

THE BUSINESS JUDGMENT RULE IN GOOD AND BAD TIMES

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Abstract

Despite many cases with seemingly contrary dicta, corporate directors' duties do not change around insolvency. Rather, directors have a fiduciary duty to the corporation, just as they have at other times, that is based on the duty of loyalty and the business judgment rule. Under the business judgment rule, the directors have broad discretion not only to decide what actions to take, but in whose interests to act. The creditors may in some circumstances sue to enforce this duty, but the fact that the creditors are suing does not affect either the duty or the remedy. The creditors individually also may sue the corporation for breach of specific contractual, tort and statutory duties, particularly on account of fraudulent conveyances. But these cases do not amount to a general shift in directors' fiduciary duties to the corporation around insolvency.

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There has been much debate about directors' fiduciary duties as the firm nears insolvency. Commentators generally agree that directors of solvent firms owe fiduciary duties only to shareholders, and not to creditors or other fixed claimants, who are left to their specific contracts.¹ The issue gets murkier when the firm nears insolvency and the shareholders have little or no stake in the firm, a situation that will be referred to here as the "insolvency scenario." Now the creditors arguably resemble residual claimants, and therefore seemingly have the same interest in the managers' maximizing the value of their interests that the shareholders had during solvency.

In determining what duties the directors owe the creditors in this situation, it is not enough to ask for whose benefit the directors run the firm.² We also need to know when directors should be held liable and the nature of the remedy. The answers to these questions depend partly on the general nature of fiduciary duties. A fiduciary relationship is a set of default rules that apply when a party delegates open-ended discretion over one's property to another.³ The fiduciary must act unselfishly except to the extent the

¹ The agreement is not universal, however. See, e.g., William J. Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 Duke L.J. 92 (1989) (arguing that defects in the market for credit may leave bondholders unprotected). This article will take for granted the general theory denying duties outside of bankruptcy and focus on whether there should be an exception in the insolvency scenario.

² See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547 (2003).

³ See Larry E. Ribstein, *Are Partners Fiduciaries*, 2005 Illinois Law Review 209. This is a structural theory that looks to the nature of the relationship rather than to the characteristics of particular parties. The question concerns the type of relationship that ought to trigger the default rules of the

contract permits him to do otherwise, such as by receiving compensation. The reason for this abnegation is that forfeiture of gain is the most effective remedy where the holder of the duty is by definition the one with the expertise to determine what might have been lost through breach.

Corporate directors clearly owe a fiduciary duty of unselfishness to the corporation, which is enforceable through an action brought by the corporation or derivatively on behalf of the corporation by a shareholder when the corporation refuses. If directors act self-interestedly, they breach their fiduciary duty to the corporation regardless of who the relevant claimants are. When the corporation nears or enters insolvency, a shareholder may no longer be the proper plaintiff. But this is primarily an issue of litigation management rather than the more fundamental one of duty.

Fiduciaries also have a duty of “care” that is not uniquely fiduciary in that it arises in non-fiduciary relationships and where there is no preexisting relationship at all.⁴ Corporate directors’ duty of care is weaker than the duty of care in other situations because it is qualified by the business judgment rule, which proscribes judicial interference where this would create excessive timidity by directors and involve the courts in decisions in which they have limited expertise.⁵ The directors’ duty of care, like the duty of loyalty, is enforced by the corporation. As with the duty of loyalty, a shareholder would ordinarily be the one to sue on behalf of the corporation when directors refuse, while a creditor might be the plaintiff when the firm is in or near insolvency. Again, this goes to the remedy rather than the duty.

The particular financial interests in the firm may relate to analyzing directors’ duties where the directors have mismanaged the firm but not breached their duty of loyalty because whether the directors have managed appropriately may depend on whose interests matter. In normal times, there is a strong argument that the directors’ duty should reflect the shareholders’ perspective because, as the residual claimants, the shareholders are most identified with the economic well-being of the firm as a whole and most vulnerable to mismanagement. By contrast, creditors and other fixed claimants have specific contract rights and fraudulent conveyance laws and other bankruptcy remedies that insulate them from most mismanagement.

The most difficult case is where the directors allegedly have mismanaged the firm and the firm is in or near insolvency. The creditors now in effect resemble residual claimants, since they will be entitled to much of what the corporation earns, at least in the near to intermediate term. However, the creditors are not the residual claimants of insolvent firms in the same way shareholders are in firms that are solvent because the shareholders are still entitled what the firm earns after paying the fixed claimants. In other words, the shareholders and creditors now, in effect, split the residual claim. This intensifies the agency problem between shareholders and creditors that was only in the background when the firm was solvent. The shareholders, who still control the board,

fiduciary relationship. The parties’ individual characteristics, such as their bargaining ability or information, relate to whether the default or customized rules of the relationship ought to be enforced, not what the default rules should be. Compare Jonathan C. Lipson, *Directors’ Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189 (2003).

⁴ See Ribstein, *supra* note 3.

