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The Expressive Function of Directors' Duties to Creditors

Jonathan C. Lipson*

This Article offers an explanation of the "doctrine" of directors' duties to creditors. Courts frequently say—but rarely hold—that corporate directors owe duties to or for the benefit of corporate creditors when the corporation is in distress. These cases are puzzling for at least two reasons.

First, they link fiduciary duty to priority in right of payment, effectively treating creditors as if they were shareholders, at least for certain purposes. But this ignores the fact that priority is a complex and volatile concept. Moreover, contract and other rights at law usually protect creditors, even (especially) when a firm is distressed. It is thus not surprising that courts do not in fact want to treat directors as fiduciaries for creditors, except in extreme cases. But this leaves us with the second puzzle: If directors are rarely treated as fiduciaries for creditors, why have the Delaware courts bothered to say so much about this, especially in their recent opinions?

This Article explores these two puzzles, and argues that these cases are best understood as examples of "expressive" judging, exhortations to good behavior not necessarily tethered to meaningful instrumental consequences. It identifies four expressive themes in these decisions on, among other things, director discretion, the boundaries of acceptable conduct towards creditors, the role of contract, and the educative function of courts. The Article concludes by noting several doctrinal gaps created by some of the recent case law, and suggests ways that the better expressive aspirations of the Delaware opinions can fill these gaps in fair and efficient ways.

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Introduction

Our thinking about corporate financial distress has undergone a profound change in the nearly thirty years since the current Bankruptcy Code was enacted.[1] Whereas business failure was once largely a subspecies of procedural or remedial law, imbued with only modest and sporadic theoretical insights, it has today become a subject of enormous sophistication, both for practitioners and academics. Vigorous debates about policy, theory and methodology abound.[2]

Perhaps the most important, if subtle, change in thinking about business distress has been to see that it is largely a problem of corporate governance.[3] Writers representing a variety of theoretical and political camps—from contractarians to empiricists—now recognize that corporate reorganization is not simply about the distribution of property; it is about human beings, and how law can set incentives to minimize the likelihood of, or damage from, corporate failure. Because corporate governance, like the more general field of agency from which it springs, is largely about incentives, the convergence between bankruptcy and corporate law is, in retrospect, no great surprise.

How odd, then, that even as our thinking about corporate reorganization and corporate law converges, we have not yet figured out how to address that body of doctrine which is arguably at the heart of corporate governance problems and which is increasingly important to discussions about corporate financial distress: directors' fiduciary duties.

Conventional wisdom teaches that, when a firm is solvent, corporate directors have no fiduciary obligations to corporate creditors. Directors manage the firm for the benefit of the firm's residual claimants who, on a standard model of priority, will be the common shareholders. When the corporation encounters financial trouble, however, courts frequently say—although rarely hold—that

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[1] 11 U.S.C. §§ 101-1330 (2000 & Supp. 2006). Originally enacted in 1978, (Bankruptcy Reform Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978)), the Bankruptcy Code recently underwent a significant revision. Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11, 18 & 28 U.S.C.). The revision should have little bearing on the issues discussed in this Article.

[2] Much of the literature reflecting this transformation, and the ensuing debates, is cited in Part I.A., *infra*.

[3] Early credit in this regard goes, in no particular order, to Professors LoPucki, Whitford, and Skeel. *See* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Corporations*, 141 U. PA. L. REV. 669 (1993); David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994)

directors owe fiduciary duties of some sort to or for the benefit of corporate creditors.[4]

Directors' duties to creditors present at least two puzzles. First, courts that talk about them make a strong, if problematic, link between duty and priority in right of payment, suggesting that directors should treat creditors as if they *were* shareholders, at least for certain purposes.[5] "By definition," Vice Chancellor Leo Strine observed in the recent and important decision in *Production Resources*, "the fact of insolvency places the creditors in the shoes normally occupied by the shareholders—that of residual risk bearers."[6] This link between priority and duty sounds good because it captures a strong intuition we have about the "absolute" nature of priority: creditors first, then shareholders.[7]

But it is nevertheless curious. While it may make theoretical sense to say that directors owe duties to residual claimants when a firm is solvent, there is no apparent reason why this logic applies to most creditors. After all, creditors are usually protected by legal rights—contract, for example—in ways that shareholders are not. Moreover, the increasingly contractual nature of priority renders it both less absolute and less helpful in identifying the "residual" claimant when a firm is distressed. Most of us would say that this is not necessarily a problem, to the extent that creditors are parties to well-formed contracts. Why should duty be asked to do the work of contract?

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[4] While there are hundreds of opinions, from Delaware and beyond, that say this, few actually find directors liable, or even permit creditors to make much procedural progress. *See also* discussion at Part I.C.

[5] This is a point I first made in Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189 (2003) [hereinafter, *Directors' Duties*].

[6] Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 791 (Del. Ch. 2004).

[7] As the Supreme Court said in the *Louisville Trust* case, "the stockholder's interest in the property is subordinate to the rights of creditors. First, of secured, and then of unsecured, creditors." Louisville Trust Co. v. Louisville, New Albany & Chi. Ry. Co., 174 U.S. 674, 684 (1899). I discuss the so-called "absolute priority rule" often associated with the *Louisville* case in Part II.A.2, *infra*.

