DELAWARE'S SOLVENCY TEST: WHAT IS IT AND DOES IT MAKE SENSE? A COMPARISON OF SOLVENCY TESTS UNDER THE BANKRUPTCY CODE AND DELAWARE LAW

BY ROBERT J. STEARN, JR. AND CORY D. KANDESTIN*

ABSTRACT

Whether a firm is solvent or not has important consequences under both Delaware state law and federal bankruptcy law. However, unlike federal bankruptcy law, which uses uniform statutory tests to determine solvency, Delaware corporate law has no uniform tests. Instead, Delaware's solvency tests have their origins in common law jurisprudence, and the tests are inconsistently defined and applied. This article examines the ambiguities in Delaware solvency law and recommends that the Delaware courts clarify the law and adopt uniform solvency tests.

I. INTRODUCTION

Insolvency currently is a hot topic in corporate law, with the discussion focused primarily on how it affects directors' fiduciary duties. In this article, we do not wade into that discussion. Instead, we write about a more fundamental subject: how does Delaware law determine when a corporation is insolvent?

Delaware law recognizes that a corporation is insolvent if it fails either of two tests: the "balance sheet" test or the "cash flow" test.[1] These tests are not statutorily defined; rather, they developed in case law[2] and the courts have not defined the tests uniformly. In some instances, Delaware cases define the balance sheet test in its "traditional" sense, where an entity is insolvent if it "has liabilities in excess of a reasonable market value of assets

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*Mr. Stearn is a director of, and Mr. Kandestin an associate at, Richards, Layton & Finger, P.A. ("RLF") in Wilmington, Delaware. The views expressed in this article are those of the authors and not necessarily those of RLF or any of its clients. The authors wish to thank Gregory V. Varallo, William J. Haubert and Russell C. Silberglied of RLF for their invaluable editorial assistance.

[1] *See, e.g.*, U.S. Bank Nat'l Ass'n v. U.S. Timberlands Klamath Falls, L.L.C., 864 A.2d 930, 947 (Del. Ch. 2004), *vacated on other grounds*, 875 A.2d 632 (Del. 2005).

[2] *See, e.g.*, Blackmore Partners, L.P. v. Link Energy L.L.C., 2005 WL 2709639, at *6 (Del. Ch. Oct. 14, 2005) ("[I]nsolvency [is] defined not as statutory insolvency but as insolvency in fact."), *reprinted in* 31 DEL. J. CORP. L. 672, 681 (2006).

held."[3] Other cases, however, have applied what appears to be a narrower balance sheet test, where insolvency occurs when a company has "a deficiency of assets below liabilities *with no reasonable prospect that the business can be successfully continued in the face thereof*."[4] Likewise, no Delaware case specifies whether to apply the cash flow test in a forward-looking manner or a present manner. The forward-looking version asks whether the company will be able to pay its debts as they become due in the near future, whereas the present version of the test simply asks whether the debtor currently is paying its debts.

As it now stands, Delaware case law on solvency is confusing and can lead to inconsistent results. Indeed, the precedent that a court chooses to follow may be outcome determinative. This uncertainty stands in stark contrast with federal bankruptcy law, which—because its solvency tests are statutory—imposes uniform tests to measure solvency.

In this article, we suggest that Delaware courts should adopt the traditional balance sheet test and the forward-looking cash flow test. We begin by comparing the federal bankruptcy and Delaware solvency tests in more detail. We then explain the inconsistencies that have developed in Delaware's balance sheet jurisprudence. We trace these inconsistencies back over a century to determine their origin, which is found in old Court of Chancery receivership cases. These cases held that to appoint a receiver for a Delaware company, a plaintiff had to do two things: prove the company's insolvency *and* convince the court to exercise its discretion to appoint a receiver. Proving insolvency was a "jurisdictional fact"—it granted the court jurisdiction to consider the case. Convincing the court to exercise its discretion was a separate inquiry. Sensibly, in many cases the court was unwilling to wrest control of an insolvent corporation from a board that honestly and diligently was endeavoring to reverse the corporation's fortune. Instead, the court appointed a receiver only if, in addition to being insolvent, the corporation had no reasonable prospect of continuing. Over the years, courts began treating these two separate inquiries as one: for a receiver to be appointed, a company's liabilities must exceed its assets "with no reasonable

[3]Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 195 n.74 (Del. Ch. 2006) (quoting Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 789 (Del. Ch. 1992)); *see also Blackmore Partners*, 2005 WL 2709639, at *3 (applying traditional balance sheet test and concluding that the company was insolvent at the relevant time), *reprinted in* 31 DEL. J. CORP. L. at 677-78.

[4]Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 782 (Del. Ch. 2004) (emphasis added) (quoting Siple v. S & K Plumbing & Heating, Inc., 1982 WL 8789, at *2 (Del. Ch. Apr. 13, 1982), *reprinted in* 7 DEL. J. CORP. L. 504, 507-08 (1982)).

prospect that the business can be continued in the face th[e]reof."[5] Fiduciary duty cases later borrowed this shorthand standard. We discuss how the standard makes sense in receivership cases, but the "no reasonable prospect" requirement leads to potentially anomalous results in fiduciary duty cases.

Next, we analyze Delaware's cash flow test. Delaware cases offer little guidance about whether the test is forward-looking or present-looking. Those cases employing the test use ambiguous language from which it is difficult to decipher which version of the test is being applied.

We conclude that the better tests to apply are the traditional balance sheet test and the forward-looking cash flow test, because they are more consistent with the policies underlying Delaware fiduciary duty law for financially distressed firms. Delaware law recognizes that when a corporation becomes insolvent-in-fact, its creditors gain standing to sue derivatively on behalf of the corporation because they become the corporation's primary residual beneficiaries.[6] The most appropriate point to mark this "shift" is when equity's value reaches $0: that is when the case law recognizes that stockholders may prefer a course of action (such as a high risk strategy) different from the course of action that may be best for the corporation itself.[7] The "traditional" balance sheet test marks this point at which interests shift because it measures when equity falls below $0 without any additional qualifiers. By contrast, the "no reasonable prospect" version would miss this point in time and treat a corporation as insolvent only when it is doomed—too late for the creditors to do much about it. Thus, the traditional balance sheet test is more consistent with Delaware case law suggesting that creditors should be able to protect their interests at a time when the corporation's directors may feel compelled to roll the dice in the hope of creating equity value.[8] Likewise, the "forward-looking" cash flow test would allow creditors to serve as a check on the corporation at a time when their interests may be more aligned with the corporation's interests than are stockholder interests. Adopting these two tests in fiduciary duty cases would lead to conceptually consistent results and bring more clarity to the present state of Delaware solvency law.

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[5]Siple v. S & K Plumbing & Heating, Inc., 1982 WL 8789, at *2 (Del. Ch. Apr. 13, 1982), *reprinted in* 7 DEL. J. CORP. L. 504, 508 (1982).

[6]*See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101-02 (Del. 2007).

[7]*See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 DEL. J. CORP. L. 1099, 1155 n.55 (1992).

[8]*See Credit Lyonnais*, 1991 WL 277613, at *34 n.55, *reprinted in* 17 DEL. J. CORP. L. at 1155 n.55.

