Harvard Law School Forum on
Corporate Governance and Financial Regulation
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Delaware Court of Chancery Revisits Creditor Derivative Standing

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In a significant decision, the Delaware Court of Chancery has rejected several proposed limitations on the ability of creditors to maintain derivative suits following a corporation's insolvency. In doing so, however, the Court reaffirmed the deference owed to a board's decisions, regardless of the company's financial condition, and the high hurdles faced by creditors in seeking to prove a breach of fiduciary duty. *Quadrant Structured Prods. Co. v. Vertin, C.A. No. 6990-VCL (May 4, 2015)*.

Quadrant, a creditor of Athilon Capital, brought a derivative action claiming that when Athilon was insolvent, its directors violated their fiduciary duties, including by authorizing repayments of debt owed to Athilon's equity owner. The defendants moved for summary judgment on the basis that Quadrant lacked standing to sue under the Delaware Supreme Court's decision in *North American Catholic Educational Programming Foundation, Inc.* v. *Gheewalla* (see memo of May 24, 2007), which permits creditors to sue directors for breach of fiduciary duty only on a derivative basis, and only once the corporation is insolvent.

First, the defendants argued that Quadrant lost its ability to sue because Athilon had been restored to solvency. The Court disagreed, declining to require that a corporation be "continuously" insolvent from the date of the challenged transaction through the end of the creditor's derivative litigation. Instead, the Court required corporate insolvency only at the time of the transaction.

Second, the defendants argued that Quadrant had to show that Athilon was "irretrievably insolvent," the standard used in receivership proceedings. Again, the Court rejected the defendants' position, holding that a creditor is required to show corporate insolvency only on a balance-sheet basis—*i.e.*, liabilities in excess of the fair market value of assets.

In rejecting these "additional hurdles," the Court explained that, following *Gheewalla* and a series of Chancery Court decisions issued by now-Chief Justice Strine, a creditor's derivative fiduciary duty claim is a "less potent" tool that: (1) can only be used after a corporation is actually insolvent (rather than in the "zone of insolvency"); (2) is generally subject to the business judgment rule

and not “facilitated by any inherent conflict between duties to creditors and duties to stockholders”; and (3) serves only as “a vehicle for restoring to the firm self-dealing payments and other disloyal wealth transfers.”

Quadrant thus makes clear that a creditor’s claim for breach of fiduciary duty is not “an easily invoked theory” in need of further “impediments.” Rather, under Delaware law, directors of a corporation—whether solvent or insolvent—are protected by the business judgment rule in making good-faith decisions aimed at maximizing the value of the firm, even if those decisions benefit shareholders or favor certain non-insider creditors over others.