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I. INTRODUCTION

In the wake of the debt binge of the 1980s, the number of financially distressed corporations has increased dramatically.[1] Because a struggling company rarely ceases operations overnight, directors still need to make investment and operational decisions concerning the best use of the company's existing assets.[2] This need remains whether the firm will regain profitability or will be liquidated. Financial distress also intensifies conflicts of interest between shareholders and creditors.[3] Indeed, when these constituencies are unable to recover their investments in the corporation because of insufficient assets, both shareholders and creditors have incentives to maximize their individual returns regardless of the possible adverse impact on other corporate participants and on the overall value of the firm.

From the perspective of corporate governance, therefore, determining for whose interest directors should act during this highly volatile period will lead to different outcomes. Directors' alliances with either shareholders or creditors influence decisions ranging from the day-to-day operation of the business to the future of the firm, such as whether to attempt an out-of-court debt restructuring or to seek protection under the Bankruptcy Reform Act of 1978.[4]

Most commentators thus far have focused on the relationship among the corporation's managers, shareholders, and creditors during bankruptcy proceedings.[5] Although corporate governance is an impor-

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1. See Lewis U. Davis, Jr., et al., *Corporate Reorganization in the 1990s: Guiding Directors of Troubled Corporations Through Uncertain Territory*, 47 Bus. Law. 1, 1 n.1 (1991) (providing statistics illustrative of the increase in both the number and size of Chapter 11 filings from the 1980s to 1990s); John C. Coffee, Jr. and William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. Chi. L. Rev. 1207, 1208 n.4 (1991) (showing the frequency and amount of debt exchange offers as part of recapitalization during 1990).

2. See Douglas G. Baird and Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 104-05 (1984) (positing that use and ownership of assets should be two separate questions in bankruptcy). See also *Michelsen v. Penney*, 135 F.2d 409, 433-34 (2d Cir. 1943) (stating that "[i]t is matter [sic] of common knowledge that . . . corporations continue, in many instances, to do their regular and ordinary business for long periods, though in a condition of actual insolvency, as disclosed by subsequent events").

3. For the purposes of this Article, the term "creditors" means holders of long-term deht (that is, holders of publicly issued bonds or debentures and commercial lenders pursuant to privately placed debt securities or term loans). Although other corporate creditors (such as employees and trade creditors) also face similar problems when a corporation becomes insolvent, discussion of their rights is heyond the scope of this Article.

4. 11 U.S.C. §§ 101-1220 (1988 & Supp. 1993) ("Bankruptcy Code").

5. See, for example, Douglas G. Baird and Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. Chi. L. Rev. 738 (1988); David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 Va. L. Rev. 461 (1992); Michael Bradley and Michael Rosenzweig, *The Untenable Case for Chap-*

tant issue when a firm is in bankruptcy, we also need to address the problem of these corporate actors' opportunistic behavior as the company's financial condition deteriorates before bankruptcy. This Article thus shifts the focus to an earlier point on the time line of corporate existence. If we can devise a set of rules that gives parties incentives to maximize the firm's value even when the firm is in financial trouble, we can reduce the overall societal loss when the corporation eventually is pushed into either voluntary or involuntary bankruptcy.

Part II of this Article examines the self-interested behavior of shareholders and creditors during pre-bankruptcy insolvency and argues that maximizing either constituency's interest does not provide an accurate yardstick for value maximization. This point is illustrated by using several numerical examples to highlight the various sources of conflict between shareholders and creditors that emerge as the company's financial health declines. Part III argues that directors should maximize the company's value even when the company is in financial distress. Because maximizing the expected value of the firm can minimize losses associated with business failure and reduce the overall cost of capital, directors should take actions that maximize the company's value even if such actions diverge from what shareholders or creditors would have chosen if left unconstrained. After arriving at this ideal standard of the directors' duty, this Part examines plausible ways of implementing this standard. The analysis suggests that the optimal means of achieving the value maximization goal is to place the cost of contracting on creditors.

The final Part of this Article examines the current law to (1) develop a theory that would explain the cases dealing with directors' fiduciary duties as the company becomes insolvent, and (2) evaluate this common-law doctrine in light of the rule proposed in Part III. Under current law, several courts have held that although directors owe duties of care and loyalty to shareholders when a firm is solvent, these duties shift to creditors upon insolvency.[6] Moreover, a recent Delaware case declared that directors' duty to maximize shareholder interest changes when the company is "operating in the vicinity of insolvency."[7] Despite the seemingly broad language used by the courts, a review of the cases

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ter 11, 101 Yale L. J. 1043 (1992); Lynn M. LoPucki and William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. Pa. L. Rev. 669 (1993).

6. See text accompanying notes 88-89.

7. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 Del. Ch. LEXIS 215, *108-09. The court, however, did not explain the meaning of the phrase "in the vicinity of insolvency" and thus failed to resolve the question of how badly the company has to perform before the directors' primary duty to shareholders changes.

indicates that the courts are enforcing the creditors' existing contractual rights instead of imposing an independent, extra-contractual duty on directors to act in the creditors' best interests. This finding is consistent with the recommendation offered by this Article.

II. Conflicts of Interest Between Shareholders and Creditors

Both shareholders and creditors are suppliers of capital; each contributes funds to the corporation in exchange for claims on cash flows generated by the entity's operations. Creditors have fixed claims against the corporation that entitle them to receive a pre-determined rate of interest and repayment of their principal at a specified maturity date. Shareholders, on the other hand, receive rights to participate in the profits of the corporation in the form of dividends, as may be declared from time to time at the board's discretion, and to share in the firm's residual assets upon corporate dissolution.[8] Given these differing rights, the interests of shareholders and creditors often diverge. For example, relative to creditors, shareholders prefer larger dividend payments and riskier investments.[9]

Although conflicts of interest between shareholders and creditors exist from the inception of a loan, the probability and magnitude of these conflicts increase as the financial condition of the firm deteriorates and its debt-equity ratio increases.[10] When the enterprise becomes

8. See Kenneth Lehn and Annette Poulsen, *Contractual Resolution of Bondholder-Stockholder Conflicts in Leveraged Buyouts*, 34 J. L. & Econ. 645, 649 (1991). See also Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. Rev. 1165, 1187 (1990); Daniel R. Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259, 1262 (1982). Although these commentators have focused on the conflict between shareholders and bondholders, this divergence of interest also exists between shareholders and commercial lenders in privately placed loans. Both bondholders and commercial lenders are fixed claimants of the firm's assets. Although differences between these two groups of creditors may exist (such as priority of claims, incentives to monitor, and degree of sophistication), both bondholders and commercial lenders have the same basic rights in the firm's assets and face similar problems posed by corporate insolvency. In addition, numerous commercial lenders actively participate in the bond market. Stewart M. Robertson, Comment, *Debenture Holders and the Indenture Trustee: Controlling Managerial Discretion in the Solvent Enterprise*, 11 Harv. J. L. & Pub. Pol. 461, 469 (1988). For the purposes of this discussion, therefore, bondholders and commercial lenders will be treated similarly and collectively referred to as "creditors" unless otherwise specified.

9. See Clifford W. Smith, Jr. and Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. Fin. Econ. 117, 118-19 (1979).

10. For empirical studies showing that shareholders gain while bondholders lose with increased leverage, see Ronald W. Masulis, *The Effects of Capital Structure Change on Security Prices: A Study of Exchange Offers*, 8 J. Fin. Econ. 139, 169-71 (1980) (demonstrating that when debt is issued and common stock is retired in exchange offers, common stock returns are significantly positive at 9.8% while straight debt returns are significantly negative at -0.3% and at -0.8% for bonds without protective covenants); Michael C. Jensen and Clifford W. Smith, Jr., *Stockholder, Manager, and Creditor Interests: Applications of Agency Theory*, in Edward I. Altman and Marti G. Subrahmanyar, eds., *Recent Advances in Corporate Finance* 93, 112-15 (Irwin, 1985)

insolvent in the sense that its liabilities exceed the value of its assets,[11] the sources of conflict between shareholders and creditors include (1) the level of risk that management should undertake, (2) the race between the parties to recover their investments in the firm, (3) the incentives to liquidate versus keeping the firm intact as a going concern, and (4) the level of investment in new projects. Essentially, these conflicts arise from the parties' differing contractual rights to the firm's assets, which in the event of insolvency allow the shareholders to enjoy the upside gain while the creditors bear the downside risk.

A. *The Level of Risk*

When the corporation is insolvent or at the brink of insolvency, the difference in risk preference between shareholders and creditors is magnified with respect to corporate investment policies. During this period of financial stress, shareholders favor highly risky projects, even if these projects have only a slight chance of generating income large enough to cover the firm's debt and still provide some return to shareholders. In contrast, creditors want management to preserve the assets available to satisfy their claims by investing conservatively and taking minimal risk.[12] Neither shareholders nor creditors have the incentive to take the optimal amount of risk that would increase the expected value of the firm. To illustrate these shortcomings, let us consider the following numerical example:[13]

> Company X is insolvent, with $8000 in assets and $10,000 in liabilities. Directors of the Company have a choice between two mutually exclusive projects. If the directors accept Project A, there is a one hundred percent chance that the firm will be

("Jensen and Smith") (summarizing 13 studies showing that leverage-increasing capital market transactions are generally associated with significantly positive abnormal returns to common shareholders, while leverage-reducing transactions reflect significantly negative abnormal returns to shareholders). But see Laurentius Marais, Katherine Schipper, and Abbie Smith, *Wealth Effects of Going Private for Senior Securities*, 23 J. Fin. Econ. 155 (1989) (stating that increased leverage does not harm existing bondholders).

11. Bankruptcy Code, 11 U.S.C. § 101(32) (1988). This definition of insolvency is commonly known as the "balance sheet test" of insolvency. Another commonly used definition of insolvency is "equity insolvency," which occurs when the company is unable to pay its debts as they become due. Revised Model Business Corporation Act § 6.40(c) (1) (ABA, 1985) (determining the validity of a distribution to shareholders). In the following discussion, unless otherwise specified, the term "insolvency" means insolvency under the balance sheet test.

12. Charles W. Adams, *An Economic Justification for Corporate Reorganizations*, 20 Hofstra L. Rev. 117, 125-27 (1991); Stephen A. Ross, Randolph W. Westerfield, and Jeffery F. Jaffee, *Corporate Finance* 421-22 (Irwin, 2d ed. 1988) ("Ross and Westerfield"); LoPucki and Whitford, 141 U. Pa. L. Rev. at 685-86 (cited in note 5). See also *Credit Lyonnais Bank*, 1991 Del. Ch. LEXIS at *108 n.55 (observing that "[t]he possibility of insolvency can do curious things to incentives [of shareholders], exposing creditors to risks of opportunistic behavior and creating complexities for directors").

13. Variations of this hypothetical will be used throughout Part II.

worth $8500. Project B is a high-risk project with two possible outcomes—a ten percent chance exists that the project will succeed and Company X will be worth $50,000, and a ninety percent chance exists that the project will fail and the Company will be worth $200. The expected value of the firm if it proceeds with Project B is $5180 (.10 x $50,000 + .90 x $200), while the expected value of the firm is $8500 if it chooses Project A.[14]

When a firm is financially sound, shareholders would choose Project A because it has a higher expected value. As residual claimants in an ongoing enterprise, shareholders seek to maximize the value of the firm. Corporate assets are put to their best use when a company builds new plants or engages in research and development to the point that the incremental gains and costs are equal at the margin. Creditors, as fixed claimants, enjoy a small benefit (in the form of increased security) when new projects generate returns beyond the amount of their loans. On the other hand, shareholders receive most of the marginal gains and incur most of the marginal costs resulting from the firm's business decisions. Accordingly, shareholders have the appropriate incentives to enhance the long-term profitability of the corporation.[15]

As the company's financial health crumbles and its equity cushion disappears, however, shareholders may pursue a different agenda. Because shareholders' claims by definition are negligible when the corporation is marginally solvent or completely insolvent, the downside risk to shareholders is minimal if risky strategies do not produce the anticipated revenues and thus cause the firm's value to decline further. The shareholders' loss is limited to the amount of their investment because of their limited liability for the company's debts. If these projects flourish, however, shareholders reap the gains from potentially large returns. Therefore, given the financial condition of Company X under which shareholders' residual claims are negligible, shareholders will have a strong preference for Project B even if the expected value of the firm will be $3320 less than if Project A were chosen.[16] This result occurs because under Project B the expected value of shareholders' wealth is

14. To focus on the conflict between shareholders and creditors, the following discussion makes the simplifying assumption that Company X has only one class of common shareholders and one class of unsecured creditors, unless otherwise indicated. For discussion of intracreditor conflicts due to different priority rights, see Jensen and Smith at 121-22 (cited in note 10); Baird and Jackson, 51 U. Chi. L. Rev. at 106-07 (cited in note 2).

15. Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* 68 (Harvard U., 1991); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 Stetson L. Rev. 23, 26-29 (1991); Jensen and Smith at 112 (cited in note 10). Compare Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. Rev. 277 (1990) (explaining that shareholders' time and risk preferences may not necessarily maximize the firm's value).

16. The expected value under Project A would be $8500, compared to $5180 under Project B.

$4000.[17] In the event Project B does not succeed and the firm's value drops to $200, the ceiling of the shareholders' loss remains fixed at the amount of their capital contributions. Faced with a one hundred percent chance of receiving nothing under Project A (because the entire $8500 goes toward satisfying creditors' claims) or a ten percent chance of receiving $40,000 under Project B, rational shareholders would choose Project B.

Unlike shareholders, creditors prefer management to risk as little as possible because they have little to gain if risky ventures succeed and will suffer further loss should these projects fail. In the case of Company X, while the expected value for creditors under Project A is $8500, it falls to $1180 under the riskier Project B.[18] Self-interested creditors would choose Project A and cut their losses at $1500 ($10,000-$8500).

The foregoing discussion indicates that if the management of a financially distressed company engages in extraordinarily risky activities, the upside gain accrues to shareholders while creditors bear the downside risk. Shareholders have a strong incentive to gamble with the firm's assets to the detriment of creditors, regardless of whether such high-risk investments maximize the expected value of the company. These investments offer the only chance that some money will be available for shareholders after debts are repaid.[19]

Notice also that if Project A is chosen, it not only has a higher expected value to Company X but also furthers creditors' interests. Indeed, commentators have argued that because creditors acquire the status of residual claimants upon insolvency, they have the proper incentives to maximize the value of the firm.[20] Despite the fact that creditors, the only parties with valid interests in the corporation's remaining assets, may have the largest stake in the outcome of an insolvent firm's business decisions, what creditors may consider in their best interest does not necessarily coincide with the goal of wealth maximiza-

17. A 10% chance exists that Company X will be worth $50,000 and $40,000 will be left for shareholders after paying $10,000 to creditors, and a 90% chance exists that the entity will be worth $200 and shareholders will receive nothing.

18. A 10% chance exists that Company X will be worth $50,000, but the creditors' share of the proceeds is limited to $10,000, the amount of their loan. On the other hand, a 90% chance exists that the firm will be worth only $200, which would be all that creditors could recover.

19. Anecdotal evidence of shareholders' appetite for risk is plentiful. For example, the founder of Federal Express, Frederick Smith, literally gambled with creditors' money when the firm was near financial collapse. In despair, Mr. Smith took $20,000 of corporate funds to Las Vegas and, fortunately for the company, his winnings provided enough additional capital to revive the firm. If Mr. Smith had not been successful at the tables, creditors would have received $20,000 less had the firm become bankrupt. Ross and Westerfield at 422 (cited in note 12).

20. Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 69 (cited in note 15); Baird and Jackson, 55 U. Chi. L. Rev. at 765-66, 774-75 (cited in note 5) (arguing that control of a reorganizing company should vest in creditors as residual claimants).

tion. This anomaly occurs because creditors, unlike "true" residual claimants "who enjoy the benefits of making good decisions and incur the costs of making bad ones,"[21] enjoy limited upside potential. Whereas shareholders of a solvent corporation have the right to the entire residual, creditors of an insolvent company (outside of bankruptcy) are entitled only to the amount of their claims, even if payoffs from the firm's investments greatly exceed the outstanding balance of their loans. In other words, creditors do not enjoy the entire gain of making good decisions, but bear the entire risk of loss of making bad ones. To illustrate this tension between the interests of the corporation and its creditors because of creditors' "incomplete" residual claimant status, let us return to Company X.

Instead of Projects A and B, the directors of Company X are considering Projects A and C. Under Project C, a forty percent chance exists that the value of the Company will be $15,000 and a sixty percent chance exists that it will be $6000. The expected value of Company X if the directors choose Project C is $9600 (.40 x $15,000 + .60 x $6000). Project C is more likely to improve the financial situation of Company X than Project A, because the expected value of the firm is higher under Project C than under Project A ($8500). Creditors would prefer Project A, however, because while the value of Project A to creditors is $8500, it is only $7600 under Project C.[22] Creditors have no incentive to bear the extra risk imposed by Project C because their share of the potential gain tops out at $10,000 even if the Project proves to be profitable, while they suffer dollar for dollar if the return is less than $10,000. Therefore, as long as creditors bear the entire risk that the company's value will decrease further, but stand to receive only a portion of the company's increase in value, creditors may choose a degree of risk that is less than the optimal level necessary to maximize the firm's value.

The foregoing example also illustrates that a corporation's fortunes do not have to improve drastically and exceed the amount of the creditors' claims for these lenders to prefer a less risky project. The expected value of Company X under Projects B ($5180) and C ($9600) falls short of the outstanding balance of the loan ($10,000). Creditors will compare their expected gain and expected loss under the proposed investments and make their decisions accordingly. Obviously, situations arise when creditors' interests coincide with those of the firm, as illustrated by the

21. Baird and Jackson, 55 U. Chi. L. Rev. at 787-88.

22. A 40% chance exists that Project C will succeed and Company X will be worth $15,000, but creditors can recover only the $10,000 they are owed. On the other hand, there is a 60% chance that Project C will fail and creditors will recover only $6000.

choice between Projects A and B. Until creditors are true residual claimants, however, they may not have the incentive to risk the amount necessary to increase the expected value of the firm.[23] Creditors may be better surrogates for residual owners because creditors have a larger stake in the outcome of an insolvent company relative to shareholders. Ideally, however, if value maximization is the goal while promotion of shareholder or creditor interest is merely the means,[24] management should exercise its business judgment to enhance the firm's value free of the distorting influence of these constituencies' self-serving behavior.

B. The Race to the Firm's Assets

Because an insolvent corporation does not have sufficient assets to satisfy all claims, each creditor is motivated to demand immediate repayment before the debtor's financial condition worsens and its limited fund diminishes. Each creditor's incentive to seek enforcement of its rights by seizing corporate assets may cause disruption in the daily operation of the company and lead to further loss.[25] In addition, piecemeal disposition of assets may generate less income than would a sale of an ongoing business with its assets intact.[26] For example, creditors may prefer the sale of Company X's specialized equipment for cash so they can be repaid immediately, even if removal of such equipment halts production completely. In addition, the realizable value of the machinery may be less than its value in the ongoing operation of the business. Although such a sale reduces both the company's value and the pool of assets available to satisfy all creditors' claims, creditors nevertheless are driven to pursue their individual remedies in order to be paid ahead of other claimants.

This behavior further illustrates that creditors' desire to recover the greatest value as early as possible does not necessarily maximize the

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23. Creditors may become true residual claimants by means such as receipt of equity in a reorganized firm in exchange for their debt claims.

24. See Part III of this Article. For a discussion of the difficulty in identifying the residual claimant in a bankrupt firm, see Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. Legal Stud. 127, 137-38 (1986); Baird and Jackson, 55 U. Chi. L. Rev. at 761-62 (cited in note 5); Skeel, 78 Va. L. Rev. at 500 (cited in note 5).

25. Upon an event of default, which is usually caused by the firm's inability to meet its debt service or to maintain certain financial ratios as required by the loan agreements, creditors can accelerate outstanding principal and accrued interest. Secured creditors can enforce their security interests in the firm's assets by selling collateral to satisfy their claims. Unsecured creditors can sue the company for breach of contract and obtain a judgment lien against the company's assets. See, for example, American Bar Association, *Model Simplified Indenture*, 38 Bus. Law. 741, 756-57 (1983).

26. Douglas G. Baird and Thomas H. Jackson, *Cases, Problems, and Materials on Bankruptcy* 40-41 (Little, Brown, 2d ed. 1990) (stating that bankruptcy law provides a solution to this common pool problem).

value of the firm. Creditors prefer to make the struggling company more viable only if viability provides them with a greater expected value.[27] Even if management can convince many creditors that exercising their withdrawal rights would not be in the creditors' best interests, some creditors still may choose to increase their own share of the firm assets regardless of the effect on the success of the attempted restructuring.

Similar to the creditors' incentive to exercise their withdrawal rights, shareholders are most likely to pressure management into paying extra dividends or other forms of distributions when the company is in financial trouble. Because the firm's insolvency eliminates shareholders' residual claims, shareholders have a strong incentive to seek illicit priority and to seize as many assets as possible before creditors do the same.[28] Shareholders' and creditors' races to the firm's assets are detrimental to each others' interests. Both groups may accelerate the eventual demise of the corporation, not because of the corporation's declining financial health, but because of their opportunistic behavior.

C. Liquidation Versus Going Concern Values

When a firm's liabilities exceed its assets, shareholders receive nothing from immediate liquidation. Accordingly, in addition to operating the company more adventurously, shareholders have an incentive to keep the company's door open as long as possible in the hope that the company will return to solvency. If the firm's value decreases further while management tries to reorganize the financial affairs of the firm, shareholders incur no additional loss. Creditors, however, will bear the downside risk if management's reorganization efforts fail and the firm's assets are further depleted.[29] Secured creditors whose claims are fully protected by the value of their collateral prefer the certainty of a prompt liquidation of the firm's assets.[30] This preference for liquidation, however, is not limited to these senior debtholders. As long as the reorganization is not expected to increase the probability or size of their

27. Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 Colum. L. Rev. 527, 542-43 (1983).

28. Fischer Black, *The Dividend Puzzle*, 2 J. Portfolio Mgmt. 5, 7 (Winter 1976) (stating that "[t]here is no easier way for a company to escape the burden of a debt than to pay out all of its assets in the form of a dividend, and leave the creditors holding an empty shell").

29. Thomas H. Jackson and Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 Va. L. Rev. 155, 158-59 (1989); Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?* (Second Installment), 57 Am. Bankr. L. J. 247, 259 (1983).

30. Jackson and Scott, 75 Va. L. Rev. at 159.

recovery, unsecured creditors also disfavor reorganization even if they will not be paid in full by an immediate liquidation.[31]

To illustrate these conflicts between shareholders and creditors caused by uncertainties surrounding an insolvent firm's future, let us return to Company X. The Company's $10,000 loans are in default, giving creditors the right to the firm's assets. If the Company's assets are broken up and sold piecemeal, the liquidation will bring in $7500. If Company X is reorganized, a fifty percent chance exists that it will regain profitability and be sold for $16,000 in a year. There is also a fifty percent chance, however, that the restructuring effort will fail and the sale will produce only $3000. The expected value of the firm at the end of a year will be $9500 (.50 x $16,000 + .50 x $3000).

Shareholders of Company X favor reorganization because the expected value of equity is $3000 if the firm continues to operate.[32] Even if the corporation's value drops to $3000, the shareholders' loss still is limited to their investment in the firm. In contrast to the shareholders, the creditors would seek liquidation because while creditors would receive $7500 if Company X were liquidated immediately, the expected value of debt under the proposed restructuring only amounts to $6500.[33] Notice that these creditors still would prefer liquidation, even though their claims are not fully covered by a security interest in the firm's assets. If reorganization does not provide them with a greater net present value, both secured and unsecured creditors would opt for immediate liquidation, which may or may not be the best use of the corporate assets.[34]

On the other hand, if the firm is worth more liquidated and a low probability exists that the firm will be revived despite restructuring, management should not waste scarce resources in these attempts. This delay would allow shareholders to speculate with creditors' money. Assume, for example, that the liquidation value of Company X is $8000. If the firm is reorganized, at the end of a year, a twenty percent chance

31. Compare Baird and Jackson, 51 U. Chi. L. Rev. at 106-07 (cited in note 2) (claiming that unlike fully secured creditors, general creditors and shareholders would resist immediate liquidation).

32. A 50% chance exists that the Company will be worth $16,000 and $6000 will be left after creditors are paid, and a 50% chance exists that the Company will be worth $3000 and nothing will be left for shareholders.

33. A 50% chance exists that the firm will turn around and pay creditors the $10,000 they are owed, and a 50% chance exists that the venture will fail and creditors will recover only $3000.