⁵ See Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, forthcoming N.D. L. REV., U Illinois Law & Economics Research Paper No. LE05-015, <http://ssrn.com/abstract=746844>.

may want the directors to take risky actions with high payoffs that are now more likely to injure the creditors. Moreover, the creditors are in a worse position than the shareholders to protect themselves other than through fiduciary duties because they normally lack any meaningful power of control.⁶

The legal quandary of who should be owed duties in the insolvency scenario disappears, however, in the face of the business judgment rule. It is no more appropriate for courts to interfere with directors' judgment in the insolvency scenario than at other times. The courts still lack expertise, and liability could still provoke excessive timidity by directors. Indeed, the business judgment rule is arguably more important as the courts are faced with uncertainty not only as to the appropriate course of action but whose interests should matter most. To be sure, the directors might be said to have incentives to lean toward the interests of the shareholders, who ultimately control their tenure, and fiduciary duties might be useful in adjusting those incentives. But these incentives are counterbalanced by the fact that powerful inside directors may have fixed claims that would tend to identify them more with the creditors than with the shareholders.

There are, therefore, strong reasons for continuing to apply the business judgment rule even in the insolvency scenario. If the business judgment rule applies, then the decision whether to favor the shareholders or the creditors in particular decisions will be left to the directors rather than the court. The directors must not act in their own interests, but rather consistently with some rational conception of the firm's interests. Characterizing the duty as one on behalf of the corporate entity in this situation does not improperly shift the focus from shareholders to creditors or others, but rather reflects the application of the business judgment rule's hands-off policy to the insolvency situation.

The issue of directors' duties in or out of insolvency differs from the issue of the remedy. Even if the directors do not owe special duties either to shareholders or to creditors, one or the other category of claimants may be given exclusive rights to sue depending on who is deemed to have the best in incentives to manage the suit.

The insolvency scenario also relates to duties the corporate debtor owes to its creditors individually. For example, when directors convey corporate assets without consideration, there may be not only a corporate action against the directors for waste, but also a remedy by the creditors against the corporation or the shareholders, or against the board under corporation statutes, as in the case of an excessive dividend. The main question in this regard is whether the creditors individually have a general fiduciary-type remedy for conduct of this sort that does not fit within the specific confines of fraudulent conveyance or other conventional duties to creditors. The answer is that a fiduciary duty would be inappropriate in this situation because it does not involve the broad delegation of discretion that characterizes a fiduciary relationship.⁷

In short, directors' duties around insolvency involve three distinct issues: the directors' duties to the corporation, the remedy for breach of these duties, and the corporate debtor's duties to creditors. Resolution of these issues requires an

⁶ For discussions of how creditor-shareholder conflicts differ near insolvency, see *Production Resources Group, L.L.C., v. NCT Group, Inc.*, 863 A.2d 772 (Del Ch., 2004); Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485 (1993).

⁷ See Ribstein, *supra* note 3 (emphasizing that the application of fiduciary duties depends on the structure of the parties' contractual relationship).

understanding both of the general nature of fiduciary duties and of the business judgment rule.

The article proceeds as follows. Part I discusses the general structure of the fiduciary relationship and the business judgment rule, and how this analysis applies to solvent firms. Part II applies fiduciary duties and the business judgment rule to the insolvency scenario, showing that the question does not change in this context, but rather remains one of fiduciary duties and the business judgment rule. Part III discusses the remedy for directors' fiduciary breach in the insolvency scenario. Part IV untangles directors duties from those of the corporation to creditors to refrain from fraudulent conveyances and breach of other specific duties. Part V concludes.

I. FIDUCIARY DUTIES AND THE BUSINESS JUDGMENT RULE

The analysis of directors' duties in the insolvency scenario must begin with general explication of fiduciary duties and the business judgment rule. Subpart A discusses the specific fiduciary duty of unselfishness. Subpart B discusses the directors' duty of care and the business judgment rule.

A. THE FIDUCIARY DUTY OF LOYALTY

Fiduciary duties are a set of implied contract terms that, in the absence of contrary agreement, accompany the open-ended power to manage another's property.⁸ The duty is what makes the delegation feasible because it otherwise would be very costly to delegate control over one's property.⁹ The property owner might try to contract for a certain level of performance and penalize the fiduciary for not performing up to that level, but for the same reason that the owner had to delegate control neither he nor a court could easily determine the standard of the fiduciary's conduct – that is, what an honest fiduciary should have produced.¹⁰ Fiduciary duties solve these problems by having a judge review the fiduciary's conduct to determine whether he acted selfishly. As Justice Cardozo said in *Meinhard*, for the fiduciary, “thought of self was to be renounced, however hard the abnegation.”¹¹ It is much easier to measure the fiduciary's gain than to try to determine a performance benchmark and give damages for deviation from that standard gain-forfeiture remedy.

Directors of publicly held corporations clearly fit into the paradigm of the fiduciary relationship. The corporation gives managers significant powers to run the

⁸ See Robert Cooter & Bradley J. Friedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1046-47 (1991); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983); L.S. Sealy, *Fiduciary Relationships*, 1962 CAMBRIDGE L.J. 69, 74-78 (proposing four categories of fiduciary relationships, three based on control or delegation and one based on undue influence); Ribstein, *supra* note 3; J.C. Shepherd, *Towards a Unified Concept of Fiduciary Relationships*, 97 LAW Q. REV. 51, 75 (1981) (receipt of power conditioned on duty to use the power in the best interests of another); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1402 (2002) (proposing a theory based on a fiduciary's control of a beneficiary's “critical resource”).

⁹ See Ribstein, *supra* note 3.

¹⁰ See Cooter & Friedman, *supra* note 8 at 1048-51.