It is thus no surprise that there is less here doctrinally than meets the eye.[8] Courts do not want to take seriously the logical implications of the priority foundations on which they have built their duties-to-creditors model. To do so might impose on directors duties of oversight, candor and value maximization that would be inappropriate to expect *ex ante* and troubling to remedy *ex post*. Courts have thus gone to great lengths to contain the inexorable logic of the priority-duty model they have created. This has led some observers to suggest that directors' duties to creditors are "much ado about little."[9]

But this leads to a second puzzle: If priority has little to do with duty, and creditors are usually able to protect themselves contractually, why have the courts—in particular the Delaware Court of Chancery, "this nation's arguably most important business court"[10]—bothered to write such lengthy, elaborate, if occasionally confusing, opinions on directors' duties to creditors?[11] Discussions of

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[8] A word about the word "doctrine." This is a term used so frequently that it, like many terms of art, has an assumed identity. I do not use the term in an especially fancy way. Black's definition is as good as any: "A rule, principle, theory, or tenet of the law." BLACK'S Law Dictionary (5th ed. 1979). *See also Wikipedia, Doctrine,* at http://en.wikipedia.org/wiki/Doctrine (defining doctrine as "from Latin *doctrina* (compare *doctor*), [doctrine] means 'a code of beliefs', 'a body of teachings' or 'instructions', taught principles or positions, as the body of teachings in a branch of knowledge or belief system").

To the extent that "doctrine" embodies "holdings" from cases, a more sophisticated approach would contrast doctrine and "dicta." A recent attempt to do that yields the following definition: "A holding consists of those propositions along the chosen decisional path or paths of reasoning that (1) are actually decided, (2) are based upon the facts of the case, and (3) lead to the judgment." *See* Michael Abramowicz & Maxwell Stearns, *Defining Dicta,* 57 STAN. L. REV. 953, 961 (2005). One could quibble with this along the following lines: What is a "proposition"? What made the judge choose the decisional path taken? What does it mean for a proposition to "lead" to a judgment? But such quibbles take us inevitably down the path to indeterminacy. *See, e.g.,* Lawrence B. Solum, *On the Indeterminacy Crisis: Critiquing Critical Dogma,* 54 U. CHI. L. REV. 462 (1987); Ken Kress, *Legal Indeterminacy,* 77 CAL. L. REV. 283 (1989).

[9] *See, e.g.,* Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency,* J. BUS. & TECH. L. (forthcoming), http://ssrn.com/abstract=832504.

[10] Leo E. Strine, Jr., *If Corporate Action is Lawful, Presumably there are Circumstances in Which it is Equitable to Take that Action: The Implicit Corollary to the Rule of* Schnell v. Chris-Craft, 60 BUS. LAW. 877, 878 (2005).

[11] *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108-09 (Del. Ch. Dec. 30, 1991); Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 791 (Del. Ch. 2004); Trenwick Am. Litigation Trust v. Ernst & Young L.L.P., 906 A.2d 168 (2006); N. Am. Catholic Educ. Prog. Found., Inc. v. Gheewalla, 2006 WL 2588971, at *11 (Del. Ch. Sept. 1, 2006). As this Article was going to press, the Delaware Supreme Court issued an opinion affirming the Delaware Chancery Court in *Gheewalla.* [11] N. Am. Catholic Educ. Programming Found., Inc. v. Rob Gheewalla, _ A.2d _, 2007 WL 1453705 (Del. May 18, 2007). This was the Delaware Supreme Court's first real pronouncement on the subject. Although it was not possible to rewrite the entire Article to account for the Supreme Court's *Gheewalla* opinion, the editors of the *Stanford Journal of Law, Business and Finance* were kind enough to allow me to add a postscript at the end that discusses it.

duty often exhibit a large gap between rhetoric and reality.[12] This gap seems especially large in Delaware courts' discussions about directors' duties to creditors. What accounts for all the talk about directors' duties to creditors?

While we can never fully know why judges write the opinions they write, one explanation of these cases is that they are expressive forms of adjudication. Although there is no precise definition of "expressive law," the general idea—and the one used here—is that law, whether statute or judicial opinion, can express values and affect social norms independent of the actual consequences of the law's application.[13] This seems especially important when law is in flux. Thus, even if Delaware courts are in fact unwilling to act on the implications of the conceptual model they have chosen, they nevertheless wish to use these cases as an opportunity to explore the changing boundaries of directorial behavior when a firm is in distress. The Delaware cases on directors' duties to creditors are expressive and experimental attempts to generate norms and standards that guide directorial behavior in this context.

To date, no one has recognized the expressive function of judicial rhetoric about the priority-duty model and directors' duties to creditors.[14] This article fills that gap and describes four important expressive themes in recent Delaware case law

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[12] Melvin Eisenberg, among others, has famously observed that there is a big difference between the standard of care implied by fiduciary doctrine and the standard of review by which courts will scrutinize the discharge of those duties. *See, e.g.*, Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993).

[13] *See, e.g.*, Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585, 586 (1998) ("According to the expressive theory of law, the expression of social values is an important function of the courts or, possibly, the most important function of courts.") (footnote omitted); Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021, 2022 (1996) ("Many people support law because of the statements made by law, and disagreements about law are frequently debates over the expressive content of law."). Richard McAdams has perhaps developed the fullest account of the expressive function of law. *See* Richard H. McAdams, *The Expressive Power of Adjudication*, 2005 U. ILL. L. REV. 1043 (2005) [hereinafter *Adjudication*]; *see also* Dhammika Dharmapala & Richard H. McAdams, *The Condorcet Jury Theorem and the Expressive Function of Law: A Theory of Informative Law*, 5 AM. L. & ECON. REV. 1 (2003); Tom Ginsburg & Richard H. McAdams, *Adjudicating in Anarchy: An Expressive Theory of International Dispute Resolution*, 45 WM. & MARY L. REV. 1229 (2004); Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649, 1684 (2000) [hereinafter *Focal Point*]; Richard H. McAdams, *An Attitudinal Theory of Expressive Law*, 79 OR. L. REV. 339, 369 (2000); Richard H. McAdams & Janice Nadler, *Testing the Focal Point Theory of Legal Compliance: Expressive Influence in an Experimental Hawk/Dove Game*, 2 J. EMPIRICAL LEGAL STUD. 87 (2005). Although, as discussed in Part III, *infra*, the idea that law performs an expressive function is not new, its current locus is often said to be Lawrence Lessig's influential article, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943, 1009-12 (1995) [hereinafter *Social Meaning*].

