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Feature

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The Fiduciary Duties of Directors of Troubled Companies

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Directors and officers of financially distressed companies often face complicated, high-pressure decisions in fulfilling their fiduciary duties. For years, practitioners, legal scholars and even judges had struggled with whether (and when) directors and officers owed such duties to creditors as a company approached or entered insolvency. Courts in Delaware — the state of incorporation for many U.S. companies — have sought to clarify the issue in two seminal decisions of the past decade. The decisions in these cases, *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*[2] and *Trenwick America Litigation Trust v. Ernst & Young*,[3] held that the duties owed to the corporation do not change as it nears insolvency or becomes insolvent. Rather, creditors simply become the principal residual beneficiaries of those duties.[4] The Delaware judiciary has recently continued to interpret and apply these decisions.

In *Quadrant Structured Products Co. v. Vertin*,[5] Vice Chancellor J. Travis Laster of the Delaware Court of Chancery expounded on *Gheewalla* and *Trenwick*. The opinion is notable for applying the "business-judgment rule" to certain decisions of non-independent directors of an insolvent firm. The *Quadrant* court held that a board decision that can rationally be intended to benefit the corporation as a whole and does not provide specific, direct benefits to any particular class of subordinated stakeholders is entitled to the protection of the business-judgment rule. The board decision at issue in *Quadrant* was the adoption of a riskier investment strategy. Since the company was insolvent, the senior creditors bore that increased risk, while junior creditors and equityholders stood to reap any rewards from the riskier strategy. Conversely, the *Quadrant* court applied the much stricter "entire fairness" standard to certain board decisions that did impart direct, specific transfers of value to certain classes of stakeholders.

Fiduciary Duties under Delaware Law

Under Delaware law, directors owe a duty of loyalty and a duty of care. The duty of loyalty obligates directors to act in good faith, in the best interests of the corporation, and to refrain from self-dealing or other acts that would confer an improper personal benefit from a director's relationship with the corporation. The duty of care requires that directors inform themselves of material and relevant information that is reasonably available to them and to act with "requisite care."[6] The standard of care that a director is held to has been described as "less exacting than simple negligence."[7]

In the discharge of their fiduciary duties, directors are generally subject to — and protected by — the business-judgment rule whereby the directors of a corporation are presumed to have acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the company. The party opposing the board's decision bears the burden of rebutting the presumption. Generally, absent evidence of an abuse of discretion, the decisions of disinterested directors — even if it turns out to have been wrong or ill-considered — will be insulated from liability by the business-judgment rule.

However, boards are not always protected by the business-judgment rule. For example, if board

1 The authors thank Jordan Weber for his help in preparing this article.
2 930 A.2d 92 (Del. 2007).
3 906 A.2d 168 (Del. Ch. 2006). Although the opinion in *Trenwick* was penned by the Delaware Court of Chancery, the opinion and its reasoning were expressly affirmed by the Delaware Supreme Court. *Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007). Statements from *Trenwick* quoted herein are from the court of chancery's decision.
4 *Gheewalla*, 930 A.2d at 101-02 (quoting *Prod. Res. Grp. LLC v. NCT Grp. Inc.*, 863 A.2d 772, 794 n.67 (Del. Ch. 2004)).
5 102 A.3d 155 (Del. Ch. 2014).
6 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).
7 *Id.* at 812 n.6 (collecting cases).

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members confront "actual conflicts of interest" that preclude a decision that was made by a disinterested, independent board majority, the decision is subject to a much more stringent "entire fairness" review, which has both procedural and substantive components.[8] Under this standard, the burden is on the director to prove that he/she properly discharged his/her fiduciary duties.

Fiduciary Duties When a Corporation Is Insolvent or Nearly Insolvent

Before *Gheewalla* and *Trenwick*, practitioners, legal scholars and judges endeavored to interpret certain judicial decisions that spoke of a shift of duties to creditors when a company is in the "zone of insolvency" or is insolvent. The genesis of the idea that duties might be owed directly to creditors of insolvent firms came from the primary pre-*Gheewalla* Delaware case on the matter, *Bovay v. H.M. Byllesby & Co.*, which described the insolvent firm as property "administered in equity as a trust" for creditors.[9] Later, a "famous" footnote, penned by Chancellor William Allen in his *Credit Lyonnais* opinion, discussed the potentially divergent interests of creditors and shareholders in the "vicinity of insolvency."[10] These and other decisions led many to conclude that fiduciary duties shift from shareholders to creditors when a company slips into insolvency.