¹¹ *Meinhard v. Salmon*, 164 N.E. 545, 548 (N.Y. 1928).

company, subject only to loose control by passive, diversified shareholders. Neither the shareholders nor the courts can effectively oversee day-to-day management, so the law ensures at least that the directors will be loyal to the corporation's interests. Unlike other settings, however, the need for managerial flexibility in the public corporation setting softens the fiduciary duty of loyalty to permit exoneration of conflicted directors if their conduct was authorized by disinterested directors or shareholders or they can show it was fair to the corporation.¹²

Because the fiduciary standard is one of disloyalty or conflict of interest, the issue of whether the directors can favor the shareholders over the creditors does not normally arise. Rather, the rule is simply that the directors may not favor their own interests. The test for fairness confirms the unimportance of particular interests in the firm by measuring fairness in terms of the corporate entity. Moreover, the duty of loyalty both in corporations and other business associations¹³ permits authorization by a vote of the equity holders alone. This supports measuring fairness in terms of the equity interests when these clash with the creditors.

B. THE DUTY OF CARE AND THE BUSINESS JUDGMENT RULE

Corporate directors also have a duty of care. This is not really fiduciary in nature, since a fiduciary does not commit all of its time to the beneficiary, and the duty inherently does not involve disgorgement of gain.¹⁴ Moreover, the duty arises even in situations where the holder of the duty does not have an open-ended management power.¹⁵ Thus, the duty of care attaches to both fiduciaries and non-fiduciaries.

Directors' duty of care is subject to the business judgment rule. This rule recognizes that courts are not business experts, and therefore cannot easily determine whether a bad result was due to mismanagement. Moreover, liability might deter fiduciaries from making beneficial but risky decisions. Shareholders, particularly of publicly traded corporations, want managers to take risks because the shareholders ordinarily protect themselves from firm-specific risk by holding diversified portfolios. But liability could cause managers to shy away from these decisions because, while shareholders would capture most of the gain, the managers would bear the risk.¹⁶

The business judgment rule accordingly gives a great deal of discretion to managers. For example, the ALI Code provides that courts cannot impose liability for an

¹² See Delaware GCL, §144.

¹³ As to partnerships, see RUPA §103(b)(3) (providing for authorization of transactions by partner vote). As to LLCs, see ULLCA §103(b)(2).

¹⁴ See Ribstein, *supra* note 3; SHEPHERD, *supra* note 8 at 49 (stating that “the duty of care has absolutely no necessary connection with fiduciary relationships”).

¹⁵ See *Pegram v. Herdrich*, 530 U.S. 211, 235 (2000) (holding that characterizing the duty of care a doctor working for a health maintenance organization as fiduciary would be an “erroneous corruption of fiduciary obligation.”).

¹⁶ See Frank H. Easterbrook & Daniel R. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 93, 98-99 (1991); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004); Ribstein, *supra* note 5.

informed and disinterested director decision that the director “rationally believes . . . is in the best interests of the corporation.”¹⁷ In other words, the director need not act “reasonably.” Indeed, the decision is insulated from review even if the court concludes in hindsight that it was irrational as long as, at the time of the decision, the director “rationally believes” it was in the corporation’s best interests.

The operation of the business judgment rule can be illustrated by the famous case in which a Disney shareholder sued the board for hiring a chief executive, giving him generous termination provisions and firing him only 14 months later for admittedly ineffective management, paying him \$140 million for his trouble. The Delaware supreme court initially dismissed the complaint.¹⁸ The chancery court upheld the complaint on remand after the plaintiff added allegations transcending mere lack of due care and amounting to bad faith – that is, conscious disregard of duty.¹⁹ But the Chancery Court dismissed the case after the plaintiff failed to prove the allegations in a lengthy trial. The Chancellor clarified the standard by opining that

the concept of intentional dereliction of duty, a conscious disregard for one’s responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct. . .²⁰

This lax standard applied because Disney, like most Delaware corporations, had taken advantage of a Delaware statutory provision permitting firms to opt out of the duty of care.²¹ This leaves only the duty of loyalty and the duty of good faith which, as Chancellor Chandler held, is violated only by “intentional dereliction of duty.”

The business judgment rule exonerates the board even where it acts arguably in the interests of non-shareholders. For example, *Shlensky v. Wrigley*,²² dismissed minority shareholders’ complaint against a majority shareholder for mismanagement based on defendant’s failure to install lights in the firm’s baseball stadium, despite the fact that every other major league team allegedly had done so. The majority shareholder had said “that baseball is a ‘daytime sport’ and that the installation of lights and night baseball games will have a deteriorating effect upon the surrounding neighborhood.”²³ The court reasoned:

[W]e are not satisfied that the motives assigned to Philip K. Wrigley, and through

¹⁷ ALI Code, §4.01.

¹⁸ *Brehm v. Eisner*, 746 a. 2d 244 (Del. 2000).

¹⁹ *In re Walt Disney Company Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003).

²⁰ *In re Walt Disney Company Derivative Litigation*, 2005 WL 2056651 (Del. Ch. August 9, 2005).

²¹ Del. Corp. Code §102(b)(7).

²² 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968).

²³ *Id.* at 778.

him to the other directors, are contrary to the best interests of the corporation and the stockholders. For example, it appears to us that the effect on the surrounding neighborhood might well be considered by a director who was considering the patrons who would or would not attend the games if the park were in a poor neighborhood. Furthermore, the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighborhood from deteriorating. By these thoughts we do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision.²⁴

The same standard obviously would apply if the plaintiff claimed that the board acted on behalf of creditors rather than customers or the sport of baseball.

