New York Law Journal

A NEW YORK LAW JOURNAL SPECIAL SECTION

Corporate Restructuring & Bankruptcy

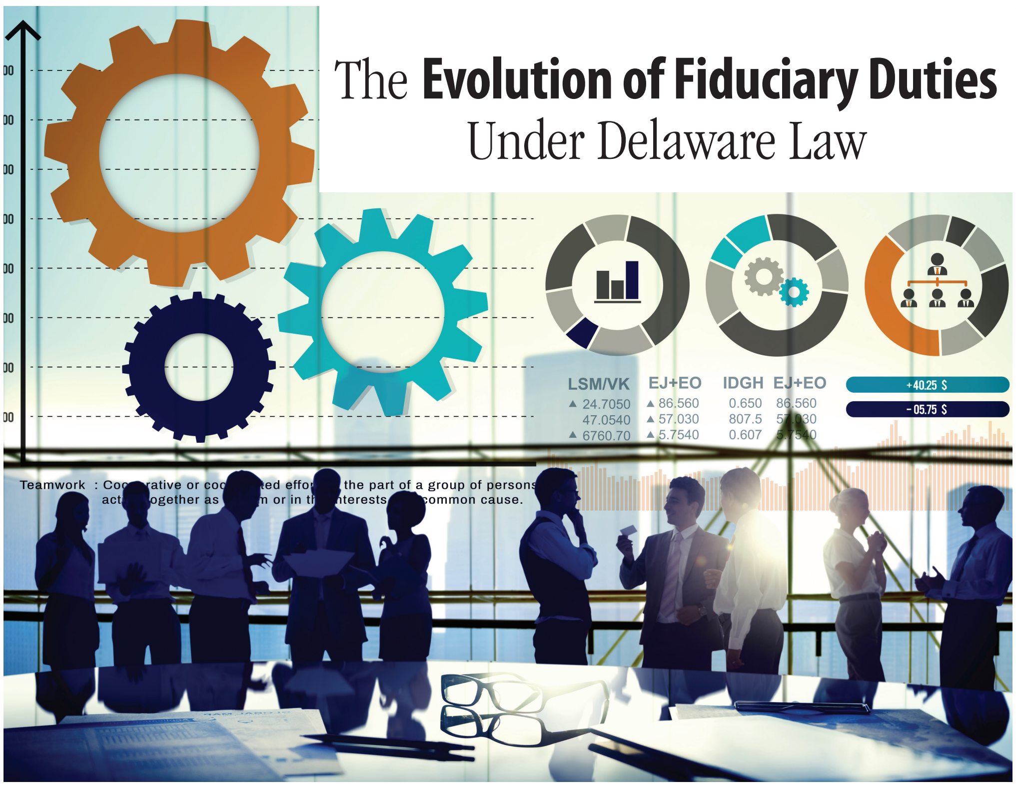
An ALM Publication

WWW.NYLJ.COM

VOLUME 254—NO. 51

MONDAY, SEPTEMBER 14, 2015

The **Evolution of Fiduciary Duties** Under Delaware Law



BY JOHN H. BAE AND KAITLIN R. WALSH

With the vast number of corporations in New York and other states in the United States that are incorporated in Delaware, the judicial pronouncements of Delaware courts on director duties are of great importance to directors and attorneys advising boards of directors. For the past 70 years, Delaware courts have grappled with the question of how directors' duties may change when a company becomes insolvent, or even enters the "zone" of insolvency. The concept that insolvency should trigger a change in directors' duties was driven by the principle that when a company becomes insolvent, the claims of the company's creditors are given higher priority over the interests of shareholders. In the context of an insolvent corporation, courts questioned whether the directors' duties shifted from shareholders to creditors; whether directors have a duty to prevent a company from going deeper into insolvency by shutting down the company and marshalling the assets for the benefit of creditors; and whether the duties shifted to creditors even when a company is solvent, but is teetering on insolvency.

All of these and other questions led to significant uncertainty as to the nature and extent of directors' duties when the corporation becomes insolvent. Although the Delaware courts ultimately were responsible for triggering many of these questions, the Delaware Supreme Court in *Gheewalla* and the recent Delaware Chancery Court decisions in *Quadrant* answered these questions and provided much needed clarity on directors' duties.

This article walks through the evolution of Delaware law on directors' duties, and provides a summary of the current state of Delaware law on the fiduciary duties of directors when a corporation is insolvent.

Duties of Directors of a Solvent Company

Under Delaware law, the directors of a solvent corporation owe their fiduciary duties, such as the duty of care and the duty of loyalty, to the corporation they serve and its shareholders. The duty of care requires that directors exercise the degree of care that an ordinary prudent person would exercise. Section 102(b)(7) of the Delaware General Corporations Law (DGCL), however, permits corporations to include clauses in the certificate of incorporation to exculpate directors from monetary damages arising from breach of duty of care.