[14] One article mentions this in passing, and then only by implication. *See* Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813, 1815 & n.7 (2002).

on directors' duties to creditors: (i) Directors should have broad discretion to act for the firm, even when the firm is distressed, so long as they have taken account of creditors' interests in some general sense; (ii) Courts will use narratives of extreme behavior to help generate norms and values that should govern directorial behavior when a firm is distressed; (iii) Contract can and should increasingly determine creditor protections; and (iv) Nonbankruptcy courts—in particular the Delaware courts—will have an important educative role in framing discussions about relations between corporate directors, debtors and creditors.

Doctrinal and expressive questions regarding directors' duties to creditors have potentially enormous consequences. The recent, massive increase in borrowing to finance corporate acquisitions and the payment of dividends and fees to the private equity firms that buy these corporations portend serious disputes over both priority and directors' duties to corporate creditors.[15] Increasingly complex financial structures (securitizations) frequently depend for their effectiveness on the appointment of "independent" directors.[16] Without a better understanding of what the Delaware courts are trying to tell us, we will have increasing difficulty advising corporate directors and creditors *ex ante* and resolving their disputes *ex post.*

This Article proceeds in four major parts. Part I describes the three major stages in the development of case law involving directors' duties to creditors, emphasizing Delaware's very recent attempts to rein in the doctrinal implications of the priority-duty model on which its jurisprudence rests. Part II develops the two major puzzles created by the cases: problems with priority and the marginal doctrinal relevance of these cases. Part III develops an expressive explanation of these cases. Part IV explores some of the doctrinal gaps left by existing law, especially as to non-contractual creditors and how the expressive features of these decisions create opportunities to fill those gaps in fair and efficient ways.

I. The Three Eras of Directors' Duties to Creditors

Courts, especially Delaware courts, and commentators routinely say that once a firm is seriously distressed, directors become fiduciaries for the benefit of corporate creditors.[17] Although creditors rarely recover on claims for breaches of such duties,[18]

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[15] As discussed below, there is growing evidence that private equity firms that buy corporations increasingly cause the corporations to borrow money that is then used to pay dividends or exorbitant fees to the owners. *See* discussions, Parts I.B. & III.B.3, below.

[16] The Comm. on Bankr. and Corp. Reorg. of The Ass'n of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 556 (1995) (explaining that "[w]here [a special purpose financing subsidiary] is owned by the originator (or an affiliate), the [special purpose entity] may be structured so that (a) one or more directors are independent.").

[17] Although failing to recognize the largely expressive function of directors' duties to creditors, an enormous body of literature has developed discussing this problem. *See, e.g.*, Christopher L. Barnett, *Healthco and the "Insolvency Exception": An Unnecessary Expansion of the Doctrine?*, 16 BANKR. DEV. J. 441, 465 (2000); Royce de R. Barondes, *Fiduciary Duties of Officers*

to have the bankruptcy case dismissed, MGM's controlling shareholder, Giancarlo Parretti entered into a restructuring agreement with the bank whereby he ceded most of his power as shareholder to CLBN.[30] Despite the restructuring agreement, it appears that Parretti persisted in attempting to control MGM.[31] Believing that Parretti was in breach of the restructuring agreement, CLBN exercised its right to take control of Parretti's stock. It then voted the stock to remove Parretti and his designees from the board and to replace them with directors selected by CLBN, led by Alan Ladd.[32] CLBN then asked the Delaware Chancery Court to confirm its appointments and enforce the restructuring agreement.[33]

Parretti asserted a variety of counterclaims against CLBN, including two alleging that CLBN and Ladd had breached duties to Parretti by creating "golden parachutes" for the bank-appointed directors and refusing to sell certain assets.[34] Chancellor Allen summarily disposed of the claims. "It is," he observed "an oddity of these facts that the change in control that the contracts contemplated is one that would return control back to an existing controlling shareholder, but I don't see that circumstance as necessarily material."[35] There was, according to Chancellor Allen, no basis for claiming the breach of any duty to Parretti as there was "persuasive evidence that the Ladd management group acted prudently with respect to these transactions from the point of view of MGM."[36]

If Chancellor Allen had said no more than this, *Credit Lyonnais* would probably not have been a terribly important or controversial decision. Parretti had, after all, ceded control to CLBN under the restructuring agreement. However, Chancellor Allen went on to announce what appears to have been a new, and ill-

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[29] *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *7-*8 (Del. Ch. Dec. 30, 1991). The court viewed the transaction as "typical" of the profligate nature of LBOs occurring at the end of the 1980s. "It was very highly leveraged . . . and the price appears to have been high. In another respect, however, it was not typical [in that] it involved a private sale to a person not associated with MGM." *Id.* at *8.

[30] *See id.* at *33 (discussing bank's control under restructuring agreement). Although Parretti retained the right to appoint three of the five members of MGM's board of directors, the board's power was significantly diminished because the restructuring agreement also created an executive committee, which was controlled by the bank's appointee. The executive committee was to have all of the powers and the duties permissible under the Delaware General Corporation Law and in most respects to act as the board of directors for MGM. *Id.* at *36 n.22.

[31] *See id.* at *35-*70.

[32] *See id.* at *70.

[33] *See id.* at *3.

[34] *See id.* at *97-*98. Technically, Parretti claimed that the duty ran to PCC, which was the 98.5 percent shareholder of MGM. Since Parretti controlled PCC, I will refer to the owner of MGM's shares as Parretti.