II. WHY SOLVENCY MATTERS

A. *Why Solvency Matters In Bankruptcy*

Though counterintuitive, a debtor need not be insolvent to file for bankruptcy, so solvency tests rarely come into play for that purpose.[9] However, they appear in other common scenarios, primarily avoidance actions.[10]

Section 547 of the Bankruptcy Code (governing preferential transfers)[11] allows a debtor to recover certain transfers that it made within the 90 days before bankruptcy if, among other things, the debtor was insolvent at the time.[12] The Bankruptcy Code presumes that a debtor is balance sheet insolvent for the entire 90-day "reach back" period,[13] but a party may rebut that presumption with "some evidence" of solvency.[14] If the party succeeds in rebutting the presumed insolvency, then the debtor must prove its insolvency as if the presumption never existed.[15]

Like section 547, section 548 of the Bankruptcy Code (governing fraudulent transfers)[16] requires a showing of insolvency. If a debtor transferred property for less than its value in the two year period before the bankruptcy, then the debtor may recover that transfer if it can show that it was insolvent at the time of the transfer under one of three tests (discussed further below).[17]

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[9] *In re* SGL Carbon Corp., 200 F.3d 154, 163 (3d Cir. 1999) ("It is well established that a debtor need not be insolvent before filing for bankruptcy protection." (citations omitted)). Although a debtor need not be insolvent to file, occasionally such a filing is *so* premature or unnecessary that it cannot support a valid bankruptcy purpose (*i.e.*, to reorganize or to preserve value that would be lost outside of bankruptcy). In such a case, a court may dismiss the petition as a bad faith filing. Whether a debtor is financially healthy is a factor courts will consider. *See, e.g.*, *id*.

[10] *See* Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P, 906 A.2d 168, 199 (Del. Ch. 2006) (explaining additional remedies available to creditors when a corporation is insolvent).

[11] 11 U.S.C. § 547 (2006).

[12] 11 U.S.C. § 547(b)(3).

[13] *E.g.*, Homeplace of Am., Inc. v. Salton, Inc. (*In re* Waccamaw's Homeplace), 325 B.R. 524, 528 (Bankr. D. Del. 2005) ("[T]he debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition." (quoting 11 U.S.C. § 547(f) (2000))).

[14] *Id.* at 529.

[15] *See, e.g.*, Union Meeting Partners v. Lincoln Nat'l Life Ins. Co. (*In re* Union Meeting Partners), 163 B.R. 229, 239 (Bankr. E.D. Pa. 1994) (citations omitted); *see also* Robert J. Stearn, Jr., *Proving Solvency: Defending Preference And Fraudulent Transfer Litigation*, 62 BUS. LAW. 359, 365-66 (2007) (discussing the presumption of insolvency).

[16] 11 U.S.C. § 548 (2006).

[17] The bankruptcy version of fraudulent transfer law is similar to Delaware's state law version (modeled on the Uniform Fraudulent Transfer Act), found at 6 *Del. C.* § 1301 *et seq.*

Solvency also becomes an issue when a seller seeks to reclaim goods that it sold to a debtor prior to the bankruptcy. In some circumstances, the Bankruptcy Code allows the vendor to reclaim goods that it sold to the debtor in the 45 day period before the bankruptcy, but only if the debtor was insolvent at the time.[18] The standard balance sheet test applies.[19]

Additionally, a solvency fight may occur when a group of equity holders tries to form an official committee.[20] To form a committee, the equity holders must show a substantial likelihood that they will receive a distribution from the debtor.[21] This usually involves determining whether the debtor is balance sheet solvent.[22] From a bird's eye view, this is the flip side of what occurs in Delaware's Court of Chancery—bankruptcy law presumes that stockholders have no interest unless they can establish solvency,[23] whereas Delaware corporate law presumes that stockholders are the primary stakeholders unless a corporation is proven to be insolvent.[24] These seem to be different sides of the same issue, both of which depend on marking the point at which equity's value reaches $0. Yet Delaware's solvency law may lead to inconsistent results when compared with federal bankruptcy law, depending on which Delaware solvency test is used.

B. *Why Solvency Matters In Delaware*

Like in federal bankruptcy law, solvency is an important concept in

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[18] 11 U.S.C. § 546(c).

[19] *Id.*

[20] *See, e.g.*, *In re* Spansion, Inc., 421 B.R. 151 (Bankr. D. Del. 2009).

[21] *Id.* at 156 (explaining that the moving party must show a substantial likelihood through a "strict application of the absolute priority rule").

[22] *See id.* at 156-63 (evaluating the debtors' solvency under the balance sheet test to determine whether to appoint an official committee to represent the debtors' shareholders).

[23] *See* Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1490 (1993). Miller explains:

> Because the Bankruptcy Code provides that creditors have priority over stockholders in the hierarchy of dividends and distributions of consideration, the argument may be made that an insolvent debtor should pursue actions that further the interests of creditors despite the potentially negative effect on its stockholders. Because stockholders of an insolvent debtor are entitled to no distribution under a plan of reorganization if the absolute priority rule is applied, the argument may be made that stockholders of an insolvent corporation in chapter 11 have no pecuniary interest in the case.

Id.

[24] *See, e.g.*, Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 790-91 (Del. Ch. 2004) ("By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders—that of residual risk-bearers.").

Delaware state law. Most prominently, it is the point at which creditors of a corporation gain standing to assert fiduciary duty claims on the corporation's behalf.[25] For some time, uncertainty existed about how to describe this shift (if "shift" is the correct characterization) and thus when the shift occurred.

The uncertainty arose from a debate sparked by one of the most famous footnotes in corporate law history, footnote 55 in the *Credit Lyonnais* case.[26] Footnote 55 elaborated on Chancellor Allen's statement in *Credit Lyonnais* that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."[27] The Chancellor's point was that directors of a financially distressed corporation who believe that they must make decisions solely for the benefit of stockholders will not necessarily make the best decision from the corporation's perspective—what is best for stockholders is not always what is best for the corporation. Thus, directors that are capable of conceiving of the corporation as a separate entity may achieve results that are more efficient and fair than directors that are beholden to the interests of any single constituency.[28]

Footnote 55 sparked a debate about the hazy nature of directors' duties in the "zone of insolvency."[29] Without knowing what those duties were or when they came into being, it was difficult to understand the significance of a firm's insolvency. The Delaware Supreme Court lifted some of the haze in its 2007 *Gheewalla* decision, where it brought clarity to the law by holding that directors of a solvent corporation in the zone of insolvency owed no direct duty to creditors.[30] The Court also held that directors of an *insolvent* firm owed no direct duty to creditors:[31]

> To recognize a new right for creditors to bring direct fiduciary

[25] *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007) ("[I]ndividual *creditors* of an *insolvent* corporation have *no right to assert direct* claims for breach of fiduciary duty against corporate directors. Creditors may nonetheless protect their interests by bringing derivative claims on behalf of the insolvent corporation.") (emphasis in original).

[26] Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp, 1991 WL 277613, at *34 n.55 (Del. Ch. 1991), *reprinted in* 17 DEL. J. CORP. L. 1099, 1155 n.55 (1992).

[27] *Id.* at *34, *reprinted in* 17 DEL. J. CORP. L. at 1155.

[28] *Id.*, *reprinted in* 17 DEL. J. CORP. L. at 1155 n.55.

