

Delaware Court of Chancery Decision Clarifies Fiduciary Issues in Insolvent Company Context

Skadden

January 2015

This article is from Skadden's *2015 Insights* and is available at skadden.com/insights.

Contributing Partners

Mark S. Chehi
Wilmington

John K. Lyons
Chicago

Contributing Associate

Ana Lucía Hurtado
Wilmington

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

The Court of Chancery of Delaware recently issued a noteworthy decision clarifying fiduciary duties and confirming business judgment rule protection for board-level business strategy decisions by directors of insolvent corporations.¹ *Quadrant Structured Products Company v. Vertin*, 102 A.3d 155 (Del. Ch. 2014).

The court's ruling reinforces continued business judgment rule protections for business strategy decisions — even decisions to pursue risky strategies — that are rationally designed to maximize the economic value of an insolvent firm as a whole. The Court of Chancery also ruled the business judgment rule does not protect directors who cause or permit the transfer of insolvent company value preferentially to a controlling stockholder or its affiliate without ratably benefiting all residual claimants (*i.e.*, creditors).

Background

Athilon Capital Corp., a Delaware-incorporated credit derivative product company, sold credit protection to financial institutions. Athilon's operating guidelines restricted its investments to short-term, low-risk securities.

The 2008 financial crisis left Athilon insolvent, and it lost its AAA/Aaa rating. Under Athilon's operating guidelines, its credit rating downgrade forced it into runoff mode.



Delaware's business judgment rule protects even high-risk business strategies that might benefit controlling shareholders when a corporation is insolvent and creditors have become its residual beneficiaries.

Subsequently, EBF & Associates purchased all of Athilon's equity and its junior subordinated notes. EBF placed four directors — three of whom were current or former EBF employees — on Athilon's five-director board.

In May 2011, Athilon's board sought and obtained permission from credit rating agencies to amend Athilon's operating guidelines to permit riskier investments. The board thereafter adopted a high-risk investment strategy.

After EBF had gained equity control over Athilon and its board, Quadrant Structured Products Company became a primary creditor of Athilon by acquiring its senior subordinated notes and subordinate notes. In October 2011, Quadrant commenced an action in the Court of Chancery asserting derivative breach of fiduciary duty claims against Athilon's board of directors and EBF.²

Quadrant alleged that Athilon's directors breached their fiduciary duties when they (1) failed to defer interest payments made to EBF on "underwater" junior subordinated notes held by EBF, (2) caused Athilon to pay excessive services agreement and software license fees to an EBF affiliate and (3) adopted a high-risk investment strategy for Athilon that benefited EBF

Delaware Court of Chancery Decision Clarifies Fiduciary Issues in Insolvent Company Context

Continued

rather than winding up and liquidating Athilon's business for the benefit of its creditors including Quadrant.³ The defendants moved to dismiss Quadrant's complaint for failure to state a claim.

The Court's Decisions

With in-depth discussion of relevant case law on fiduciary duties and corporate insolvency, including the Delaware Supreme Court's *Gheewalla*⁴ decision, the Court of Chancery decided that Quadrant's challenges to Athilon's transfers of value to its controlling shareholder EBF and an EBF affiliate stated derivative fiduciary breach claims. However, the court dismissed Quadrant's challenge of the Athilon board's strategic decision to take on greater business risk (instead of winding up and liquidating Athilon's insolvent business), holding that the business judgment rule applied to strategic decision-making.

High-Risk Investment Strategy Protected by Business Judgment Rule

The Court of Chancery applied the business judgment rule presumption to dismiss Quadrant's asserted claim that the defendants breached their fiduciary duties by amending Athilon's operating guidelines to permit Athilon to make riskier investments when it was insolvent.⁵

Quadrant had argued that, given Athilon's insolvency, its directors should have pursued a wind-down and liquidation for the benefit of its creditors rather than a high-risk investment strategy. Quadrant's rationale was that Athilon's creditors allegedly bore all the risk of failure of the high-risk strategy, while EBF as controlling shareholder and holder of underwater junior subordinated notes would enjoy any upside of the strategy's success.