[35] *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215 at *107.

[36] *Id.* at *108.

defined, set of duties owed by directors to or for the benefit of corporate creditors: "At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."[37]

2. Chancellor Allen's Hypothetical

To illustrate how duty under these circumstances might work, Chancellor Allen offered a lengthy discussion of the presumed incentives directors might have, depending on a corporation's financial condition. The bulk of the analysis appeared in a footnote in the form of a hypothetical designed to show that "[t]he possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors."[38] The hypothetical assumed a corporation with a single asset—a significant judgment, on appeal, against a solvent corporation. The corporate plaintiff had only a single class of creditors: bondholders owed $12 million.[39] Chancellor Allen then suggested three possible outcomes with varying degrees of likelihood: (i) 25% chance of affirmance, (ii) 70% chance of modification, and (iii) 5% chance of reversal.[40] After discounting for these possible outcomes, he suggests that the board would assume that the current value of the judgment was $15.55 million.[41] This would leave equity of around $3.55 million after satisfaction of the $12-million claims of the bondholders.[42]

The problem posed in the hypothetical was this: What sort of settlement offer should the directors accept, and on what basis? A settlement offer of $12.5 million or $17.5 million would, Chancellor Allen surmised, be rejected by a board that viewed itself as solely bound to act on behalf of shareholders because shareholders would view any offer of less than $21.75 million as inadequate.[43] Chancellor Allen suggested

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[37] *Id.* at *108 (footnotes omitted). In using the term "residue risk bearer," Chancellor Allen invoked the language and construct of priority, a subject treated in Part II.A. below. Strictly speaking, Chancellor Allen could not have treated CLBN (or any of MGM's creditors) as such because the company was not yet insolvent. Being only in the "vicinity" of insolvency, the residual risk bearer on a standard theory of priority would be either junior unsecured creditors or Parretti (through his holding company, PCC). The indeterminacy implicit in the construction of this "zone" of insolvency is one of several frustrating features of *Credit Lyonnais*.

[38] *Id.* at *108 n.55.

[39] *Id.* at *108.

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] *Id.* at *108 n.55. Chancellor Allen came to this surmise based on the discounted values of the various possible outcomes of the appeal: "[T]he litigation alternative, with its 25% probability of a $39 million outcome to [the shareholders] ($51 million – $12 million [=] $39 million) has an expected value to the residual risk bearer of $9.75 million ($39 million x 25% chance of affirmance), substantially greater than the $5.5 million available to them in the settlement." *Id.* at *108 n.55.

that directors should reject both extremes and take the middle course.[44] This result, he observed, would require:

> [D]irectors 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.[45]

Credit Lyonnais was widely viewed as a controversial case, for at least two reasons. First, some read it to create a sword for plaintiffs who might sue corporate directors.[46] This interpretation appealed to the bankruptcy bar (or at least those who often represent bankruptcy trustees or creditors' committees) as it suggested a basis for recovery, and thus a new source of work.

Second, no one quite knew when these duties (and the risks they entail) would attach. Real insolvency is difficult enough to identify with any precision *ex ante* in a going concern.[47] Anticipating it seems a very tall order. If one uses a conventional definition of insolvency— based on net book assets at fair value—many firms are in the "vicinity" of insolvency. Highly leveraged transactions—going private with debt

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Although he did not cite the case, Chancellor Allen was postulating a solution to the problem presented in *In re Central Ice Cream Co.*, 59 B.R. 476, 488 (Bankr. N.D. Ill. 1985), *aff'd*, 62 B.R. 357 (N.D. Ill. 1986), where the debtor's sole asset was a verdict against McDonald's Corporation for $52 million. Before McDonald's motion for judgment notwithstanding the verdict was decided, McDonald's offered $15.5 million in settlement. *Id.* at 482-83. That amount was sufficient to pay creditors in full, but left the estate with only $1 million to $3 million, the bulk of which probably would have been applied to expenses of administration. The bankruptcy court approved the settlement over the objection of shareholders. *Id.* at 492. *See also In re* Central Ice Cream Co., 836 F.2d 1068, 1076 (7th Cir. 1987) (upholding lower court's finding and awarding reasonable attorneys' fees as damages); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 784 n.368 (1993) (discussing the *Central Ice Cream* case).

[44] *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at *108 n.55 ("[O]ne 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.").

[45] *Id.*

[46] *See, e.g.*, Barondes, *supra* note 17, at 66-71 (arguing that *Credit Lyonnais* should be read to create rights that are "affirmatively enforceable" by creditors against directors of companies in the vicinity of insolvency); *see also* Royce de R. Barondes, *Fiduciary Duties in Distressed Corporations: Second Generation Issues*, J. BUS. TECH. L. REV. (forthcoming 2007).

[47] *See Directors' Duties*, *supra* note 5, at 1212; *see also* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1943-44 (2006) ("Disparities in investors' views over how to value the enterprise and how the judge will value it drive much of the bargaining in large business reorganization cases.").

assumed by the target—could easily have this effect. This notion of the "zone" of insolvency has intrigued commentators, even though it is not a subject that lawyers are especially well equipped to analyze and even though it is not, in my estimation, a useful analytic category.[48]

As with the trust fund cases, central to the logic of *Credit Lyonnais* is the link between duty and priority. Duties shift away from shareholders, on Chancellor Allen's analysis, when the firm enters a pre-insolvency zone of distress, a time when, like Schrödinger's cat, residual claimant status might flicker between shareholders and creditors.[49] *Credit Lyonnais* may mean that directors have no duties to any particular constituency when it becomes practically impossible to identify a residual claimant. Yet, this shift can occur in the first place only if solvency on a standard model of priority influences the existence and vector of duty.