The duty of loyalty requires that directors must act in good faith and in the best

JOHN H. BAE *is a member and* KAITLIN R. WALSH *is an associate at Mintz Levin Cohn Ferris Glovsky and Popeo in New York, where they practice in the bankruptcy, restructuring and commercial law department.*

interest of the corporation, and must not engage in self-dealing or usurpation of corporate opportunities.

Shifting of Duties Upon Insolvency

More than 70 years ago, the Delaware Supreme Court in *Bovay v. H.M. Byllesby & Co.*, 38 A.2d 808 (Del. 1944), stated that an "insolvent corporation is civilly dead in the sense that its property may be administered in equity as a trust fund for the benefit of creditors." Id. at 813. *Bovay* was one of the earliest decisions to raise the question of whether directors' duties shifted from shareholders to creditors when a company becomes insolvent, and whether directors had a duty to hold the corporation's assets in trust for the benefit of creditors.

Later, the Delaware Chancery Court in *Credit Lyonnais Bank Nederalnd, N.V. v. Pathe Communications*, 17 Del. Corp. L. 1099 (Del. Ch. Dec. 30, 1991), raised the notion that the directors' duties may shift for the benefit of creditors even when a company is solvent, but when it enters the "zone of insolvency." There, the court stated in the infamous footnote 55: "The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors." Id. at 1159 n.55. The decision recognized that "the right (both the efficient and fair) course" for directors of an insolvent corporation might diverge from what stockholders would want. Id.

Deepening Insolvency

A claim against directors for "deepening insolvency" was raised in *Trenwick America Litig. Trust v. Ernst & Young*, 906 A.2d 168 (Del. Ch. 2006), where the plaintiff asserted that directors of an insolvent corporation owe a duty to creditors to prevent a company from going into deeper insolvency, and that they had a duty to shut down the company to preserve the assets for the benefit of creditors.

The court in *Trenwick* held that Delaware law does not recognize a cause of action for "deepening insolvency," or for failing to liquidate the company when the company is losing money. Id. at 174. Rather, directors of an insolvent company may pursue a business strategy that they believe will make the company more valuable, even if the strategy may make the company less so, and ultimately, lead to insolvency. The court held that directors are not guarantors of the chosen strategy's success, and are protected by the business judgment rule. Id.

Direct or Derivative Claim

A creditor's ability to sue directors directly (as opposed to derivatively) was addressed by the Chancery Court in *Production Resources Group v. NCT Group*, 863 A.2d 772 (Del. Ch. 2004). Bringing a claim derivative of the corporation would subject the creditor to the exculpation clause under DGCL §102(b). By bringing a direct claim, the creditor would not be bringing the action on behalf of the corporation, and hence, the exculpation provision contained in the corporate charter would not apply. In *Production Resources*, a creditor brought an action seeking the appointment of a receiver and asserting a direct claim against the directors for breach of fiduciary duties. The court held that once a corporation is insolvent, creditors become the initial residual claimants, and may bring a claim against the directors, but the claims must be *derivative* of the corporation. Id. at 791-93. The court, however, left open the possibility that under limited circumstances, a creditor may be able to bring a *direct* claim against the directors. The court reasoned that if the board of an insolvent company took action that frustrated the ability of a particular creditor to recover on its claim to benefit other stakeholders, the creditor may be able to bring a direct claim. Id.

> 'Trenwick' held that **Delaware law does not recognize** a cause of action for "deepening insolvency."

Clarification of Delaware Law

In its seminal decision, *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92 (Del. 2007), the Delaware Supreme Court addressed many of the questions raised in earlier decisions of the Delaware courts. The court clarified that the duties of directors of corporations in the zone of insolvency do not change and that directors must continue to discharge their fiduciary duties to the corporation and its shareholders. The court also confirmed that directors of an insolvent corporation do not owe direct duties to creditors, but as the residuary interest holders, creditors may bring derivative claims against directors on behalf of the corporation for a breach of fiduciary duty.

In *Gheewalla*, a creditor brought direct claims against the directors, asserting they breached fiduciary duties owed to the creditor when company was either insolvent or in zone of insolvency. The court affirmed the lower court's judgment dismissing the complaint, explaining that recognizing a right for creditors to bring direct fiduciary duty claims against directors of insolvent corporations would create a conflict between the directors' duty to maximize value for the benefit of all interested parties and a direct fiduciary duty to individual creditors. Id. at 103. In so finding, the court noted that creditors' rights are protected through negotiated agreements, security instruments and fraudulent conveyance laws. Id. at 100.

Although *Gheewalla* provided much needed clarity regarding the scope of directors' duties while a corporation is either in a zone of insolvency or insolvent, the decision left open questions as to whether directors' duties shifted to the corporation's creditors, or whether the duties continued to be owed to the corporation and shareholders.

Directors' Duties Further Clarified

The Delaware Chancery Court in *Quadrant Structured Products v. Vertin*, 102 A.3d 155, 176 (Del. Ch. 2014) (*Quadrant I*), and *Quadrant Structured Products v. Vertin*, 115 A.3d 535 (Del. Ch. 2015) (*Quadrant II*), relied on *Gheewalla* to provide further clarity on directors' duties when a corporation becomes insolvent.

