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The Duty to Creditors in Near-Insolvent Firms: Eliminating the "Near-Insolvency" Distinction

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NOTES

The Duty to Creditors in Near-Insolvent Firms: Eliminating the "Near-Insolvency" Distinction

I. INTRODUCTION

"Even at our best, we are only out for ourselves."[1]

It is human nature to act in one's own interest. Though ethicists and psychologists may disagree about the extent to which self-interest is a motivating factor behind human behavior, most accept that it plays some role.[2] Assuming that human behavior is at least in part a function of self-interest, laws should be expected to reflect that behavior. Many already do: the law of agency imposes a duty on the agent to act with obedience towards his principal,[3] and the ABA Model Rules of Professional Conduct prohibit a lawyer from representing a client when the lawyer's personal interests interfere with the representation.[4] Where money is involved, the need to curb the incentive to advance one's own interests at the expense of another is even greater; for example, the law prohibits a corporate director from enriching himself at the expense of the corporation.

Specifically, the law of fiduciary duty addresses the problems associated with having one group of people manage the money of a second group. In the corporate context, the law of fiduciary duty is a (usually) well-defined concept with a substantial amount of case law. This predictability is a desirable characteristic, as it enables directors to make confident business decisions without fear that they have breached their duties to the corporation and its shareholders. Given

1. Claire Andre & Manuel Velasqeuz, *Unmasking the Motives of the Good Samaritan*, 2 ISSUES IN ETHICS (1989), http://www.scu.edu/ethics/publications/iie/v2n1/samaritan.html.

2. *See* Michael Anthony Slote, *An Empirical Basis for Psychological Egoism*, 61 J. PHIL. 530, 530-37 (1964). *See generally* C.D. Broad, *Egoism as a Theory of Human Motives*, *in* BROAD'S CRITICAL ESSAYS ON MORAL PHILOSOPHY (David R. Cheney ed., 1971).

3. RESTATEMENT (SECOND) OF AGENCY § 385 (1958).

4. MODEL RULES OF PROF'L CONDUCT R. 1.7 (2002).

the size and breadth of today's largest corporations, liability for breach of a fiduciary duty can be staggering. Accordingly, states have strived to clarify their corporate jurisprudence.[5]

While the law of fiduciary duty is clear when applied to healthy, solvent corporations, its application becomes muddled when applied to financially distressed firms. In part, this is because a financially distressed firm is a different beast than a solvent firm. The "corporate enterprise" of an insolvent firm comprises the same constituencies[6] as a solvent firm, but the interests and risk levels of the respective constituencies are changed. Whereas these interests are usually harmonious in a solvent corporation, each self-interested constituency might find itself in tension with the others when insolvency is looming.

Consequently, as a corporation nears insolvency and finally becomes insolvent, the common law's emphasis on shareholder interests makes less and less sense. Upon insolvency, shareholders have nothing more to lose, as little equity remains in the company. At the same time, however, they still have everything to gain; although their shares are presently worthless, they retain the potential to be worth something, if the corporation can reverse its financial distress. A rationally self-interested shareholder would favor high risk ventures to maximize firm value, since he cannot lose any more money. The shareholder becomes a high stakes gambler, using other people's money—the creditors—as ante. Given the limited downside, why not gamble with the corporation's remaining assets and try to rebuild some of its value?

From the creditor's point of view, however, this is an undesirable course of action because shareholder risk-taking will more likely than not diminish the value of the remaining corporate assets from which the creditors must get paid. If the firm is truly insolvent, then the creditors will satisfy their claims with money derived from the liquidation of corporate assets, with each creditor taking his share of the corporate pie. Any dissipation of these assets caused by precarious ventures taken on behalf of the shareholders will mean less money for the creditors. From the creditor's standpoint, insolvency causes the shareholder to lose his status as a residual claimant, since it is now the creditors who bear any risk of loss.

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5. For example, it is said that one reason why so many corporations are chartered in Delaware is because of the expertise of the courts and the substantial body of case law, which provides a measure of predictability.

6. Corporate constituencies include groups that make up the entire corporate enterprise, for example, shareholders, creditors, employees, suppliers and customers. The term can include local communities, governments, and even NGOs.

Although law as applied to *near-insolvent* firms is unclear, it is at least clear that upon *insolvency in fact*, a duty is owed to creditors.[7] This duty arises from the "trust fund doctrine," which holds that the directors of an insolvent corporation become the trustees of the remaining corporate assets, of which the creditors are the beneficiaries. The directors thus owe the firm's creditors a fiduciary duty as any trustee would owe the duty to a trust beneficiary. A competing theory, known as the "at-risk doctrine," holds that an obligation is owed to creditors because creditors of an insolvent firm bear most of the downside risk and may be subjected to shareholder opportunism.[8] In any case, it is now settled that a fiduciary duty is owed to the creditors of a firm that is insolvent in fact.

It is still unsettled, however, whether this duty extends to creditors when a corporation is in a state of near-insolvency. State courts and federal bankruptcy courts have recently considered the issue of fiduciary duties in near-insolvent firms. At one end of the spectrum, courts allow for the possibility of an affirmative duty to creditors.[9] At the other extreme, courts hold that no real "duty" is owed to creditors of near-insolvent firms.[10]

This Note rejects the idea that creditors are the beneficiaries of fiduciary duties in near-insolvency. Any consideration of creditor interests in a near-insolvent firm should be derivative of the general duty to the corporate enterprise. A director's obligations are thus permissive in nature: directors of near-insolvent firms need not consider creditor interests, although they may choose to do so. Directors may also decide how much weight to allocate to those

7. Throughout this Note, I use the phrase "insolvent in fact" to refer to a firm that is clearly and objectively insolvent. The phrase "near-insolvent" refers to a firm that is not yet objectively insolvent, but not quite solvent either. The distinction is important because law that applies to firms that are "insolvent in fact" does not necessarily apply to firms that are "near-insolvent." The term "near-insolvency" encompasses what other courts and commentators sometimes characterize as "the vicinity of insolvency," "the zone of insolvency," "doubtful solvency," and "risk of insolvency." *See infra* note 76.

8. Pamela L.J. Huff & Russell C. Silberglied, *From* Production Resources *to* Peoples Department Stores*: A Similar Response by Delaware and Canadian Courts on the Fiduciary Duties of Directors to Creditors of Insolvent Companies*, 2 J. BUS. & TECH. L. (forthcoming 2007) (manuscript at *10), *available at* http://www.law.umaryland.edu/conferences/Twilight/SILBERGLEID%20&%20HUFF.PDF.

9. *See, e.g.*, FDIC v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982) (holding that directors of an insolvent corporation owe direct fiduciary duty to creditors in their capacity as trustees of corporate assets).

10. *See, e.g.*, Prod. Res. Group, L.L.C. v. NCT Group, 863 A.2d 772, 788-89 (Del. Ch. 2004) (suggesting that there is no affirmative duty in near-insolvency, but rather that directors may benefit from an additional "shield" to protect them from shareholder lawsuits).

interests. Ultimately, their duty is really owed to the corporation itself.

This "discretionary" approach embraces the sometimes-obscured principle that directors owe their duty to the entire corporate enterprise, not just to shareholders.[11] It conceptualizes the entire corporation as a bundle of self-interested constituencies, each with interests and risk levels that are sensitive to the corporation's financial health. This approach recognizes that, when a firm is near-insolvent, directors are entitled to consider strategies that are less risky than a shareholder seeking to maximize share value would consider optimal. In this sense, the discretionary approach is consistent with current corporate common law, by allowing (but not compelling) directors to consider the interests of other stakeholders when those interests can be tied to aggregate firm value.[12]

The discretionary approach avoids some of the larger problems afflicting trust fund based theories. First, the trust fund doctrine cannot legitimately be extended beyond insolvency in fact. In a near-insolvent firm, however, the directors' role as trustees has not yet been triggered, so an extension of an affirmative fiduciary duty based on their status as trustees makes little sense. Conversely, the discretionary approach can be conceptually applied beyond insolvency in fact.

Second, unlike many current formulations based on the trust fund doctrine, the discretionary approach does not have a triggering point; no time, expense, or effort need be wasted in determining when it is activated. A trust-fund duty that is triggered only upon insolvency (or near-insolvency) requires directors to gauge their corporation's financial health. However, it is difficult to determine exactly when a firm becomes insolvent or near-insolvent. The discretionary approach avoids this entire issue. It does not recognize a duty that runs affirmatively from directors to creditors that is triggered upon the occurrence of a certain event. Rather, the duty is first and foremost a

11. *See, e.g.*, Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There any "There" There?*, 75 S. CAL. L. REV. 1169, 1176-77 (2002) (explaining that outside of *Revlon* situations, directors may consider stakeholder interests if those interests are tied to the long-term value of the corporate enterprise).

12. *See* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1282 n.29 (Del. 1989) (holding that a board of a target company may consider the impact of the bid on other constituencies, "provided tbat it bears some reasonable relationship to general shareholder interests"); *see also* Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990) (holding that unless *Revlon* duties are implicated, directors are not under a duty to maximize shareholder value in the short term and may thus favor a merger offering shareholders a lower premium, but, in the good faith belief of the directors, a better long-term value).

constant duty to the corporation from which creditors, as a class, may benefit derivatively. The corporation remains the object of the injury as well as the recipient of any damages award. Only where a creditor is so singled out that his injuries are clearly separable from any harm to the corporate entity should a direct claim be allowed.

Third, and most importantly, the discretionary approach brings predictability to an area of law that has been plagued by ambiguity. Directors trying to comply with their corporate common law duty to shareholders might feel compelled to undertake risky ventures to restore equity to a near-insolvent corporation. The failure of these ventures has, in some situations, exposed the directors to creditor lawsuits.[13] Conversely, directors who consider the interests of creditors in an attempt to avoid liability have been sued anyway, this time by their own shareholders.[14] Without the benefit of predictable law, corporate directors are placed in the untenable position of facing potential liability no matter what they do. The discretionary approach brings stability to the directors of a near-insolvent firm by extending a familiar duty that is consistent with corporate common law: it allows them, but does not compel them, to incorporate creditor interests into their business judgment. Ultimately, because board decisions made in a near-insolvent corporation should be scrutinized the same way as decisions made in a solvent corporation, the entire "near-insolvent" distinction should be done away with.