3. The Doctrinal Implications of Credit Lyonnais

While *Credit Lyonnais* was an important decision, very few of us stopped to consider the full doctrinal implications of its priority-based logic. What might *Credit Lyonnais* really mean? If the case really meant that directors owed duties to creditors once a firm entered the "vicinity" of insolvency, it created some potentially serious problems. Consider a few:

- *Candor.* Cases like *Malone v. Brincat*[50] hold that when directors of solvent corporations communicate with shareholders, they have a duty of candor. While *Malone* was not the law in 1991, its predecessors—in particular *Lynch*[51]—would also have imposed important disclosure obligations on directors. Would these duties of candor shift to creditors even before insolvency? If so, how would corporations ever effectively engage in the workout negotiations that frequently take place between creditors and the corporation when the company is distressed?[52]

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[48] *See Directors' Duties,* note 5, at 1212.

[49] This famous thought experiment posited that uncertainties in quantum theory suggested that a cat placed in a sealed environment with a poison gas triggered by radioactive decay could be alive or dead at the same time.
See Schrödinger's cat, http://en.wikipedia.org/wiki/Schr%C3%B6dinger's_cat (visited 8/6/06).

[50] 722 A.2d 5, 7 (Del. 1998).

[51] *See* Lynch v. Vickers Energy Corp., 383 A.2d 278, 279 (Del. 1977) (holding that in making a tender offer to acquire the stock of the minority stockholders, a majority stockholder "owed a fiduciary duty . . . which required 'complete candor' in disclosing fully 'all the facts and circumstances surrounding the 'tender offer.'") (quoting Lynch v. Vickers Energy Corp., 351 A.2d 570, 573 (Del. Ch. 1976)).

[52] Although involving somewhat different facts, the Delaware Chancery court held in the *Bren* case that failures of disclosure to creditors of an insolvent limited partnership may breach fiduciary duties. *See* Bren v. Capital Realty Group Senior Hous., Inc., 2004 WL 370214,

- *Monitoring.* Directors are generally said to have "a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them,"[53] an obligation which the *Caremark* court said required some form of regularized monitoring mechanism.[54] The Delaware Supreme Court recently endorsed this standard in *Stone v. Ritter*.[55] Yet, as with a duty of candor, should the duties suggested by *Caremark* and *Ritter* apply with equal force to or for the benefit of corporate creditors, even before the firm is insolvent? The idea that directors might have duties to monitor in anticipation of insolvency could have real punch for creditors since many failures will, in hindsight, have been predictable had there been proper monitoring.
- *Final Period Duties.* Perhaps the greatest problem posed by *Credit Lyonnais* would involve the special duties of directors when a firm engages in a final period transaction. In the classic cases—*Revlon*[56] and *Van Gorkom*[57]—the inference is that directors should maximize firm value when a change of control is inevitable. But, if bankruptcy also typically results in a change in control (from shareholders to creditors), and a transaction that places the firm in the zone of insolvency is the first step toward bankruptcy, what are directors to do? Maximize value for shareholders, risking liability to creditors? Or take a more conservative approach that might protect creditors, but may also shortchange shareholders?[58]

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at *7 (Del. Ch. Feb. 27, 2004) ("At this preliminary stage, the Court cannot hold that there is no set of facts that could be proven . . . that would entitle [plaintiff] to relief. Defendants only weakly dispute Bren's assertion that the General Partner owed a duty of full disclosure to the Noteholders in connection with the requested consents.").

[53] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[54] *See* In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) (stating in dicta that directors may be liable "for a breach of the duty to exercise appropriate attention" which may include "an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss").

[55] 911 A.2d 362, 369-70 (Del. 2006)("We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls, or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations . . . .").

[56] *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 175-76 (Del. 1986).

[57] *See* Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985).

[58] As discussed below, *Omnicare* presented an opportunity for the Delaware Supreme Court to resolve this question. It chose not to, entirely ignoring the fact that the target corporation was in financial distress when directors had to choose between more and less

C. Constraining *Credit Lyonnais*

Given these potential problems created by *Credit Lyonnais*, it is not surprising that the Delaware courts have been reluctant to follow through on its doctrinal implications. Yet, the Delaware courts remain unwilling to jettison the rhetoric of the priority-duty model, frequently stating that directors owe duties to creditors because creditors step into the "shoes" of shareholders when the firm is distressed. In this third and most recent stage in the development of directors' duties to creditors, the priority-duty model seems to work as a one-way ratchet. It justifies dismissing creditors' claims with the same sorts of procedural devices used to eliminate shareholder claims when a firm is solvent—the business judgment rule or exculpatory charter clauses—but apparently provides creditors few, if any, correlative protections.

1. Production Resources

The first of these third-generation opinions is *Production Resources*, which was essentially a protracted collection matter that happened to land in Delaware Chancery Court.[59] The plaintiff, creditor Productions Resources Group (PRG), grew exasperated with the evasiveness of the debtor, defendant NCT Group (NCT), a Delaware corporation, and sought the appointment of a receiver for NCT under DGCL § 291 and damages for breaches of fiduciary duty by NCT's directors.[60]

Although he declined to appoint a receiver,[61] Vice Chancellor Strine did use this case as an opportunity to dilate on the scope and nature of directors' duties to creditors. He began by expressing doubt that "there is a magic dividing line that should signal the end to some, most, or all risk-taking on behalf of stockholders or even on behalf of creditors, who are not homogenous and whose interests may not be served by a board that refuses to undertake any further business activities that involve risk."[62] Strine consequently rejected *Credit Lyonnais* to the extent that it contemplates that creditors of a corporation in the "zone of insolvency" may assert

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risky final-period transactions. *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003). *See also* part II.B.2, *infra*.

