciaries would pursue a more conservative strategy and prepare to liquidate the company.

Vice Chancellor Laster rejected this position, citing earlier precedents holding that even when a Delaware corporation is insolvent, its directors may continue to pursue strategies to maximize the corporation's value even if they risk increasing the company's insolvency, thereby potentially harming creditors. "[W]hen directors make decisions that appear rationally designed to increase the value of the firm *as a whole* [emphasis added], Delaware courts do not speculate about whether those decisions might benefit some residual claimants more than others." He analogized that situation to cases where the Delaware courts have applied the business judgment rule to board decisions approving transactions that treat all shareholders equally, even though some shareholders may have a greater interest in the transactions than others – such as where a controlling shareholder causes a company to pay out extraordinary dividends to meet its cash needs, but all shareholders receive the dividends.

The court therefore held that Quadrant could not rebut the business judgment rule deference given to board decisions merely "by alleging that the Board has decided to pursue a relatively more risky business strategy to benefit its sole common stockholder, EBF. Although the Company is insolvent, and the directors are dual-fiduciaries [owing duties to Athilon and to EBF], the Board does not face a conflict between the interests of the

primary residual claimants (the creditors) and the interests of secondary residual claimants (the stockholders)." And conversely, by the same token, "the business judgment rule would protect a board's decision to pursue an efficient liquidation."

In sum, as long as the strategy adopted by the board is conceivably a rational means of maximizing the corporation's value under the circumstances, it is entitled to the protection of the business judgment rule, whether it involves taking on more risk to return to profitability (thereby benefitting shareholders) or proceeding to an efficient liquidation (thereby benefitting creditors).

## Can directors of an insolvent corporation properly take actions that directly transfer value from the corporation to a controlling shareholder or its affiliate?

No, unless the transactions are entirely fair to the corporation. Whereas general strategic decisions about the best way to maximize the value of the enterprise as a whole are protected by the business judgment rule, transactions that directly transfer value from an insolvent corporation to a controlling shareholder or related party are subject to judicial review under the entire fairness standard and may result in director liability.

Ordinarily, a transfer of value from a *solvent* entity to a 100 percent stockholder cannot give rise to a fiduciary duty claim, because the stockholder already owns the value indirectly and beneficially before the transaction. But the situation is different when the corporation is insolvent and creditors become residual claimants. In that case, the creditors have an interest in the value of the corporation, and they are deprived of that interest when there is a direct transfer to a controlling shareholder. Vice Chancellor Laster therefore reasoned that Athilon's payment of interest to EBF on the junior notes and allegedly excessive service and license fees to its affiliate ASIA must be judged under the entire fairness standard that ordinarily applies to self-dealing transactions, with the defendants bearing the burden of proof. He also held that he could not determine at the motion to dismiss stage whether Athilon's directors, even those who were facially independent and disinterested, should be shielded by the corporation's exculpation clause under 8 Del. C. § 102(b)(7) from Quadrant's fiduciary duty claims relating to these transactions. Accordingly, the court refused to dismiss these claims. It also permitted Quadrant to proceed with fraudulent transfer claims challenging these transactions.

## Conclusion

The *Quadrant* decision confirms that directors of an insolvent Delaware corporation are protected by the business judgment rule when they make strategic decisions about maximizing the company's value, even if those decisions disproportionately benefit shareholders while putting creditors at risk (or vice versa). This rule applies even if the board is controlled by the benefitting shareholder, as in *Quadrant*. But direct transfers of value from an insolvent corporation to a controlling shareholder or related party are subject to entire fairness review and can potentially expose the directors to liability. *Quadrant* illustrates why it is important for boards of insolvent corporations to distinguish carefully between these different kinds of decisions.

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### Endnotes

[1] With regard to standing to pursue derivative claims, Vice Chancellor Laster held in *Quadrant* that creditors do not need to meet the contemporaneous ownership requirement of 8 Del. C. § 327, which provides that "[i]n any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complaints or that such stockholder's stock thereafter devolved upon such stockholder by operation of law." By its terms, he concluded, this statute only applies to stockholders. If the contemporaneous ownership rule were applied to creditors, then they would lose standing to assert claims for conduct that pre-dates the company's insolvency, making it less likely that such claims would be pursued. Vice Chancellor Laster also raised, but did not decide,

the question of whether creditors should be subject to the demand futility and demand refusal requirements for derivative suits under Delaware Court of Chancery Rule 23.1.



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