34. Because the going concern value of Company X exceeds its liquidation value, the best interests of the firm and its constituencies would be served if shareholders and creditors can negotiate a deal in which creditors will receive something worth more than $7500 and less than $10,000 in exchange for waiving the exercise of their default rights. This side-payment most likely will be in the form of personal guarantees or additional capital contributions by shareholders. See Baird and Jackson, 55 U. Chi. L. Rev. at 751-53 (cited in note 5).

exists that it will be worth $30,000 and an eighty percent chance exists that it will be worth $2000. Allowing the business to continue will benefit shareholders because they have a twenty percent chance of receiving $20,000 after repaying creditors. Nonetheless, management should liquidate Company X. The firm is not worth saving with an expected value after reorganization of $7600 (.20 x $30,000 + .80 x $2000), which is lower than its current liquidation value. The Company's assets should be redeployed to more productive uses. Under these circumstances, the creditors' interests happen to be aligned with the value maximization goal.

D. *The Incentive to Underinvest*

Shareholders of an insolvent corporation typically underinvest in new projects when most of the payoffs would benefit creditors. Consider Company X again, with $8000 in assets and $10,000 in liabilities. Suppose shareholders have an opportunity to invest an additional $5000 in new technology, which will increase the firm's value to $14,000.[35] Although this investment has a positive net present value, shareholders will turn down this opportunity. After all, shareholders will receive only $4000 after paying creditors ($14,000 minus $10,000 of debt), $1000 less than their additional capital contribution. Obviously, creditors prefer this investment because their claims would be paid in full. Creditors benefit at the shareholders' expense because shareholders bear the entire cost of the investment, while sharing the increase in asset values with creditors.[36] In other words, shareholders' incentive to underinvest is just another manifestation of the loss of their residual claimant status.

III. The Optimal Solution to Conflicts of Interest

A. *Value Maximization as the Goal*

The discussion of conflicts of interest in the foregoing Part indicates that neither shareholders nor creditors have the incentive to maximize the value of the insolvent firm. Shareholders are highly motivated to overinvest in risky propositions and to underinvest in stable ones. Shareholders also are likely to delay liquidation, even if this strategy causes further loss to the firm. Likewise, creditors do not have the necessary incentive to maximize profitability of the firm because of their

35. Because the shareholders' investment of $5000 would lead to a $6000 increase in the firm's value ($14,000-$8000), the $14,000 figure, therefore, assumes a 20% rate of return on the shareholders' additional contribution.

36. Ross and Westerfield at 422-23 (cited in note 12).

incomplete residual owner status and their desire to be paid as soon as possible. Essentially, two groups of potential decisionmakers exist whose incentives to maximize their individual returns may lead to inefficient results.

The analysis thus far has assumed implicitly that value maximization is a socially desirable goal. Therefore, before we can make a normative recommendation as to what directors' duty should be when a firm is insolvent, it is important to ask whether directors of financially troubled enterprises should continue to strive for value maximization.[37]

When a company is financially sound, profit maximization benefits all participants in the corporate venture and promotes societal welfare.[38] As residual claimants, shareholders' gain depends on the expected value of the firm's future income streams. Although creditors' return on their investments is fixed, the likelihood of their return also depends on revenues generated by the company's assets. A successful corporation also provides jobs for workers and goods and services desired by consumers. If a firm operates inefficiently, it will find competition with more efficiently operated firms difficult. Therefore, the goal of value maximization enhances efficient allocation of resources and increases overall welfare.[39] When a company is solvent, shareholders' interest coincides with this goal. Accordingly, requiring directors to maximize shareholder interest provides a fairly accurate benchmark for maximizing the long-term, wealth-producing capacity of the firm.

Given the desirability of value maximization, this focus should not change when a corporation is in financial trouble. When the short-term interests of both shareholders and creditors no longer coincide with value maximization, directors should take actions that will enhance the value of the corporate entity without favoring one constituency over the other. In other words, directors should pursue projects that have positive net present value to the company as a whole, and not just a positive effect on either debt or equity. This rule puts corporate assets to their best use and minimizes the loss associated with financial setbacks.

37. For a discussion of the desirability of maximizing a bankrupt firm's value as a goal of bankruptcy law, see Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775 (1987); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. Chi. L. Rev. 815 (1987); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 Colum. L. Rev. 717 (1991); LoPucki and Whitford, 141 U. Pa. L. Rev. at 780-87 (cited in note 5).

38. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times § 6 at 32 (Sept. 13, 1970); John H. Matheson and Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 Minn. L. Rev. 1313, 1329 (1992).

39. See Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 38 (cited in note 15). See also Martin Lipton and Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. Chi. L. Rev. 187, 203-05 (1991).

A firm still can be economically viable even if it is insolvent.[40] The decline in demand for the company's products may not reflect the quality of its business operation or the competency of its management. For example, consider ABC Company, which makes ball bearings for car manufacturers. The Company is struggling to meet its debt service because its major customers are experiencing a downturn in sales caused by the general recession. In addition, foreign competitors, profiting from a stronger dollar, are flooding the U.S. market with cheaper ball bearings. Because the current use of the Company's assets (as a ball bearing manufacturer) represents the best use of these assets, management should not liquidate the assets item-by-item to satisfy some of the creditors' claims. If the Company's best alternative is to sell one of its plants and use the proceeds to upgrade and modify its operations to make longer lasting ball bearings for uses other than car parts, management should undertake this investment despite its higher risk to creditors. Because of the investment's positive net present value, creditors will recover more for each dollar of their loans. Even if the Company ultimately is liquidated, a rule requiring management to make value-enhancing investments will result in more revenues and a larger pool of assets to satisfy the firm's claimants. Therefore, requiring directors to take actions that maximize the present value of the firm despite its financial distress will lead to efficient results in a period of uncertainty and sharp conflicts of interest.

In addition to minimizing losses caused by business failures, a value maximization standard reduces the overall cost of capital. If creditors know that directors must maximize the company's value even when it is financially distressed, these investors will be willing to accept a lower rate of return due to decreased risk. This rule better protects creditors from the opportunistic behavior of shareholders. For example, shareholders will be unable to engage in excessively risky activities that could cause the Company's value to decline further or to delay liquidation if an immediate sale of the Company's assets would produce a higher return. Because the value maximization standard reduces shareholders' ability to increase the riskiness of the loans upon insolvency, creditors also will incur less monitoring costs to prevent shareholders from depleting assets available for repayment of the loans. Given the lower risk of shareholder opportunism and reduced monitoring costs, the corporation may pay creditors less for the use of their capital. In

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40. Richard A. Posner, *Economic Analysis of Law* 377 (Little, Brown, 3d ed. 1986).

short, a value maximization standard can reduce the cost of capital by lowering the agency cost of debt.[41]

Despite the efficiency of a value maximization rule, a plausible criticism of this goal predicts that managerial actions that maximize the firm's value would have distributional effects.[42] Recall Company X's choice between Projects A and C. Although the firm's expected value is higher if the firm chooses Project C ($9600) than if it proceeds with Project A ($8500), the value of Project C to creditors is $7600 in comparison with $8500 under Project A. The relative benefit to Company X between Projects C and A is $1100 ($9600 versus $8500), while the relative loss to creditors is $900 ($7600 versus $8500).[43] If we stop the analysis here, an apparent uncompensated transfer of wealth from creditors to shareholders will occur if Project C is chosen.

When, however, creditors consider whether to lend money to the company, insolvency is a foreseeable risk that these investors can take into account.[44] In addition, under the value maximization rule, creditors would anticipate that when directors take actions that enhance the value of an insolvent firm, such actions may impose an additional risk of loss on their investments. Creditors would adjust the terms of their loans to reflect (1) the anticipated changes in business and leverage risk, and (2) a risk premium for possible variance in their estimates

41. The application of agency theory to participants in a firm was first expounded by Professors Jensen and Meckling. Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976), reprinted in Michael C. Jensen and Clifford W. Smith, Jr., eds., *The Modern Theory of Corporate Finance* 110-12 (McGraw-Hill, 1984). According to this theory, investors (both shareholders and creditors) are principals who engage managers as agents to make investment and operating decisions for the benefit of investors. Generally, agency costs are caused by the divergence of interest between the principal and the agent. One form of agency costs is the agency costs of debt that are associated with ensuring that managers would not take actions that would impair the value of the debt. Therefore, agency costs of debt include (1) the costs of structuring, administrating, and enforcing protective covenants in loan agreements; and (2) the reduction in the firm's profitability caused by the side effects of loan covenants that occasionally limit managers' ability to take optimal actions. The key insight of this theory is that because creditors will consider these costs in determining the terms of their loan, all agency costs are borne hy the debtor company. Id. at 106-15. For the purpose of the present discussion, because the value maximization rule reduces the risk of shareholder opportunism and thus, the risk of non-payment and monitoring costs, this rule will lower agency costs of debt. Notice also that the resulting cost savings will accrue to shareholders through a lower interest rate on the use of creditors' funds. For a detailed discussion of the agency theory, see Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. Corp. L. 205, 230-38 (1988).

42. LoPucki and Whitford, 141 U. Pa. L. Rev. at 782 (cited in note 5).

43. See Part II.A.

44. Jackson and Scott, 75 Va. L. Rev. at 160 (cited in note 29). See also Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 Tex. L. Rev. 51, 53 (1992) (arguing that bankruptcy law is a term of the contract between the firm and its creditors because bankruptcy is a contingency known to both parties).

before they agree to supply funds to the corporation.[45] An analysis that focuses on creditors' loss is incomplete. An analogy can be drawn to the relationship between charging an insurance premium and paying for insured losses. Although the insurance company would incur loss when the insured event occurs, the insured has compensated the insurer for bearing this risk of loss.[46] Similarly, if the proposed value maximization rule is adopted, creditors will not be worse off because the debtor corporation would have paid a higher price for creditors' willingness to bear the additional risk of potential diminution in the value of their investments.[47]

B. *Choosing a Rule to Implement the Value Maximization Goal*

The foregoing discussion suggests that the most efficient rule would require directors to maximize the firm's value regardless of the firm's financial condition. This standard can both minimize losses associated with business failure and reduce the overall cost of capital. Even if we agree that value maximization should be the goal, however, the question of how to implement this standard remains. One possibility would be for directors to maximize shareholder interests regardless of the firm's financial condition and would require creditors to contract specificially for directors to maximize the company's value ("Rule No. 1"). A second option would impose on directors a duty to act in the creditors' best interests once the firm becomes insolvent ("Rule No. 2"). A third option would be to adopt the value maximization standard as the default rule if the loan agreement is silent regarding directors' duty ("Rule No. 3").[48]

In choosing between these rules, one of the determinative factors should be the parties' relative abilities to specify their rights and obli-

45. See Smith and Warner, 7 J. Fin. Econ. at 119 (cited in note 9) (stating that bondholders will estimate the behavior of stockholders in pricing the bond issue); Ronald L. Gilson, *The Law and Finance of Corporate Acquisition* 251 (Foundation, 1986). For an example of how the price of debt securities reflects their riskiness, see Jerold B. Warner, *Bankruptcy, Absolute Priority, and the Pricing of Risky Debt Claims*, 4 J. Fin. Econ. 239 (1977) (analyzing the defaulted bonds of bankrupt railroad companies and demonstrating that the price of these debt securities reflects both probability of bankruptcy and deviations from the absolute priority rule).

46. Kenneth Scott, *The Law and Economics of Event Risk* 18 (John M. Olin Program in Law and Economics, Stanford Law School Working Paper No. 62, 1990).

47. For a discussion of how legal rules can be both Kaldor-Hicks efficient and Pareto superior once their price effects are considered in contractual settings, see Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 Stan. L. Rev. 361, 364-66 (1991); Richard Craswell, *Efficiency and Rational Bargaining in Contractual Settings*, 15 Harv. J. L. & Pub. Pol. 805, 808-13 (1992).

48. In the language of the current law, under Rule No. 1, shareholders would be protected by directors' fiduciary duty while creditors' rights are governed by contract. In contrast, under Rule No. 2, creditors' interest would be promoted by directors' fiduciary obligation upon insolvency.

gations by contract. For example, Rule No. 1 places the burden on creditors to negotiate explicitly for the directors' duty to maximize the corporation's net worth. If creditors fail to do so, directors only would be obligated to maximize shareholder wealth. On the other hand, Rule No. 2 assumes that creditors are unable to protect their rights by contract, and thus, need extracontractual protection. Another factor to consider in choosing a rule is enforceability. Although a rule may be theoretically sound, it is of little use to the parties if its standards are difficult to implement.