In *Quadrant Structured Products*, Athilon Capital and its wholly-owned subsidiary were engaged in the business of selling credit protection to financial institutions. In order to obtain and maintain a AAA/Aaa credit rating, which was essential to Athilon's business model, Athilon was required to have a limited business purpose and to adopt and follow certain operating guidelines. Under these guidelines, Athilon's investment activities were limited to investing in only short-term, low-risk debt securities. In addition, if certain adverse events occurred, Athilon would go into "runoff," which required Athilon to wind down and liquidate. Athilon suffered significant losses during the 2008 financial crisis. By August 2010, Athilon went into "runoff." EBF & Associates purchased all of Athilon's junior subordinated notes and all of Athilon's equity. After gaining control of the company, EBF appointed a new board of directors, which amended the operating guidelines, in part to allow Athilon to engage in riskier business activities. Subsequently, Quadrant Structured Products Company (the Plaintiff) purchased other Athilon subordinated notes.

Plaintiff filed a complaint against Athilon's board of directors alleging various claims, including derivative claims for breach of fiduciary duties. Plaintiff argued that Athilon was insolvent by the time EBF took control, and because the credit default industry had collapsed and Athilon was prohibited under its operating guidelines from engaging in other lines of business, there was no opportunity for the company to become solvent again. Plaintiff alleged that the board should have maximized the value of the company for the benefit of its stakeholders during the "runoff" by liquidating the company, rather than using Athilon's assets to engage in a high risk business strategy.

On a motion to dismiss, the *Quadrant I* court ruled that the board's decision to engage in the high risk business strategy was protected by the business judgment rule. Id. at 192. In so holding, the court determined that there is no "conflict between the interests of the primary residual claimants (the creditors) and the interests of secondary residual claimants (the stockholders)." Id.

The court in *Quadrant I* clarified: "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." Id. at 193.

Defendants moved for summary judgment on the ground that in order for creditors to have standing to bring derivative claims against directors, (1) the company must be insolvent at the time of the suit and continuously thereafter; and (2) there is no reasonable prospect for the company to return to solvency. See *Quadrant II*, 115 A.3d at 539. The court denied summary judgment, holding that under *Gheewalla*, creditors must show that the company was insolvent at the time of the suit, but there is no requirement that the creditor demonstrate that the company remained insolvent. Further, the requirement that the company be irretrievably insolvent is considered in the context of appointing a receiver, and is not required for creditors to have standing to bring derivative claims. Id. at 544.

Explaining the Delaware Supreme Court's decision in *Gheewalla*, the court in *Quadrant II* summarized the state of Delaware law as follows:

• There is no fiduciary duty that arises in the context of zone of insolvency.

• Creditors cannot bring direct claims for breach of fiduciary duty.

• Directors of insolvent corporations do not owe fiduciary duties to creditors.

• Directors owe duties to the corporation for the benefit of all residual interest holders, which include both creditors and shareholders.

• Delaware does not recognize the theory of "deepening insolvency," and directors do not have a duty to shut down the insolvent corporation to marshal assets for creditors.

• Directors may make decisions that benefit the corporation as a whole, and the participants in the capital structure will benefit in accordance with the priority scheme.

Id. at 546-48.

Practical Implications for Directors

The recent clarification of Delaware law regarding directors' fiduciary duties when the company is insolvent or in the zone of insolvency provides meaningful guidance to directors. Rather than having to focus on whether their decisions will better serve the interests of shareholders or creditors, directors can now focus on the interests of the corporation and its community of interests as a whole, which include the interests of both shareholders and creditors as the corporation's residual risk bearers. In addition, directors are shielded from derivative actions by creditors when the company is in the nebulous "zone of insolvency."

Trustees and creditors' committees in Chapter 11 cases will have greater difficulty in asserting breach of fiduciary duty claims in the post-*Gheewalla* and *Quadrant* world. Claims for breaches occurring during the "zone of insolvency" are no longer permitted. And even when the corporation's challenged actions occurred during insolvency, so long as directors can show that they acted for the interests of the corporation and its residual risk bearers, plaintiffs will have difficulty asserting claims based on the notion that directors preferred the interests of shareholders over the interests of creditors.

The recent Delaware decisions could also have an impact on the ability of creditors' committees to obtain *STN* standing on the ground that the debtor has "unjustifiably fail[ed]" to bring claims that are "likely to benefit the reorganization estate," since the claims may no longer be "colorable" under current Delaware law. See *In re STN Enterprises*, 779 F.2d 901, 904 (2d Cir. 1985), remanded, 73 B.R. 470 (Bankr. D.Vt. 1987). For example, a bankruptcy court may not be inclined to grant standing to a creditors' committee to sue the debtor's board of directors when the directors' alleged breaches appear to have occurred when the company was in the zone of insolvency, or when the directors can show that they focused on the interests of the corporation and not solely on creditors' interests.

Ultimately, directors are still protected by the business judgment rule defense. So long as they act on an informed basis and consider the interests of the corporation and its residual risk bearers in making their decisions, they will be protected, even if their decisions are later criticized.