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

[60] *Id.* at 775, 777-78. *See also Second Amended and Verified Complaint*, Prod. Res. Group v. NCT, Group, Inc., C.A. No. 114-N, p. 13 ¶ (b) (filed Mar. 22, 2004, Del. Ch.) [hereinafter, *Production Resources Complaint*].

[61] DEL. CODE. ANN. tit. 8, § 291 provides: "Whenever a corporation shall be insolvent, the Court of Chancery, on the application of any creditor or stockholder thereof, may at any time, appoint 1 or more persons to be receivers of and for the corporation . . . ." DEL. CODE ANN. tit. 8, § 291 (2007). Although PRG adequately pleaded insolvency (NCT's liabilities were nearly five times its assets and it could not borrow from anyone), Vice Chancellor Strine declined to appoint a receiver, as this was a mo ion to dismiss. *Prod. Res.*, 863 A.2d at 783.

[62] *Prod. Res.*, 863 A.2d at 788 n. 52.

claims against directors for breaches of fiduciary duty.[63] Instead, he found the "spirit" of *Credit Lyonnais* was that the business-judgment rule protected directors acting in good faith, who pursue a less risky business strategy in the light of potential insolvency because the directors fear a riskier strategy would cause the corporation to default on its legal obligations to creditors.[64]

Vice Chancellor Strine explicitly embraced the priority-duty model: "By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders—that of residual risk bearers."[65] And, the Vice Chancellor did not merely talk the talk; he also walked the walk, treating the creditor, PRG, as if it were asserting shareholder claims, at least for certain purposes.

First, he found that even if directors had duties to creditors in the zone of insolvency, creditors did not necessarily have standing to assert breach of fiduciary duty claims.[66] Strine reasoned that many of their claims should be treated as derivative claims, just as though they had been asserted by shareholders. "[R]egardless of whether they are brought by creditors when a company is insolvent," Vice Chancellor Strine observed, "these claims remain derivative, with either shareholders or creditors suing to recover for a harm done to the corporation as an economic entity and any recovery logically flows to the corporation and benefits the derivative plaintiffs indirectly to the extent of their claim on the firm's assets."[67] Although the opinion is opaque on which claims would have been derivative for this purpose, and fails to explain how creditors could possibly jump the unusual procedural hurdles that typically bar derivative actions,[68] Vice Chancellor Strine nevertheless thinks that creditors of the insolvent corporation are to be treated as if they were shareholders for purposes of asserting derivative claims.

Second, he held that the exculpatory clause in NCT's charter would protect the directors, just as it would have protected them if shareholders had made the same claims.[69] Although DGCL § 102(b)(7) fails to mention creditors specifically, Strine reasoned that the statute's "plain terms" applied to claims belonging to the corporation.[70] Therefore, the derivative claims asserted by the plaintiffs fell within

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[63] *Id.* at 789-90.

[64] *Id.* at 787.

[65] *Id.* at 791.

[66] *Id.* at 789 n.54.

[67] *Id.* at 792.

[68] Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 892 (Del. Ch. 2004). The Vice Chancellor appears to have been peeved that the parties had "not burdened" him with a discussion of Rule 23.1, which requires shareholders to make demand on the board before proceeding with a derivative suit. *Id.* at 796.

[69] *Prod. Res.*, 863 A.2d at 793. Corporate charter provisions that insulate directors from personal liability to the "corporation or its stockholders" for breaches of the duty of care are authorized by DEL. CODE ANN. tit. 8, § 102(b)(7).

[70] *Id.* As discussed in Part IV.B., *infra*, I question this analysis. I do not think this is a fair reading of section 102(b)(7) or sound policy.

the scope of the exculpatory provision.[71] Strine reasoned the purpose of § 102(b)(7) was to encourage capable persons to serve as directors "by providing them with the freedom to make risky, good faith business decisions without fear of personal liability."[72] There is, he wrote, a "real danger" that a fact-finder, when evaluating evidence that the directors' business strategy failed, would be biased by hindsight and therefore would incorrectly conclude the directors breached the duty of care.[73]

Despite these concerns, Vice Chancellor Strine held that in extraordinary circumstances, creditors might be able to assert direct claims against directors:

> I will resolve the motion on the established principle that when a firm is insolvent, the directors take on a fiduciary relationship to the company's creditors, combining that principle with the conservative assumption that there might, possibly exist circumstances in which the directors display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor.[74]

The Vice Chancellor said that in rendering this decision he was not "making any broad pronouncements that would have large policy implications."[75] This was undoubtedly motivated by the many vexing problems that would be presented if he really did treat NCT's directors as fiduciaries for PRG, perhaps the most important of which would involve the double-bind of having to act as fiduciary toward a litigating adversary:

> I want to make clear what this opinion does not conclude. I do not rest my decision in any manner on the proposition that it is a breach of fiduciary duty for the board of an insolvent company to engage in vigorous, good-faith negotiations with a judgment creditor. That, in fact, might be the *duty* of a board, which necessarily has to balance the interests of all those with a claim to the firm's inadequate assets.[76]

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[71] *Prod. Res.*, 863 A.2d at 793.

[72] *Id.*

[73] *Id.* at 794.

[74] *Id.* at 798.

[75] *Id.* Strine appeared to have been ambivalent about the novelty and difficulty of the problems presented by directors' duties to creditors. On the one hand, he claimed that "[e]valuating a creditor's claim that directors have breached fiduciary duties owed to the firm involves no novel inquiry, as the court can draw deeply on the principles that apply in typical derivative cases." *Id.* at 801. Yet, he also claimed that the basic attributes of directors' duties to creditors—e.g., what obligations directors would owe to corporate creditors—"are very important in this context for obvious reasons." *Id.* at 797.

[76] *Id.* at 800.