1. Placing the Costs of Contracting on Creditors

At first blush, Rule No. 1 appears implausible because creditors would want management to maximize the creditors' interests instead of the firm's. The company, however, is unlikely to agree to this request. Investment and operational decisions that are advantageous to creditors do not necessarily benefit the entity as a whole. For example, although creditors would favor less risky projects as long as these projects generate enough income to repay the loans, these investments may not be the best use of the firm's assets.[49] Besides being inefficient, these investments may not generate enough income to compensate shareholders for the use of their capital. The company enjoys little benefit if it cannot maintain its equity at the desired level because its shareholders can earn a higher rate of return elsewhere.[50]

In addition, creditors probably would not have bargained for business strategies aimed at minimizing risk even if management presented the option at the outset. If creditors truly wanted risk-free investments, they would have bought Treasury bills or other low-risk instruments. By voluntarily lending money to the corporation, creditors must have found the risk-return combination offered by the enterprise satisfactory. Under these circumstances, a value maximization goal that allows management to take the optimal level of risk would be advantageous to creditors because the more profitable the firm, the more likely sufficient funds will be available to repay creditors at the promised rate of return.[51] Because a value maximization standard benefits both the corporation and its creditors, self-interested parties are likely to agree on this mutually advantageous rule ex ante. Now that we have addressed the threshold question of why creditors may want management to under-

49. See Jensen and Smith at 112 (cited in note 10) (observing that "bondholders would have incentives to pay too few dividends, issue too little debt, and choose projects with too little risk").

50. See Smith and Warner, 7 J. Fin. Econ. at 121 (cited in note 9) (arguing that a unique set of financial contracts would maximize the firm's value by minimizing the costs caused by the creditor-shareholder conflicts).

51. See note 39 and accompanying text.

take actions that would maximize the company's value, the question remains as to whether it would be efficient for creditors to bear the cost of contracting.

a. *The Relative Ability to Assess Risk and Monitor*

Commentators have argued that creditors can better assess risk and monitor certain managerial conduct than individuals.[52] First, banks and other commercial lenders usually specialize in providing funds to companies in certain industries. Their knowledge of the trends and developments in the corporate debtor's particular industry enables them to evaluate and monitor the firm's major decisions, such as opening new plants or manufacturing new product lines. Indeed, these lenders have ready access to information regarding a debtor corporation and its business associates, and other corporate participants may consult these lenders regarding the company's financial strength.[53] Second, these creditors have the expertise to appraise both the firm-specific and industry-specific risks (such as the adequacy of the corporate borrower's financial ratios) and to negotiate tailor-made provisions to protect their own interests.[54] Third, fewer lenders are involved for each term loan and for each issue of privately placed debt securities. These creditors have greater incentive to monitor managerial compliance with the loan agreement because of their larger economic stake in the transaction.[55] On the other hand, individual shareholders with relatively small holdings lack both the expertise and the incentive to evaluate independently

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52. See, for example, Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 46-47 (cited in note 15); Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. Chi. L. Rev. 499, 501-02 (1976). For a discussion of why creditors are in a better position to specify their rights by contract, see Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 90-92; Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 Duke L. J. 173, 180-81; Macey, 21 Stetson L. Rev. at 36-39 (cited in note 15); Dale B. Tauke, *Should Bonds Have More Fun? A Reexamination of the Debate Over Corporate Bondholder Rights*, 1989 Colum. Bus. L. Rev. 1, 26-28.

53. See Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. Legal Stud. 1, 11 n.28 (1981); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 Yale L. J. 49, 56 (1982) (providing discussions of why banks are in a better position to monitor debtors).

54. Schwartz, 10 J. Legal Stud. at 11 n.28; Levmore, 92 Yale L. J. at 56; Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 46 (cited in note 15).

55. Robertson, 11 Harv. J. L. & Pub. Pol. at 469 (cited in note 8); Ross and Westerfield at 557 (cited in note 12). Even with publicly held debt securities, in which the debtholders are widely-dispersed, each with a relatively small investment in the company, the indenture trustee can reduce the free-rider problem. The trustee, usually a large commercial bank, is required to review compliance certificates and reports to ensure the terms of the indenture are met. Robert I. Landua, *Corporate Trust Administration and Management* 55 (Columbia U., 3d ed. 1985). For a discussion of the adequacy of the trustee's duty in protecting bondholders, see Robertson, 11 Harv. J. L. & Pub. Pol. at 476-77.

the feasibility of the firm's business plans and to monitor its progress. Therefore, in comparison to individual shareholders, these institutional lenders are in a better position to bear the cost of writing and enforcing contracts that restrict management's discretion to create significant new risks to the firm.[56]

The foregoing arguments, however, falter when these institutional lenders also have large holdings of equity securities in the company. This type of shareholder would have both the ability and the incentive to calculate risk and to monitor management.[57] Despite the possibility of the institutional investors wearing both shareholder and creditor hats, the existence of debt in a company still facilitates more monitoring than the presence of equity alone, because while shareholders are in the firm for the duration, debt must be repaid. Since companies are obligated to pay back their loans, they must obtain new financing to carry on their business. Each time companies return to the capital market, they are subject to market scrutiny and have to compensate investors at a rate of return that reflects the risk investors would bear. Therefore, the need to repay debt provides more frequent opportunities for monitoring and reassessment of the firms' performance.[58] The need for additional capital also gives corporate borrowers the incentive to avoid conduct that would inflict losses on existing creditors. If a company has the reputation of engaging in opportunistic behavior at its creditors' expense, new investors either will refuse to do business with the entity or will adjust the terms of their loans to reflect the perceived increase in default risk.[59]

In addition to the benefit of placing the burden of contracting on the party that has the lower information and coordination costs, Rule No. 1 does not affect creditors' willingness to provide funds to the corporation because creditors retain the flexibility to decide how much risk

56. Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 46 (cited in note 15); Posner, 43 U. Chi. L. Rev. at 502 (cited in note 52). Other creditors also can rely on these sophisticated lenders' ability to assess risk and to monitor by arranging to cross-default their loans to senior loans.

57. In addition, in closely-held corporations, individual shareholders would have the expertise because they also perform managerial functions. These shareholders, however, may lack incentives to monitor managerial compliance with loan agreements because they would be supervising their own actions.

58. Easterbrook and Fischel, *Economic Structure of Corporate Law* at 46 (cited in note 15).

59. Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 Bus. Law. 413, 434 (1986); Richard Brealey and Stewart Myers, *Principles of Corporate Finance* 399 (MacGraw-Hill, 2d ed. 1984) (observing that "[a] firm or individual that makes a killing today at the expense of [a] creditor will be coldly received when the time comes to borrow again"); Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 Am. Econ. Rev. 650, 654 (1974).

they want to take and can vary their commitments accordingly.[60] For example, some creditors may not want to bargain for the directors' duty to maximize the firm's value, preferring instead a higher interest rate in anticipation of potential losses resulting from shareholders' opportunistic behavior. On the other hand, some creditors would accept a lower rate of return in exchange for the directors' promise to enhance the long-term profitability of the company.[61] These creditors may choose to write up general contractual provisions such as covenants giving creditors the ability to accelerate the outstanding balance of the loan if they determine, at their sole discretion, that the directors have engaged in transactions that would reduce the company's net worth. Creditors also can draft detailed provisions specifying the types of action directors must take to achieve the value maximization goal. Examples include covenants requiring the debtor to continue in a particular line of business and to adhere to a schedule specifying the acceptable range of monthly production by the firm.

A benefit of more detailed provisions is that the courts can determine relatively easily whether the debtor has breached the contract (such as the firm's failure to meet the agreed-upon production schedule) and can enforce the respective rights and obligations of the parties. Several disadvantages, however, accompany these provisions. The conditions of the company or the general economy may change, thus making the existing limitations on the entity's business decisions nonoptimal. Amending the loan agreements every time a change occurs would be costly. In addition, regardless of the specificity of the contractual terms, drawbacks may result as creditors' ability to restrict managerial discretion increases. For example, the court may subordinate certain creditors' claims in a bankruptcy proceeding if these claimants are deemed "in control" of the corporate debtor and have exercised their power over the company's business to their own advantage and to other creditors' detriment.[62] For this doctrine to apply, the courts have required the plaintiff to show that the controlling creditor engaged in

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60. In one sense, Rule No. 1 is an example of a penalty default rule because it gives creditors the incentive to contract around a no-protection default rule that they may not want and to spell out the provisions that they desire. Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L. J. 87, 91 (1989). Indeed, the corporation and its creditors, dealing at arm's length, can set the terms of their agreement more cheaply ex ante than if the courts try to figure out ex post what the parties would have agreed on as the appropriate tradeoff between risk and return. Id. at 93.

61. See text accompanying note 41.

62. Bankruptcy Code, 11 U.S.C. § 510(c) (1988) (adopting the common-law doctrine of equitable subordination). Ordinarily, a creditor has no duty to deal fairly with the debtor corporation or its other creditors. Once a creditor has control over the firm's operation, however, it assumes a duty of fair dealing and its conduct is subject to the court's scrutiny. *In re American Lumber Co.*, 5 Bankr. 470, 477 (D. Minn. 1980).

some type of inequitable conduct such as fraud, and this conduct resulted in harm to the other creditors or unfair advantage to the controlling lender.[63] Therefore, to preserve their priority and to recover their claims, creditors should not exercise their power over the business affairs of the corporation to the detriment of the corporation or of third parties.[64]

Despite its advantages, Rule No. 1 may lead to inefficient results if creditors decide not to bargain for the directors' duty to maximize the company's value. By default, directors instead would maximize shareholder wealth.[65] Despite this potential drawback of Rule No. 1, creditors would demand a higher rate of return in exchange for the directors' right to exercise complete discretion. In this case, the company is paying for the freedom to undertake risky activities that would benefit shareholders.[66] This higher interest rate is a part of the firm's cost of capital. Management would weigh the benefit of managerial discretion against its cost and act accordingly. In other words, even if creditors do not specifically contract for the directors' duty to promote the firm's best interest, Rule No. 1 still can achieve the benefits of the value maximization standard. First, although creditors may suffer loss because of shareholder opportunism, the company has paid creditors in advance for bearing this risk. In this sense, the creditors' loss associated with business failure is minimized by ex ante compensation. Second, if directors have agreed to promote shareholder interest even in the event of insolvency, the benefit of such a decision must exceed its cost to the firm, and the cost of capital is lower under this alternative for this particular company.

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63. See, for example, *In the Matter of Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977); *In the Matter of Clark Pipe & Supply Co., Inc.*, 870 F.2d 1022, 1027 (5th Cir. 1989). Courts typically have applied the doctrine of equitable subordination to creditor claims by an insider or controlling party, such as a parent corporation or a sole shareholder, provided one of the following also is present: (1) fraudulent conduct by such party, (2) mismanagement of the insolvent corporation, or (3) inadequate capitalization of the entity. Robert C. Clark, *Corporation Law* 53 (Little, Brown, 1984); Asa S. Herzog and Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 90-112 (1961).

64. For a discussion of the potential liability of creditors found to be in control of the corporate debtor, see Margaret Hambrecht Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 Bus. Law. 343 (1975).

65. For a discussion of the shortcomings of enhancing shareholders' interests while the corporation is insolvent, see notes 16-17 and accompanying text.

66. See Easterbrook and Fischel, *The Economic Structure of Corporate Law* at 51 (cited in note 15).

A second criticism of Rule No. 1 concerns the difficulty of writing a contract that provides for all contingencies.[67] Despite this concern for creditors' ability to protect themselves, creditors can plan for major contingencies that will affect their interests.[68] When they cannot anticipate with a comfortable degree of certainty, creditors will demand a risk premium that allows for margin of error. Thus, creditors will not suffer loss unless they systematically underestimate the default risk and fail to demand adequate compensation.[69]

b. The Potential Enforcement Problem[70]

Although the previous subpart illustrated that institutional creditors can better bear the cost of contracting, we still need to evaluate the enforceability of Rule No. 1. One potential drawback of this rule is that it may be subject to abuse by creditors. For example, Company X has a long-term note with a fixed interest rate at ten percent per annum. Although the loan does not mature for another ten years, because of a steady increase in the level of inflation, the current interest rate for a loan with similar terms is fifteen percent per annum. Under these circumstances, to escape unfavorable terms creditors may have an incentive to claim that the directors have breached the loan agreement by failing to maximize the firm's value. If creditors can declare default and accelerate the maturity of their loan, they will be able to earn a higher rate of return by lending their funds at the new rate.

Extending the business judgment rule to shield the directors' business decisions when they are challenged by creditors can alleviate this concern for potential abuse. If the directors (1) were informed to the extent they reasonably believed to be appropriate under the circumstances, (2) had a rational basis for believing that the business judgment was in the best interest of the corporation, and (3) had no interest

67. Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* 21-23 (Free, 1975); Oliver E. Williamson, *Transaction Cost Economics*, in Richard Schmalensee and Robert D. Willing, eds., 1 *Handbook of Industrial Organization* 139 (North-Holland, 1989).