As with the duty of loyalty, the business judgment rule speaks in terms of the corporation's best interests, rather than those of any particular claimants on the corporation's assets. This lack of specificity simply reflects the lightness of the court's scrutiny. For the same reason that the court does not review the directors' acts, it also does not review the directors' choice of which corporate interests these acts favor, as long as the directors make the choice disinterestedly.

II. DIRECTORS' DUTIES TO INSOLVENT CORPORATIONS

As the corporation nears insolvency, creditors' interests increasingly resemble equity claims. While creditors' claims are limited to specific obligations to pay principal and interest, these limitations matter less as equity disappears and overall debts approach and exceed assets. Specific contractual constraints on the shareholders' and directors' actions that are sufficient to protect creditors during solvency may not protect them against the much broader set of actions that can harm creditors of insolvent or nearly insolvent corporations. Indeed, creditors in this situation arguably are even more appropriate beneficiaries of fiduciary duties than shareholders because creditors generally lack control powers.

This raises the question whether the directors in the insolvency scenario should be deemed to owe fiduciary duties to the firm's creditors. It is important to emphasize that the question is *not* whether directors *have* fiduciary duties in this situation: they clearly continue to be fiduciaries, just as they were prior to insolvency. Rather, the question is whether the nature of the directors' duties change as a result of insolvency, so that the directors are deemed to owe fiduciary duties to the creditors instead of, or in addition to, the shareholders.

The critical argument against changing fiduciary duties in the insolvency scenario is that creditors do not simply replace shareholders as residual claimants near insolvency. Rather, they are simply added to shareholders as an additional class of residual claimants with conflicting interests. Making directors fiduciaries to creditors would put them in the obviously difficult situation of having to balance these obligations, as where they must choose between an alternative that has both a limited upside that satisfies creditors' claims and a limited downside and an alternative that could have a positive payoff for shareholders but where creditors would bear most of the downside risk. Indeed, there is,

²⁴ *Id.* at 780.

if anything, a special need for business judgment rule protection, since this difficult balancing is added to the other imponderables inherent in business decisions. Moreover, a judicially imposed duty in this situation would cause significant problems of predictability and litigation risk because of the difficulty of defining when the duty applies – that is, whether the corporation was insolvent or near insolvency.²⁵

A prominent approach in this situation is to hold that the directors owe duties of loyalty, care and good faith to the corporate entity that require them to balance the interests of the shareholders, creditors and other corporate constituencies.²⁶ The best explication of what this might mean is Chancellor Allen’s opinion in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, in which he used the illustration of a solvent corporation with \$12 million in debt having as its sole asset a \$51 million judgment that has an expected value (taking into account the chances of affirmance, modification and reversal on appeal) of \$15.55 million. Chancellor Allen noted that the creditors would be willing to accept any settlement offer above \$12 million. However, the shareholders might reject an even higher settlement if there is a significant chance (say 25%) that the judgment would be affirmed. The Chancellor observed:

But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than \$15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act. . . . ²⁷

This dictum deals with the business question of how the directors of an insolvent corporation should approach managing the firm. The question under the business judgment rule, however, is not what the directors “should” do from the standpoint of the socially efficient outcome, but when directors will be held liable for favoring a particular interest. This question can be readily answered by the same rules discussed in Part I: the directors are liable for breaching a duty of loyalty through self-interested conduct, or a duty of care, subject to the business judgment rule, or the even laxer good faith duty applied in *Disney*. From this perspective, the *Credit Lyonnais* dictum is relevant mainly in illustrating the difficulty of the directors’ decision. In other words, Chancellor Allen’s dictum is not an instruction to courts to find a breach of duty whenever the board does not find precisely the right balance between shareholder and creditor interests, but rather

²⁵ For cases dealing with this definition problem, see *Production Resources Group, L.L.C., v. NCT Group, Inc.*, 863 A.2d 772 (Del Ch., 2004); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784 (Del.Ch.1992).

²⁶ See *Odyssey Partners v. Fleming Companies*, 735 A.2d 386 (Del. Ch. 1999); *In re Unifi Corp; Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del.Ch.1991) (dispute between third parties over membership of corporate board); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784 (Del.Ch.1992).

²⁷ See *Credit Lyonnais* at n. 55.

generally to refrain from imposing liability because of the difficulty of finding that balance.

In light of this difficulty, it is not surprising that, despite judicial language suggesting that directors must balance the interests of various constituencies, there are no cases holding the directors liable simply for getting the balance wrong where they did not violate the generally applicable loyalty, care or good faith duties. The difference between the general dictum in the insolvency scenario calling for a balancing of interests and the much narrower holdings applying the business judgment rule in determining the directors' actual duties is evident from an analysis of a few of the more prominent cases.

In *Credit Lyonnais*, Chancellor Allen held that managing creditors did not breach a duty to the 98% shareholder by failing to sell corporate assets, despite the shareholder's need for capital. The court suggested that sale would have brought a "fire sale" price. Imposing liability on the directors in this situation would have involved second-guessing the directors for making an objectively reasonable decision because they did not consider the majority shareholder's personal financial decision, a result that would compromise the business judgment rule's objectives of protecting reasonable risk-taking and preventing undue judicial interference.