2. Trenwick

Vice Chancellor Strine continued to explore the nature of directors' duties to creditors—and to rein in *Credit Lyonnais*—in the recent *Trenwick America* decision.[77] The *Trenwick* litigation arose from the bankruptcy of Trenwick America Corporation (Trenwick America), which was the wholly-owned U.S. subsidiary of the Bermuda-based insurance-holding company, Trenwick Group, Inc. (Trenwick Parent).[78] Trenwick America's plan of reorganization created the plaintiff, Trenwick America Litigation Trust (the Litigation Trust), which obtained, among other things, all of Trenwick America's claims, as well as "derivative creditor and shareholder claims."[79]

The Litigation Trust asserted a host of claims against, among others, the directors of Trenwick Parent and Trenwick America, and the Trenwick Parent's accountants, Ernst & Young, for, among other things, fraud, breach of fiduciary duty and deepening insolvency. These claims arose from a series of acquisitions and restructurings undertaken by the Trenwick entities and affiliates beginning in 1998, and apparently completed in 2000 (three years before the bankruptcy cases were commenced).[80] At the completion of these transactions, these entities were apparently solvent.[81]

Using a variety of well-established procedural tools, Vice Chancellor Strine dispatched the Litigation Trust's complaint entirely. First, Strine observed that the Litigation Trust had no standing to pursue any *direct* claims of Trenwick America creditors because none were assigned to the Litigation Trust under Trenwick America's plan of reorganization or otherwise.[82] Second, he noted that even if the Litigation Trust had derivative claims, those were exclusively claims of Trenwick America—not Trenwick Parent.[83] Under "settled principles of Delaware law," however, Strine noted that "a parent corporation does not owe fiduciary duties to its wholly-owned subsidiaries or their creditors."[84] Moreover, if the directors had, and breached, any fiduciary duties, they would have run to Trenwick Parent—not

[77] Trenwick Am. Litig. Trust v. Ernst & Young LLP, 906 A.2d 168 (2006). As of this writing, *Trenwick* is on appeal. *Appeal docketed*, No. 495 (Del. Sept. 14, 2006).

[78] *Id.* at 175.

[79] *Id.* at 189-90 (quoting Trenwick Am. Corp. Second Amended Plan of Reorganization § 1.16 (emphasis omitted)).

[80] *Id.* at 172.

[81] *Id.*

[82] *Id.* at 190-91. Nor, he added, could such claims ever have been asserted by the Litigation Trust, even if assigned to it, since bankruptcy trustees or litigation trusts created under confirmed plans of reorganization can apparently never have standing to pursue claims belonging exclusively to creditors. *Id.* at 191 (discussing, among others, Caplin v. Marine Midland Grace Co., 406 U.S. 416 (1972), which so held). The construction of standing under *Trenwick* and certain other cases creates a remedial gap which I discuss in Part IV.A, below.

[83] Trenwick Am. Litig. Trust v. Ernst & Young LLP, 906 A.2d 168 (2006) at 191-92.

[84] *Id.* at 191 (citations omitted).

Trenwick America. Thus, in the absence of grounds to pierce Trenwick Parent's corporate veil, the Litigation Trust simply could not assert claims of Trenwick America itself. Buttressing his view that the Litigation Trust could not recover from Trenwick Parent's directors were the business judgment rule as well as an exculpatory clause in Trenwick Parent's charter.[85] Both applied with equal force to further undercut the Litigation Trust's position.

Third, even though it was "in one respect, on firmer ground" than the other claims, Strine also dismissed the plaintiff's claim that Trenwick America's directors breached duties owed to Trenwick America.[86] This claim was stronger, Strine acknowledged, because there is little question that the directors owe duties to some extent to the corporate entity itself.[87] Here, however, the "context" in which Trenwick America's directors owed duties to Trenwick America effectively nullified the plaintiff's claim because Trenwick America was a wholly-owned subsidiary of Trenwick Parent. Delaware's Supreme Court has, Strine observed, "made clear that, 'in a parent and wholly-owned subsidiary context, directors of the subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders.'"[88] This "settled rule of law [was] of critical importance," Strine reasoned, because "the Trenwick America board had no duty to replicate the deliberative process of its sole stockholder's board of directors."[89]

3. Gheewalla

As of this writing, Delaware's most recent move to constrain the doctrinal implications of *Credit Lyonnais* appears in the *Gheewalla* case.[90] In *Gheewalla*, the

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[85] *Id.* at 192-195.

[86] *Id.* at 200.

[87] *Id.* (citations omitted).

[88] *Id.* (quoting Andarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988) (citing Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

[89] Trenwick Am. Litig. Trust v. Ernst & Young LLP, 906 A.2d 168 (2006) at 200-01. ("There is no sound basis to hold that the boards of wholly-owned subsidiaries must engage in their own parallel . . . processes . . . ."). This may be another example of reluctance to take seriously the implications of the priority-duty model of directors' duties to creditors. If the Trenwick America subsidiary were insolvent, and we believe—as Strine and many others do—that insolvency effectively subrogates creditors to the rights of shareholders, then Trenwick America's creditors should have displaced its shareholder, Trenwick Parent, as the residual claimant. If so, then presumably Trenwick America's directors would have had (and perhaps breached) duties to Trenwick America's creditors.