68. For example, loan covenants usually limit the company's ability to change the nature of its business, to borrow, to merge, to pay dividends, to sell assets, to change its capital structure, or to engage in transactions with affiliated entities. Indeed, creditors can demand a poison put provision that requires the company to repurchase their claims at a predetermined price upon the occurrence of specified events. Macey, 21 Stetson L. Rev. at 38-39 (cited in note 15). For a discussion of different categories of covenants, see Smith and Warner, 7 J. Fin. Econ. at 124-25 (cited in note 9).

69. For example, despite junk bonds' high rate of default, empirical studies have shown that creditors have charged sufficient interest rates to compensate for default. Coffee and Klein, 58 U. Chi. L. Rev. at 1207-08 n.2 (cited in note 1) (providing a summary of studies).

70. The following discussion only applies to situations in which creditors have bargained for the directors' promise to maximize the value of the firm.

in the transaction in question,[71] creditors should not be able to challenge directors' business decisions in court.

On the other hand, as the firm's financial condition deteriorates, creditors may encounter difficulties when they try to enforce their legitimate contractual rights. When a company is financially sound, management has an incentive to fulfill its promises pursuant to the debt contracts because any breach of the covenants is considered an event of default. In addition, a default under one loan may trigger defaults on the company's other loans if the loans contain cross-default provisions. Upon default, creditors have the right to accelerate the maturity of the loan or to foreclose on the collateral if the debt is secured. Because these proceedings are costly and disruptive to the daily operation of the company, management most likely will comply with the terms of the loan or renegotiate these provisions to avoid default.[72]

As the company approaches insolvency, however, management may have an incentive to breach its contract with creditors. For example, instead of paying creditors, the firm may want to use its remaining cash to salvage its operation. Although this action may not be the best use of the company's assets, it will give the entity another chance to regain its profitability. Management will not be overly concerned if the creditors bring an action against the company for breach of contract, because the company can seek protection under the Bankruptcy Code.[73] Neither will the company be too concerned with gaining a reputation for reneging on its promises if it does not plan to return to the capital market. After all, the disciplinary effect of the market works only when the corporation is a repeat player.[74]

Despite the seeming vulnerability of creditors upon insolvency, the corporation may not have a strong incentive to take action that will harm creditors' interest. A struggling company usually needs additional funds to continue its operation, and existing creditors (in addition to

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71. American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* § 4.01(C) at 182 (Proposed Final Draft Mar. 31, 1992). Use of the business judgment rule currently applies to suits by shareholders challenging directors' business decisions. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). A similar business judgment standard also applies to business decisions by the debtor-in-possession in a Chapter 11 proceeding. Raymond T. Nimmer and Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 Bankr. Dev. J. 1, 12-14 (1989).

72. Smith and Warner, 7 J. Fin. Econ. at 151 (cited in note 9).

73. Creditors are enjoined from instituting or continuing any action for enforcement of their rights upon the filing of a bankruptcy petition by the debtor corporation. Bankruptcy Code, 11 U.S.C. § 362 (1988). See also LoPucki and Whitford, 141 U. Pa. L. Rev. at 677 (cited in note 5) (analyzing the advantages of reorganizing through bankruptcy relative to out-of-court restructuring).

74. See Tauke, 1989 Colum. Bus. L. Rev. at 30 (cited in note 52); McDaniel, 41 Bus. Law. at 434 (cited in note 59).

existing shareholders) may be its best source of capital. By providing new financing, existing creditors can help management revive the company and generate enough income to pay off both old and new loans. In return, these creditors will be in a better position to renegotiate the terms of their old loans with management.[75]

2. Maximizing the Interests of Creditors

Under Rule No. 2, directors are obligated to act in the best interest of the creditors once the firm becomes insolvent. Arguably, this duty would include taking minimal risk to preserve corporate assets, maximizing cash flow, and negotiating the best terms possible for creditors in a recapitalization. As discussed earlier, however, actions that creditors would consider in their best interest do not necessarily have the highest expected value to the insolvent firm. Therefore, a rule requiring directors to maximize creditors' interests unconditionally will not achieve the value maximization goal.

Arguably, Rule No. 2 would be necessary if creditors cannot protect themselves against the risk of loss when the firm experiences financial distress. We have already discussed that creditors are not left defenseless. Business failure constitutes a foreseeable risk that no creditor can avoid. Creditors can calculate the possibility of default and set the terms of their loans accordingly. In addition, a troubled corporation's need to obtain additional debt financing will reduce its incentive to engage in opportunistic behaviors at creditors' expense.

3. Value Maximization as the Default Rule

A third means of achieving the value maximization goal is to require directors to maximize the company's net present value regardless of the financial condition of the firm. This Rule has the advantage of sending a clear signal to the directors that their duty to act in the cor-

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75. See LoPucki and Whitford, 141 U. Pa. L. Rev. at 703 (cited in note 5). If creditors' contractual rights are suspended because the company decides to seek protection under the Bankruptcy Code, these investors are not left without any protection. Creditors are given a voice in the management of the debtor corporation via the creditors' committee, which has the power to "investigate the acts . . . of the debtor, the operation of the debtor's business and the desirability of the continuance of such business," and to participate in the formation of a plan. Bankruptcy Code, 11 U.S.C. §§ 1103(c)(2)-(c)(3) (1988).

If creditors are unable or unwilling to wait out the bankruptcy process, they may be able to sell their claims to third parties. This market for debt claims of distressed companies is made possible by the recent surge of "vulture funds," which consist of institutional investors who would purchase defaulted bonds, unpaid trade claims, or outstanding bank loans at a fraction of their face amount in anticipation of a restructuring. Coffee and Klein, 58 U. Chi. L. Rev. at 1214 (cited in note 1). For discussion of this phenomenon, see generally Diana B. Henriques, *The Vulture Game*, N.Y. Times § 6 at 18 (July 19, 1992).

poration's best interest remains constant throughout the life of a corporation. When conflicts of interest between shareholders and creditors would lead to different investment and operational decisions, this Rule will obligate directors to choose the course of action that will maximize the firm's value, even if the action differs from what shareholders or creditors may prefer.

The major drawback of this Rule is ensuring directors' compliance with this duty. When the company is solvent, shareholders have incentives to enforce a value maximization rule because actions that maximize the company's net worth also maximize shareholder wealth. But as the company's financial condition becomes more precarious, neither shareholders nor creditors have incentives to ensure that directors are taking actions that promote the firm's long-term profitability.[76] Therefore, a default rule that requires directors to maximize the firm's value is of little benefit if it lacks an effective enforcement mechanism.

The impracticability of Rule No. 3 is further supported by both theoretical discussion and empirical evidence of managerial behaviors when the corporation is in financial trouble.[77] Given their significant firm-specific capital, managers are more concerned with preservation of the firm and their jobs.[78] When managers seek to maximize the prospect of the firm's survival, their actions "sometimes closely reflect creditor interest, at other times mirror interests of owners, and in still other cases satisfy neither."[79] A recent empirical study of large, publicly held corporations that filed and emerged from reorganization proceedings between 1979 and 1988 demonstrates that most managers did not engage in actions that maximized values of their firms during reorganization proceedings.[80] Instead, managers tend to put their companies in a "holding pattern" until these enterprises emerge from bankruptcy,

76. Courts may not have the adequate incentives to control directors' accountability. After all, judges do not have any stake in the outcome of these troubled companies. Judges also lack the expertise to evaluate directors' decisions. The courts are not in the business of figuring out whether the transactions in dispute maximized the firm's value. Judges only have information regarding ex post realization and are not well-suited to evaluate the adequacy of ex ante probabilities. For a discussion of similar arguments about judges' lack of incentives and business expertise in the context of shareholder derivative suits, see Daniel Fischel and Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 Cornell L. Rev. 261, 273 (1986).

77. See, for example, Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. Legal Stud. 277 (1991); Lopucki and Whitford, 141 U. Pa. L. Rev. 669 (cited in note 5).

78. Rose-Ackerman, 20 J. Legal Stud. at 292-94.

79. Id. at 309.

80. LoPucki and Whitford, 141 U. Pa. L. Rev. at 752 (cited in note 5). Generally, "these companies did not start new businesses, make acquisitions not integrally related to the company's existing business, expand significantly the existing business, or engage in other high risk activity" that might have increased the value of the entities. Id. at 748.

which lasts on average almost four years.[81] Given the high probability of non-optimal decisions, we need to design a rule of implementation that gives parties incentives to enforce a value maximization standard against the managers and hold them accountable for their actions.

The foregoing evaluation of alternative means to achieve the value maximization goal indicates that although each option has advantages and drawbacks, on balance, Rule No. 1 is the most promising. First, by placing the cost of contracting on the party who is in the better position to assess risk and monitor, we will incur lower transactions costs. Second, Rule No. 1 is more easily enforced than the other options. Although creditors face potential obstacles as they try to enforce their contracts when the company becomes insolvent, a greater likelihood of reaching the value maximization goal exists under this rule. If creditors have accepted a lower rate of return in exchange for the directors' promise to maximize the firm's value, creditors will have the incentive to enforce such a promise to avoid uncompensated loss.

Up to this point, we have examined the problems caused by corporate insolvency from both the theoretical and normative perspectives. The analysis illustrates that a sharp distinction should not exist between the directors' duty before and after insolvency. Directors should maximize the value of the firm regardless of its financial status, and the optimal means of reaching this goal is to require creditors to bargain for this duty. The remaining portion of this Article examines the current law governing directors' duty and demonstrates that, contrary to cases suggesting that directors owe creditors extracontractual duties once the firm becomes insolvent, the courts still rely on the contractual process between the corporation and its creditors as a means of protecting creditors' rights. In fact, a closer look at these decisions indicates that the courts are implementing a standard that is fairly consistent with Rule No. 1.

IV. Current Law

A. *Directors' Duty Prior to Insolvency*

When a company is financially healthy, directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.[82] Tradi-

81. Julian R. Franks and Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. Fin. 747, 748 (1989).

82. *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986); *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814, 824 (1981); *Ass'n of Haystack Properties v. Sprague*, 145 Vt. 443, 494 A.2d 122 (1985).

tionally, courts have refused to extend fiduciary duties for the benefit of creditors and have repeatedly held that creditors' rights are limited by the terms of their contracts with the corporation.[83] Under this general rule, directors need not take creditors' interests into account in their decision-making process. For example, in *Katz v. Oak Industries, Inc.*,[84] the court held that the bondholder's complaint that the corporation's pending exchange offer benefited its shareholders at the bondholder's expense did not allege a cognizable legal wrong.[85] The court reasoned that it is the "obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders; that they may sometimes do so 'at the expense' of others . . . does not for that reason constitute a breach of duty."[86] Accordingly, absent statutory provisions or bond indenture terms affording such protection, courts will not provide protection against the likelihood that corporate restructuring may impose greater risk of loss on bondholders and thus transfer wealth from bondholders to shareholders.[87]

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83. *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989); *Simons v. Cogan*, 549 A.2d 300, 303 (Del. 1988); *Katz v. Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986); *Speer v. Dighton Grain, Inc.*, 229 Kan. 272, 624 P.2d 952, 961 (1981); *Merriman v. Smith*, 599 S.W.2d 548, 553 (Tenn. Ct. App. 1979); *Sutton v. Reagan and Gee*, 405 S.W.2d 828, 834 (Tex. Ct. App. 1966). See also American Bar Foundation, *Commentaries on Indentures* 2 (A.B.F., 1971), commenting that the rights of a debt securities holder are "largely a matter of contract. There is no governing body of statutory or common law that protects the holder of unsecured debt securities against harmful acts by the debtor except in the most extreme situations. Short of bankruptcy, the debt security holder can do nothing to protect himself against actions of the borrower which jeopardize its ability to pay the debtor unless he takes a mortgage or other collateral or establishes his rights through contractual provisions set forth in the debt agreement or indenture."

84. 508 A.2d 873 (Del. Ch. 1986).

85. Id. at 879.

86. Id. (footnote omitted).

87. Id. Twenty-nine states, in response to the surge of hostile takeovers in the 1980s, have potentially departed from these general principles of fiduciary obligations by enacting "other constituency" statutes. A typical statute provides that in considering the best interests of the corporation, the board of directors may take into account the interests of non-shareholder constituencies such as employees, customers, creditors, suppliers, and the communities in which facilities of the corporation are located. For the text of these statutes, see *Symposium: Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 Stetson L. Rev. 1 app. (1991) ("*Symposium*").

