Duties of Directors of Insolvent Corporations

By Francis G. X. Pileggi

The fiduciary duties of directors of a company experiencing financial difficulty were clarified recently by a decision from the Delaware Court of Chancery. In essence, the fiduciary duties of loyalty and care and the requirement to act in the best interest of the corporation do not change when a company is insolvent or on the brink of insolvency.

Rather, when a company becomes insolvent, a shift occurs under Delaware law whereby creditors gain standing to bring derivative actions for breach of fiduciary duty—something they may not do if the corporation is solvent. Those duties are not special duties to creditors, but rather they remain the fiduciary duties that directors owe to the corporation to maximize its value for the benefit of all residual claimants. When a company becomes insolvent, those residual claimants include creditors.

Reasonable people might differ about the exact point in time when a company becomes insolvent, whether based on the balance sheet test or the cash flow test under state law or other applicable factors under federal bankruptcy law. At that point, creditors have standing to sue derivatively on behalf of the corporation, just as a shareholder could in a solvent corporation to enforce fiduciary duties that may not have been fulfilled by the directors. The Delaware Chancery Court decision that clarified directors' duties in this context was *Quadrant Structured Products Company, Ltd. v. Vertin*.

The fundamental principle confirmed by Vice Chancellor J. Travis Laster is that "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." The deferential review afforded by the business judgment rule will not be withheld simply because an allegedly risky strategy is challenged if the business decision is intended to increase the value of the entity as a whole, as opposed to a decision intended to benefit only a particular person or class of security holders.

The court in this decision confirmed that directors of corporations do not owe any fiduciary duty directly to creditors even when the company is insolvent or close to insolvency. The reasoning behind this principle is that creditors do not need direct fiduciary protection because creditors are afforded protection through contractual agreements, the law of fraud, fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law, and other sources of creditor rights.

The basic background of this case is that Quadrant owned debt securities issued by Athilon Capital Corp. Quadrant alleged that Athilon is insolvent, giving Quadrant standing to sue derivatively. Quadrant claimed that Athilon's board of directors breached their fiduciary duty by seeking in several ways to benefit Athilon's controller, defendant EBF & Associates. Quadrant argued that the board of Athilon sought to benefit EBF by investing Athilon's assets in riskier securities. If the riskier strategy succeeded, or succeeds in the future, the securities that EBF owns would become more valuable. If the strategy fails, however, senior creditors like Quadrant would suffer the loss.

Quadrant also argued that because two members of Athilon's board are also agents of EBF and a third board member was not independent, a majority of the Athilon board was lacking disinterest in the decision to favor EBF. Thus, in Quadrant's view, they should be subject to the entire fairness standard rather than the deferential business judgment rule.

This situation presented the conflict that arises when a director wears two hats as a fiduciary for the corporation and for a large common stockholder. The conflict occurs when the corporation becomes insolvent and the class of residual risk bearers expands to include creditors. In such a situation, the directors must decide between two groups—creditors and stockholders—whose inherently different risk preferences give them inherently different interests at a time when both groups can legitimately be the proper subject of the directors' decisions. Generally speaking, the business judgment rule may still apply if the decisions would either increase or decrease the value of the entity as a whole, as opposed to a decision that would benefit a particular

person or only one class of security holders.

The court further reasoned that directors, not courts, are charged with weighing the cost and benefits in making a decision about how much risk a company should assume. Taking on increased risk was a rational business strategy for Athilon in this case. That decision may either turn out poorly or may increase the value of the entity. The decision of the board to increase the risk profile of Athilon's investment portfolio was not so far beyond the bounds of judgment that it supports an inference of bad faith.

The court also explained a bedrock principle of Delaware law that corporate action is "twice tested." First, it is tested to determine compliance with the technical rules of the applicable statute, corporate charter, bylaws, and other entity-specific contractual agreements, such as a stock option plan or stockholder agreements. No such violation was alleged in this case.

The second test—after an analysis that the legal test has established compliance—is an examination of the discretionary exercise of authority, known as the equitable test. This analysis is undertaken through the lens of a standard of review. The business judgment rule and the more heightened entire fairness standard are the two most common standards of review.

The business judgment 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 interest of the company." In order to establish bad faith, it must be an irrational decision that is so blatantly imprudent that it is inexplicable in the sense that no well-motivated and minimally informed person could have made it. Only when a decision lacks any rationally conceivable basis will a court infer bad faith and a breach of duty.

Although the business judgment rule applied in this case to the decision regarding risk strategy, the decision to continue paying interest on notes that benefited EBF, when it had the option of deferring that interest, was subject to the standard of review known as the entire fairness test. This standard applies when the business judgment rule is rebutted, such as when a transaction involving self-dealing by a controlling shareholder is alleged.

Because the decision to pay interest, even though it could have been deferred, on junior notes only benefited EBF, it was considered a self-dealing transaction by a controlling shareholder. Under the entire fairness standard, absent any protective procedural devices, the defendant directors will bear the burden of proving that the transaction with the controlling stockholder was entirely fair both in process and in price to the minority stockholders.

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In a situation where a director sits on the board of a parent corporation and that of a subsidiary, the well-settled Delaware law is that "[t]here is no dilution of fiduciary obligation where one holds dual or multiple directorships." If the interests of the beneficiaries diverge, the fiduciary faces an inherent conflict of interest. There is no safe harbor for such divided loyalties in Delaware.

The dual-fiduciary problem arises in a solvent corporation when directors face a conflicting fiduciary interest that diverges from promoting the value of the corporation for the benefit of the undifferentiated equity. When a corporation is insolvent, as in this case, Quadrant asserted the directors faced a dual-fiduciary problem because the interests of the primary residual claimants (the creditors) diverged from those of the equity. The court reasoned, however, that 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. This principle can been seen in decisions holding that equal treatment of stockholders operates as a presumptive safe harbor for corporate fiduciaries, including controlling stockholders and directors, even when those fiduciaries allegedly have divergent economic interests.

This case also involved the recognition of a fraudulent conveyance claim that was separate from the analysis of a breach of fiduciary duty. That was a separate statutory analysis in the 75-page opinion that was also the subject of a shorter decision denying a motion for reconsideration, both of which were issued in October.

In sum, this decision should give comfort to directors who otherwise satisfy the prerequisites of the business judgment rule standard of review to make appropriately risky decisions in the context of a company facing financial difficulties.

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