[29] *See, e.g.*, *Gheewalla*, 930 A.2d at 99 nn.27-28 (citing case law and numerous articles on the topic); U.S. Bank Nat'l Ass'n v. U.S. Timberlands Klamath Falls, L.L.C., 864 A.2d 930, 948 (Del. Ch. 2004) ("[T]he so-called zone of insolvency has not been clearly defined . . . .").

[30] *Gheewalla*, 930 A.2d at 101.

[31] *Id.* at 103.

> claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors.[32]

Instead, an insolvent corporation's creditors could bring derivative claims on behalf of the corporation for breach of fiduciary duty.[33]

Post-*Gheewalla*, the significance of insolvency is now clear. It marks a shift in Delaware law, though that shift does not refer to an actual shift of duties *to* creditors (duties do not shift to creditors). Instead, the shift refers primarily to standing: upon a corporation's insolvency, its creditors gain standing to bring derivative actions for breach of fiduciary duty, something they may not do if the corporation is solvent, even if it is in the zone of insolvency.[34] Insolvency also may involve a subtler substantive shift affecting directors' focus as they carry out their fiduciary obligations.[35]

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[32] *Id.*

[33] *Id.* at 101-03.

[34] *Gheewalla*, 930 A.2d at 101-03. "Creditors may . . . protect their interest by bringing derivative claims on behalf of the insolvent corporation . . . ." *Id.* at 103.

[35] *Compare Gheewalla*, 930 A.2d at 101:

> When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment *in the best interests of the corporation for the benefit of its shareholder owners*.

Id. (emphasis added), *and* Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 787 (Del. Ch. 2004):

> [O]ur corporate law (and that of most of our nation) expects that the directors of a solvent firm will cause the firm to undertake economic activities that maximize the value of the firm's cash flows primarily for the benefit of the residual risk-bearers, the owners of the firm's equity capital. So long as the directors honor the legal obligations they owe to the company's creditors in good faith, as fiduciaries they may pursue the course of action that they believe *is best for the firm and its stockholders*.

Id. (emphasis added) (footnote omitted), *with Gheewalla*, 930 A.2d at 101 ("When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value."), *and Prod. Res.*, 863 A.2d at 790-91:

> When a firm has reached the point of insolvency . . . [t]he directors continue to have the task of attempting to maximize the economic value of the firm . . . . *But the fact of insolvency does necessarily affect the constituency on whose behalf the directors are pursing that end. By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders—that of residual risk-bearers*.

Id. (emphasis added) (footnote omitted).

Solvency also plays a role outside of Delaware fiduciary duty law. The fact of insolvency creates jurisdiction for the Court of Chancery to appoint a corporate receiver under 8 *Del. C.* § 291.[36] Concepts similar to balance sheet solvency also affect whether a corporation may pay dividends under 8 *Del. C.* § 170[37] or redeem or repurchase its own stock under 8 *Del. C.* § 160.[38] Finally, as in bankruptcy, solvency plays a role in Delaware's fraudulent transfer statute.[39]

III. THE SOLVENCY TESTS

A. *The Bankruptcy Tests*

1. Balance Sheet Test

The Bankruptcy Code sets out a uniform test for solvency, commonly referred to as the balance sheet test: "[t]he term 'insolvent' means . . . financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation."[40] The definition requires that assets be valued at a "fair valuation," although the Bankruptcy Code does not define "fair valuation."[41] What is clear, however, is that the balance sheet test does not involve a simple comparison of balance sheet assets and liabilities:

> While the inquiry is labeled a "balance sheet" test, the court's insolvency analysis is not literally limited to or constrained by the debtor's balance sheet. Instead, it is appropriate to adjust items on the balance sheet that are shown at a higher or lower

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[36] DEL. CODE ANN. tit. 8, § 291 (2001) ("Whenever a corporation shall be insolvent, the Court of Chancery, on the application of any creditor or stockholder thereof, may, at any time, appoint 1 or more persons to be receivers of and for the corporation . . . .").

[37] DEL. CODE ANN. tit. 8, § 170 (2001) (providing, *inter alia*, that dividends may be paid out of surplus).

[38] DEL. CODE ANN. tit. 8, § 160 (2001) ("[N]o corporation shall: (1) Purchase or redeem its own shares of capital stock for cash or other property when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation").

[39] *See* DEL. CODE ANN. tit. 6, § 1301 *et seq.* (2005) (generally requiring proof of insolvency to establish constructively fraudulent transfers.)

[40] 11 U.S.C. § 101(32)(A) (2006); *see also* Stearn, *supra* note 15, at 360-64 (discussing the Bankruptcy Code balance sheet test).

[41] *See, e.g.*, Stearn, *supra* note 15, at 361 (discussing the fact that the key term "fair valuation" is not defined in the Bankruptcy Code).

> value than their going concern value and to examine whether assets of a company that are not found on its balance sheet should be included in its fair value.[42]

Accounting and GAAP figures are not dispositive.[43] Contingent assets and liabilities must be considered.[44] Given the subjective nature of these concepts, solvency disputes frequently center on the appropriate valuation of a debtor's assets, and occasionally its contingent liabilities.[45]

2. Other Tests

One provision of the Bankruptcy Code incorporates two additional solvency tests. Section 548, which addresses fraudulent transfers,[46] provides that a transfer may be avoided if, among other things, it was made while the debtor was unable to pay its debts as they came due.[47] This is the cash flow test. To apply the test, an overall assessment must be made of the debtor's liquidity, which then should be compared to projected debt payments.[48] Bankruptcy's version of the test includes a subjective component—knowledge that the transfer will leave the debtor with insufficient liquidity to satisfy its obligations.[49] Also, the test is forward-looking—it focuses on the

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[42]Peltz v. Hatten, 279 B.R. 710, 743 (Bankr. D. Del. 2002) (citations omitted); *see also* Stearn, *supra* note 15, at 361 (noting that the balance sheet is only a starting point and collecting additional cases).

[43]Stearn, *supra* note 15, at 361; *see also* EBC I, Inc. v. Am. Online, Inc. (*In re* EBC I, Inc.), 380 B.R. 348, 358 (Bankr. D. Del. 2008); Miller v. Barenberg (*In re* Bernard Techs., Inc.), 398 B.R. 526, 530-31 (Bankr. D. Del. 2008).

[44]*See, e.g.*, Mellon Bank, N.A. v. Official Comm. Unsecured Creditors (*In re* R.M.L., Inc.), 92 F.3d 139, 156 (3d Cir. 1996) (noting that "if a debtor's treatment of an item as an 'asset' depends for its propriety on the occurrence of a contingent event, a court must take into consideration the likelihood of that event occurring from an objective standpoint"); Advanced Telecomms. Network, Inc. v. Allen (*In re* Advanced Telecomms. Network, Inc.), 321 B.R. 308, 335 (Bankr. M.D. Fla. 2005) ("In making a determination as to solvency, both contingent liabilities and contingent assets are appropriately considered."), *rev'd on other grounds,* 490 F.3d 1325, 1335 (11th Cir. 2007).

[45]*See* Stearn, *supra* note 15, at 363 ("Although application of the balance sheet test can lead to any number of disputes, in almost every case the primary debate will be about the value of the debtor's assets. Indeed, solvency battles generally morph into valuation fights."). Unless they are contingent, liabilities are valued at their face value. *See, e.g.,* Travellers Int'l AG v. Trans World Airlines, Inc. (*In re* Trans World Airlines, Inc.), 134 F.3d 188, 196-98 (3d Cir. 1998).