Gheewalla put an end to any notion of shifting duties or a zone of insolvency. Specifically, the court confirmed that directors' duties always run to the corporation, and that creditors become the beneficiaries of these duties only after a corporation actually becomes insolvent. Upon insolvency, the "creditors take the place of the shareholders as the residual beneficiaries of any increase in value," which in turn grants creditors standing to bring derivative — but not direct — actions.[11] Decisions in the wake of *Gheewalla* have echoed that reasoning.[12]

Trenwick, like *Gheewalla*, focused on the continuity and commonality of the relevant fiduciary duties rather than on any discontinuity.[13] Under the *Trenwick* decision, whether the corporation is solvent, insolvent or unknowably in transition, the duties of directors are essentially the same: "to pursue value maximizing strategies" for the benefit of the corporation.[14] By focusing on the unchanging nature of the fiduciary duties that are owed to the corporation, these cases together provide a relatively straightforward framework for the application of fiduciary duties.

8 *In re Trados Inc. S'holder Litig. (Trados II)*, 73 A.3d 17, 35-36 (Del. Ch. 2013). As *Trados II* details, Delaware law also applies an "enhanced scrutiny" standard, which is an intermediate level of scrutiny of board decisions between the business-judgment rule and entire fairness review. *Id.* Enhanced scrutiny applies when the board faces "potential conflicts of interest because of the decisional dynamics present in particular recurring and recognizable situations." *Id.*

9 38 A.2d 808, 813 (Del. 1944).

10 *Quadrant*, 102 A.3d at 174 (quoting *Credit Lyonnais Bank Nederland NV v. Pathe Commc'ns Corp.*, 17 Del. J. Corp. L. 1099, 1159 n.55 (Del. Ch. Dec. 30, 1991)).

11 *Gheewalla*, 930 A.2d at 101.

12 *See Wells Fargo Bank NA v. Konover*, No. 3:05-CV-1924 CFD, 2011 U.S. Dist. LEXIS 32079, at *61 n.36 (D. Conn. March 28, 2011) (recognizing that directors do not owe fiduciary duties to creditors during hypothetical "zone of insolvency"); *RSL Commc'ns PLC v. Bildirici*, 649 F. Supp. 2d 184, 206 (S.D.N.Y. 2009) (considering contract-based and other protections afforded to creditors, shifting of directors' fiduciary duties to creditors upon entering "zone of insolvency" would result in "redundant legal protections to creditors, while impeding corporations' ability to recruit qualified directors, generate capital, and serve their general wealth-maximizing function").

13 *See Shandler v. DLJ Merch. Banking Inc.*, C.A. No. 4797-VCS, 2010 Del. Ch. LEXIS 154, at *55-56 (Del. Ch. July 26, 2010) (citing *Gheewalla* and *Trenwick* for proposition that directors always have duty to exercise their good faith business judgment to try to maximize value of corporation, not to advance interests of particular class of creditors).

14 906 A.2d at 175.

Directors May Pursue Strategies that Carry Risk and Continue to Be Protected by the Business-Judgment Rule

The *Trenwick* decision also affirmed that the business-judgment rule allows directors of both insolvent and solvent enterprises to engage in appropriate, calculated risk-taking with the aim of adding value to their firms. The *Trenwick* court noted that directors are free and "expected to seek profit for stockholders, even at risk of failure," whether or not their companies may be insolvent.[15] As long as the directors acted with due diligence and good faith, the business-judgment rule protects them from liability, regardless of outcome: "That [a board's] strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action."[16] Under the *Trenwick* decision, disinterested directors remain protected by the business-judgment rule from most subsequent second-guessing by courts and other constituencies, even in cases of insolvency.

> ***Quadrant* should encourage and protect directors — even if they are not disinterested — to engage in business activities that they ... believe to be in the best interest of the corporation, even if they increase risk for all or only certain of the corporation's stakeholders.**

The *Quadrant* Case

Background

Athilon Capital Corp., through its wholly owned subsidiary, sold credit protection to large financial institutions in the form of credit-default swaps on senior collateralized debt obligations, such as mortgage-backed securities. Essential to this business model was the maintenance of a AAA credit rating, which rested in part on the company's prior agreement to comply with various constraints in its operating guidelines that limited the risk that it could assume. In the event that Athilon ran afoul of certain financial conditions defined in its operating guidelines, the company would enter a "runoff," which mandated an eventual liquidation of the enterprise.