Part II of this Note provides a general overview of corporate fiduciary duties and how they have been interpreted to apply to solvent and insolvent corporations. Part III examines the "expansion" of insolvency duties to include near-insolvent corporations and surveys the most recent court decisions. Part IV proposes that a discretionary approach is the solution that is most consistent with contemporary corporate law. Just like in a solvent corporation, directors of a near-insolvent corporation should be entitled to balance the interests of the corporate constituencies in a way that is reasonably related to shareholder interests. Since the analysis is the same in both solvency and near-insolvency, there is no reason to continue distinguishing between the two.

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13. *See, e.g.*, Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (*In re* Buckhead America Corp.), 178 B.R. 956, 960 n.4 (Bankr. D. Del. 1994).

14. Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., No. 12150, 1991 WL 277613, at *20 (Del. Ch. Dec. 30, 1991). (considering an action by a 98% shareholder versus board of directors for pursuing less risky course of action arguably in favor of creditor interests and opposed to the shareholder's interests).

II. CORPORATE FIDUCIARY DUTIES

Fiduciary duties are context-specific, for they shift to new beneficiaries as the financial status of the corporation changes. In a solvent firm, fiduciary duties run to the benefit of the corporation and its shareholders. When a firm is insolvent in fact, the duty extends to creditors. To complicate matters, however, a few courts now distinguish near-insolvent corporations, which lie somewhere in the ambiguous realm between solvency and insolvency.[15] Thus, any analysis of fiduciary duties in near-insolvent corporations must first begin with an examination of fiduciary duties owed in clearly solvent and clearly insolvent corporations.

A. Directors' Duties in a Solvent Corporation

In a solvent corporation, directors generally owe fiduciary duties to the corporation and its shareholders.[16] Shareholders are in need of fiduciary protection because of the open-ended nature of their relationship with the corporation and its directors. A shareholder is an "owner" of the corporation, but in most cases he cannot exercise any control over its ordinary business operations.[17] Thus, a shareholder must rely on a second class of people, directors, to manage the corporation.[18] The law behind this concept evolved as a response to the basic problems involved with one person managing another person's money. As Adam Smith put it,

> the directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance [as a true owner]. . . . Negligence and profusion, therefore, must always prevail, more of less, in the management of the affairs of such a company.[19]

Thus, by holding directors accountable to the corporation and its shareholders for their acts of disloyalty or imprudence, the law of

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15. *See id.* at *108 n.55 (noting, in dictum, that when a corporation enters 'the vicinity of insolvency,' directors may consider creditor interests).

16. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

17. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2007) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ."). There are some exceptions to the strict separation of functions between shareholders and directors, such as in certain forms of closely held corporations.

18. Directors often manage a corporation through the acts of their agents, the corporate officers.

19. ADAM SMITH, THE WEALTH OF NATIONS 700 (Modern Library 1937) (1776).

fiduciary duty minimizes the "negligence and profusion" found wherever one person acts in the interests of another.

In becoming an owner of shares, the shareholder takes on the dual roles of risk-taker and residual claimant. However, although the shareholder bears the risk, it is the director and officer who, through their decisions, can directly affect the value of the firm. Thus directors must act as "custodians entrusted with the management of the shareholders' assets."[20] Since a shareholder does not set forth his rights in a written contract, fiduciary duties "fill the gap," acting as an alternative to the express delineation of rights among the shareholder, the corporation, and its directors.

Fiduciary duties in solvent corporations take two general forms. First, directors owe a duty of loyalty to put the corporation's interests ahead of their own.[21] The duty of loyalty is implicated, among other things, when a director usurps a corporate opportunity,[22] engages in self dealing,[23] or assigns himself excessive compensation at the corporation's expense.[24] Second, directors must abide by a general duty of care to exercise the reasonable diligence that a person in a like position would exercise.[25] Directors are protected from judicial second-guessing of their business decisions by the procedural and substantive advantages of the "business judgment rule," a presumption that directors will act in a reasonably informed manner when making a business decision; however, courts have sometimes denied directors the benefits of the business judgment rule when a plaintiff rebuts it upon a showing gross negligence.[26]

Conversely, the only duties owed to creditors in a solvent corporation are contractual in nature. There is no recognized fiduciary

20. Brent Nicholson, *Recent Delaware Case Law Regarding Director's Duties to Bondholders*, 19 DEL. J. CORP. L. 573, 575 (1994).

21. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361-62 (Del. 1993); MODEL BUS. CORP. ACT § 8.30(a) (1984).

22. *See* Guth v. Loft, Inc., 5 A.2d 503, 511 (Del. 1939) (holding that if a director takes an opportunity that is (1) in the line of the corporation's business; (2) in which the corporation has a reasonable expectancy; and (3) the director's interest conflicts with the corporation's interest, then he may not seize the opportunity).

23. DEL. CODE ANN. tit. 8, § 144 (2007) (setting forth the requirements that must be met in order to cleanse an interested transaction).

24. *See, e.g.*, Byrne v. Lord, Nos. 14040, 14215, 1995 Del. Ch. LEXIS 131, at *11 (Del. Ch. Nov. 9, 1995) (holding that a stock option compensation plan must involve an identifiable benefit to the corporation and must bear a reasonable relationship to the value of the services the corporation receives).

25. MODEL BUS. CORP. ACT § 8.30(b) (1984).

26. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

duty that runs directly to creditors of a solvent corporation.[27] The general rationale is that creditors, unlike shareholders, can (and will) expressly negotiate their rights in a written contract. Moreover, where the corporation is solvent, creditors will at least hypothetically get paid, and thus will have no reason to be unhappy.

B. Directors' Duties in an Insolvent Corporation

A corporation undergoes a fundamental change when it becomes insolvent. In a solvent, profitable corporation, all constituencies are theoretically content. Management aims to maximize firm value, shareholders have equity in the profitable enterprise, and creditors are paid as the corporation's debts come due. But when the firm slides into insolvency, the general contentment dissipates. Shareholders will favor undertaking riskier ventures to boost share value, creditors will want the corporation to avoid risky endeavors, and management is caught in the middle.

Upon insolvency, courts apply the rationale of the "trust fund doctrine," which holds that directors of an insolvent corporation "no Ionger owe a duty to stockholders who no longer have any viable economic interest in the entity."[28] Instead, the corporation's assets are preserved to pay off creditor claims. Directors' duties thus shift from "long term value maximization to preservation of existing asset value for eventual distribution to creditors."[29]

1. Determining Insolvency—The Balance Sheet and Equitable Insolvency Tests

Since the trust-fund approach triggers only upon insolvency-in-fact, boards must face the ambiguous task of determining exactly *when* a firm becomes insolvent. The two prevalent tests for determining insolvency are the "balance sheet test" and the "equitable insolvency test." According to the balance sheet test, a firm is insolvent if its liabilities exceed its assets.[30] Under the equitable

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27. Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992) (citing Harff v. Kerkorian, 324 A.2d 215, 222 (Del. Ch. 1974), *rev'd in part on other grounds*, 347 A.2d 133 (Del. 1975)).

28. Gregory V. Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239, 244 (1992).

29. *Id.*

30. Ramesh K.S. Rao, David Simon Sokolow & Derek White, *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially Distressed Firm*, 22 IOWA J. CORP. L. 53, 63 (1996) (the author uses the term "bankruptcy test" rather than "balance sheet test," although they both refer to the same test).

insolvency test, a firm is insolvent if it cannot pay its debts as they come due in the ordinary course of business.[31] Given the malleability of accounting figures, reasonable people may disagree on when a firm is insolvent in fact, especially under the balance sheet test, which relies on a comparison of accounting figures. The difficulty of determining exactly when solvency ends and insolvency begins is troubling, since insolvency is the triggering point of the trust-fund duty to creditors. As a consequence, directors must operate without clearly knowing when their duties will shift, if they have not shifted already.

2. The Diverging Nature of Shareholder and Creditor Interests upon Insolvency

Unsurprisingly, tensions arise between the shareholders and creditors of an insolvent firm. Consider a firm that is insolvent under both the balance sheet and equitable insolvency tests. In such a case of clear insolvency, liabilities exceed assets. By definition, there is no equity left in the firm to be distributed to shareholders. Further, since the firm has been operating at a loss, it cannot distribute dividends out of its income stream. The firm's insolvency essentially turns its assets into a "trust fund for the payment of all the debts of the corporation."[32] Given that the firm's liabilities exceed its assets, however, some creditors must accept less than they are fully owed. At the same time, shareholders are incented to undertake risky endeavors to restore share value. In other words, the two constituencies will disagree about the proper degree of risk that the board should incorporate into its attempts to maximize firm value.[33] If courts do not recognize some sort of change in directors' duties, then a board of an insolvent corporation will be induced to comply with its duties to the shareholders and embark on excessively risky courses of action, to the detriment of creditors.

3. The Trust Fund Doctrine

Recognizing the divergences between the interests of shareholders and creditors, courts have granted additional protections to creditors of insolvent corporations. The "trust fund doctrine"

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31. *Id.*

32. Wood v. Dummer, 30 F. Cas. 435, 436 (C.C.D. Me. 1824) (No. 17,944).

33. *See* Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Director's Duty to Creditors*, 46 VAND. L. REV. 1485, 1494-96 (1993) (noting the differences between shareholder and bondholder incentives in a near-insolvent corporation).

provides the basis for these protections. The doctrine holds that when a corporation becomes insolvent, its assets are held in trust for distribution to creditors; thus, directors, as trustees, owe a fiduciary duty to creditors to protect the firm's remaining assets.[34]

The trust fund doctrine was first introduced by the United States Supreme Court in *Wood v. Drummer*.[35] It originated from modest roots, standing solely for the proposition that creditors, who are preferred over shareholders in the distribution of assets, may sue to recover assets wrongfully distributed. In *Wood*, an insolvent bank issued a liquidating dividend to its shareholders, to the detriment of its creditors.[36] The creditors sued to recover the capital distributed to the shareholders. The Court held in favor of the creditors, finding that while there was no evidence of fraud in issuing the dividend, the "capital stock of banks is to be deemed a pledge or trust fund for the payments of the debts contracted by the bank."[37]

Over time, state courts pushed the trust fund doctrine beyond its original scope. The Delaware courts first confronted the doctrine in *Asmussen v. Quaker City Corporation*.[38] There, the chancery court initially rejected the doctrine, holding that, in the absence of bad faith, a debtor was not liable for preferring some creditors over others.[39] The Delaware Supreme Court adopted the doctrine a decade later in *Bovay v. H.M. Byllesby & Co.*[40] The court held that:

> an insolvent corporation is civilly dead in the sense that its property may be administered as a trust fund for the benefit of creditors. The fact which creates the trust is the insolvency, and when that fact is established, the trust arises, and the legality of the acts thereafter performed will be decided by very different principles than in tbe case of solvency.41

Despite Delaware's initial hesitancy to adopt and expand the trust fund doctrine, a recent case has solidified the doctrine's place in Delaware corporate law. In *Geyer v. Ingersoll Publications Co.*,[42] the court had to decide exactly when a firm becomes insolvent, thus triggering trust fund duties. Thomas Geyer, a creditor of Ingersoll Publications Co. ("IPCO"), sued to collect upon a two million dollar note, claiming that IPCO entered into transactions that caused its

34. Jewel Recovery, L.P. v. Gordon (*In re* Zale Corp.), 196 B.R. 348, 354-55 (Bankr. N.D. Tex. 1996).

35. *Wood*, 30 F. Cas. at 435.