[46]11 U.S.C. § 548 (2006).

[47]11 U.S.C. § 548(a)(1)(B)(ii)(III) (2006) ("The trustee may avoid any transfer . . . if the debtor voluntarily or involuntarily . . . intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.").

[48]*See* Stearn, *supra* note 15, at 394 (discussing the application of the cash flow test).

[49]11 U.S.C. § 548(a)(1)(B)(ii)(III) (2006) ("[I]ntended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured."); *see*

debtor's ability to pay debts as they mature.[50]

A transfer also may be avoided if, among other things, at the time of the transfer the debtor "was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital."[51] The Bankruptcy Code does not define the term "unreasonably small capital," but case law generally has interpreted it to mean "the inability to generate sufficient profits to sustain operations,"[52] also taking into account the company's access to credit.[53] Thus, a court should consider all reasonably anticipated sources of operating funds.[54] Although similar to the cash flow test, the unreasonably small capital test stops short of cash flow insolvency.[55] Accordingly, a company that is solvent under the unreasonably small capital test also likely is solvent under the cash flow test.[56]

B. *Delaware Solvency Tests*

Delaware solvency law generally does not have a statutory basis like the Bankruptcy Code and instead has developed from years of common law jurisprudence. There are a few discrete areas of Delaware law that do have statutory definitions of insolvency, such as Delaware's fraudulent transfer statute[57] and commercial code.[58] Outside of these statutory exceptions,

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also Stearn, *supra* note 15, at 391-93 (explaining the difficulty in proving § 548's subjective element).

[50]11 U.S.C. § 548(a)(1)(B)(ii)(III); Kipperman v. Onex Corp., 411 B.R. 805, 836 (N.D. Ga. 2009) ("[W]hether a debtor is able to pay its debts as they become due[ ] is a forward-looking standard."); *see also* Stearn, *supra* note 15, at 393-94 (discussing how to apply the cash flow test).

[51]11 U.S.C. § 548(a)(1)(B)(ii)(II) (2006); *see also* Stearn, *supra* note 15, at 385-91 (discussing the "unreasonably small capital" test).

[52]Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1070 (3d Cir. 1992).

[53]*See* EBC I, Inc. v. Am. Online, Inc. (*In re* EBC I, Inc.), 380 B.R. 348, 359 (Bankr. D. Del. 2008) ("[T]he unreasonably small capital test . . . analyzes whether at the time of the transfer the company had insufficient capital, including access to credit, for operations."); *see also* MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 944 (S.D.N.Y. 1995) ("The [unreasonably small capital] test is aimed at transferees that leave the transferor technically solvent but doomed to fail."); Stearn, *supra* note 15, at 387 ("[A]ccess to sufficient credit, *standing alone*, may be significant evidence of adequate capital.").

[54]Peltz v. Hatten, 279 B.R. 710, 745 (Bankr. D. Del. 2002) (quoting *Moody*, 971 F.2d at 1072 n.24).

[55]*See Moody*, 971 F.2d at 1070 ("[U]nreasonably small capital denotes a financial condition short of equitable insolvency.").

[56]*See id.* at 1075 ("Because we assume the notion of unreasonably small capital denotes a financial condition short of equitable insolvency, it follows that the transaction did not render Jeanette equitably insolvent either."); *see also* Stearn, *supra* note 15, at 393 ("[A] company that passes the adequate capital test likely will pass the ability to pay debts test as a matter of course.").

[57]DEL. CODE ANN. tit. 6, § 1302(a) (2005) ("A debtor is insolvent if the sum of the debtor's

which apply to specific areas of law, Delaware common law applies, and Delaware common law has no uniform test.

1. Balance Sheet Test

Because it has developed from case law and not statute, Delaware's balance sheet test has been stated differently. Over the years, these varying definitions have evolved to the point of becoming borderline inconsistent. For example, some cases describe the test in its "traditional" sense—liabilities exceeding assets: "an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held."[59] Other cases, however, add a qualifier to the traditional test. These cases state that a company is insolvent if it has a "deficiency of assets below liabilities"[60] *and* there is "'no reasonable prospect that the business can be successfully continued in the face thereof.'"[61] On its face, the "no reasonable prospect" test is a narrower one; not only must a company's liabilities exceed the fair market value of its assets, but the company also must have no realistic hope of continuing to do business. Under this standard, fewer companies are insolvent.

The Delaware Bankruptcy Court's recent decision in *Teleglobe USA, Inc. v. BCE Inc.* demonstrates how a court's choice of standard may have an outcome determinative effect.[62] In *Teleglobe*, the court had to determine

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debts is greater than all of the debtor's assets, at a fair valuation."); § 1302(b) (2005) ("A debtor who is generally not paying debts as they become due is presumed to be insolvent.").

[58] *Id.* at § 1-201(23) ("'Insolvent' means: (A) Having generally ceased to pay debts in the ordinary course of business other than as a result of bona fide dispute; (B) Being unable to pay debts as they become due; or (C) Being insolvent within meaning of federal bankruptcy law.").

[59] Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 789 (Del. Ch. 1992); *see also* Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 195 n.74 (Del. Ch. 2006) (stating that "insolvency in fact occurs at the moment when the entity 'has liabilities in excess of a reasonable market value of assets held'" (quoting *Blackmore Partners*, 2005 WL 2709639, at *6, *reprinted in* 31 DEL. J. CORP. L at 681)); *Blackmore Partners*, 2005 WL 2709639, at *6 ("Under long established precedent, one of those circumstances is insolvency, defined not as statutory insolvency but as insolvency in fact, which occurs at the moment when the entity 'has liabilities in excess of a reasonable market value of assets held.'" (quoting *Geyer*, 621 A.2d at 789)), *reprinted in* 31 DEL. J. CORP. L. at 681; U.S. Bank Nat'l Ass'n v. U.S. Timberlands Klamath Falls, L.L.C., 864 A.2d 930, 947 (Del. Ch. 2004) (explaining that "a company may be insolvent if 'it has liabilities in excess of a reasonable market value of assets held.'" (quoting *Geyer*, 621 A.2d at 789)).

[60] N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 98 (Del. 2007).

[61] *Gheewalla*, 930 A.2d at 98 (quoting N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 2006 WL 2588971, at *10 (Del. Ch. Sept. 1, 2006), *reprinted in* 32 DEL. J. CORP. L. 612, 634-35 (2007); Prod. Res. Grp., L.L.C. v. NCT Grp., Inc, 863 A.2d 772, 782 (Del. Ch. 2004) (quoting Siple v. S & K Plumbing & Heating, Inc., 1982 WL 8789, at *2 (Del. Ch. Apr. 13, 1982), *reprinted in* 7 DEL. J. CORP. L. 504, 508 (Apr. 13, 1982)).