Equity-Linked Investors, L.P. v. Adams,²⁸ eliminates any doubt about Chancellor Allen's application of the business judgment rule in this situation. The Chancellor held that the board could favor the interests of the common shareholders over those of the preferred shareholders by obtaining an outside investment that diluted the preferred interest rather than opening the bidding to the preferred shareholders, who probably would have liquidated the company. Chancellor Allen noted the rule that creditors were owed only "contractual" and not fiduciary duties²⁹ and applied this rule to the preferred shareholders in the present case.³⁰ The court reasoned:

[w]hile the board in these circumstances could have made a different business judgment, in my opinion, it violated no duty owed to the preferred in not doing so. The special protections offered to the preferred are contractual in nature.³¹

The case was complicated by plaintiff's argument that, since the transaction amounted to a transfer of control, this triggered the board's special duties under *Paramount Communications Inc. v. QVC Network Inc.*³² to maximize shareholder value. In other words, the plaintiff was *not* seeking to apply some special fiduciary duty to fixed claimants, but rather to get favored treatment as an *equity* holder. Because the firm's value consisted of the combined value of the common and preferred, in effect this meant maximizing the value of the corporation as a whole, just as Chancellor Allen had

²⁸ 705 A.2d 1040 (Del. Ch. 1997).

²⁹ See *infra* text accompanying note 60.

³⁰ As to the application of fiduciary duties to preferred shareholders, including an analysis of *Equity-Linked*, see William Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 Mich. L. Rev. 891 (2002).

³¹ 705 A. 2d at 1042.

³² 637 A.2d 34 (Del. 1994).

suggested in *Credit Lyonnais*. In the present case, because the preferred shares' liquidation preference was below water, a favorable ruling would have let the preferred make a "credit bid" exceeding the bid the firm accepted. In other words, the court explicitly permitted the board *not* to maximize the value of the corporation as a whole, and instead to maximize the value of the equity's interest. This enabled the board to follow through on its business plan to continue research and development rather than to liquidate. The court reasoned:

Where judgment is inescapably required, all that the law may sensibly ask of corporate directors is that they exercise independent, good faith and attentive judgment, both with respect to the quantum of information necessary or appropriate in the circumstances and with respect to the substantive decision to be made.³³

In short, reading *Equity-Linked* together with *Credit Lyonnais* clarifies that Chancellor Allen does not support a general duty to maximize corporate value in the insolvency scenario, taking into account creditors' interests. Directors in the insolvency scenario, as in solvent corporations, need only avoid conflicts and are otherwise broadly protected by the business judgment rule. Just as this let them maximize the creditors' interests in *Credit Lyonnais*, so they could prefer the equity's interest over that of the debt-like preferred in *Equity-Linked*.³⁴

Other leading cases are consistent with the approach in *Credit Lyonnais* and *Equity-Linked*. A prominent example is *Production Resources Group, L.L.C., v. NCT Group, Inc.*,³⁵ in which Vice Chancellor Strine held that directors had no special duties to creditors that would justify not applying the Delaware fiduciary opt-out provision.³⁶ Instead, the court held that any suit for breach of duty in the near-insolvency situation continues to be one on behalf of the corporation, even if can be maintained by creditors.³⁷ Whether the directors have breached their duties in this situation involves an application of the business judgment rule. Thus, the directors may be liable if they destroyed the corporation in an attempt to preserve going concern value.³⁸ This would involve the complete sacrifice of one set of interests to the other with no hope of entity gain, as where the directors take a fling in Las Vegas to save the company from bankruptcy while throwing all the risk on the creditors.

In *Odyssey Partners v. Fleming Companies*,³⁹ minority shareholders alleged that

³³ 705 A. 2d at 1059.

³⁴ In another post-*QVC* case, *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003), the court went even further and held that the board *must*, in effect, prefer the shareholders by rejecting a deal that would have been more beneficial to the creditors.

³⁵ 863 A.2d 772 (Del Ch., 2004).

³⁶ See Del GCL §102(b)(7).

³⁷ As to the creditors' right to maintain the suit, see *infra* Part III.

³⁸ See *Production Resources*, 863 A.2d at 791, n. 60.

³⁹ 735 A.2d 386 (Del. Ch. 1999).

the board breached its duty of loyalty by failing to adequately consider a Chapter 11 filing, which effectively allowed the majority shareholder and major creditor of the corporation to foreclose on its security interest in the corporation's assets. The court reasoned:

When bankruptcy and foreclosure are compared, and the effects of both on the shareholders, creditors and other corporate constituencies balanced, the decision to proceed with the foreclosure cannot be said to have been made in bad faith or a manner that was disloyal to ABCO, taken as a whole.

Again, the court used multiple-constituency-type language. But the court *held* that the board could favor the majority shareholder/creditor's interest, consistent with the business judgment rule that applies in or out of the insolvency scenario.

It is important to distinguish rights of *creditors* against the corporation and shareholders arising out of fraudulent-conveyance-type transfers from fiduciary duty claims on behalf of the *corporation* against corporate managers. Creditors' individual rights are discussed in more detail below in Part IV. The relationship between these rights and the directors' duties to the corporation that are the focus of this section is illustrated by the following two cases.

Geyer v. Ingersoll Publications Co.,⁴⁰ is often cited as holding in favor of directors' special duties to creditors in the insolvency scenario, but in fact adds nothing to the above cases. The issue was whether a non-shareholder creditor of the corporation could assert personal jurisdiction over a non-resident resident director under a Delaware statute⁴¹ that provided for jurisdiction "in any action or proceeding against such director, trustee or member for violation of his duty in such capacity." The parties agreed that there was an "insolvency exception" to the general rule of no fiduciary duties to creditors, so the only question for the court was whether the exception arose even without a statutory insolvency proceeding. The court held that it did, and accordingly permitted the exercise of personal jurisdiction in a case alleging that the director caused the corporation to cancel management agreements for consideration paid to the director that caused the corporation to be unable to make payments due plaintiff. Since the case involved only the personal jurisdiction point, the court did not determine whether the duty was breached. More importantly, this case did not involve any special duty by the board to manage in the creditors' interests close to insolvency. Instead, it involved a fraudulent-conveyance-type transfer of the type discussed below in Part IV, which would breach the duty the defendant, who was also the corporation's sole shareholder, owed the plaintiff creditor.