36. *Id.* at 436.

37. *Id.*

38. Asmussen v. Quaker City Corp., 156 A. 180 (Del. Ch. 1931).

39. *Id.* at 181.

40. Bovay v. H.M. Byllesby & Co., 38 A.2d 808 (Del. 1944).

41. *Id.* at 813 (citations omitted).

42. Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784 (Del. Ch. 1992).

own insolvency and thus its inability to pay back the debt it owed Geyer.[43] Geyer argued that IPCO was insolvent in fact, which triggered its trust fund duties. IPCO moved for dismissal, arguing that insolvency duties are only triggered upon the filing of a bankruptcy petition.[44]

The bulk of the court's decision focused on determining when the duty to creditors is activated. It noted as a preliminary matter that "neither party *seriously* disputes that when the insolvency exception does arise, it creates fiduciary duties for the directors for the benefit of creditors."[45] The real question was whether these duties were triggered upon insolvency in fact, or rather upon the commencement of a formal bankruptcy proceeding. The court held that insolvency in fact triggered these duties, regardless of whether the debtor had filed for bankruptcy.[46]

Thus, although directors owe their duties to the corporation and its shareholders, a new beneficiary is created when a firm becomes insolvent. Upon insolvency in fact, it is now generally accepted that directors owe a duty to creditors. Exactly how far beyond insolvency in fact this duty reaches is still unclear.

III. THE PROBLEM: DIRECTORS' DUTIES IN NEAR-INSOLVENT FIRMS

Recently, the duty to creditors expanded once more, this time beyond insolvency in fact. In a single footnote, Chancellor Allen of the Delaware Court of Chancery revived the debate on insolvency duties and their proper scope.

A. The Credit Lyonnais *Opinion and the "Vicinity of Insolvency"*

The debate shifted to near-insolvency after the Delaware Court of Chancery found a board of directors not liable for acting in the interests of creditors in a firm that was in the "vicinity of insolvency."[47] The controversy in *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*[48] arose from an attempted leveraged

43. *Id.* at 786-87.

44. *Id.* at 787.

45. *Id.* (emphasis in original).

46. *Id.* at 790 ("[F]iduciary duties to creditors arise when one is able to establish the fact of insolvency.").

47. Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991).

48. *Id.*

buyout[49] ("LBO") of MGM/UA Communication Company ("MGM"). The sponsor of the LBO, Pathe Communications Corp. ("Pathe"), was controlled by a dominant shareholder, Giancarlo Paretti ("Paretti"). After executing the LBO, Pathe—and by implication, Paretti—owned 98.5% of MGM.[50] Paretti promptly elected himself as chairman of MGM's board and appointed himself as chief executive officer.[51]

However, Paretti soon ran into financial trouble. The financing of the LBO, which Chancellor Allen described as "Byzantine,"[52] required Pathe to take out large loans from Credit Lyonnais Bank Nederland ("the Bank"). Additionally, MGM had to license away its film rights, in order to raise money to finance its own acquisition.[53] As a result, it was left short of cash and cash-producing assets.[54] Further, in an attempt to keep costs down, Paretti laid off personnel, including many in the finance department.[55] The situation grew worse as the remaining personnel struggled to cope with the increased workload. Many "key people" resigned, leaving MGM with deficient internal controls.[56] To make matters even worse, Paretti had raised $130 million of financing by licensing out MGM movie rights in a "put agreement" that, if activated by the licensee, would force MGM to refund $100 million immediately.[57] Paretti kept the nature of the put agreement hidden from the Bank. Finally, in early 1990, due to lack of cash flow, trade creditors forced MGM into an involuntary bankruptcy proceeding.[58]

Paretti worked with the Bank to salvage MGM. The Bank agreed to extend additional credit on the condition that Paretti step down from his position as chief executive officer and agree to the Bank's designation of a new CEO experienced in the entertainment

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49. A leveraged buyout is a mechanism by which a "management or finance entrepreneur acquires control of a company through borrowed funds." *Id.* at *2. The entrepreneur raises money by having the target company issue debt instruments to finance its own acquisition. Ideally, the entrepreneur would take over the company, sell off non-core assets and turn the core business into a more efficient enterprise. The debt should be paid off over time from the target's own revenue stream. When unsuccessful, LBOs can lead to insolvency of the company, since the company's debts are often a crushing burden.

50. *Id.* at *6.

51. *Id.*

52. *Id.* at *4. Chancellor Allen likely meant that the financing scheme was intricate and complicated, although it is conceivable that he used the word "Byzantine" to refer to the deal as scheming or devious. *Id.*

53. *Id.* at *6.

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.* at *14.

58. *Id.* at *2.

business.[59] A new five-person board of directors was created, composed of the new CEO, a chief operating officer chosen by the CEO, and three directors chosen by Paretti. The Bank also forced Paretti to enter into a "Corporate Governance Agreement," whereby the Bank would receive voting control of MGM should Paretti and Pathe default on their loans.[60]

The new governance structure ran into immediate problems because Paretti attempted to hinder its operation by interfering with the new CEO's authority. According to Chancellor Allen, "Paretti barely masked his efforts to continue to dominate and control the management of MGM."[61] Despite warnings from the Bank, Paretti persisted in his efforts to control MGM, such as calling a board meeting without a quorum and resolving that "Giancarlo Paretti be, and he hereby is, authorized to sign all agreements in order to put into proper form the [company's] existing commitments."[62] In response to Paretti's constant attempts to violate the Corporate Governance Agreement, the Bank exercised its right for voting control of Pathe's stock.[63]

Pathe sued after the Bank refused to vote in favor of selling MGM's interest in a foreign movie distribution company. The sale would have raised cash, arguably enough so that Paretti and Pathe could take a large step in the direction of regaining control of MGM. Pathe argued that the Bank, which now controlled MGM, was obligated to act in the best interests of MGM's shareholders—that is, Pathe and Paretti. Pathe contended that since Paretti was a 98% shareholder, the Bank should have approved the sale, as it would have operated in Paretti's best interest.

The court rejected Pathe's argument, holding that:

> in these circumstances where the company was in bankruptcy until May 28 and even thereafter the directors labored in the shadow of that prospect, [the Bank's board of directors] was appropriately mindful of the potential differing interests between the corporation and its 98% shareholder. At 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.[64]

In the now (in)famous footnote 55, reproduced in full below, Chancellor Allen elaborated:

59. *Id.* at *11 n.22.
60. *Id.* at *11.
61. *Id.* at *12.
62. *Id.* at *19.
63. *Id.* at *21.
64. *Id.* at *34.

> The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors. Consider, for example, a solvent corporation having a single asset, a judgment for $51 million against a solvent debtor. The judgment is on appeal and thus subject to modification or reversal. Assume that the only liabilities of the company are to bondholders in the amount of $12 million. Assume that the array of probable outcomes of the appeal is as follows:
>
> | | Expected value |
> |---|---|
> | 25% chance of affirmance ($51mm) | $12.75 mm |
> | 70% chance of modification ($4 mm) | $2.8 mm |
> | 5% chance of reversal ($0) | $0 |
>
> Expected Value of Judgment on Appeal: $15.55 mm
>
> Thus, the best evaluation is that the current value of the equity is $3.55 million. ($15.55 million expected value of the judgment on appeal, minus the $12 million liability to bondholders). Now assume an offer to settle at $12.5 million (also consider one at 17.5 million). By what standard do the directors of the company evaluate the fairness of these offers? The creditors of this solvent company would be in favor of accepting either a $12.5 million offer or a $17.5 million offer. In either event they will avoid the 75% risk of insolvency and default. The stockholders, however, will plainly be opposed to acceptance of a $12.5 million settlement (under which they get practically nothing). More importantly, they very well may be opposed to acceptance of the $17.5 million offer under which the residual value of the corporation would increase from $3.5 million to $5.5 million. This is so because the litigation alternative, with its 25% probability of a $39 million outcome to them ($51 million - $12 million = $39 million) has an expected value to the residual risk bearer of $9.75 million ($39 million x 25% chance of affirmance), substantially greater than the $5.5 million available to them in the settlement. While in fact the stockholders' preference would reflect their appetite for risk, it is possible (and with diversified shareholders likely) that shareholders would prefer rejection of both settlement offers.
>
> But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than $15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes his duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.[65]

Thus, the Bank was not liable for choosing a course of action arguably not in the best interest of MGM's controlling shareholder, because it was entitled to consider the interests of other corporate constituencies. In refusing to sell the movie distribution company, the board had permissibly benefited MGM's creditors to the detriment of its 98% shareholder.

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65. *Id.* at *34 n.55.

Credit Lyonnais broke new ground. It extended some sort of insolvency duty beyond insolvency in fact to situations where a corporation labors in the shadow (or vicinity) of insolvency. However, the opinion raised new questions: What is the vicinity of insolvency? What is the proper scope of the duty to creditors in that zone? Can creditors sue for a direct breach of duty? Can creditors bring a derivative action? Does this extended duty act in parity with fraudulent conveyance law? What place does the business judgment rule hold in the zone of insolvency? As outlined below, courts have answered these questions in different ways.