[62] Teleglobe USA, Inc. v. BCE Inc. (*In re* Teleglobe Commc'ns Corp.), 392 B.R. 561, 597 (Bankr. D. Del. 2008). RLF was counsel to the debtors (referred to in this discussion as the

whether a subsidiary could pierce a parent corporation's attorney-client privilege under the "fiduciary exception."[63] The answer to that question depended, in part, on whether the subsidiary was insolvent.[64] If not, then the parent corporation's fiduciary duties to the subsidiary "flowed back up to [the parent company] as the only party with a legitimate interest in [the subsidiary's] success,"[65] and the subsidiary could not invoke the fiduciary exception.[66] But "if [the subsidiary was] insolvent, then the[] creditors also had a legitimate interest in [the subsidiary's] success,"[67] and the subsidiary would be able to invoke the exception.[68]

Delaware law governed and the parties fought over which solvency standard to apply. Not surprisingly, the subsidiary (which wanted to show insolvency) argued for the traditional balance sheet test, while the parent (which wanted to show solvency) argued for the "no reasonable prospect" test.[69] The court acknowledged that the latter test was narrower and chose to apply it for two reasons.[70] First, the case was on remand from the Third Circuit, whose opinion cited (with no discussion and arguably in *dicta*) a definition of insolvency from the *Production Resources* case, which used the "no reasonable prospect" language.[71] Thus, the parent argued that the narrower test already was law of the case. Second, the Bankruptcy Court rejected the subsidiary's attempts to distinguish *Production Resources* because other Delaware cases also have used the "no reasonable prospect" language to determine insolvency for fiduciary duty purposes.[72] The Bankruptcy Court's decision to apply the narrower test, combined with its criticism of the methodology used by the subsidiary's solvency expert, meant defeat for the subsidiary on its privilege fight.[73]

"subsidiary").

[63]*Id.* at 597-98.

[64]*Id.*

[65]*Id.* (quoting Teleglobe USA, Inc. v. BCE Inc. (*In re* Teleglobe Commc'ns Corp.), 493 F.3d 345, 386 (3d Cir. 2007)).

[66]*Teleglobe*, 392 B.R. at 597.

[67]*Id.*

[68]*See id.*

[69]*Teleglobe*, 392 B.R. at 598-99.

[70]*Id.* at 599.

[71]Teleglobe USA, Inc. v. BCE Inc. (*In re* Teleglobe Commc'ns Corp.), 493 F.3d 345, 384 (3d Cir. 2007) ("Under Delaware law, a corporation is insolvent if it has '. . . a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof . . . .'" (quoting Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 782 (Del. Ch. 2004))).

[72]*Teleglobe*, 392 B.R. at 599 (citing N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 98 (Del. 2007)).

[73]*Id.* at 599-601. "While Teleglobe may have had a deficiency of assets below its liabilities without consideration of BCE's funding, the Court concludes that it did not lack reasonable prospects of continuing its business until April 23, 2002, when BCE announced that it would no

Teleglobe demonstrates the material difference between the two versions of the balance sheet test that have developed in Delaware case law. Given the importance of solvency analysis, especially in fiduciary duty cases involving distressed firms, the inconsistency in Delaware law on the subject gives rise to great uncertainty. Indeed, some cases applying the traditional standard cite to cases applying the narrower standard as if there was no difference between the two, when plainly there is.[74]

Where did this "no reasonable prospect" language come from? The answer is surprising. Almost no Delaware case in a century has had any substantive discussion of it. Most cite back to a previous case, which in turn cite to a previous case, and so on.

Working backwards, the chain begins with the Delaware Supreme Court's 2007 decision in *Gheewalla*.[75] In that case, the Supreme Court acknowledged that the Court of Chancery had defined insolvency using the "no reasonable prospect" standard, but the Supreme Court did not discuss the standard or acknowledge its difference from the more traditional standard. All that it wrote was:

> The Court of Chancery opined that insolvency may be demonstrated by either showing (1) "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof," or (2) "an inability to meet maturing obligations as they fall due in the ordinary course of business."[76]

Nor did the Court of Chancery in *Gheewalla* discuss the standard.[77] Instead, it cited four cases, two of which applied the traditional test and did not mention the phrase "no reasonable prospect."[78] The other two cases,

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longer fund Teleglobe." *Id.* at 601.

[74] *See, e.g.*, Banet v. Fonds De Regulation, 2009 WL 529207, at *3 (Del. Ch. Feb. 18, 2009) (using the traditional test but citing to *Production Resources*—a "no reasonable prospect" case—as authority).

[75] *Gheewalla*, 930 A.2d at 98.

[76] *Id.* (footnotes omitted).

[77] *See Gheewalla*, 2006 WL 2588971, at *10 (Del. Ch. Sept. 1, 2006) ("Insolvency may be demonstrated by either showing (1) 'a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof,' or (2) 'an inability to meet maturing obligations as they fall due in the ordinary course of business.'" (quoting Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 782 (Del. Ch. 2004))), *reprinted in* 32 DEL. J. CORP. L. 612, 634-35 (2007).

[78] McDonald v. Williams, 174 U.S. 397, 403 (1899) (defining an insolvent corporation as an entity with assets valued at less than its debts); Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 789 (Del. Ch. 1992) ("[A]n entity is insolvent when it has liabilities in excess of a reasonable market value of assets held.").

Production Resources and *Siple v. S & K Plumbing & Heating, Inc.*, used the phrase, but neither case discussed the significance of the words or applied them in an outcome determinative way.[79]

In *Production Resources*, the defendant attempted to invoke the phrase to prove that it was not insolvent because it still had a "reasonable prospect" of continuing its business in the face of its liabilities.[80] The court found, however, that the plaintiff sufficiently alleged that the defendant's "drastic circumstances" showed that it had no continuing viability.[81] So the case did not turn on which standard the court used— at least at the pleading stage, the defendant was insolvent either way. Thus, it did not matter which standard the court applied, and the court did not discuss the difference between the two.

Likewise, in *Siple*, a receivership case, the court cited older receivership cases without further discussing the "no reasonable prospect" standard.[82] It cited *Freeman v. Hare & Chase, Inc.*,[83] which in turn cited an older case, *Whitmer v. William Whitmer & Sons, Inc.*[84] *Whitmer* then cited the seminal case, *Atlantic Trust Co. v. Consolidated Electric Storage Co.*[85]

Atlantic Trust, a New Jersey case, appears to be the source of the "no reasonable prospect" language cited by the chain of cases above.[86] At issue in *Atlantic Trust* was whether the Court of Chancery should appoint a

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[79] *Prod. Res.*, 863 A.2d at 782 ("To meet the burden to plead insolvency, [the Plaintiff] must plead facts that show that [Defendant] has . . . 'a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof . . . .'" (citations omitted)); Siple v. S & K Plumbing & Heating, Inc., 1982 WL 8789, at *2 (Del. Ch. Apr. 13, 1982) ("Insolvency . . . may consist of a deficiency of assets below liabilities with no reasonable prospect that the business can be continued in the face th[e]reof . . . ."), *reprinted in* 7 DEL. J. CORP. L. 504, 508 (1982).

[80] *Prod. Res.*, 863 A.2d at 782-83.

[81] *Id.* at 783-84.

[82] *See Siple*, 1982 WL 8789, at *2, *reprinted in* 7 DEL. J. CORP. L. 507-08.

[83] 142 A. 793, 795 (Del. Ch. 1928) ("Insolvency . . . may be . . . a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof.").

[84] 99 A. 428, 430 (Del. Ch. 1916). The court observed:

> It is not true . . . that an inability to meet obligations as they accrue is the only definition of insolvency. An excess of liabilities over assets may constitute insolvency, unless it appear [sic] that there is a reasonable prospect that the business could be successfully continued notwithstanding the deficiency of assets . . . . In this case the deficiency of assets is the basis of the claim of insolvency.