Despite this expansive language, commentators have expressed doubt about the impact of these statutes on the law of corporate governance because (1) many key states of incorporation—especially Delaware—have declined to adopt a constituency law; (2) all but one of these statutes permit, but do not mandate, directors to consider the interests of non-shareholder constituencies; and (3) the common law in most of these jurisdictions, as codified by the statutes, requires consideration of other constituencies' interests to bear some beneficial relationship to the interest of shareholders. Meredith M. Brown, *When the Corporation Is Financially Troubled, Director's Role Changes*, Nat'l L. J. S10 (May 20, 1991); Charles Hansen, *Other Constituency Statutes: A Search for Perspective*, 46 Bus. Law. 1355, 1369-75 (1991); ABA Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 Bns. Law. 2253, 2261 (1990).

B. Directors' Duty Upon Insolvency

There is, however, an important yet ill-defined exception to the legal primacy of shareholder interests. Several courts have held that once the corporation becomes insolvent, directors owe a fiduciary duty to creditors.[88] This shift of fiduciary obligations takes place even if insolvency occurs long before liquidation or commencement of bankruptcy proceedings.[89] Arguably, this duty to creditors can be construed broadly to require directors to take actions that would maximize the creditors' interests once the firm becomes insolvent. On the other hand, this duty can be construed more narrowly to require only that directors treat all creditors equally and to prohibit directors from withdrawing corporate assets for the benefit of themselves, shareholders, or some preferred creditors.[90]

To date, courts have not interpreted these "other constituency" statutes. Although such statutes do not expressly create fiduciary duties towards non-shareholder constituencies, the debate continues whether courts should interpret these statutes to extend such protection. See, for example, *Symposium*, 21 Stetson L. Rev. 1; ABA Committee on Corporate Laws, 45 Bus. Law. 2253.

88. See, for example, *In re STN Enterprises*, 779 F.2d 901, 904 (2d Cir. 1985) (interpreting Vermont law); *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981) (interpreting New York law) (superseded by state statute); *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F.2d 973, 977 (4th Cir. 1982) (interpreting South Carolina law); *Brown v. Presbyterian Ministers Fund*, 484 F.2d 998, 1005 (3d Cir. 1973) (interpreting Pennsylvania law) (superseded by state statute); *Automatic Canteen Co. of Am. v. Wharton*, 358 F.2d 587, 590 (2d Cir. 1966) (interpreting Indiana law); *In re Xonics, Inc.*, 99 Bankr. 870, 872 (Bankr. N.D. Ill. 1989); *In re Holly Hill Medical Ctr, Inc.*, 53 Bankr. 412, 413-14 (Bankr. M.D. Fla. 1985); *Matter of IMI, Inc.*, 17 Bankr. 784, 786-87 (Bankr. E.D. Wis. 1982); *In re Roberts, Inc.*, 15 Bankr. 584, 586 (Bankr. D. R.I. 1981); *A.R. Teeters & Assoc., Inc. v. Eastman Kodak Co.*, 172 Ariz. 324, 836 P.2d 1034, 1043 (1992); *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814, 824 (1981); *Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974), aff'd in part & rev'd in part on other grounds, 347 A.2d 133 (Del. 1975); *Synder Elec. Co. v. Fleming*, 305 N.W.2d 863, 869 (Minn. 1981); *Rosebud Corp. v. Boggio*, 39 Colo. App. 84, 561 P.2d 367, 372 (1977); *Hixson v. Pride of Texas Distributing Co., Inc.*, 683 S.W.2d 173, 176 (Tex. Ct. App. 1985).

89. *Clarkson Co. Ltd.*, 660 F.2d at 512; *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787-88 (Del. Ch. 1992). See also *In re O.P.M. Leasing Services, Inc.*, 28 Bankr. 740, 760 (Bankr. S.D.N.Y. 1983). A recent Delaware case indicates that the directors' duty changes when a corporation operates in the "vicinity of insolvency." *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 Del. Ch. LEXIS 215 *108-09.

Unfortunately, the courts have offered little guidance as to how "insolvency" may be determined in a suit by creditors alleging breach of fiduciary duty. Some courts seem to have adopted the equity insolvency test, while other courts appear to be using the balance sheet test. Compare *New York Credit Men's Adjustment Bureau v. Weiss*, 305 N.Y. 1, 110 N.E.2d 397, 398 (1953), and *Cargill Inc. v. Am. Pork Producers, Inc.*, 426 F. Supp. 499, 503 (D. S.D. 1977), with *Automatic Canteen Co. of Am.*, 358 F.2d at 588-89, and *Sea Pines Co.*, 692 F.2d at 974.

90. Coffee and Klein, 58 U. Chi. L. Rev. at 1255-56 (cited in note 1).

1. Litigated Transactions Resemble Fraudulent Conveyances or Voidable Preferences

Upon closer examination, the courts seem to have adopted the narrower version of directors' obligations.[91] All 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.[92] These cases fall into five general categories: (1) withdrawing assets from the insolvent corporation as alleged payment of claims that the directors had against the corporation, such as loans to the company or unpaid commissions;[93] (2) using corporate funds to pay off the company's loans

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91. The cases reviewed included cases cited by commentators as representative of the current law and cases found in Lexis by using relevant search terms. See Davis, et al., 47 Bus. Law. 1 (cited in note 1); Dennis J. Block and Jonathan M. Hoff, *Duties of Directors of Distressed Corporations*, N.Y. L. J. 5 (Nov. 8, 1990); Michael L. Cook and Carolyn S. Schwartz, *At a Troubled Company, Officers and Directors Owe Creditors First*, Nat'l L. J. 22-24 (Mar. 16, 1987); Andrew L. Bab, Note, *Debt Tender Offer Techniques and the Problem of Coercion*, 91 Colum. L. Rev. 846 (1991); Coffee and Klein, 58 U. Chi. L. Rev. 1207 (cited in note 1); Steven R. Gross, Deborah F. Stiles, and Charles E. Joseph, *Directors Face Risks in Workout*, Nat'l L. J. 19-22 (Apr. 15, 1991); Brown, Nat'l L. J. S10 (cited in note 87); and 19 C.J.S. *Corporations* § 741 (1990).

The Lexis search was conducted on December 4, 1992, and the Lexis "library" and "file" used were "Mega" and "Newer," which included both federal and state cases decided after 1944. The exact search terms used were "INSOLVEN! W/20 CORPORATION W/30 DIRECTOR! W/20 DUTY W/20 CREDITOR!" and generated 89 cases. Some overlap exists between cases cited by commentators and cases found in Lexis.

92. The courts have reasoned that, upon insolvency, the directors become "trustees" for the creditors and hold corporate assets as a "trust fund" for the benefit of these investors. See *Sea Pines Co.*, 692 F.2d at 976-77; *Clarkson Co. Ltd.*, 660 F.2d at 512; *Automatic Canteen Co. of Am.*, 358 F.2d at 590; *New York Credit Men's Adjustment Bureau*, 110 N.E.2d at 398. Therefore, the directors of an insolvent corporation "occupy a fiduciary position towards the creditors, just as they do toward the corporation when it is solvent." *Automatic Canteen Co. of Am.*, 358 F.2d at 590. As fiduciaries, directors would have breached their fiduciary duty to creditors if the directors divested corporate property for their own benefit. *Collie v. Becknell*, 762 P.2d 727, 731 (Colo. Ct. App. 1988); *Fagan v. La Gloria Oil and Gas*, 494 S.W.2d 624, 628 (Tex. Ct. App. 1973).

93. *Pepper v. Litton*, 308 U.S. 295 (1939); *Burroughs v. Fields*, 546 F.2d 215 (7th Cir. 1976); *First Option of Chicago, Inc. v. Polonitza*, 1990 U.S. Dist. LEXIS 9449 (E.D. Ill.); *Matter of Candlewood Shores Estates, Inc.*, 20 Bankr. 377 (Bankr. D. Conn. 1982); *Matter of IMI, Inc.*, 17 Bankr. 784; *Walk-In Medical Ctrs., Inc. v. Breuer Capital Corp.*, 778 F. Supp. 1116 (D. Colo. 1991); *Poe & Assoc., Inc. v. Emberton*, 438 S.2d 1082 (Fla. Ct. App. 1983); *Fountain v. Burke*, 160 Ga. App. 262, 287 S.E.2d 39 (1982); *Boyd v. Boyd & Boyd, Inc.*, 386 N.W.2d 540 (Iowa Ct. App. 1986); *Snyder Elec. Co. v. Fleming*, 305 N.W.2d 863 (Minn. 1981); *Portage Insulated Pipe Co. v. Costanzo*, 114 N.J. Super. 164, 275 A.2d 452 (1971); *Smith v. Cox*, 831 P.2d 981 (N.M. 1992); *Tigrett v. Pointer*, 580 S.W.2d 375 (Tex. Ct. App. 1978); *Fagan v. La Gloria Oil and Gas Co.*, 494 S.W.2d 624; *Wortham v. Lachman-Rose Co.*, 440 S.W.2d 351 (Tex. Ct. App. 1969).

Because some cases fall into more than one category, they are cited more than once. For example, in *Fagan*, the directors manipulated corporate affairs and kept tbe business going for the sole purpose of paying claims that they had against the corporation and claims tbey bad personally guaranteed. *Fagan*, 494 S.W.2d at 631. Therefore, this case (and others like it) are discussed in several categories.

that the directors had personally guaranteed;[94] (3) engaging in transactions, usually without fair consideration to the company, for the benefit of its parent corporation or related entities;[95] (4) pocketing the proceeds of a sale of all corporate assets to a third party[96] or otherwise transferring property to a related entity, leaving the former corporation insolvent;[97] and (5) other forms of self-dealing in which the directors use assets of the insolvent firm for their own benefit, such as pledging stock owned by the corporation as collateral to finance the directors' personal stock purchases.[98] A common theme prevalent in these cases is the resemblance to fraudulent conveyances or voidable preferences under bankruptcy law.[99] Because creditors can seek redress under fraudulent conveyance or voidable preference law should someone try to seek illicit

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94. *South Falls Corp. v. Rochelle*, 329 F.2d 611 (5th Cir. 1964); *Davis v. Woolf*, 147 F.2d 629 (4th Cir. 1945); *In re Holly Hill Medical Ctr., Inc.*, 53 Bankr. 412; *In re Ozark Restaurant Equip. Co., Inc.*, 41 Bankr. 476 (Bankr. W.D. Ark. 1984); *Ware v. Rankin*, 97 Ga. App. 837, 104 S.E.2d 555 (1958); *Fagan*, 494 S.W.2d 624.

95. *Sea Pines Co.*, 692 F.2d 973; *Clarkson Co. Ltd.*, 660 F.2d 506; *Automatic Canteen Co. of Am.*, 358 F.2d 587; *South Falls Corp.*, 329 F.2d 611; *In re Ozark Restaurant Equip. Co., Inc.*, 41 Bankr. 476; *Swanson v. Tomlinson Lumber Mills, Inc.*, 307 Minn. 180, 239 N.W.2d 216 (1976); *B&S Rigging & Erection, Inc. v. Wydella*, 353 N.W.2d 163 (Minn. App. 1984).

96. *Rosebud Corp.*, 561 P.2d 367; *Hixson*, 683 S.W.2d 173.

97. *Livesay Indus., Inc. v. Livesay Window Co.*, 305 F.2d 934 (5th Cir. 1962); *Saracco Tank & Welding Co. v. Platz*, 65 Cal. App. 2d 306, 150 P.2d 918 (1944); *Tigrett*, 580 S.W.2d 375.

98. *In re O.P.M. Leasing Serv., Inc.*, 28 Bankr. 740 (Bankr. S.D.N.Y. 1983). See also *Collie*, 762 P.2d 727 (finding tbat instead of obtaining refinancing on behalf of the corporation to prevent foreclosure of corporate assets, the defendant director allowed the foreclosure to take place and then purchased the foreclosed property for his own benefit at a price substantially lower than fair market value); *In re Roberts, Inc.*, 15 Bankr. 584 (Bankr. D. R.I. 1981) (holding that a director breached his fiduciary duty to a company's creditor when he skimmed cash from daily proceeds and his embezzlement scheme directly caused the company's insolvency).