*B. Post-*Credit Lyonnais *Jurisprudence*

Courts have interpreted the *Credit Lyonnais* decision in three related ways. First, some treat *Credit Lyonnais* as a sword giving creditors the ability to sue.[66] Second, some find that a breach of duty will occur only under a narrowly defined set of circumstances, such as self-dealing, fraudulent conveyance, or improper preference of one creditor over the others.[67] Third, some hold that *Credit Lyonnais* acts only as a shield for directors, who cannot be held liable for considering the interests of other constituencies in the zone of insolvency.[68] Each of these interpretations will be discussed in turn.

1. *Credit Lyonnais* as a Sword for Creditors

Courts that treat *Credit Lyonnais* as a sword begin with the proposition that *Credit Lyonnais* operates in parity with *Geyer v. Ingersoll Publications Co.*[69] In *Geyer*, the Delaware Court of Chancery established that a direct trustee-like duty is owed to creditors of a firm that is insolvent in fact.[70] The *Credit Lyonnais* court, so the argument

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> The breach of th[e] duty [that directors owe to creditors in their capacity as trustee] gives rise to a claim that can be pursued by the creditors. Delaware may have expanded this duty, as distinguished from the directors' fiduciary duty to the corporation, when the corporation operates within a zone of insolvency.

Jewel Recovery, L.P. v. Gordon (*In re* Zale Corp.), 196 B.R. 348, 354-55 (Bankr. N.D. Tex. 1996) (citations omitted).

67. Steinberg v. Kendig (*In re* Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 655-56 (Bankr. N.D. Ill. 1998).

68. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 788 (Del. Ch. 2004)

69. Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784 (Del. Ch. 1992); *see, e.g.*, *Jewel Recovery*, 196 B.R. at 354-55 (noting tbat Delaware may have expanded the duty to creditors from insolvency to near-insolvency).

70. *Id.* at 787, 790.

goes, did not change the substance of this duty, it merely expanded its scope to near-insolvency.[71] Thus, the duty owed in insolvency in fact is identical to the duty owed in near-insolvency—both are derived from trust law. According to this approach, when a firm is either insolvent in fact or near-insolvent, creditors have the right to challenge a board's decisions as a breach of fiduciary duty. A prime example of this approach is the case of *Weaver v. Kellogg*, where a federal district court denied summary judgment on the grounds that "under both Delaware law and Texas law, corporate insiders . . . may have a fiduciary duty to the corporation's creditors even when the corporation [i]s not insolvent."[72]

Likewise, in *In re Zale Corp.*, a bankruptcy court sitting in Texas allowed a creditor to sue a near-insolvent corporation for breach of fiduciary duty. [73] There, the creditor alleged that the corporate directors had stripped the corporation of its assets during the effectuation of an LBO and merger.[74] Although the corporation was not yet insolvent, the court invoked the trust fund doctrine as justification for the right to sue:

> Delaware law recognizes that when a corporation becomes insolvent, the assets of the corporation become a trust for the benefit of the corporation's creditors. The corporate directors then hold a fiduciary duty as trustees to protect the assets for the creditors. The breach of that duty can give rise to a claim that can be pursued by the creditors. *Delaware may have expanded this duty, as distinguished from the directors' fiduciary duty to the corporation, when the corporation operates within a zone of insolvency.* Delaware does not appear to require that the corporation cease doing business or be incapable of conducting its business. [75]

In other words, a corporation need not be insolvent in fact in order to trigger a fiduciary duty owed to creditors. Although the *Zale* court did not explicitly extend the trust fund rationale to near-insolvent firms, it left open the possibility that the doctrine applies to firms that are on the outer-edge of insolvency or near-insolvency.[76]

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71. *Jewel Recovery*, 196 B.R. at 355.

72. Weaver v. Kellogg, 216 B.R. 563, 583-84 (Bankr. S.D. Tex. 1997).

73. *Jewel Recovery*, 196 B.R. at 354-55.

74. *Id.* at 354.

75. *Id.* at 354-55 (emphasis added) (citations omitted).

76. Near-insolvency has never been adequately defined. *See, e.g.*, Peoples Dep't Stores, Inc. (Trustee of) v. Wise, [2004] 3 S.C.R. 461, 493 (Can.) ("The directors' fiduciary duty does not change when a corporation is in the nebulous 'vicinity of insolvency.' That phrase has not been defined; moreover, it is incapable of definition and has no legal meaning. What it is obviously intended to convey is a deterioration in the corporation's financial stability."). There is no magic line that can be inserted somewhere between solvency and insolvency denoting the exact point at which insolvency happens. For example, the same firm may be deemed insolvent according to one method (such as the balance sheet test) but solvent according to another (such as the equitable insolvency test). This reflects the inherent unpredictability of associating a shift of fiduciary duties with the near-insolvency standard.

A similar result was reached in *In re Buckhead America Corp.*[77] The dispute in *Buckhead* arose from an LBO of a parent corporation financed heavily by its wholly owned subsidiary.[78] The financing arrangements allegedly caused the subsidiary to become insolvent.[79] Buckhead America Corporation ("Buckhead") was a 100% owned subsidiary of Days Inn of America Corporation ("DIC").[80] Defendants owned 49.5% of DIC.[81] In an attempt to "go private," DIC directed Buckhead to buy the other 50.5% of DIC stock.[82] Buckhead financed this transaction by incurring $175 million in debt.[83] The stock was then essentially given away to Reliance Capital Group, L.P. ("RCG"), from whom Buckhead received no consideration.[84]

Plaintiffs, creditors of Buckhead (now in a Chapter 11 bankruptcy proceeding), alleged fraudulent conveyance and breach of fiduciary duty.[85] Concerning the latter claim, the creditors claimed that

> (1) such actions (the LBOs) were taken for defendants' own benefit and not for the benefit of [Buckhead], (2) [Buckhead] was rendered insolvent as a result of the two LBOs at issue, and (3) [Buckhead's] insolvency obligated the directors to 'give their . . . loyalty, and owe a fiduciary duty to, the creditors of the corporation—not its shareholders.[86]

The *Buckhead* court allowed the breach of fiduciary duty claim to proceed past a motion to dismiss, rejecting Buckhead's argument that "to the extent the [Buckhead] directors took actions for the benefit of [DIC], its sole stockholder . . . such conduct is completely consistent with their duty of loyalty."[87] The court never determined whether Buckhead was insolvent or near-insolvent. The complaint alleged both, but the court's discussion did not distinguish between the two. Instead, relying on *Credit Lyonnais*, the court allowed the breach of fiduciary duty claim to proceed. [88]

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77. Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (*In re* Buckhead Am. Corp.), 178 B.R. 956, 968 (Bankr. D. Del. 1994).

78. *Id.* at 959-60.

79. *Id.* at 960.

80. *Id.* at 959.

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.* at 960.

85. *Id.*

86. *Id.* at 968.

87. *Id.*

88. The specific words relied upon by the court were: " '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,' including the corporation's creditors." *Id.* (citation

A significant difference between *In re Zale* and *In re Buckhead* is the way in which the courts justified the duty to creditors. The *Zale* court based its duty on the trust fund doctrine, finding that the duty originated from the directors' obligations as trustees of the corporate assets,[89] whereas the *Buckhead* court described the duty to creditors as part of the general duty to the corporate enterprise.[90] In other words, the *Zale* and *Buckhead* courts, relying on identical precedent cases, came up with different rationales for the same rule. The rule, however, has different implications based on which rationale is used. The *Zale* discussion emphasized the creditor's right to have assets preserved for his benefit, suggesting that a duty is owed directly to creditors. The *Buckhead* discussion suggested that a duty is owed only indirectly to creditors, as a byproduct of the duty to the entire corporate enterprise.

The *Zale* opinion leaves open the possibility that the duties owed in a near-insolvent firm are the equivalent to those owed in an insolvent firm. Such a rule fails to distinguish between the two separate theories that justify a duty to creditors: the trust fund doctrine and the at-risk theory. Although the trust fund doctrine applies in insolvency in fact, it loses conceptual force when applied to firms that are not clearly insolvent. *Credit Lyonnais*, which seems to be based on the theory that a board may permissibly incorporate the interests of creditors—who are increasingly "at risk" in a near-insolvent firm—into its business judgment, suggests that a more limited obligation is owed to creditors of near insolvent firms.

2. The Empirical Approach—*Credit Lyonnais* as a Sword, but Only in Limited Circumstances

Some courts, wary of the potential uncertainty that an affirmative duty to creditors would create, have limited the application of the insolvency duty to specific factual circumstances where the creditor can show fraud or self-dealing. For example, in *Ben Franklin Retail Stores*, the bankruptcy court dismissed a creditor claim for breach of fiduciary duty because the creditor could not allege directorial self-dealing. [91] There, the creditors sued the directors and

omitted) (quoting Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991)).

89. Jewel Recovery, L.P. v. Gordon (*In re* Zale Corp.), 196 B.R. 348, 354-55 (Bankr. N.D. Tex. 1996).

90. *In re Buckhead Am. Corp.*, 178 B.R. at 968.

91. Steinberg v. Kendig (*In re* Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 655-56 (Bankr. N.D. Ill. 1998).

officers of Ben Franklin Retail Stores, Inc. ("Ben Franklin") and its subsidiaries for allegedly creating misleading accounting figures in order to induce a loan.[92]

In dismissing the claim, the court first noted the general rule that in a solvent corporation, "directors do not owe creditors duties beyond the relevant contractual terms absent 'special circumstances.'"[93] It also accepted the premise that in insolvency, directors owe duties to creditors.[94] However, it questioned the scope of these insolvency duties. The Ben Franklin directors argued that the duties merely "require that directors refrain from self dealing or preferring shareholders or favored creditors over the general creditor body."[95] Conversely, the creditors contended that "directors of an insolvent corporation owe duties of care, loyalty and good faith to creditors similar to those owed to shareholders of solvent corporations."[96]

The court sided with the Ben Franklin directors. Beginning with the language of *Credit Lyonnais*,[97] it framed the opinion as an attempt to protect all constituencies from the opportunistic behavior of the others.[98] The court further inferred from *Credit Lyonnais* that the duties are owed to the corporation, not directly to creditors, characterizing that case and *Geyer v. Ingersoll Publications Co.*[99] as

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92. Specifically, the creditors claimed that the defendants were liable for "wrongfully prolonging the Debtors' corporate lives beyond the point of insolvency by misrepresenting the true value of the Debtor's accounts receivable." *Id.* at 649.

93. *Id.* at 653.

94. *Id.*

95. *Id.*

96. *Id.*

97.