Id. While *Siple* also cited *Kenny v. Allerton Corp.*, 151 A. 257, 258-59 (Del. Ch. 1930), that case primarily addressed the cash flow test.

[85] 23 A. 934, 936 (N.J. Ch. 1892).

[86] *Atl. Trust*, 23 A. at 936 (no support cited for the use of the phrase "no reasonable prospect").

receiver to wind up a corporation.[87] The court summarized the law as follows:

> The principle which I think should control the court in the exercise of this power is this: never to appoint a receiver unless the proof of insolvency is clear and satisfactory, *and* unless it also appears that there is no reasonable prospect that the corporation, if let alone, will soon be placed, by the efforts of its managers, in a condition of solvency.[88]

In other words, to appoint a receiver, a movant must first prove insolvency and then convince the court that the corporation's managers have no prospect of fixing the situation. This second requirement is distinct from the first and makes clear that the court need not appoint a receiver just because a corporation is insolvent. "It is thus seen that the establishment of the fact of insolvency does not make it the duty of the court to appoint a receiver in all cases and under all circumstances, but simply places it in a position where it must exercise its best discretion."[89]

Delaware receivership law bears out this distinction. It recognizes that insolvency is a jurisdictional fact: the *fact* of insolvency creates jurisdiction for the Court of Chancery to hear a case under 8 *Del. C.* § 291. Once a movant establishes the fact of insolvency, the court then may choose whether to exercise its discretion to appoint a receiver.[90] The court only will do so if it finds appointing a receiver to be "a necessary and useful act."[91] Appointing a receiver is a "drastic" act because it displaces a corporation's board and management.[92] Therefore Delaware courts employed the "no reasonable prospect" standard to guide their discretion: if a corporation's managers have a reasonable prospect of bringing the corporation out of financial distress, then the court should not appoint a receiver.[93] "A court should never wrest control of a business from the hands of those who have demonstrated their ability to manage it well, unless it be satisfied that no

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[87] *Id.* at 934-36.

[88] *Id.* at 936 (emphasis added); *see also id.* at 935 ("[T]he power of the court . . . depends exclusively on the fact of insolvency . . . until that fact is clearly established, the court can do nothing. The proof in support of a jurisdictional fact must always be clear and convincing").

[89] *Id.* at 936.

[90] *See, e.g.*, Vulcan-Cincinnati, Inc. v. Burnside Corp., 1962 WL 69570, at *3 (Del. Ch. July 13, 1962) (assuming the company was insolvent but declining to exercise discretion to appoint receiver).

[91] *Id.*

[92] *See* Salnita Corp. v. Walter Holding Corp., 168 A. 74, 75 (Del. Ch. 1933).

[93] *Id.*

course, short of the violent one, is open as a corrective to great and imminent harm."[94]

Thus, the "no reasonable prospect" language developed to serve a specific purpose in receivership cases—to inform the court's discretion after the jurisdictional fact of insolvency had been proven. Later Delaware cases (and cases citing Delaware cases) seem to have merged these two distinct principles into one shorthand standard: "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof."[95]

Other than *Production Resources*, where it did not matter which standard the Court used, only one other Delaware case appears to have discussed the difference between the two balance sheet tests.[96] In *Francotyp-Postalia AG & Co. v. On Target Technology, Inc.*, the petitioner sought appointment of a custodian pursuant to 8 *Del. C.* § 226(a)(2).[97] The corporation's solvency mattered because the alleged director deadlock arose from a capital call to cure the alleged insolvency.[98] If the corporation was solvent, then there would be no director deadlock and no basis for appointment of a custodian.[99] In finding the company solvent, the Court of Chancery rejected application of the balance sheet test to start-up companies because "[i]t is all too common, especially in the world of start-up companies like IJT, for a Delaware corporation to operate with liabilities in excess of its assets for that condition to be the sole indicia of insolvency."[100] Instead, the

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[94]*Id.*

[95]Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 782 (Del. Ch. 2004) (quoting Siple v. S & K Plumbing & Heating, Inc., 1982 WL 8789, at *2 (Del. Ch. Apr. 13, 1982), *reprinted in* 7 DEL. J. CORP. L. 504, 508 (1982)).

[96]*See* Francotyp-Postalia AG & Co. v. On Target Tech., Inc., 1998 WL 928382, at *5 (Del. Ch. Dec. 24, 1998), *reprinted in* 24 DEL. J. CORP. L. 649, 659 (1999).

[97]*Id.* at *3-4 (citing DEL. CODE ANN. tit. 8, § 226(a)(2)), *reprinted in* 24 DEL. J. CORP. L. at 657-58. Section 226(a)(2) provides:

> The Court of Chancery, upon application of any stockholder, may appoint 1 or more persons to be custodians, and, if the corporation is insolvent, to be receivers, of and for any corporation when . . .
>
> (2) The business of the corporation is suffering or is threatened with irreparable injury because the directors are so divided respecting the management of the affairs of the corporation that the required vote of action by the board of directors cannot be obtained and the stockholders are unable to terminate this division.

DEL. CODE ANN. tit. 8, § 226(a)(2).

[98]*Francotyp-Postalia*, 1998 WL 928382, at *4, *reprinted in* 24 DEL. J. CORP. L. at 658.

[99]*See id.*, *reprinted in* 24 DEL. J. CORP. L. at 658.

[100]*Id.* at *5, *reprinted in* 24 DEL. J. CORP. L. at 659; *see also* Teleglobe USA, Inc. v. BCE Inc. (*In re* Teleglobe Commc'ns Corp.), 392 B.R. 561, 601 (Bankr. D. Del. 2008) (citing *Francotyp-Postalia* for this proposition).

court found that the cash flow test was the only reasonable test to apply to start-ups.[101] To support its holding, the court relied on the "no reasonable prospect" language found in other cases, which in its view supported its conclusion that the balance sheet test was inappropriate for start-up companies:

> Even the *Siple* Court's version of insolvency based on liabilities in excess of assets requires the additional element that there be no reasonable prospect that the business can be continued in the face of that condition, suggesting that liabilities in excess of assets, alone, does not constitute insolvency.[102]

The court recognized that at least one other Delaware case, *Geyer v. Ingersoll*, omitted the "no reasonable prospect" language,[103] but distinguished that case: "I do not believe the *Geyer* Court, in its discussion of insolvency, was advancing a precise definition that this court is to use in determining whether, in fact, an entity is insolvent."[104]

But was the *Francotyp* court correct that the balance sheet test never can apply to start-ups? That conclusion could be justified if the test used *book value* of assets;[105] indeed, on a book value basis, it is not unusual for a start-up's assets to fall short of its liabilities. However, that result does not follow from a balance sheet test that uses *fair market value*, like the Bankruptcy Code test.[106] A start-up company's fair market valuation may account for the possibility of future cash flows, subject to a discount factor. The present value of those cash flows would not reflect as assets in a book value test, but they would in a fair market value test. The *Francotyp* court seemed to have book value in mind, so its rejection of the balance sheet test for start-up companies (and endorsement of the "no reasonable prospect" test) should not extend beyond tests applying book value rather than fair

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[101] *Id.* at *5 ("I find the only reasonable application in the circumstances of this case to be when a corporation is unable to meet its debts as they fall due in the usual course of business."), *reprinted in* 24 DEL. J. CORP. L. at 659.