*In re Unifi Communications*⁴² more clearly distinguishes the corporation's duty directly to creditors from the board's duty to the corporation. The complaint by the trustee in bankruptcy on behalf of the debtor corporation alleged that the board breached its duties to the corporation by depleting corporate assets after it was insolvent in order to help a director "salvage his equity interest." The defendants opposed summary judgment by claiming that they had a limited duty to creditors that "requires only that the director

⁴⁰ 621 A.2d 784 (Del. Ch. 1992).

⁴¹ 10 Del. Code. §3114(a).

⁴² 317 B.R. 13 (D. Mass. 2004).

not engage in self-dealing or other conduct that prefers any corporate constituent over creditors.” The court distinguished the cases cited by defendants, notably including *Geyer*, in which the plaintiffs were creditors. Plaintiff had argued that

[i]t is hornbook law that corporate directors owe the corporation they serve fiduciary duties of due care, loyalty and good faith . . . Although at least some of those duties expand to include creditors when a company nears insolvency, there is an ever-present duty to the corporation itself.⁴³

The court noted that the trustee had no standing to bring an action specifically on the creditors’ behalf, so that the trustee’s claim had to be one on behalf of the corporation. Because the defendants failed to address the trustee’s argument about the duties owed the corporate entity, the court denied defendants’ motion for summary judgment.

As in cases like *Credit Lyonnais*, *Unifi* did not hold that directors breached their duty by favoring one interest over another in the insolvency scenario. Indeed, *In re Global Service Group LLC*,⁴⁴ a case decided around the same time as *Unifi* and involving the same type of alleged misconduct, clearly held that the directors’ decision to continue operating an insolvent company rather than liquidating was subject to the business judgment rule, and therefore did not result in liability absent “specific allegations that the fiduciary acted in bad faith or with fraudulent intent.”⁴⁵

These cases involving directors’ duties to the corporation in the insolvency scenario, as in cases outside the scenario, hold that directors’ duties are defined by the general duties of loyalty, care and good faith, importantly qualified by the generous protection of the business judgment rule. Although the cases contain language indicating that the directors must pay particular attention to the creditors’ interests in this situation, or to the corporate entity, none hold inconsistently with the general rule. Rather, the language about maximizing the “corporate” interest really just confirms the absence of judicial interference in any decision the directors choose to make, as long as the directors avoid conflicts or deliberate harm.

III. REMEDIES

The question of the remedy for breach of the directors’ duty is theoretically separate from that of the duty. The traditional remedy for breach of the directors’ duty to the corporation is a suit by the corporation, or by a shareholder derivatively on behalf of the corporation. In the latter case, the main actor is usually the plaintiff’s attorney, who is paid a percentage of the recovery.

The important issue for present purposes is whether the remedy should depend on whether the action is brought in the insolvency scenario. State corporate laws generally deny standing to creditors in derivative suits, though a trustee in bankruptcy can sue derivatively on behalf of the corporation.⁴⁶ The nature of the suit is identical to a

⁴³ *Id.* at 18-19.

⁴⁴ 316 B.R. 451 (2004).

⁴⁵ *Id.* at 461.

⁴⁶ See Note, *Creditors’ Derivative Suits on Behalf of Solvent Corporations*, 88 Yale L.J. 1299

standard shareholders' derivative action, in which the recovery also goes to the corporation rather than to individual plaintiffs. The fact that the main beneficiaries of a corporate recovery happen at a particular point in time to be the creditors has no important consequences for either the duty or the remedy.

Individual creditors, as distinguished from the trustee, may be able to sue derivatively in bankruptcy with the court's permission, at least on claims of breaches of duty to the creditors that the creditors could bring outside of bankruptcy.⁴⁷ *Official Committee of Unsecured Creditors of Cybergenics Corp., on Behalf of Cybergenics Corp. v. Chinery*⁴⁸ authorized a creditors' committee to bring derivative claims based on alleged fraudulent transfers where the bankruptcy court held that the debtor's refusal to bring the claims was unreasonable.⁴⁹ The bankruptcy court's finding was equivalent to a state court's finding that would allow a derivative suit to proceed over the board's objection.⁵⁰

It is not clear, however, the extent to which a bankruptcy or non-bankruptcy court would allow individual creditors to sue on a claim based on a general breach of fiduciary duty that would have been maintained by the shareholders on the corporation's behalf outside of bankruptcy. The basic question should be whether the creditor has the best incentives to maintain the suit. Such a suit may be justified in bankruptcy on the same ground as in *Cybergenics* – that is, based on a finding that the trustee's refusal to sue is unreasonable. Even outside of bankruptcy, the creditors may have better incentives than the shareholders where the corporation is insolvent. Because a suit on behalf of an insolvent corporation may eventually be stayed or enjoined in bankruptcy⁵¹ and effectively taken over or released by the trustee,⁵² this may sharply reduce a contingent-fee plaintiffs' attorney's incentives to take on such a case. If the main driver of the action is the plaintiff rather than the attorney, a substantial creditor might have better incentives to sue on behalf of an insolvent corporation than would a nominal or even a substantial shareholder.