> [I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

Id. at 655 (citation omitted) (quoting Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991)).

98.

> The potential "opportunistic behavior" about which the chancellor expressed concern, then, was the disposition of property at "fire sale prices" for the sole benefit of the shareholder, and unreasonable risk-taking, also for the sole benefit of shareholders, with corporate assets. . . . The chancellor's solution was to shield such directors from liahility to shareholders by declaring that their duty is to serve the interests of the corporate enterprise, encompassing all its constituent groups, without preference to any.

Id.

99. Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787-88 (Del. Ch. 1992) (recognizing the existence of a duty to creditors when a corporation is insolvent in fact).

cases where "the alleged wrongful act involved the disposition of assets for the benefit of shareholders, but to the detriment of the entire corporate enterprise rather than any single group interested in the corporation at a point in time when the shareholder's wishes should not be the directors' only concern."[100] Hence, where there is no injury to the aggregate corporate enterprise, there is no breach of fiduciary duties. Conversely, where directors act for the benefit of the entire corporate enterprise (framed in terms of wealth-maximization), then they do not breach their fiduciary duties, even if they act in detriment to a single, specific constituency, such as creditors.

According to the court, directors who create misleading accounts receivable figures in order to induce a loan do not breach any fiduciary duty if their actions benefit the corporation as a whole [101] The creditors' claims were based entirely upon injury to the creditor constituency, but what mattered was injury to the entire corporate enterprise. In other words, the creditors could bring a successful fiduciary duty action only in situations where the creditor class is injured *and* the aggregate corporate enterprise is harmed. Such a situation will exist in limited circumstances, for example, where the creditors can allege that:

> the debtors did not get full value for the debts they incurred, or that they did not use that value in an effort to restore the corporation to financial health. That is . . . that the Defendants did not use corporate assets in 'an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.[102]

Directors, then, only breach their duty in limited situations involving self-dealing or misappropriation of corporate assets because in such cases the creditors *and* the entire corporate enterprise are harmed.[103]

Comparing *Ben Franklin Retail Stores Inc.* with *In re Buckhead* reveals another nuance in the way courts perceive insolvency duties. Both courts held that according to *Credit Lyonnais*, a duty is owed to the entire corporate enterprise. The *Buckhead* court left open the possibility of board liability in situations where a board acts arguably for the good of the corporate enterprise, but to the detriment of a single constituency. Conversely, the *Ben Franklin* court requires that the corporate enterprise itself be injured. That is, it

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100. *In re* Ben Franklin Retail Stores, Inc., 225 B.R. at 655 (citation omitted) (quoting *Geyer*, 621 A.2d at 789).

101. *Id.* at 656.

102. *Id.*

103. Although directors can also be held liable for breach of the duty of care, corporate charters often exculpate directors from liability for breach of the duty of care. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2007) (authorizing a corporation to exculpate its directors from liability for breach of the duty of due care, subject to certain exceptions).

treats the corporation as a "black box"—unless a director uses the corporation in a way that robs it of its assets, there can be no breach of a fiduciary duty to creditors.

From an empirical standpoint, the *Ben Franklin* standard provides a realistic assessment of how many judges decide insolvency duty cases. The court's analysis was influenced by the observations of Professor Laura Lin, who argued that, as of 1993, "[a]ll of the decisions in which the courts have allowed creditors to recover for breach of fiduciary duty have involved directors of an insolvent corporation diverting corporate assets for the benefit of insiders or preferred creditors."[104] Professor Lin's empirical observations, although over a decade old, still retain force today. For example, in *Bank of America v. Musselman*, a federal district court sitting in Virginia held that a creditor may not sue an officer for breach of fiduciary duty absent proof of self dealing. [105] In justifying its holding, the court referred to its empirical analysis that most courts will not hold management liable absent some sort of self-dealing.[106] Similarly, in four other cases in which there was no showing of self-dealing, the courts all refused to find the directors liable.[107]

However, the *Ben Franklin* interpretation is not without its problems. It fails to address situations in which a creditor is significantly harmed, but where that harm is beneficial to the corporation. Consider a situation where the directors of a near-insolvent corporation act in a manner that does not lower the value of the corporation and in fact benefits the corporation, but that hinders the attempts of an individual creditor to recover.[108] Is there a breach of fiduciary duty toward that creditor?[109] Under the *Ben Franklin* standard, it is not a breach of fiduciary duty, since the duty is owed to the corporation, not the creditor. In other words, the creditor could not bring a derivative action. Moreover, it is unclear whether the creditor

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104. Lin, *supra* note 33, at 1513 (citation omitted), *quoted in In re Ben Franklin Retail Stores, Inc.*, 225 B.R. at 655.

105. Bank of Am. v. Musselman, 222 F. Supp. 2d 792, 797 (E.D. Va. 2002).

106. *Id.* at 799 n.17.

107. *Id.* at 799-801 (discussing Helm Fin. Corp. v. MNVA R.R., 212 F.3d 1076 (8th Cir. 2000); *In re Ben Franklin Retail Stores, Inc.*, 225 B.R. at 646; First Nat'l Bank of Boston v. Une, No. 87 C 10831, 1988 WL 130050 (N.D. Ill. 1988); St. James Capital Corp. v. Pallet Recycling Assocs. of N. Am., 589 N.W.2d 511 (Minn. App. 1999)).

108. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 797 (Del. Ch. 2004).

109. Vice Chancellor Strine deferred answering his own hypothetical, stating that "there are a myriad of policy considerations that would arise by the indulgence or non-indulgence of a fiduciary duty claim of this type and I am reluctant to ponder their viability without better help." *Id.*

could bring a direct fiduciary duty action against the directors.[110] Thus, unless and until it becomes settled law that a creditor can bring a direct suit for harms resulting from being singled out, the *Ben Franklin* standard leaves open the troubling possibility that such behavior on the part of directors would be permissible.

3. *Credit Lyonnais* as a Shield for Directors

In *Production Resources Group, L.L.C. v. NCT Group, Inc.*,[111] ("*Production Resources*"), Vice Chancellor Strine of the Delaware Chancery Court suggested that *Credit Lyonnais* should be read to operate as a shield for directors, rather than as justification for giving creditors the benefit of an affirmative fiduciary duty in the zone of insolvency.[112] The case arose out of a breach of fiduciary duty claim brought by creditor Production Resources Group ("PRG") against debtor NCT Group Inc. ("NCT"). NCT owed PRG a debt of $2,000,000, but it was on the verge of insolvency and never paid. However, NCT was able to continue operating due to capital infusions by its controlling shareholder, Carole Salkind ("Salkind").[113]

The facts of the case were particularly egregious. The NCT board had

> (1) not convened an annual stockholder meeting for several years; (2) caused NCT to pledge billions of shares more than are authorized by its charter; (3) permitted Salkind to obtain liens on the assets of the corporation; (4) retained no less than 8 companies affiliated with Salkind under substantial consulting contracts while refusing to cause the company to pay its debt to PRG; (5) placed funds from Salkind into a subsidiary company, rather than NCT itself, in order to avoid collection efforts by PRG; and (6) paid substantial salaries and bonuses to [two directors] while refusing to cause the company to pay its debt to PRG.[114]

On these findings, the court held that NCT was insolvent in fact and that PRG, in its capacity as a creditor, could initiate a derivative action for the harm the board caused to the corporation.

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110. Vice Chancellor Strine raises the possibility that a creditor in this situation can directly sue for breach of fiduciary duty. Under Delaware law, a corporation may favor one creditor over another, unless the favored creditor is an insider. Asmussen v. Quaker City Corp., 156 A. 180 (Del. Ch. 1931). However, the court assumed, for the purposes of its opinion, that "there might, possibly exist circumstances in which the directors display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor." *Prod. Res. Group,*, 863 A.2d at 798.

111. *Prod. Res. Group*, 863 A.2d at 772.

112. For an in-depth discussion of Vice Chancellor Strine's opinion, see Huff & Silberglied, *supra* note 8.

113. *Prod. Res. Group*, 863 A.2d at 774.

114. *Id.* at 799-800.

Although the court allowed PRG to sue, it emphasized that the injury was to the corporation, not the creditor.[115] Thus, "poor decisions by directors that lead to a loss of corporate assets and are alleged to be breaches of equitable fiduciary duties remain harms to the corporate entity itself."[116] PRG's claims were derivative in nature, because they were derived from harm to the corporation.[117] Thus, PRG could sue on behalf of the corporation to recover the value by which NCT was diminished, but could not bring a fiduciary duty action on behalf of itself individually.

While the above analysis was enough to rule on the facts of the case, the court also discussed, in dicta, the proper interpretation of *Credit Lyonnais* as applied to near-insolvent firms.[118] The court disapproved of the idea that *Credit Lyonnais* created an affirmative duty to creditors in near-insolvent firms, stating that those courts were "using the law of fiduciary duty to fill gaps that do not exist."[119] Creditors already possess protections such as "strong covenants, liens on assets, and other negotiated contractual protections,"[120] and they can rely on the implied covenant of good faith and the law of fraudulent conveyance.[121] These protections adequately remedy most of the situations that creditors confront when a corporation does not pay its debts.[122]

Thus, the *Production Resources* court reaffirmed the notion that there should be no duty to creditors in near-insolvency, but that there instead remains a constant duty to the corporation, with an accompanying shift in the balance of interests of the affected constituencies. As Chancellor Allen stated in *Credit Lyonnais*, the

115. *Id.* at 792. ("[T]he transformation of a creditor into a residual owner does not change the nature of the harm in a typical claim for breach of fiduciary duty by corporate directors.").