99. Under both fraudulent conveyance statutes and the Bankruptcy Code, transfers made or obligations incurred by the debtor with actual intent to hinder, delay, or defraud creditors are fraudulent conveyances and may be set aside by creditors or the trustee in bankruptcy. Uniform Fraudulent Conveyance Act § 7, 7A U.L.A. 509 (West, 1985); Uniform Fraudulent Transfer Act § 4(a)(1), 7A U.L.A. 652 (West, 1985); Bankruptcy Code, 11 U.S.C. § 548(a)(1) (1988). In addition, a transfer is voidable as a fraudulent conveyance if the transaction was made without fair consideration (or reasonably equivalent value) and accompanied by one of the following: (1) the debtor is or will thereby be rendered insolvent, (2) the debtor is left with an "unreasonably small" capital to conduct its business after the transfer, or (3) the debtor made such transfer with the intent or belief that it will incur debts beyond its ability to pay as they mature. Uniform Fraudulent Conveyance Act §§ 4, 5, 6, 7A U.L.A. 474-507 (West, 1985); Uniform Fraudulent Transfer Act §§ 5(a), 4(a)(2)(i), 4(a)(2)(ii), 7A U.L.A. 652-57 (West, 1985); Bankruptcy Code, 11 U.S.C. § 548(a)(2) (1988).

The voidable preference section of the Bankruptcy Code further provides creditors with redress by undoing transfers made within a defined pre-bankruptcy period that resulted in certain creditors receiving illicit preferred treatment. Bankruptcy Code, 11 U.S.C. § 547 (1988). Under § 547(b) a transfer is presumptively a preference if it was made to a creditor, on account of an antecedent debt, during the 90 days before the filing of the bankruptcy petition, and while the debtor was insolvent, provided the transfer made the creditor better off than it would have been if the transfer had not been made. The reach-back period, however, is one year for insiders. Id.

priority, a cause of action based on breach of fiduciary duty seems to add little to the current statutory scheme.

One plausible advantage may be that this additional duty may deter directors from benefitting themselves at the expense of creditors because they can be held personally liable for breach of duty to creditors. The effectiveness of this rule, however, depends on the difference between the amount of liability imposed on directors and the amount of gratuitous benefit or impermissible preference received by these insiders. To illustrate the significance of this relationship, consider the following examples.

Company Y is insolvent, with $100 in assets and $800 in liabilities. A few weeks before the Company became insolvent, one of its directors, Mr. D, caused the firm to pay him $300 for services that he never performed. If Mr. D's liability for breach of duty to creditors is limited to the $300 that he has received, this result is similar to setting aside a transfer under fraudulent conveyance law. Indeed, several courts have stated explicitly that when directors breach their duty to creditors by preferentially transferring corporate assets to themselves, directors' personal liability is limited to the value of the assets that they received, even if such recovery is less than the amount of the corporation's debt to the creditor.[100] Accordingly, this version of the liability rule does not have any greater deterrent effect than those provided by existing statutes.

On the other hand, holding directors liable for the entire amount of the debt that the corporation is unable to repay can overdeter in certain circumstances. For example, in the case of Mr. D, if he is required to pay creditors the $700 that they could not collect from Company Y,[101] this remedy would punish Mr. D, who only pocketed $300. This rule loses its punitive effects, however, if the amount owed to creditors is less than the value of corporate assets transferred to directors. To illustrate this situation, assume that Mr. D paid himself $1200 instead of $300. Requiring Mr. D to pay creditors $700 would still leave him with $500. This result would not constitute a windfall for Mr. D if he also is the firm's sole shareholder because he would have received $500 after paying off creditors even if he did not wrongfully convey assets to himself. If Mr. D is not the sole shareholder of Company Y, the other shareholders can sue Mr. D to recover the $500 to which he is not enti-

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100. *Walk-In Medical Ctrs., Inc.*, 778 F. Supp. at 1125; *A.R. Teeters & Assoc., Inc.*, 836 P.2d at 1041; *Henry I. Siegel Co., Inc. v. Holliday*, 27 Tex. Sup. Ct. J. 162, 663 S.W.2d 824, 827 (1984); *Hixson*, 683 S.W.2d at 176; *Block v. Olympic Health Spa, Inc.*, 24 Wash. App. 938, 604 P.2d 1317, 1325 (1979).

101. Company Y owes creditors $800, hut has $100 worth of assets; therefore, only $700 is uncollectable.

tled. Under these circumstances, holding directors personally liable is similar to setting aside an illicit transfer of corporate assets. Accordingly, the various scenarios involving Company Y illustrate that a common-law cause of action based on breach of fiduciary duty to creditors has added deterrence only if (1) the amount of recovery that a creditor is seeking exceeds the value of corporate assets that the directors diverted for their own benefit, and (2) the directors are required to satisfy the creditor's entire claim against the insolvent corporation.

Another advantage of imposing upon directors a fiduciary obligation to creditors is that this duty allows creditors to seek relief from directors who may not have received any direct benefits themselves, but either approved the challenged transfer or sat idly by while the transaction was taking place. In other words, a fiduciary duty gives creditors an additional remedy by granting them the right to recover against directors who failed to exercise due care and allowed other corporate insiders to misappropriate corporate assets at the creditors' expense. This rule would give directors proper incentives to keep themselves informed of the corporation's affairs and to monitor the firm's activities.

For example, in *Rosebud Corp. v. Boggio,*[102] a payee on a promissory note brought an action for payments due under the note against the corporate maker and its two directors. Although the corporate debtor was insolvent, its director, Natale Boggio (Natale), sold substantially all of its assets and converted the sales proceeds for his own use.[103] The court held that because directors of an insolvent corporation are deemed to be trustees for its creditors, Natale breached his duty by divesting corporate property for his own benefit.[104] In addition to holding Natale personally liable, the creditor was entitled to hold Natale's fellow director, Louis Boggio (Louis), liable for the unpaid debt. The court reasoned that Louis breached his duty to the plaintiff by sitting idly by and allowing Natale to convert corporate assets to the creditor's detriment.[105] In short, the court held Louis personally liable although he did not appear to have benefited from Natale's action.[106]

A third explanation of the fiduciary duty doctrine is that despite the functional equivalence between this common-law claim and the current statutory scheme, a cause of action based on breach of fiduciary obligation is necessary to protect creditors' rights to priority when

102. 39 Colo. App. 84, 561 P.2d 367 (1977).

103. Id. at 370.

104. Id. at 373.

105. Id.

106. See also *Clarkson Co. Ltd. v. Shaheen,* 660 F.2d 506 (2d Cir. 1981); *Francis v. United Jersey Bank,* 87 N.J. 15, 432 A.2d 814 (1981); *New York Credit Men's Adjustment Bureau v. Weiss,* 305 N.Y. 1, 110 N.E.2d 397 (1953).

fraudulent conveyance or voidable preference laws are unavailable or inapplicable.[107] For example, in *Snyder Electric Co. v. Fleming*,[108] creditors of an insolvent corporation sued its director (who also was the president and sole shareholder) to recover a money judgment against the corporation. The court held Minnesota's fraudulent conveyance statute inapplicable to the challenged transactions between the defendant director and the corporation because the transactions were supported by adequate consideration.[109] The court then noted that after the corporation became insolvent, the director transferred corporate funds to himself for payment of loans he made to the entity.[110] Although these transactions resembled voidable preferences, the court could not invoke Section 547 of the Bankruptcy Code because no bankruptcy petition had been filed.[111]

Because the state fraudulent conveyance statute was inapplicable and the federal voidable preference provision was unavailable, the court relied on the common-law doctrine of fiduciary obligation and held that the director breached his fiduciary duty to creditors by favoring himself over other creditors.[112] With this result, the court sought to prevent directors from taking advantage of their relationship to the corporation and from obtaining a preference over other creditors who possess equally meritorious claims.[113] Accordingly, this case represents a situation in which the courts use the common-law fiduciary duty to creditors

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107. For a similar argument that doctrines of equitable subordination and piercing of the corporate veil are, in part, ways of overcoming the limitations of fraudulent conveyance law, see Clark, *Corporation Law* at 39 (cited in note 63).

108. 305 N.W.2d 863 (Minn. 1981).

109. Id. at 867-68. The court also rejected the plaintiffs' alter ego claim because the evidence would not support the factors necessary to disregard the corporate entity. Id. at 868-69.

110. The director took an assignment of accounts receivable from the corporation in payment for previous "wages due to officer and note due to officer." In addition, when corporate assets were sold, the proceeds were applied to a note that was signed by the director personally. Id.

111. Note that although transfers in satisfaction of an antecedent debt constitute fair consideration under the fraudulent conveyance statute, these transfers are voidable under Section 547 of the Bankruptcy Code. Compare Uniform Fraudulent Conveyance Act § 3, 7A U.L.A. 448 (West, 1985) with 11 U.S.C. § 547(b)(2)(1988).

112. 305 N.W.2d at 869. The court reasoned:

> Directors and officers may make loans to their corporations and they may use the same methods as other creditors to collect bona fide corporate debts owed to them, but only so long as the corporation is solvent. When a corporation is insolvent, or on the verge of insolvency, its directors and officers become fiduciaries of the corporate assets for the benefit of creditors. . . . As fiduciaries, they cannot by reason of their special position treat themselves to a preference over other creditors.

Id. (citations omitted).

113. Id.

to set aside transfers to overcome the limitations of fraudulent conveyance and voidable preference statutes.[114]

The foregoing discussion indicates that a cause of action based on breach of fiduciary duty has several plausible advantages over a claim based on violation of fraudulent conveyance or voidable preference statutes. These added features of a common-law duty, however, are still aimed at protecting creditors from transfers of assets by an insolvent corporation that serve no business purpose and deplete assets available to satisfy creditors' claims. For example, although imposing personal liability on directors may have a greater deterrent effect against illicit preferences under certain circumstances than merely setting aside such conveyances, the underlying goal remains the preservation of the existing priority of repayment. This goal is consistent with another pattern found in the cases described in the following subpart.

2. Litigated Transactions Involve Closely Held or Related Corporations

All of the decisions in which the courts have found breaches of fiduciary responsibility to creditors either involve closely held corporations in which directors are also shareholders[115] or corporations that are under common ownership and control.[116] For example, in *Fountain v.*

114. See also *Poe & Assoc., Inc. v. Emberton*, 438 S.2d 1082 (Fla. Dist. Ct. App. 1983); *Smith v. Cox*, 831 P.2d 981 (N.M. 1992).

115. *Pepper v. Litton*, 308 U.S. 295 (1939); *Burroughs v. Fields*, 546 F.2d 215 (7th Cir. 1976); *South Falls Corp. v. Rochelle*, 329 F.2d 611 (5th Cir. 1964); *Livesay Indus., Inc. v. Livesay Window Co.*, 305 F.2d 934 (5th Cir. 1962); *Davis v. Woolf*, 147 F.2d 629 (4th Cir. 1945); *First Options of Chicago, Inc. v. Polonitza*, 1990 U.S. Dist. LEXIS 9449 (N.D. Ill.); *In re O.P.M. Leasing Serv., Inc.*, 28 Bankr. 740 (Bankr. S.D.N.Y. 1983); *Matter of Candlewood Shores Estates, Inc.*, 20 Bankr. 377 (Bankr. D. Conn. 1982); *In re Roberts, Inc.*, 15 Bankr. 584 (Bankr. D. R.I. 1981); *Walk-In Medical Ctrs., Inc. v. Breuer Capital Corp.*, 778 F. Supp. 1116 (D. Colo. 1991); *Saracco Tank & Welding Co. v. Platz*, 65 Cal. App. 2d 306, 150 P.2d 918 (1944); *Collie v. Becknell*, 762 P.2d 727 (Colo. Ct. App. 1988); *Rosebud Corp. v. Boggio*, 39 Colo. Ct. App. 84, 561 P.2d 367 (1977); *Poe & Assoc., Inc.*, 438 S.2d 1082; *Fountain v. Burke*, 160 Ga. App. 262, 287 S.E.2d 39 (1981); *Ware v. Rankin*, 97 Ga. App. 837, 104 S.E.2d 555 (1958); *Boyd v. Boyd & Boyd, Inc.*, 386 N.W.2d 540 (Iowa Ct. App. 1986); *Synder Elec. Co. v. Fleming*, 305 N.W.2d 863 (Minn. 1981); *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814 (1981); *Portage Insulated Pipe Co. v. Costanzo*, 114 N.J. Super. 164, 275 A.2d 452 (1971); *Cox*, 831 P.2d 981; *New York Credit Men's Adjustment Bureau v. Weiss*, 305 N.Y. 1, 110 N.E.2d 397 (1953); *Hixson v. Pride of Texas Distrib. Co.*, 683 S.W.2d 173 (Tex. Ct. App. 1985); *Tigrett v. Pointer*, 580 S.W.2d 375 (Tex. Ct. App. 1978); *Fagan v. La Gloria Oil & Gas Co.*, 494 S.W.2d 624 (Tex. Ct. App. 1973); *Wortham v. Lachman-Rose Co.*, 440 S.W.2d 351 (Tex. Ct. App. 1969).