The Court of Chancery disagreed, explaining that Delaware law "does not require the Board to shut down Athilon's business and manage towards a near-term dissolution for the benefit of creditors. Notwithstanding a company's insolvency, '[t]he directors continue to have the task of attempting to maximize the economic value of the firm.'" The court held that the business judgment rule presumption protected the board's decision to adopt Athilon's high-risk strategy because "when directors make decisions that appear rationally designed to increase the value of the firm as a whole, Delaware courts do not speculate about whether those decisions might benefit some residual claimants more than others."

While Quadrant alleged that the Athilon directors were "acting for the benefit of EBF and contrary to the interests of other stakeholders," that did not sufficiently "call into question the rationality of a riskier investment approach" or support a bad faith inference. Quadrant failed to rebut the business judgment rule presumption because it did not demonstrate Athilon's directors received any "direct and specific benefits" by adopting the risky business strategy.

Accordingly, the Court of Chancery dismissed the claim challenging the board's business strategy decision: "to hold otherwise and treat directors as interested in pursuing a riskier business decision that allegedly benefitted the equity holder such that the standard of review would escalate to entire fairness would be inconsistent with ... *Gheewalla* [which] declin[ed] to recognize the existence of fiduciary duties owed directly to creditors."

Nondeferral of Interest Payments and Excessive Fees Paid to Affiliate of Controlling Shareholder

The Court of Chancery held that Quadrant's allegations challenging Athilon's failure to defer interest payments made to EBF, and Athilon's payment of excessive service and license fees to an EBF affiliate, stated derivative breach of fiduciary duty claims against the directors and EBF. The court decided that the challenged payments were actionable because they diverted funds from Athilon to EBF (Athilon's sole shareholder) when Athilon was insolvent and its creditors had become the residual beneficiaries of any increase in Athilon's value.

Citing *Gheewalla*, the court reasoned that when a corporation like Athilon is insolvent, its creditors take the place of its shareholders as the residual beneficiaries of any increase in corporate value. When a corporation is insolvent, "a transfer of value to the sole stockholder does not inure to the ratable benefit of all of the residual claimants [but rather] transfers value . . . owned beneficially and indirectly by all of the residual claimants to the party in control of the corporation."

Accordingly, the court concluded that the business judgment rule presumption did not apply to protect the director defendants, and they therefore had the burden of proving the entire fairness of the challenged payments.

Implications

Quadrant highlights Delaware's business judgment rule protection of rational board-level business strategy decisions that attempt to maximize the economic value of a corporation — even decisions adopting a high-risk business strategy that might benefit controlling shareholders when a corporation is insolvent and creditors have become its residual beneficiaries. The *Quadrant* decision also illustrates litigation risks directors of insolvent corporations face if they permit transactions that transfer value to or for the benefit of a controlling shareholder or its affiliate.

¹ Delaware has three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny and entire fairness. Delaware's default standard of review is the "business judgment rule," a principle of nonreview that reflects and promotes the role of the board of directors as the proper body to manage the business and affairs of the corporation. The rule presumes that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Only when a decision lacks any rationally conceivable basis will a court infer bad faith and a breach of duty.

"Entire fairness" is Delaware's most onerous standard of review of director decisions. The entire fairness standard applies when a plaintiff rebuts one or more of the presumptions of the business judgment rule and applies when there is a challenge to a transaction involving self-dealing by a controlling shareholder.

² Delaware law imposes fiduciary duties on those who effectively control a corporation.

³ Quadrant's complaint also asserted fraudulent transfer, waste, constructive dividend and conspiracy claims. The fraudulent transfer and waste claims survived the defendants' motion to dismiss to the extent such claims challenged the nondeferral of interest on EBF's junior subordinated notes and payment to EBF's affiliate of excessive service agreement and license fees.

⁴ *North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007) (holding that creditors may sue directors of insolvent corporations derivatively but not directly).

⁵ On October 28, 2014, the court denied Quadrant's motion to reconsider this ruling. *Quadrant Structured Prods. Co. v. Vertin*, No. 6990-VCL (Del. Ch. Oct. 28, 2014).