116. *Id.*

117. According to the court, "the reason for this bears repeating – the fact of insolvency does not change the primary object of tbe director's duties, which is the firm itself. The firm's insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value." *Id.*

118. The court characterized near-insolvent firms as firms within the "zone of insolvency." *Id.* at 790.

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.* ("[W]itb these protections, when creditors are unable to prove that a corporation or its directors breached any of the specific legal duties owed to them, one would think that the conceptual room for concluding that the creditors were somehow, nevertheless, injured by inequitable conduct would be extremely small, if extant.").

duty is owed to the "corporate enterprise . . . [and] to the community of interest that sustained the corporation."[123]

Since the duty is owed to the corporate entity, directors of near-insolvent firms receive the procedural and substantive protections of the business judgment rule.[124] According to the *Production Resources* court,

> the *Credit Lyonnais* decision's holding and spirit clearly emphasized that directors would be protected by the business judgment rule if they, in good faith, pursued a less risky business strategy precisely because they feared a more risky strategy might render the firm unable to meet its legal obligations to creditors and other constituencies.[125]

On the particular facts of *Credit Lyonnais*, the directors were given a shield to defend from stockholder suits for making decisions based on stakeholder interests. A logical extension of *Credit Lyonnais*, then, is the reverse: directors of near-insolvent firms can be shielded from stakeholder claims alleging that directors are not adequately considering stakeholder interests. In both cases, the alleged harm is not only to the affected constituency, but also to the corporation, as "poor decisions by directors that lead to a loss of corporate assets . . . remain harms to the corporate entity itself."[126] A board's duties, then, do not undergo profound changes as the corporation nears insolvency—the duty runs to the benefit of the corporation, as always. Consequently, just like when making any other regular business decision, the business judgment rule should remain applicable and operate to protect directors who make reasonably informed decisions in good faith.[127]

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123. Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., No. 12150,1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

124. Courts have come to different conclusions on whether the business judgment rule applies to decisions made during insolvency. For an example of a court declining to apply the business judgment rule, see Mims v. Kennedy Capital Mgmt., Inc. (*In re* Performance Nutrition, Inc.), 239 B.R. 93, 111 (Bankr. N.D. Tex. 1999) ("[T]he business judgment rule may be wholly inapplicable in a case where the corporation is insolvent."); see also Unsecured Creditors Comm. v. Gen. Homes Corp. (*In re* Gen. Homes Corp.), 199 B.R. 148, 151-52 (Bankr. S.D. Tex. 1996) ("[M]oreover, while the business judgment rule may apply to the decisions of solvent corporations, it has no consequence in the context of a conservatorship."). For an example of a court applying the business judgment rule, but ruling in favor of creditors, see Official Comm. of Unsecured Creditors of Toy King Distribs., Inc. v. Liberty Sav. Bank (*In re* Toy King Distribs., Inc.), 256 B.R. 1 (Bankr. M.D. Fl. 2000). For an example of a court applying the business judgment rule and holding in favor of the debtor corporation, see Odyssey Partners, L.P. v. Fleming Co., 735 A.2d 386 (Del. Ch. 1999).

125. *Prod. Res. Group,* 863 A.2d at 788.

126. *Id.* at 792.

127. *Id.* ("[T]he business judgment rule remains important and provides directors with the ability to make a range of good faith, prudent judgments about the risks they should undertake on behalf of troubled firms.").

IV. THE SOLUTION: APPLYING THE DISCRETIONARY APPROACH TO NEAR-INSOLVENCY

Much of the confusion in near-insolvency law stems from the fact that courts have not distinguished between the two separate rationales for extending a duty to creditors. The first rationale, the trust fund doctrine, treats directors of an insolvent firm as trustees and creditors as beneficiaries. The second rationale, the "at risk" doctrine,[128] recognizes that as the corporation nears insolvency, the shareholders will favor riskier strategies since they bear minimum downside and unlimited upside potential. This risk of shareholder opportunism falls on the creditors, who must rely on the remaining corporate assets to satisfy their contractual claims.

The duties created by the two rationales are not identical. The trust fund doctrine turns the creditor into the beneficiary of a fiduciary duty, while the "at risk" doctrine favors a discretionary duty, or at best an indirect duty that is derivative of the general duty to the corporation. The trust fund doctrine is well established as the primary rationale for the duty to creditors in insolvency in fact. However, the *Credit Lyonnais* opinion, which arguably extended duties into the near-insolvency context, did not base its reasoning on the trust fund doctrine. Instead, the court seems to have adopted "at risk" approach. Despite Chancellor Allen's long footnote explaining his reasons,[129] some courts have failed to distinguish between the two rationales and have extended a duty to creditors in near-insolvent firms based on the trust fund doctrine.

Because of the differences in the underlying rationales, however, the two doctrines are not synonymous and must be distinguished. Creditors are not true principals and so, when a corporation is not insolvent in fact, treating creditors as the beneficiaries of an affirmative fiduciary duty would make no sense. However, blind adherence to shareholder primacy ignores the greater risk of shareholder opportunism and is thus an equally poor solution. As discussed below, a discretionary approach, derivative of the general duty to the corporation, would be the most consistently applied standard in a near-insolvent firm.

128. Huff & Silberglied, *supra* note 8, at *10.

129. Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

A. Outside of Insolvency In Fact, Creditors Are Not True Principals

The corporate form is afflicted by the classic agency problem. Shareholders invest money in the firm, becoming its theoretical owners, but they have no say in how the firm is run. Instead, directors are charged with managing the business and affairs of the corporation.[130] In an effort to combat the incentive to steal or work less diligently than if one's own money were at risk, corporate common law imposes a duty on directors to act with loyalty and prudence. Thus, rather than impose a scheme whereby every shareholder must contract with the corporation to ensure its rights, the law creates broad duties requiring directors to act in a proper manner.[131] The director, also known as the fiduciary, owes his duties to the corporation and its shareholders, the principals. To some extent then, whether creditors should be the subject of a duty in near-insolvency depends on whether they fall into the traditional mold of "principal," as that term is used in the fiduciary-principal relationship. Under the trust fund doctrine, creditors of firms that are insolvent in fact are deemed principals, since the directors become trustees of the remaining corporate assets. However, in near-insolvency, directors have not yet been converted into trustees. Absent that transformation, there is no basis for treating creditors as principals.

A fiduciary duty arises from a fiduciary relationship, which in turn requires a heightened degree of trust. A fiduciary's duties "go beyond mere fairness and honesty; they oblige him to act to further the beneficiary's best interests."[132] Typical relationships that require such a high degree of trust and reliance include attorney-client, trustee-beneficiary, executor-heir, and doctor-patient. Conversely, a debtor-creditor relationship is adversarial in nature. A debtor merely owes the creditor an obligation to repay a debt. Beyond this contractual obligation, nothing more is owed. A debtor may owe a creditor a duty to act in good faith, but the debtor need not act in furtherance of the creditor's interests.[133] Absent the triggering of the

130. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (2007).

131. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361-62 (Del. 1993) (duty of loyalty); Aronson v. Lewis, 473 A.2d 805, 812-13 (Del. 1984) (duty of care and the business judgment rule); MODEL BUS. CORP. ACT § 8.30(a) (1984) (duty of loyalty).

132. Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 882.

133. For a discussion of how the shift of fiduciary duty to creditor is not supported by two leading classical theories of fiduciary duty, contractarian and fiduciarian, see J. William Callison, *Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice*, 2 J. BUS. & TECH. L. (forthcoming 2007), *available at* http://www.law.umaryland.edu/conferences/Twilight/CALLISON.PDF.

trust fund doctrine, this obligation does not rise beyond the level of "mere fairness and honesty" that is indicative of a contractual relationship.

B. Directors Should Not Be Compelled to Consider Only Shareholder Interests in Near-Insolvency

The most common explanation as to why a creditor should not be the beneficiary of a fiduciary duty is that the creditor can contract to protect himself accordingly. For example, if a creditor believes that there is a risk that the corporation may default, then he can deny credit, raise the interest rate to reflect the increased risk, or demand some form of security.[134] However, not every creditor can rely on these contractual protections.

Ultimately, the question must be asked: Who is the creditor? The notion that all creditors can rely on contractual protections assumes that creditors are large sophisticated entities who voluntarily take on the role of creditor, such as banks. But what about individuals whose only claim against the corporation is a court-awarded damages judgment? Can an involuntary one-time creditor be placed on the same terms as professional creditors? As one commentator put it,

> creditors are viewed as freely bargaining their contracts and thus assuming the risk of insolvency; hence directors should owe no duty to consider the interests of creditors. Yet the number and range of creditors of corporations varies. It is true that senior secured lenders are frequently in a position to bargain a premium in their debt arrangements that accounts for the risk of financial distress. . . yet even wbere such creditors have the bargaining power to impose self-help remedies when the corporation breaches the contract or to temper the risk of harm from firm failure, such creditors may not be able to bargain protection for directorial self-dealing, shirking, or conduct that is in breach of the director's duties to the corporation. . . . In contrast to the secured and senior creditors, there are thousands of creditors who have neither the bargaining power nor the information or resources to negotiate protections against risk of firm failure. Thus, while they become residual claimants, they have not been able to bargain any risk premium.[135]

The argument that creditors can contract for their own protections thus assumes that (1) the debtor-creditor relationship is voluntary; (2) the creditor has the necessary bargaining power to secure adequate protections; and (3) that creditors are able to bargain for protection from self-dealing in the first place.

The first assumption ignores involuntary creditors. Corporations are often the target of litigation. Any judgment against

134. *Id.* (listing common arguments against the shift of fiduciary duties to creditors in the vicinity of insolvency).

135. Janis Sarra, *Wise People, Fiduciary Obligation and Reviewable Transactions, Director's Liability to Creditors*, *in* ANNUAL REVIEW OF INSOLVENCY LAW (Janis Sara ed., 2004).

the corporation creates an involuntary creditor who has not had the opportunity to bargain for any protections. Likewise, the second assumption, that creditors have the requisite amount of bargaining power, is also untrue in some situations. Many trade creditors, for example, "are small suppliers, and are dependent on the debtor corporation for a sizeable portion of their orders."[136] In a competitive market, a trade creditor may feel compelled to forego bargained-for protections. At the very least, a trade creditor dependent upon the debtor will not be able to diversify its risks.[137]

The third assumption, that creditors will be able to bargain for protection from self-dealing, is the most speculative. Perhaps some creditors possess sufficient information on management integrity to demand a premium for a risk of breach of duty. However, expecting the majority of creditors to bargain for such a premium is unrealistic. A creditor should be able to rely on the assumption that a director or majority shareholder will act in good faith and in compliance with his duties to the corporation. It is unclear what information would even suffice to raise the possibility that a firm's directors and managers are at risk of engaging in self-dealing. Self-dealing is hard to predict, so unless all creditors always bargain for additional self-dealing protection (thus universally raising the cost of capital), then some form of added protection should be granted to creditors.[138]

C. A Discretionary Approach, Derivative of the General Duty to the Corporation, Is the Most Workable Standard for Near-Insolvent Firms

Contractual provisions may adequately protect most creditors, but they will fail to protect some, especially in a near-insolvent firm where the creditor bears an increased risk of being subjected to shareholder opportunism. The *Credit Lyonnais* court recognized this inadequacy, and sought to redress it by holding that directors of a near-insolvent firm may permissibly incorporate creditor interests into their business judgment, as when, for example, a board decides to pursue a less risky course of action more favorable to creditors. However, as discussed above, courts have interpreted *Credit Lyonnais* in different ways.[139] Some recognize a constant duty to the

136. *Id.* at 75.