[102] *Id.*, *reprinted in* 24 DEL. J. CORP. L. at 659.

[103] *Id.* at *5 n.8, *reprinted in* 24 DEL. J. CORP. L. at 659 n.8.

[104] *Id.*

[105] Book value is the "value at which an asset is carried on a balance sheet." BLACK'S LAW DICTIONARY 77 (3d pocket ed. 2006).

[106] The Court of Chancery noted this distinction in a later case. *See* U.S. Bank Nat'l Ass'n v. U.S. Timberlands Klamath Falls, L.L.C., 864 A.2d 930, 948 (Del. Ch. 2004) ("The defendants are clearly right to argue that having liabilities in excess of the *book value of assets* is not dispositive of the issue of whether a company is insolvent. If it were, many start-up companies would be insolvent." (emphasis added)).

market value.

2. Cash Flow Test

Delaware law on the cash flow test, like the balance sheet test, developed from common law jurisprudence. The test is not entirely clear: the unanswered question is whether the test is present or forward-looking. In other words, does a company become cash flow insolvent only at the point when it actually defaults on a debt? Or is it insolvent at an earlier point, when it becomes clear that the company will not be able to pay its debt in the future?[107]

The case law does not answer this question definitively. Some cases suggest that the test is forward-looking.[108] In *U.S. Bank*, the Court of Chancery held that the test is whether a company is "unable to pay its debts as they fall due in the usual course of business."[109] The court then applied this test in a forward-looking manner by examining whether the company in that case would be able to pay back its notes when those notes came due.[110] On a motion to dismiss, the court refused to draw an inference of insolvency from the fact that the defendant was late in paying its most recent interest payment on the notes, but ultimately did draw an inference of insolvency because the plaintiffs' allegations implied that the defendant would not be able to pay the principal amount of the notes in the future.[111]

Similarly, in *Blackmore Partners*, the Court of Chancery stated that "the 'cash flow test' . . . examines whether a company can 'reasonably meet its *anticipated* fixed (on-balance sheet and contingent) obligations as they become due.'"[112] The word "anticipated" implies that the test looks to future

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[107]*See, e.g.*, Teleglobe USA, Inc. v. BCE Inc. (*In re* Teleglobe Commc'ns Corp.), 392 B.R. 561, 602-03 (Bankr. D. Del. 2008) (reflecting parties' dispute as to whether the cash flow test was present or forward-looking under Delaware law).

[108]*See, e.g.*, Blackmore Partners, L.P. v. Link Energy L.L.C., 2005 WL 2709639, at *3 (Del. Ch. Oct. 14, 2005) ("[T]he 'cash flow test' . . . examines whether a company can 'reasonably meet its anticipated fixed . . . obligations as they become due.'"), *reprinted in* 31 DEL. J. CORP. L. 672, 677 (2006); *U.S. Bank*, 864 A.2d at 947 ("First, a company is insolvent if it is 'unable to pay its debts as they fall due in the usual course of business.'"); *see also* J.B. Heaton, *Solvency Tests*, 62 BUS. LAW 983, 984 (2007) (discussing Delaware law) ("[The cash flow test] is a forward-looking test. It is not enough to be able to meet current obligations; the firm must be able to meet its future obligations as well.").

[109]*U.S. Bank*, 864 A.2d at 947 (quoting Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992)).

[110]*Id.* at 948.

[111]*Id.*

[112]*Blackmore Partners,* 2005 WL 2709639, at * 3, *reprinted in* 31 DEL. J. CORP. L at 677 (emphasis added) (footnote omitted) (citation omitted).

debts. The case is not definitive, though, because it is unclear whether the court was stating its own view of the cash flow test or merely was summarizing one of the parties' views.[113]

Other cases use ambiguous language hinting that the test is present-looking. In *Production Resources*, the Court of Chancery described the test in the present tense: "'an inability to meet maturing obligations as they fall due in the ordinary course of business.'"[114] In *Odyssey Partners, L.P. v. Fleming Cos.*,[115] the court found a company to be insolvent because it had failed to pay debts that already had come due.[116] Likewise, in *Pereira v. Farace*,[117] a Federal Court of Appeals applying Delaware law rejected the forward-looking version of the cash flow test and held that the test applied only to present debts.[118]

IV. THE PATH FORWARD

In contrast to the bankruptcy solvency tests, which benefit from uniform statutory definitions, Delaware's tests are not as clear. Some courts apply the traditional balance sheet test, while others apply a narrower version. Some courts describe the cash flow test in forward-looking terms and others in the present tense. One of the hallmarks of Delaware corporate law—predictability—cries out for guidance on this issue, especially because the issue leads to important shifts in Delaware fiduciary law.[119]

As shown above, although the narrower "no reasonable prospect" test makes sense in cases applying the Delaware receivership statute, the standard is really an amalgamation of two principles—insolvency and judicial reluctance to displace a corporation's management that is diligently

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[113] *See id.* (citing the defendants' expert report, not Delaware case law, for its definition of the cash flow test).

[114] Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 782 (Del. Ch. 2004) (citing Siple v. S & K Plumbing & Heating, Inc., 1982 WL 8789, at *2 (Del. Ch. Apr. 13, 1982), *reprinted in* 7 DEL. J. CORP. L. 504, 508 (1982)). The court concluded that the plaintiff adequately pled cash flow insolvency because the defendant had not *paid* debts owed to two significant creditors. *Id.* at 784.

[115] 735 A.2d 386 (Del. Ch. 1999).

[116] *Id.* at 417.

[117] 413 F.3d 330 (2d Cir. 2005).

[118] *Id.* at 343 (explaining that "the Delaware test looks solely at whether the corporation has been paying bills on a timely basis").

[119] *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) ("'This Court has endeavored to provide the directors with clear signal beacons and brightly lined channel markers as they navigate with due care, good faith, and loyalty on behalf of a Delaware corporation and its shareholders.'" (quoting Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998))).

endeavoring to keep the corporation viable. The second of these principles has its place in receivership cases, where the court must exercise substantial discretion, but would appear to serve no purpose in fiduciary duty cases, which do not require the exercise of discretion once insolvency is found.

From a normative standpoint, the traditional balance sheet test is the better test to apply in fiduciary duty cases because, unlike the "no reasonable prospect" test, it grants creditors the ability to assert claims on behalf of the corporation at the moment stockholder equity reaches $0 (and thus when creditor recoveries become less than 100%). Much like a stockholder of a solvent corporation, a creditor of an insolvent corporation has the primary incentive to pursue derivative claims because it is "'the principal constituency injured by any fiduciary breaches that diminish the firm's value.'"[120] This and other "equitable considerations" have caused the Delaware Supreme Court to hold that creditors of an insolvent corporation are appropriate parties to pursue derivative claims.[121] These same considerations should guide courts in determining *when* a corporation becomes insolvent for fiduciary duty purposes.

