Client Alert

May 2015

DE Court Addresses Creditor Standing to Bring Derivative Suits

In *Quadrant Structured Products Company, Ltd. v. Vertin*, the Delaware Court of Chancery made two key rulings concerning the rights of creditors to bring derivative lawsuits against corporate directors.[1] First, the court held that there is no continuous insolvency requirement during the pendency of the lawsuit. Rather, the creditor must only show that the corporation was insolvent when the lawsuit was filed. Second, the court held that insolvency can be shown based on a traditional balance sheet test and that the creditor was not required to show that the corporation had no reasonable prospect of returning to solvency. The court's rulings are favorable to creditors seeking to pursue claims against the directors and officers of distressed corporations.

Court's Opinion

In *Quadrant*, a creditor initiated a derivative suit against the corporation's directors. During the pendency of the lawsuit, the defendants argued that the corporation had returned to solvency. They thus moved for summary judgment against the plaintiff-creditor, arguing that there is a continuing insolvency requirement for creditors to maintain derivative standing. By analogy, Delaware imposes a continuous ownership requirement on stockholders, which requires that they maintain share ownership throughout the lawsuit.

The court rejected this argument, concluding that a creditor only has to show the corporation was insolvent when the derivative suit was filed. The court noted that this could result in two different parties – that is, creditors and shareholders – pursuing claims with different objectives. It reasoned, however, "the court supervising the derivative litigation has ample tools available to manage it."

The defendants also argued that, for a creditor to have standing, the corporation must be insolvent with no reasonable prospect of returning to solvency. The court rejected this argument too. It stated that such an "irretrievable insolvency" requirement has only applied when a court is asked to appoint a receiver. It thus held that insolvency can be shown by reference to two traditional tests: the balance sheet test or the cash flow test.

Summary of Delaware Law

Since 2006, Delaware law has evolved significantly in shaping the rights of creditors and the duties of directors as distressed corporations. The *Quadrant* court summarized the state of law as follows:

- There is no legally recognized "zone of insolvency" with implications for fiduciary duty claims. The only transition point that affects fiduciary duty analysis is insolvency itself.

- Regardless of whether a corporation is solvent or insolvent, creditors cannot bring direct claims for breach of fiduciary duty. After a corporation becomes insolvent, creditors gain standing to assert claims derivatively for breach of fiduciary duty.

[1] *Quadrant Structured Products Company, Ltd. v. Vertin*, C.A. No. 6990-VCL, mem. op. (Del. Ch. May 4, 2015).

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- The directors of an insolvent firm do not owe any particular duties to creditors. They continue to owe fiduciary duties to the corporation for the benefit of all of its residual claimants, a category which now includes creditors. They do not have a duty to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgment that this is indeed the best route to maximize the firm's value.

- Directors can, as a matter of business judgment, favor certain non-insider creditors over others of similar priority without breaching their fiduciary duties.

- Delaware does not recognize the theory of "deepening insolvency." Directors cannot be held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors.

- When directors of an insolvent corporation make decisions that increase or decrease the value of the firm as a whole and affect providers of capital differently only due to their relative priority in the capital stock, directors do not face a conflict of interest simply because they own common stock or owe duties to large common stockholders. Just as in a solvent corporation, common stock ownership standing alone does not give rise to a conflict of interest. The business judgment rule protects decisions that affect participants in the capital structure in accordance with the priority of their claims.

Conclusion

The court's ruling is favorable to creditors because it reduces two potential obstacles to pursuing derivative claims. Viewed in a broader context over the past decade, however, Delaware courts have not significantly expanded creditors' rights to pursue fiduciary claims. For example, they have ruled that creditors cannot bring direct claims for breach of fiduciary duty,[2] the corporation must be insolvent rather than in the "zone of insolvency,"[3] and Delaware does not recognize a cause of action for "deepening insolvency."[4] They have also affirmed the protections of the business judgment rule unless insiders engaged in conflicted, wealth-transferring transactions.[5] Still, *Quadrant* is a reminder of the perils of managing a distressed corporation and the potential risks to directors and officers.

Contact

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[2] *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).

[3] *See id.*

[4] *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom. Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007) (TABLE).

[5] *Shandler v. DLJ Merchant Banking, Inc.*, 2010 WL 2929654 (Del. Ch. July 26, 2010); *Prod. Res. Gp., L.L.C. v. NCT Gp., Inc.*, 863 A.2d 772 (Del. Ch. 2004).

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