137. *Id.*

138. Some commentators have argued that insolvency duties should be owed only to certain types creditors, such as unsecured creditors or tort-claimants. *See e.g.*, J.C. Lipson, *Director's Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189 (2003).

139. *See supra* Part III.B.

corporation, from which creditors can bring derivative claims for breach of insolvency duties.[140] Others grant an affirmative duty to creditors without carefully confining the duty to clear insolvency.[141] As discussed below, the latter courts go too far and create a standard that is unacceptably difficult to apply. A discretionary approach avoids the troubling issue of determining when near-insolvency duties are triggered. Further, it is better applied in practice and is consistent with other aspects of state corporate law.

1. The Discretionary Approach Avoids the Problem of Defining Exactly When Insolvency Duties Are Triggered

If creditors are to be treated as beneficiaries of a fiduciary duty, then there is the problematic issue of determining when the duty is triggered. A duty triggered by insolvency in fact or near-insolvency would require a gauging of the financial health of the corporation on a continuous basis, so that directors would know with some degree of certainty when their duties are activated. If the duties are to begin upon the filing of a formal bankruptcy petition, then directors will know (and have some control over) exactly when their duties shift. However, the duty arises upon insolvency in fact, not upon the filing of a bankruptcy petition.[142]

Determining when a corporation is insolvent in fact is no easy task. According to one commentator, "accounting information is being called on to draw a definite line on which liability hangs yet which in many ways does not yield certain results."[143] Accounting details are fraught with judgment calls about how a particular account should be valued. Theoretically, if two separate and independent accountants audit two identical near-insolvent companies, one might find that the company is solvent, and the other might conclude that it is insolvent.

The equitable insolvency test, which focuses on whether a firm can pay its debts as they come due, provides some measure of accuracy to the analysis. Using the test, it could be possible to determine if a firm is solvent on any given day. However, the knowledge that on Monday a corporation is solvent, while on Tuesday it is insolvent, only to be solvent again on Wednesday, is not helpful. As one Australian

140. Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group Inc. (*In re* Buckhead America Corp.), 178 B.R. 956 (Bankr. D. Del. 1994); Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).

141. Jewel Recovery, L.P. v. Gordon (*In re* Zale Corp.), 196 B.R. 348 (Bankr. N.D. Tex. 1996).

142. Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784 (Del. Ch. 1992).

143. David Wishart, *Models and Theories of Directors' Duties to Creditors*, 14 NEW ZEALAND U. L. REV., 323, 344 (1991).

commentator put it, "a company may move in and out of insolvency as its fortunes fluctuate . . . the duties of directors should be evaluated from a broad perspective and not on the basis of technicalities."[144]

The issue becomes more complicated now that Delaware and other jurisdictions arguably recognize that some sort of obligation is owed in near-insolvency. Many corporations consistently operate in near-insolvency, such that, under some interpretations, directors in these corporations would often owe their duties to creditors as well as to shareholders.[145] Furthermore, it is difficult to determine precisely the bounds of near-insolvency. Since near-insolvency has never been adequately defined, it is a shapeless concept.

In an attempt to define near-insolvency, a few courts in other common law jurisdictions have suggested that duties should shift to creditors when there is a "risk of insolvency."[146] Under this approach, insolvency duties arise when "a contemplated course of payment or other course of action would jeopardize solvency."[147] Thus, insolvency duties could arise when a company is solvent, but is considering a risky course of action that could result in insolvency.[148] Aside from the broadness of this rule, one must question how it would apply in practice. What level of scienter is required on the part of directors? Knowledge that their decision might lead to insolvency? A more realistic standard would be the gross negligence standard. However, this standard requires courts to ask whether a board of directors is liable to creditors because things did not turn out well in cases where a board of a solvent corporation makes a good faith decision to undertake a high-risk course of action in order to maximize firm value.

Recognizing a discretionary duty avoids the "triggering" inquiry altogether. Directors consistently owe a duty to the corporation. As part of this duty, they would consistently owe an indirect duty to creditors because creditors are part of the corporate enterprise. The discussion in most boardrooms would not be focused upon whether the duty to creditors has been triggered, but instead upon how much weight, if any, should be assigned to the creditors'

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144. Andrew Keay, *The Director's Duty to Take into Account the Interests of Company Creditors: When is it Triggered?*, 2001 MELBOURNE U. L. REV., 1, 10-11.

145. *Id.*

146. Kinsella v. Russell Kinsella Pty. Ltd. (in liq), (1986) 4 N.S.W.L.R. 722, 733 (Austl.). *Kinsella* has recently been criticized and *de facto* rejected by the High Court of Australia in *Spies v. The Queen*, (2000) 201 C.L.R. 603 (Austl.) (holding that directors of a near-insolvent company do not owe creditors an independent fiduciary duty).

147. Nicholson v. Permakraft Ltd., [1985] 1 N.Z.L.R. 242 (N.Z.C.A.).

148. *See* Keay, *supra* note 144 (arguing that the insolvency duties should be triggered when there is a risk of insolvency).

interests. Ultimately, the board should be confident that a good faith and well-thought out decision will be upheld by the courts.

Indeed, this seems to be the direction that other leading common law jurisdictions are heading. Most are hostile to the idea of an affirmative duty to creditors.[149] However, like in the United States, the law in other commonwealth countries has developed out of contradictory and confusing precedents. Many older cases in these jurisdictions suggested that there might be some sort of direct duty, although none held so definitively.[150] The first case to consider the issue was *Walker v. Wimborne*, in which the Australian High Court held that, although directors owe a general duty to the corporation, this duty encompasses both shareholder and creditor interests when the firm is in financial distress.[151] Similarly, in *Kinsella v. Russell Kinsella Pty. Ltd.*, the court found that:

> where a company is insolvent the interests of the creditors intrude . . . once it is accepted, as in my view it must be, that the director's duty to a company as a whole extends in an insolvency context to not prejudicing the interests of creditors, . . . [then] the shareholders do not have the power or authority to absolve the directors from that breach.[152]

In 2002, the High Court of Australia rejected these older cases, instead suggesting that directors need only incorporate creditor interests into their business judgment to the extent that it benefits the corporation.[153]

Likewise, in 2004, the Supreme Court of Canada held that a duty of care is owed to all corporate constituents, including creditors.[154] Conversely, the duty of loyalty is owed to the corporation alone. Thus, a director who makes a good faith and honest decision when the firm is near-insolvent is protected from liability. According to the Court,

> perfection is not demanded . . . courts are ill-suited and should be reluctant to second guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable, on the facts of any case, of determining

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149. *See, e.g., Spies*, 201 C.L.R. at 603 (holding that directors of a near-insolvent company do not owe creditors an independent fiduciary duty); Peoples Dep't Stores, Inc. (Trustee of) v. Wise, [2004] 3 S.C.R. 461 (Can.) (finding no direct duty to creditors, although a duty of care is owed to all).

150. *See* Winkworth v. Edward Baron Dev. Co., (1987) B.C.L.C. 193, 197-98 (K.B.) (language suggesting a direct duty); *Nicholson*, 1 N.Z.L.R. at 242 (same); Jeffree v. Nat'l Cos. and Sec. Comm'n, (1989) 15 A.C.L.R. 217, 221 (K.B.) (same).

151. Walker v. Wimborne, (1976) 50 A.L.J.R. 446 (Austl.); *see also* David Thomson, *Directors, Creditors, and Insolvency: A Fiduciary Duty or a Duty not to Oppress?* 58 U. TORONTO. FAC. L. REV. 31, 38 (2000) (discussing the leading cases in common law jurisdictions).

152. Kinsella v. Russell Kinsella Pty. Ltd. (in liq), (1986) 4 N.S.W.L.R. 722, 730, 731 (Austl.).

153. *Spies*, 201 C.L.R. at 603.

154. *Peoples Dep't Stores*, 3 S.C.R. at 461.

> whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision.[155]

The Court was explicit in conveying the point that there is no shift of duties upon the nearing of insolvency:

> The director's fiduciary duty does not change when a corporation is in the nebulous "vicinity of insolvency." That phrase has not been defined; moreover, it is incapable of definition and has no legal meaning. What it is obviously intended to convey is a deterioration in the corporation's financial stability. In assessing the actions of directors it is evident that any honest and good faith attempt to redress the corporation's financial problems will, if successful, both retain value for the shareholders and improve the position of creditors.[156]

Thus, an affirmative duty approach has been rejected by the highest courts of two other commonwealth jurisdictions. Although some older cases, like a few of the United States cases discussed above, suggest a duty to creditors in near-insolvency, the newer high court decisions support the argument that a duty to creditors in near-insolvency is a problematic standard.

2. The Discretionary Approach is Better Applied in Practice

The discretionary approach avoids a number of practical inadequacies of the affirmative duty approach. An affirmative duty in near-insolvency, by definition, allows a creditor to sue the board for breach of fiduciary duty before the firm is actually insolvent. Conceivably, then, directors could face two separate derivative suits at the same time: one brought by shareholders and one brought by creditors.[157]

Worse still, if the affirmative duty takes the form of a direct duty, such that individual creditors can sue on their own behalf, then the rule would "invite a multiplicity of actions, encourage litigation and [waste] considerable time and expense, all of which would be lessened if the company were the only possible litigant."[158] Further, a direct duty creates the potential for double recovery, thus violating "that important principle of insolvency law, the *pari passu* principle, [which operates] by preventing any one creditor from stealing a march

155. *Id.* at 493.

156. *Id.* at 483

157. *See, e.g.,* Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 790 n.56 (Del. Ch. 2004).

158. Donna W. McKenzie Skene, *The Director's Duty to the Creditors of a Financially Distressed Company: A Perspective from Across the Pond,* 2 J. BUS. & TECH. L. (forthcoming 2007) (manuscript at 4), *available at* http://digitalcommons.law.umaryland.edu/blc_2005/4/.

on other creditors."[159] In short, a direct duty would create a race to the courthouse.