116. *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F.2d 973 (4th Cir. 1982); *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506 (2d Cir. 1981); *Automatic Canteen Co. of Am. v. Wharton*, 358 F.2d 587 (2d Cir. 1966); *In re Holly Hill Medical Ctr., Inc.*, 53 Bankr. 412 (Bankr. M.D. Fla. 1985); *In re Ozark Restaurant Equip. Co., Inc.*, 41 Bankr. 476 (Bankr. W.D. Ark. 1984); *Swanson v. Tomlinson Lumber Mills, Inc.*, 239 N.W.2d 216 (Minn. 1976); *B&S Rigging & Erection, Inc. v. Wydella*, 353 N.W.2d 163 (Minn. Ct. App. 1984).

Burke,[117] Fountain, who was the president, sole director, and sole shareholder of Service Aluminum, Inc., was held personally liable to a judgment creditor of the corporation for corporate funds that he distributed to himself after the corporation became insolvent. The corporation in question was highly successful until a fire. Thereafter, the company became insolvent because of inadequate insurance to cover its losses.[118] Fountain had capitalized the corporation at $31,000 and lent the entity a large share of its operating capital, $179,999 of which was outstanding at the time of the fire.[119] When the corporation's insolvency became obvious, Fountain paid off certain debts, mostly secured, and used the remaining $100,000 of corporate funds to repay his loan to the company. His actions rendered the company unable to pay its other business debts.[120]

The court held that Fountain violated his duty to the firm's creditors because as an officer and director, Fountain was obligated to apply corporate assets primarily to the payment of the company's debts upon corporate insolvency. Fountain could not lawfully apply these proceeds to the payment of existing debts owing to him, or give preference to existing debts that the corporation owed to others for which he was also primarily liable.[121]

Fountain involves the typical, closely held corporation whose shareholders usually serve as officers and directors. Because insolvency eliminates their equity interests in the company, these director-shareholders have a strong incentive to recover their investments in the firm by transferring assets to themselves under the guise of loan repayments, leaving the company's coffers empty for collection by creditors. Even if these alleged shareholder loans are supported by adequate consideration, absent a legitimate priority claim, corporate insiders are only entitled to share pro rata in the distribution of assets to all creditors similarly situated.[122] Therefore, even if common law imposes fiduciary obligations on directors to act on behalf of creditors, this doctrine, as applied to closely held corporations, actually aims to ensure that all creditors' claims are equitably satisfied before shareholders can assert their equity rights against an insolvent corporation's assets.

The attempt to convey assets out of a corporation before creditors are paid occasionally involves a more elaborate scheme by the share-

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117. 160 Ga. App. 262, 287 S.E.2d 39 (1981).

118. Id. at 40.

119. Id.

120. Id.

121. Id. at 40-41.

122. Timothy J. Bjur and J. Jeffrey Reinholtz, eds., 15A *Fletcher Cyclopedia of the Law of Private Corporations* § 7469 (Callaghan, 1990).

holder-directors. In *Fagan v. La Gloria Oil and Gas Company*,[123] a judgment creditor of the corporation brought suit against its officers and directors. The corporation, Cooper Petroleum Company (Cooper), was owned by Fagan, his son, and his two sons-in-law. These four individuals also served as officers and directors of Cooper.[124] The plaintiff based his claim against Cooper on a guaranty that Cooper had executed for the benefit of another entity owned and controlled by Fagan, which was adjudged bankrupt.[125] Before the plaintiff's judgment against Cooper became final, Cooper became insolvent and ceased to do business.[126] The plaintiff sued the defendant directors to recover its unsatisfied claim against the corporate debtor.[127]

The court found that the defendants breached their fiduciary duty to the creditor by manipulating Cooper's business affairs to keep the company in business for the sole purpose of paying their personal claims against the company and the claims of creditors to whom they were secondarily liable.[128] The defendants also paid themselves alleged bonuses while the corporation was insolvent, even though the terms of their employment contracts specified that such bonuses were available only if the company generated a net profit before tax.[129] In addition, the defendants transferred all assets of Cooper to themselves, their family members, and another corporation that they controlled.[130] The defendants' actions essentially stripped the corporation of any surplus funds it otherwise would have had to pay its creditors. Accordingly, the court held these directors personally liable to the plaintiff for failing to administer the corporate assets for the creditors' benefit and to ensure that equitable shares of these assets were distributed to the creditors.[131]

Similarly, in cases involving related corporations under common control, the challenged transactions usually involve actions taken by directors of the insolvent firm for the benefit of its related corporations. For example, in *Swanson v. Tomlinson Lumber Mills, Inc.*,[132] the debtor corporation was one of several corporations solely owned by Kenneth Tomlinson or jointly owned by him and other members of his family. Tomlinson served as a director and president for all of these

123. 494 S.W.2d 624 (Tex. Ct. App. 1973).
124. Id. at 627.
125. Id.
126. The plaintiff's judgment against Cooper became final on March 24, 1971; the company became insolvent on June 30, 1966. Id. at 627, 629.
127. Id. at 627.
128. Id. at 631.
129. Id. at 630.
130. Id. at 630-31.
131. Id. at 631.
132. 239 N.W.2d 216 (Minn. 1976).

corporations.[133] The assets of the debtor corporation consisted almost entirely of accounts receivable from other Tomlinson corporations.[134] After the commencement of the plaintiff's action to collect on a note defaulted on by the debtor corporation, Tomlinson converted all of the firm's accounts receivable to long-term notes. The corporation received no consideration for conversion of the current assets into long-term receivables.[135] Apparently, the purpose of this transaction was to give other Tomlinson entities additional time to meet their obligations, which was necessary to avoid financial ruin.[136] The court held that Tomlinson breached his fiduciary duty to the corporation's creditors because the conversion of accounts receivable practically froze all of the company's assets and essentially rendered it insolvent (that is, unable to meet its obligations as they became due). Accordingly, the court set aside the conversion for the benefit of the plaintiff creditor.[137]

The discussion of cases involving closely held and related corporations further supports the notion that courts are using the directors' duty to creditors to protect creditors' contractual rights to priority of repayment. None of the cases in which directors were held to have breached their duty expanded the directors' obligations to creditors beyond what the contract already provided. This approach is consistent with Rule No. 1, under which creditors are specifically required to contract for their rights, including the directors' duty to maximize the net present value of the firm. A recent Delaware case illustrates this point.

Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.[138] dealt with a contest for control of Pathe Communications Co. (MGM) between MGM's primary lender, Credit Lyonnais, and its indirect ninety-eight and one-half percent shareholder, Giancarlo Parretti. In the late 1980s, Pathe Communications (Pathe) acquired MGM in a highly leveraged transaction financed largely by Credit Lyonnais and its affiliates.[139] Soon after the acquisition, MGM began to experience a severe cash shortage, and MGM's trade creditors filed a Chapter 7 bankruptcy proceeding against the company only five months after the acquisition.[140]

As a condition for providing the additional financing necessary for MGM to emerge from the bankruptcy proceeding, the bank negotiated

133. Id. at 217.
134. Id. at 217-18.
135. Id. at 218.
136. Id.
137. Id. at 221.
138. 1991 Del. Ch. LEXIS 215.
139. Id. at *7-8, *10-14.
140. Id. at *8, *20-23.

and obtained certain changes in the governance of MGM.[141] Parretti agreed to step down as the Chief Executive Officer (CEO), and a new CEO was elected with the bank's approval.[142] In addition, a Corporate Governance Agreement was executed which provided that MGM would have a five member board consisting of the new CEO, a Chief Operating Officer (COO) to be selected by the new CEO, and three other members to be chosen by Pathe.[143] The company would be operated by an Executive Committee, consisting of the new CEO and COO, with broad power to manage MGM's day-to-day business without interference from Pathe and Parretti.[144] To ensure compliance with the Corporate Governance Agreement, the bank entered into a Voting Trust Agreement with Parretti and Pathe, which gave the bank the right to vote the MGM and Pathe shares if Pathe or Parretti violated the terms of the agreement.[145]

Soon after the provision of the new financing, Pathe and Parretti sought the approval of the Executive Committee to start paying off MGM's indebtedness to Credit Lyonnais by selling assets held by MGM's foreign subsidiaries.[146] By its terms, the Corporate Governance Agreement would terminate if Pathe reduced the outstanding balance of the loan to a certain level, and thereafter governance of MGM would return to Parretti.[147] The Executive Committee did not approve the proposed asset sales because the prices were too low and the sales could jeopardize the company's operation.[148]

In June 1991, the bank determined that Parretti had breached the terms of the Corporate Governance Agreement by constantly meddling in MGM's management, and exercised its rights under the Voting Trust Agreement to remove the Pathe directors from MGM's board.[149] The bank then filed this action under Delaware General Corporation Law Section 225 seeking to validate its newly elected board.[150] Pathe and Parretti counterclaimed that the directors of MGM breached their fiduciary duty to its shareholders by failing to implement the proposed asset sales.[151] Finding that the MGM directors made the disputed decisions while the company was laboring in the shadow of bankruptcy,

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141. Id. at *30-31.
142. Id. at *31-32.
143. Id. at *37.
144. Id. at *107-09.
145. Id. at *70.
146. Id. at *45.
147. Id. at *35-36.
148. Id. at *107-09.
149. Id. at *70.
150. Id. at *1.
151. Id. at *107.

the court held that the directors did not breach their duty of loyalty to the controlling shareholder.[152] The court began its analysis by stating:

> At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residual risk bearers, but owes its duty to the corporate enterprise . . . .
>
> [T]he board [of directors] . . . had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.[153]

Therefore, the directors did not violate their fiduciary obligations when they failed to "immediately facilitat[e] whatever asset sales were in the financial best interest of the controlling stockholder" when such sales were not in the best interest of the corporation.[154]

Unlike earlier cases, *Credit Lyonnais* does not involve fact patterns similar to fraudulent conveyances or other misappropriation of corporate assets, and the company is still operating despite its insolvency. In a lengthy footnote, the court used a numerical example to illustrate that in managing the business affairs of a solvent corporation in the vicinity of insolvency, the directors must recognize that "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."[155]

Although *Credit Lyonnais* appears to depart from the line of cases involving directors' duty upon insolvency, it actually is consistent with the courts' traditional efforts to protect creditors' contractual rights.[156] Despite the court's sweeping language, the creditor in this case specifically bargained for a contractual commitment from the debtor corporation that required its Executive Committee to manage the corporation without interference from the controlling shareholder and prohibited the Committee from promoting the shareholder's interest at the expense of other corporate constituencies. Arguably, in this case, as suggested by Rule No. 1, the creditor contracted for the directors' duty to maximize the long-term profitability of the firm instead of shareholder wealth, and the court merely enforced the parties' agreement.

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152. Id. at *108-09.

153. Id.

154. Id. at *109.

155. Id. at *108 n.55. For a discussion of *Credit Lyonnais* and its implications, see generally John C. Coffee, Jr., *Court Has a New Idea on Directors' Duty*, Nat'l L. J. 18 (Mar. 2, 1992).

156. Compare Daniel J. Winnike, Credit Lyonnais: *An Aberration or an Enhancement of Creditors' Rights in Delaware?*, 6 Insights 31 (1992); *"Footnote of the Year" Has Lawyers Wondering About the Zone of Insolvency*, 24 Sec. Reg. & L. Rep. (BNA) 388 (1992).

V. Conclusion

Although actions that maximize the value of a financially troubled corporation benefit both shareholders and creditors and minimize overall loss, the self-interested behavior of these constituencies deviates from this socially desirable goal. Efficiency-minded lawmakers[157] should re-enforce directors' duty to maximize the firm's value, even if pursuit of this business strategy diverges from what shareholders or creditors (and even managers themselves) would have chosen. This Article suggests that the optimal means of achieving this goal is to require creditors to negotiate for directors' duty to maximize the firm's value. The proposed rule would give creditors incentives to bargain for the provisions they want, to calculate the appropriate risk premium, and to monitor managerial compliance with the terms of the loan agreements. A review of the current cases indicates that despite the broad language regarding directors' fiduciary duty to creditors, the courts are protecting creditors' existing contractual rights even upon corporate insolvency. In other words, the courts essentially are implementing a standard that assigns the cost of contracting to the party better equipped to bear this cost, a rule not too far removed from the optimal means of implementing the value maximization goal.

157. This term is borrowed from Ayres and Gertner, 99 Yale L. J. at 94 (cited in note 60).