Athilon funded its business by issuing several tranches of notes in three series: senior subordinated notes, subordinated notes and junior subordinated notes. Athilon suffered heavy losses in the wake of the recent financial crisis, and its runoff provision was triggered in August 2010.

Meanwhile, EBF & Associates began investing in Athilon, eventually acquiring all of the outstanding equity and outstanding junior subordinated notes at deeply discounted prices. Pursuant to its new control of Athilon, EBF appointed four of the five board directors. Two of these newly appointed directors were employed and compen-

15 *Id.* at 174.

16 *Id.* at 205.

sated by EBF, and the third was a former employee. After the EBF takeover, Quadrant Structured Products Co. Ltd. purchased the senior subordinated notes and subordinated notes of Athilon. After holding the notes for several months, Quadrant brought a derivative suit against the directors of Athilon and EBF, claiming, on behalf of the corporation, a breach of the fiduciary duty of loyalty owed to the corporation and its stakeholders.

Claims of Breach of Fiduciary Duties in *Quadrant*

In its derivative claims against the Athilon directors, Quadrant asserted that Athilon was insolvent and that to maximize the value of the enterprise would require liquidating the business. Quadrant argued that the Athilon board, under the control of EBF, instead transferred value from Athilon to EBF without appropriate compensation. Quadrant made three primary allegations: The board caused Athilon to (1) unnecessarily pay interest on the bonds owned by EBF, even though such payments could be deferred without penalty under the indenture; (2) pay exorbitant fees to EBF's affiliates for services that were far above the market rate; and (3) engage in a speculative change in the company's investment strategy for the sole benefit of EBF and at the expense of other stakeholders of the corporation. Athilon allegedly abandoned its low-risk business model by casting off the constraints under which it originally operated when the creditors invested. As holders of out-of-the-money residual claims in the equity and subordinated debt, the complaint argued, EBF faced no downside risk of failure of the Athilon investments, but stood to reap all of the benefits from the new high-risk strategy.

The Decision in *Quadrant*

Vice Chancellor Laster, in adjudicating the motion to dismiss Quadrant's complaint, held that the claims alleging unnecessary payment of interest and the payment of excessive fees would not be dismissed. Rather, the court held that these payments could be found to be transfers of value to a distinct constituency at the expense of the corporation. Given EBF's influence on the board, the court opined that these transactions would be subject to an entire fairness review. As for the claims of breach of fiduciary duty in shifting to a riskier business strategy, the vice chancellor's opinion held that the business-judgment rule applied and, in light of the pleaded facts, shielded the directors from liability as a matter of law.

In addition to reaffirming *Trenwick*'s holding that directors can still undertake risky ventures in a good-faith attempt to maximize the corporation's value, *Quadrant* went further and held that even *non-independent* directors have the protection of the business-judgment rule in that circumstance. Even assuming the truth of the facts of the complaint, that the senior creditors would bear the risk of loss, and the junior debt and equity would enjoy the upside, the non-independent directors (appointed by the owners of the junior subordinated debt and equity) were still entitled to the most deferential standard of review.

Quadrant extends strong protection to decisions that "appear rationally designed to increase the value of the firm as a whole."[17] Under its reasoning, even board decisions that benefit one class of stakeholders, by transferring the risk borne by one group of residual claimants to another, should be protected by the business-judgment rule as long as they affect the entire business and do not confer "direct or specific benefits" to one group.[18] However, not all board decisions will satisfy these criteria, and any decision by non-independent directors that provides direct and specific benefits to one group of stakeholders is likely to be reviewed under a more stringent standard.

Conclusion

Vice Chancellor Laster's opinion in *Quadrant* differentiates between apparent self-dealing through direct and specific transfers of value and decisions that affect the corporation overall, even though the risks and rewards of such decisions are borne unequally by classes of stakeholders. The borders between these two types of decisions are not always clear and will likely be the subject of future litigation. But much has stayed the same since *Gheewalla* and *Trenwick*: Both before and after insolvency, directors' duties are and remain to inform themselves of the pertinent facts, act with requisite care and strive to maximize the value of the entire corporation.

Quadrant should encourage and protect directors — even if they are not disinterested — to engage in business activities that they, in good faith, believe to be in the best interest of the corporation, even if they increase risk for all or only certain of the corporation's stakeholders. In all events, directors of distressed companies should also remain informed of the material and relevant information in the decision-making process, and should seek appropriate legal advice to ensure they are faithfully discharging their duties of loyalty and care. abi

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17 *Quadrant*, 102 A.3d at 187-88.

18 *Id.* at 190.