Production Resources is an important case supporting the creditor's right of action. The court refused to dismiss a creditor's suit under the Delaware statute for appointment of a receiver. The court held that suit by a creditor was justified,

(1979).

⁴⁷ These claims are discussed in *infra* Part IV.

⁴⁸ 330 F.3d 548 (3rd Cir. 2003). *See also* *In re Commodore Int'l Ltd.*, 262 F.3d 96 (2d Cir.2001) (also allowing creditors committee to sue derivatively with the approval of the bankruptcy court).

⁴⁹ *But see* *In re Fox*, 305 B.R. 912 (10th Cir. BAP 2004) (denying standing to bring a §548 claim).

⁵⁰ *See Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

⁵¹ *See* Bankruptcy Code, §§105, 362; *In re KMart Corp.*, 285 B.R. 679 (Bankr. N.D. Ill. 2002); *In re Zenith Laboratories, Inc.*, 104 B.R. 659 (D. N.J. 1989).

⁵² *See Agostino v. Hicks*, 845 A.2d 1110 (Del. Ch. 2004) (holding that suit against 49% owner who became creditor in bankruptcy alleging that directors entered into an agreement that precluded the corporation from pursuing other value maximizing transactions and that the agreement transferred voting control without payment of a control premium was derivative in nature and therefore could be released by the bankruptcy court in its confirmation of the corporation's Chapter 11 plan through which the creditor became the sole shareholder).

particularly since the creditor lacked other remedies. Notably, the court held that the identity of the plaintiff did not affect the nature of the remedy. Thus, as discussed above,⁵³ because the suit remained one on behalf of the corporation rather than for an individual creditor, the directors were still protected by the Delaware fiduciary opt-out that applied to shareholder derivative suits.

IV. THE CORPORATION'S DUTIES TO CREDITORS

The discussion so far shows that directors as such have no special duties in the insolvency scenario. Although courts sometimes have seemed to hold that the board in this situation owes duties to the “corporation,” which may include creditors, this is in fact no more than a restatement of the court’s limited scrutiny of board decisions under the business judgment rule.

The question remains whether courts should impose fiduciary duties on corporate creditors to their debtors. Fiduciary duties might seem appropriate here to redress the agency problem that arises when creditors entrust money to debtors that have an incentive to engage in transactions whose risk is imposed on creditors while shareholders reap potential rewards.⁵⁴ This does not implicate the business judgment rule because the liability is imposed on the corporation, or perhaps its owners, rather than on the corporation’s managers. However, this issue tangentially relates to directors duties to the corporation because recognizing a fiduciary duty by the corporate debtor effectively requires the corporation’s agents to act on creditors’ behalf, as they would if they had direct fiduciary duties to creditors.

This is not, however, an appropriate situation in which to apply fiduciary duties. In contrast to the open-ended discretion that shareholders give managers to maximize profits, creditors demand regular payments of principal and interest and contract to control the specific types of misbehavior such as excessive dividends that could threaten these obligations.⁵⁵ A broad fiduciary remedy by debtors to creditors therefore would be inconsistent with the general nature of fiduciary duties.⁵⁶

It might seem that open-ended duties to creditors would be appropriate to the extent that creditors of insolvent corporations resemble residual claimants as the equity interest becomes valueless. But the existence of a fiduciary duty should depend on the nature of the contract. Thus, the arguments based on creditors’ specific contracts still hold. While most creditors’ contracts arguably are designed for solvent companies, the contracts theoretically can be drafted to offer increased protection in the insolvency

⁵³ See *supra* text accompanying note 36.

⁵⁴ See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

⁵⁵ See Douglas G. Baird and Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, http://papers.ssrn.com/paper.taf?abstract_id=692023, Vanderbilt Law and Economics Research Paper No. 05-08, U Chicago Law & Economics, Olin Working Paper No. 247 (March 24, 2005) (discussing creditors’ significant control powers and arguing that “[r]ather than add ill-defined fiduciary duties to the contracts that they write, a better course may be to ensure that such duties do not impede the exercise of contractual rights for which creditors have bargained”).

⁵⁶ See Ribstein, *supra* note 3.

scenario, including increased creditor control.⁵⁷ The creditors' decision to rely on specific protections rather than an open-ended duty therefore should continue to control the result.⁵⁸

Consistent with this reasoning, courts generally have held that corporate debtors do not have fiduciary duties to the firm's creditors. duties to creditors.⁵⁹ As Chancellor Allen explained in *Katz v. Oak Industries, Inc.*:⁶⁰

Under our law—and the law generally—the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature. Arrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.

The corporation may owe specific duties to its creditors, particularly including the duty to refrain from fraudulent conveyances. The fraudulent conveyance theory accommodates the need to deter debtor misbehavior with the need to limit judicial interference with credit agreements. Given creditors' decision to contract for specific constraints on debtor conduct, only a limited additional measure of protection is appropriate. Fraudulent conveyance liability, like the fiduciary duty of unselfishness, focuses on a particular category of clear misconduct for which the courts are able to fashion a remedy. The theory applies where the debtor takes an action that not only creates an extra risk for creditors, but does so where there can be no legitimate business purpose – that is, an insolvent corporation gives away its property. The remedy is straightforward: recover the assets, usually through an action by the trustee in bankruptcy acting for the debtor.