The "when" should be when equity's value reaches $0. It is at this point that the stockholders' interests no longer are aligned with the corporation's interests.[122] The reasoning for this is set forth in famous footnote 55.[123] When stockholders no longer have any equity in a corporation, arguably they have nothing left to lose. They still have unlimited upside potential, however, because their presently worthless shares may one day regain value. As Chancellor Allen demonstrated in *Credit Lyonnais*, directors that are beholden to stockholder interests might not make the best decision from the corporation's standpoint, because the stockholders—who bear no downside risk and retain unlimited upside

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[120]*Gheewalla*, 930 A.2d at 102 (citing Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 794 n.67 (Del. Ch. 2004)); *see also Prod. Res*., 863 A.2d at 794 n.67 ("Because the creditors need to look to the firm for recovery, they are the correct constituency to be granted derivative standing when the firm is insolvent, as they are the constituency with a claim on the corporation's assets, assets which could be increased by a recovery against the directors.").

[121]*Gheewalla*, 930 A.2d at 102 ("Therefore, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation. Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.").

[122]*Id.* at 101 ("When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.") (emphasis in original).

[123]Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991) ("The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors."), *reprinted in* 17 DEL. J. CORP. L. 1099, 1155 n.55 (1992).

potential—could favor riskier strategies to maximize their equity's value.[124] Vice Chancellor Strine expounded on this issue in *Production Resources*:

> Of course, when a firm is insolvent, creditors do not become residual claimants with interests entirely identical to stockholders, they simply become the class of constituents with the key claim to the firm's remaining assets. As an academic commentator aptly put it, "creditors [of an insolvent corporation] do not enjoy the entire gain of making good decisions, but bear the entire risk loss of making bad ones." Because creditors have no interest beyond the debts owed to them, they have no incentive (and much to risk) by encouraging business strategies that would risk the payment of the bulk of their claims but provide some hope that the firm's value will increase to the level at which there could be a return for the equity. It is for this reason that Chancellor Allen's *Credit Lyonnais* decision emphasized the duties of the directors to the firm and their duty to responsibly maximize its value, a duty that might require pursuing a strategy that neither the stockholders nor the creditors would prefer. When a firm is insolvent or near insolvency, the interests of its stockholders and creditors can be starkly divergent, with the stockholders preferring highly risky strategies that creditors would eschew.[125]

Choosing the riskier strategy lets the stockholders gamble at the other constituencies' expense and, if the risk does not pay off, destroy aggregate corporate value rather than increase it.[126] Thus, the balance sheet test should aim to measure the point when stockholders' equity becomes valueless because that is when creditors become the primary residual beneficiaries and, therefore, the principal constituency injured by any breaches reducing the firm's value. That is the point when creditors should receive standing to sue on behalf of the corporation.

The traditional balance sheet test best identifies that point because it measures when equity reaches $0 without any additional qualifiers. The "no reasonable prospect" test does not; it treats a corporation as insolvent only

[124]*See id.*, *reprinted in* 17 DEL. J. CORP. L. at 1155 n.55.

[125]*Prod. Res.*, 863 A.2d at 790 n.57 (citations omitted).

[126]*See id.*; *see also Credit Lyonnais*, 1991 WL 277613, at *34 n.55 (noting that "the stockholders' preference would reflect their appetite for risk"), *reprinted in* 17 DEL. J. CORP. L. at 1155 n.55.

well after creditors have become the corporation's primary residual beneficiaries *and* only once it is relatively certain that the corporation will fail. So it would allow creditors to assert derivative claims only far beyond the point at which equity falls below $0. Thus, the "no reasonable prospect" test frustrates the rationale for allowing creditors to assert derivative claims in the first place, because it keeps them from asserting claims until well after they become the principal constituency that would be injured by any breaches reducing firm value.

This same reasoning suggests that the forward-looking cash flow test is more consistent with Delaware fiduciary law than the present-looking test. Under the forward-looking test, a company is cash flow insolvent if it cannot pay its anticipated debts as they come due, *and* it cannot refinance itself or fix the situation. In other words, a company is insolvent when a *future* default is relatively certain, but before the default occurs. At this point—and no later—the creditors are the corporation's primary constituency because they will have to look to the corporation's assets to repay their debt upon the reasonably certain default, and so they have the greatest interest in seeing the corporation's assets maximized.[127] Stockholders, on the other hand, may be incentivized to press the corporation to take excessive risk (for example, to attempt to avoid the default). Thus, the forward-looking cash flow test captures the point at which it makes sense to give creditors standing to sue derivatively. As one commentator observed, "an ability-to-pay test that looked at only the entity's historical rather than prospective ability to pay its debts has little value in deterring credit-harming activities before they happen."[128]

By contrast, applying the test in the present tense does not capture the reasons for giving creditors standing to assert derivative claims in insolvent corporations. The present-looking test treats a company as insolvent when it defaults on its debt, but not before. Thus, creditors seeking to remedy (or perhaps prevent) a corporate harm would have to wait until after the corporation fails to gain standing. It makes little sense to give creditors the ability to check a corporation's directors from improperly favoring stockholder interests at the expense of the corporation only when it is too late

[127]*See Prod. Res.*, 863 A.2d at 794 n.67 (Del. Ch 2004) ("Because the creditors need to look to the firm for recovery, they are the correct constituency to be granted derivative standing when the firm is insolvent, as they are the constituency with a claim on the corporation's assets, assets which could be increased by a recovery against the directors."); *see also id.* ("Creditors also generally have no expectation that they will be able to recover against the directors or stockholders of firms with whom they contract.").

[128]Heaton, *supra* note 108, at 989 n.30.

for the creditors (or the corporation) to do anything about it.[129]

Moreover, in some cases the present-looking test could treat an otherwise healthy corporation as insolvent simply because it has defaulted on a debt, even if the company still can fix its financial distress. Thus, the test can create a concern similar to that in receivership cases—a reluctance to displace a financially distressed corporation's managers who are working diligently to bring the corporation out of distress.[130] Directors of an otherwise healthy company experiencing short-term liquidity problems should manage the corporation for its stockholder owners if the corporation is healthy over the long-term. The present-looking test, however, would treat this type of corporation as insolvent and thus implicate concerns analogous to those that the "no reasonable prospect" test addresses in receivership cases.

V. CONCLUSION

Delaware corporate law prides itself on providing clear guidance for directors. But Delaware's solvency tests lack this quality because the Delaware courts have not yet addressed (or even recognized) the ambiguities in the law. We hope this article demonstrates why they should. Solvency can have an outcome determinative effect in a case, and so can the test that a court uses to determine solvency. Uniformity would eliminate the risk of inconsistent and unpredictable results, and bring solvency tests within the "brightly lined channel markers" that are the hallmark of Delaware corporate jurisprudence.

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[129] Admittedly, the rationale for the forward-looking cash flow test may not be as strong as the rationale for the traditional balance sheet test. Theoretically, a company that is cash flow insolvent under the forward (or even present) looking test could be balance sheet solvent, for example, if the company has valuable but illiquid assets that will take time to sell. Creditors could expect full, albeit delayed, recovery in liquidation and there also might be something left over for equity. The relative certainty of near-term corporate failure, however, would incentivize stockholders to favor riskier strategies at the potential expense of the corporation. Healthy corporations with material but illiquid assets generally should be able to use those assets as security to obtain financing to assist with debt repayment, thereby avoiding cash flow insolvency. Thus, on balance, the forward-looking test more appropriately captures the point at which creditors should have derivative standing.

[130] Salnita Corp. v. Walter Holding Corp., 168 A. 74, 75 (Del. Ch. 1933) ("A court should never wrest control of a business from the hands of those who have demonstrated their ability to manage it well, unless it be satisfied that no course, short of the violent one, is open as a corrective to great and imminent harm.").