Rights of Creditors and Duties of Directors of Insolvent Delaware Entities Clarified

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When companies are in financial distress the question arises as to what rights shift to creditors from shareholders or other equity owners. The Delaware Chancery Court recently addressed this issue in some detail in Quadrant Structured Products Co., Ltd. v. Vertin (C.A. No. 6990-VCL, May 4, 2015). The court held that creditors are entitled to bring a derivative action against the directors for breach of fiduciary duty if the corporation is “insolvent” at the time the action is brought. In doing so, it compared the ground rules that were thought to apply before a series of Delaware decisions addressing rights of creditors upon insolvency that began with N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A. 2d 92 (Del. 2007), with those that the court believes now apply. These ground rules include the meaning of insolvency, when it is determined, the inapplicability of the “irretrievable insolvency concept,” rejection of the theory of “deepening insolvency” and definition of the duties owed by directors in these circumstances.

The following are the applicable ground rules identified by the court in Quadrant:

• For there to be a shift in rights to creditors, the corporation must in fact be insolvent. There is no recognized concept of “zone of insolvency.”

• Insolvency is determined at the time the action is brought and there is no requirement of “continuing insolvency.” Thus, maintenance of the action is not affected by the corporation subsequently regaining solvency. Nor is it necessary for the creditor to establish “irretrievable insolvency” (i.e., there is no reasonable prospect of returning to solvency), which is the test applicable for appointment of a receiver.

• Insolvency can be established under the traditional “balance sheet” test. For purposes of the balance sheet test, the “reasonable market value” of assets can be considered, as opposed to just financial statement or book values, and this can include the “prospect value” of business opportunities to the extent they exceed the amount of debt incurred to pursue them.
Creditors do not have direct claims against the directors for breach of fiduciary duties but only may assert derivative claims.

Directors do not owe any special duties to creditors but rather must exercise their duties in the best interests of the corporation for the benefit of all its residual claimants, including creditors. The performance of the directors’ duties is normally tested under the “business judgment rule.”

There is no theory of “deepening insolvency” under which directors could be liable to creditors by incurring greater losses from continuing to operate the business. Similarly, the “trust fund doctrine” requiring the directors to manage the business conservatively does not apply.

Directors do not have a conflict of interest just because they own common stock.

The Quadrant decision does not address how the actions of the directors while the corporation is insolvent are to be assessed and whether the fact of insolvency will affect that assessment, other than to reject doctrinal notions of trust fund conservatism and special duties to creditors and to recognize application of the business judgment rule in appropriate circumstances. Left for future decisions is whether the fact of insolvency will affect the way the business judgment rule is applied. In addition, the decision, while recognizing that stockholders might also gain standing to bring a derivative action, does not address how the potentially competing interests of creditors and stockholders, and of preferred stockholders and common stockholders, are to be reconciled.

Although the Quadrant decision does not answer all questions, it goes a long way to clarify the rights of creditors when a Delaware entity is insolvent and the duties of directors in those circumstances.

For more information on the matters discussed in this Locke Lord QuickStudy, please contact the author:

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