The fraudulent conveyance remedy is sometimes characterized one for breach of fiduciary duty. For example, in *LaSalle National Bank v. Perelman*,⁶¹ Marvel's note holders sued the directors in a Chapter 11 proceeding for breach of fiduciary duties to them based on paying the note proceeds to Marvel's parent, consistent with offering memoranda stating that Marvel would make such distributions. The court denied relief because the subsidiary was not insolvent at the time of the distributions. The court also noted that the offering memorandum explicitly contemplated such distributions. The

⁵⁷ See Lin, *supra* note 6 (discussing creditors' ability to protect themselves in insolvency situations).

⁵⁸ See Ribstein, *supra* note 3 (emphasizing that fiduciary duties arise out of the structure of the parties' relationship).

⁵⁹ See *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1526 (S.D.N.Y. 1989); *Simons v. Cogan*, 549 A.2d 300 (Del. 1988); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Harff v. Kerkorian*, 347 A.2d 133 (Del. 1975) (reversing dismissal of fraud allegations). *But see* *Fox v. MGM Grand Hotels, Inc.*, 187 Cal. Rptr. 141 (Cal. Ct. App. 1982) (holding in favor of fiduciary duties to creditors in connection with spinoff to common shareholders).

⁶⁰ 508 A.2d 873, 879 (Del. Ch. 1986).

⁶¹ 82 F. Supp.2d 279 (D. Del. 2000).

“fiduciary duty” characterization in this case confuses the issue. If the firm had been insolvent, fraudulent conveyance liability would have been appropriate.

The corporation’s duty to its creditors should be distinguished from the cases discussed above in this article in which the duty is one by directors to properly manage the corporate entity on behalf of whoever is interested in the corporation’s assets. This duty requires the directors to refrain from self-dealing and from waste of corporate assets that violates the business judgment rule. Self-dealing and waste account for all of the cases Laura Lin characterized as breaches of fiduciary duties to creditors:

(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; (2) using corporate funds to pay off the company's loans that the directors had personally guaranteed; (3) engaging in transactions, usually without fair consideration to the company, for the benefit of its parent corporation or related entities; (4) pocketing the proceeds of a sale of all corporate assets to a third party or otherwise transferring property to a related entity, leaving the former corporation insolvent; 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.⁶²

Lin argues that “[a] common theme prevalent in these cases is the resemblance to fraudulent conveyances or voidable preferences under bankruptcy law.”⁶³ Even if that is the case, it does not explain why some remedy other than fraudulent conveyance or voidable preference is appropriate, particularly where the conduct does not meet the tests for liability under those theories. In fact, these cases do not stretch the boundaries of more specific remedies because they involve claims brought by the *corporation* against the *directors* who breached their fiduciary duty to the corporation in dealing with corporate assets. By contrast, a fraudulent conveyance or preference claim is one by *creditors* against the debtor, shareholders or others who received corporate assets in violation of the corporate debtor’s duty to the creditors. Lin had difficulty fitting the above categories into the standard fiduciary duty category only because she assumed that the directors’ fiduciary was specifically to the shareholders. However, as discussed throughout this article, neither the duty of loyalty nor the business judgment rule requires or permits a distinction between a duty to the shareholders and one to the corporate entity.

The sole remaining question is the narrow one of whether there are any circumstances in which the creditors *individually* may bring a *non-derivative* fiduciary action against either shareholders or directors that is *not* based on a fraudulent conveyance or violation of other specific statutory or contractual duty of the corporate debtor to its creditors. *Production Resources* addressed this issue. The court made clear that most of the creditor’s claims were on behalf of the corporation, though the action was not formally a derivative action. However, the creditor did sue individually for breach of fiduciary duty based on an alleged promise to sell stock owned by the debtor’s subsidiary in order to pay the judgment owed to the plaintiff. The court said that, in addition to the question of whether this was properly brought as a derivative claim, there

⁶² See Lin, *supra* note 6 at 1513-14 (footnotes omitted).

⁶³ *Id.* at 1514.

was also

utility in applying fiduciary duty law quite cautiously, to avoid unduly benefiting creditors by enabling them to recover in equity when they could not prevail on legal tort or contract claims. At the same time, as noted earlier, the fact of [the corporation's] insolvency might influence the application of traditional torts, like common law fraud, by enabling [the creditor] to recover for cases of material omission. These and other complexities bear serious consideration later in the case.⁶⁴

In other words, while the court acknowledged the slight possibility that an individual creditor might have a fiduciary duty claim that was outside the bounds of specific creditor remedies, the scope of any such relief would be narrow. If the creditor of a corporation in or near insolvency was able to recover, it would most likely be under a traditional fraud or other theory whose application was shaped by the circumstances, including the corporation's insolvency.

V. CONCLUDING REMARKS

Despite many cases with seemingly contrary dicta, directors of insolvent or near-insolvent corporations do not have a fiduciary duty to creditors. Rather, they have a fiduciary duty to the corporation, just as they have at other times, that is based on the duty of loyalty and the business judgment rule. Under the business judgment rule, the directors have broad discretion not only to decide what actions to take, but in whose interests to act. The creditors may in some circumstances sue to enforce this duty, but the fact that the creditors are suing does not affect either the duty or the remedy. The creditors also may sue the corporation individually for breach of specific contractual, tort and statutory duties, particularly including the duty to refrain from fraudulent conveyances. But none of these cases amount to a general director fiduciary duty to creditors.

⁶⁴ 863 A.2d at 801, n. 88.