Moreover, a shift of duties to creditors upon insolvency could "chill entrepreneurial skills and encourage directors to adopt defensive strategies instead of maximizing opportunities and profits for the shareholder's benefit."[160] A board of directors should be free to make good faith plans to maximize the value of a near-insolvent firm. Exposing them to potential lawsuits from disgruntled creditors concerned about the riskiness of the plans would encourage the abandonment of potentially profitable plans.[161]

3. The Discretionary Approach Is Consistent with Other Aspects of Corporate Law

Over the past fifty years, Delaware corporate law has articulated the notion that, absent special circumstances, directors owe a duty to the corporation itself.[162] The contrary view was that corporations existed for the sole purpose of maximizing shareholder wealth.[163] The classic case of *Dodge v. Ford Motor Co.* represents an

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159. *Id. Pari Passu* is defined as "proportionally; at an equal pace; without preference." BLACK'S LAW DICTIONARY (8th ed. 2004). It prevents creditors from racing to the courthouse, since the order in which claims are brought will not affect their distribution in bankruptcy.

160. Jacob S. Ziegel, *Corporate Governance and Directors' Duties to Creditors: Two Contrasting Philosophies*, ANNUAL REVIEW OF INSOLVENCY LAW, *supra* note 135, at 133, 157.

161. *See Prod. Res. Group*, 863 A.2d at 790.

> I doubt the wisdom of a judicial endeavor to second-guess good-faith director conduct in the so-called zone [of insolvency]. Although it is easy to posit extreme hypotheticals involving directors putting cash in slot machines, the real world is more likely to generate situations when directors face a difficult choice between pursuit of a plausible, but risky, business strategy that might increase the firm's value to the level that equity holders will receive value, and another course guaranteeing no return for equity but preservation of value for creditors. Absent self-dealing or other evidence of bad faith, by what measure is a court fairly to critique the choice made through an award of damages?

Id.

162. *See* Leo E. Strine, Jr., *The Social Responsibility of Boards of Direetors and Stockholders in Change of Control Transactions: Is There Any "There" There?*, 75 S. CAL. L. REV. 1169 (2002) (describing how Delaware law leans toward the "social entity" school of thought, except in circumstances where *Revlon* duties are triggered). The entity school holds that "the corporate board of directors owes its duties to the corporation itself, rather than to the stockholders." *Id.* at 1171. William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 264 (1992) (describing the "social entity" theory of the corporation, which emerged over the last century).

163. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440-41 (2001) (describing the shareholder primacy model); *see also* Strine, *supra* note 162, at 1170-71 (describing the "property" school of thought).

extreme of this shareholder primacy model.[164] There, the Michigan Supreme Court forced Ford Motor Company to declare a dividend after the Company declined to do so on the grounds that it had made too much money and was better off sharing the gains with the public by cutting prices.[165] A review of the case law since then, however, suggests that *Dodge v. Ford* was an outlier case. More recent court decisions have granted directors greater discretion in considering the interests of non-shareholders when making operational business decisions.[166] Delaware directors may now consider the interests of other constituencies, provided that those interests "bear some reasonable relationship to general shareholder interests."[167] Generally, this has allowed boards to look past the short term interests of shareholders and incorporate the interest of other stakeholders by justifying a decision on the grounds that it promotes an even greater (although less certain) long-term value.[168]

In other words, the long-term interests of the corporation can encompass the interests of its stakeholders. If a board can tie stakeholder interests to the long-term value of the corporation and its shareholders, then it may permissibly consider those interests. This opens up the possibility that corporations are societal institutions with greater responsibilities than merely ensuring a maximum return for shareholders. As Chancellor Allen put it,

> corporate purpose can be seen as including the advancement of the general welfare. The board of directors' duties extend beyond assuring investors a fair return, to include a duty of loyalty, in some sense, to all those interested in or affected by the corporation. This view could be labeled in a variety of ways: the managerialist conception, the institutionalist conception, or the social entity conception. All would be descriptive, since

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164. Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

165. *Id.* at 507 ("[I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others.").

166. *See* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1282 n.29 (Del. 1989) (holding that a board of a target company may consider the impact of the bid on other constituencies, "provided that it bears some reasonable relationship to general shareholder interests"); Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1986) (narrowing the *Unocal* holding by requiring that any consideration of non-shareholder interests be rationally related to a benefit accruing to the shareholders); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (holding that a board of directors may take into account the impact on constituencies other than shareholders when it decides whether to adopt a takeover defense).

167. *Mills Acquisition Co.*, 559 A.2d at 1282 n.29. An exception arises when *Revlon* duties are activated, in which case directors must maximize shareholder value without regard to other stakeholder interests.

168. *See, e.g.*, Paramount Commc'ns, Inc. v. Time, Inc., 570 A.2d 1136, 1140 (Del. 1990) (holding that Time and Warner may merge, even though a Time-Paramount merger would offer the shareholders a greater premium because, among other things, the Time directors made good faith and reasonable findings that Time's long-term value would be greater served by a merger with Warner).

> the corporation is seen as distinct from each of the individuals that happens to fill the social roles that its internal rules and culture define. The corporation itself is, in this view, capable of bearing legal and moral obligations.[169]

The above-mentioned Delaware approach is representative of the corporate common law in other jurisdictions.[170]

Basing the near-insolvent corporate board's obligation to creditors on the discretionary approach is consistent with how stakeholder interests are treated under current law. The discretionary approach creates an "obligation" that is derivative of the general duty to the corporation. In other words, it allows directors to consider creditor interests, but only to the extent that doing so benefits the corporation. Like current law, directors would be given a shield, in the form of greater discretion, with which to defend themselves from shareholder suits. Creditors, however, would not be given a sword for the attack.

By way of contrast, an affirmative-duty approach would not structurally mesh with a board's other duties. If a director owed a fiduciary duty to creditors, how would the board reconcile its new obligations with the existing duties it already owes to the shareholders? The director would owe an identical duty to two constituencies whose interests are often adversarial. In addition, many creditors can rely on other bodies of law for protection, such as the implied covenant of good faith and fair dealing, fraudulent conveyance law, and contract law. As one court put it, allowing creditors to challenge director decisions as a breach of fiduciary duty "arguably . . . involves using the law of fiduciary duty to fill gaps that do not exist."[171]

Doing away with the notion that there is a duty to creditors outside of insolvency brings back a measure of stability to the law of fiduciary duty.[172] Corporate common law should aim to create clear and precise standards that directors can rely on when making business decisions. The discretionary approach protects directors from lawsuits filed by discontented creditors and at the same time permits directors to integrate creditor interests into their business decisions.

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169. Allen, *supra* note 162, at 265.

170. ABA Committee on Corporate Laws, *Other Constituency Statutes: Potential for Confusion*, 45 BUS. L. 2253, 2261 (1990) ("We helieve the Delaware courts have stated the prevailing corporate common law in this country: directors have fiduciary responsibilities to shareholders which, while allowing directors to give consideration to the interests of others, compel them to find some reasonable relationship to the long-term interests of shareholders when so doing.").

171. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 789-90 (Del. Ch. 2004).

172. Callison, *supra* note 133 (arguing that there should be no duty to creditors because creating a duty would impose unacceptable ambiguity upon directors).

Overall, a well-functioning corporation requires directors who will make decisions for the good of the entire corporation, including its stakeholders.

V. CONCLUSION

Ever since the 1991 *Credit Lyonnais* decision, courts and commentators have disagreed about the scope of what obligations, if any, are owed to creditors of a near-insolvent firm. Before *Credit Lyonnais*, many courts recognized that fiduciary duties were owed in firms that were insolvent in fact. These duties arose out of the trust-fund doctrine, which treated creditors as the beneficiaries of a corporate trust composed of the firm's remaining corporate assets. Directors, as trustees, owed a fiduciary duty parallel to any other trustee-beneficiary relationship. A second doctrine, labeled by some commentators as the "at risk" doctrine,[173] imposed a fiduciary duty to protect creditors based on their role as the primary down-side risk bearers in an insolvent firm. The "at risk" doctrine does not necessarily favor the creation of a duty to creditors in near-insolvency.

The *Credit Lyonnais* Court sparked controversy when it recognized that directors could consider creditor interests in "the vicinity of insolvency."[174] Many courts have read *Credit Lyonnais* to stand for the proposition that an affirmative duty extends to creditors in a near-insolvent firm. However, the trust fund doctrine loses its force when applied outside of insolvency, since the duty it creates arises from the trustee-beneficiary relationship created in an insolvent firm. Further, the idea of a duty to creditors seems to create an unworkable standard that is inconsistent with how current law treats other stakeholders.

Yet the idea that creditor interests should never receive extra regard in a near-insolvent firm is equally unsatisfactory. Although many creditors can rely on express and implied contractual protections, some, such as judgment-creditors, have no contract. Additionally, given the chances that a near-insolvent firm may soon become insolvent, directors should not be penalized for incorporating creditor interests into their business decisions, as long as those decisions are made in good faith.

The discretionary approach offers directors the protection they deserve for guiding a financially distressed firm. It authorizes

173. Huff & Silberglied, *supra* note 8.

174. Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., No. 12150,1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991).

directors of near-insolvent firms to act with regard to creditor interests, but does not force them to do so. The directors are protected from shareholder lawsuits claiming that the corporation should adopt riskier strategies. However, creditors cannot sue unless they seek to remedy an injury to the corporate enterprise. Since the duty is more of a shield than a sword, there is no "triggering point," as there would be if a duty were owed directly to creditors.

Most importantly, the discretionary approach is the most easily applied standard. It is also consistent with how corporate common law treats other stakeholders. Directors crave stability and predictability in the law. A standard based on the general duty to the corporate enterprise is familiar to directors seeking to comply with their duties. A board would no longer face the untenable situation of being sued by their shareholders or, if not, by their creditors. The discretionary approach is first and foremost a defensive approach, such that "directors who make good faith, careful judgments in the honest belief that they are acting in the best interests of the corporation should not fear liability."[175] Since this approach is the same regardless of whether the firm is solvent or near-insolvent, there is no point in retaining that distinction any longer.

Cory Dean Kandestin[*]

175. E. Norman Veasey, *What Happened In Delaware Corporate Law And Governance From 1992-2004*, 153 U. PA. L. REV. 1399, 1430 (2005).

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