[90] N. Am. Catholic Educ. Programming Found., Inc. v. Rob Gheewalla, 2006 WL 2588971 (Del. Ch. Sept. 1, 2006). As discussed in note 11, above, when this Article was going to press, the Delaware Supreme Court issued an opinion affirming the *Gheewalla* Chancery Court decision. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Rob Gheewalla, _ A.2d _, 2007 WL 1453705 (Del. May 18, 2007). Although time would not permit a full rewrite of this Article, there is a brief postscript, *infra*, discussing the Supreme Court decision and its implications for the observations made here.

plaintiff, North American Catholic Educational Programming Foundation, Inc. (NACEPF), held licenses to certain radio spectrum. NACEPF, along with certain other holders of similar spectrum licenses, entered into a "Master Use and Royalty Agreement" (Master Agreement) with Clearwire Holdings, Inc., a Delaware corporation (Clearwire). Under the somewhat complex terms of this agreement, it appears that Clearwire was to purchase from licensees, such as NACEPF, spectrum that they had sublicensed to companies such as Sprint and Worldcom, as the sub-licenses expired.[91] The ultimate goal was apparently to "'develop the spectrum assets of [NACEPF and other license holders] into an operating, national system of wireless connections to the internet.'"[92]

According to the plaintiff, however, the defendants—who were three directors appointed by Clearwire's principal investor, Goldman Sachs—had a "'hidden agenda . . . to use the rights granted Clearwire in the Master Agreement to extract concessions from Sprint, Worldcom and other wireless operators.'"[93] Whether or not Goldman actually had such a plan became moot in June of 2002, when Worldcom's accounting problems came to light, leading to speculation that there would soon be "a glut of available spectrum."[94] Following the collapse of the spectrum market, Clearwire entered into negotiations with all of the parties to the Master Agreement and made a variety of payments to those parties to settle claims that they may have had against Clearwire.[95] NACEPF, however, refused to settle. Without further financing from Goldman Sachs (or anyone else), Clearwire soon went out of business.[96]

NACEPF claimed, among other things, that Clearwire "was either insolvent or in the 'zone of insolvency'" and therefore owed fiduciary duties to NACEPF, a "'substantial creditor.'"[97] NACEPF alleged the defendant directors breached fiduciary duties by: (i) failing to preserve Clearwire's assets for its benefit and the benefit of its creditors "when it became apparent that Clearwire would not be able to continue as a going concern and would need to be liquidated," and (ii) "holding on" to NACEPF's spectrum rights even though it did not use them (i.e., by further sublicensing them) "solely to keep Goldman Sachs's investment 'in play.'"[98]

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[91] *Id.* at *3 ("The 'business plan reflected in the terms of the Master Agreement' envisioned that Clearwire would exercise its power to obtain rights in [NACEPF's] . . . licenses as the existing [sublicenses] . . . expired and current lessees [sic] failed to exercise their rights of first refusal.") (quoting Complaint at ¶ 21). Apparently, the Complaint (and the parties) used the terms "licensee" and "lessee" interchangeably. *Id.* at n.33.

[92] *Id.* at *4 (quoting Complaint at ¶ 22).

[93] *Id.* (quoting Complaint at ¶ 28).

[94] *Id.* (quoting Complaint at ¶ 34).

[95] *Id.* at *5.

[96] *Id.*

[97] *Id.* (quoting Complaint at ¶ 45).

[98] *Id.* at *5 (quoting Complaint at ¶ 45).

Vice Chancellor Noble began his analysis by observing that he would be limited to the question whether a creditor could assert a direct—rather than a derivative—claim against directors of a Delaware corporation that was either insolvent, or in the vicinity if insolvency.[99] At least part of the court's analysis turned on the fact that, for reasons not explained, NACEPF "waived any basis it may have had for pursuit of its claim derivatively."[100] It thus apparently sought only to assert direct claims against the directors. Defendants, not surprisingly, argued that this issue had not been resolved by *Production Resources*, and that Delaware courts should in fact recognize only derivative—not direct—creditor claims.[101]

Since the court accepted that Clearwire was seriously distressed,[102] it addressed the standing question from both the zone-of-insolvency and insolvency perspectives. As to the former, the court relied on Delaware's recent *Tooley* decision, reasoning that the direct/derivative distinction "'must be based solely on the following questions: Who suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy?'"[103] Thus, as the *Gheewalla* court observed, a "'direct claim . . . is a claim on which the stockholder can prevail without showing an injury or breach of duty to the corporation, and one in which no relief flows to the corporation.'"[104]

Applying this basic rule in the zone of insolvency, the court distinguished two major rationales offered for treating directors as fiduciaries for creditors: (i) the "incentive-to-enforce" rationale, and (ii) the much-maligned "trust fund" theory.[105] The court first concluded that creditors would not have the same "incentive to enforce" fiduciary duties as shareholders if permitted to sue directly:

> Put simply, in contrast to stockholder and (by analogy in this limited context) creditor derivative actions, *direct* claims by creditors would not help the corporate collective because the benefit would accrue to the creditor bringing the direct claim. Any marginal benefit of such enforcement effort potentially accruing to the corporate collective would likely be outweighed by the disruption of the established corporate governance mechanism. NACEPF has neither offered any persuasive policy rationale favoring recognition of such claims which might mitigate or rebut these concerns nor has it identified

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[99] *Id.* at *8.
[100] *Id.*
[101] *Id.* at *9.
[102] *Id.* at *10
[103] *Id.* at *11 (quoting Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031 (Del. 2004)).
[104] *Id.* (quoting Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC, 2006 WL 846121, at *6 (Del. Ch. Mar. 28, 2006)).
[105] *Id.* at *11.

any case law supporting its theory that claims are directly assertible by creditors in this context.[106]

The court further concluded that the trust-fund doctrine would create no basis for bringing a direct claim against directors for zone-of-insolvency duty breaches because "[t]he court has traditionally been reluctant to expand existing fiduciary duties."[107] Here, it would be inappropriate to expand these duties (or the persons who may enforce them). Because "'[c]reditors are often protected by strong covenants, liens on assets, and other negotiated contractual protections,'" among many other protections at law, "'one would think that the conceptual room for concluding that the creditors were somehow, nevertheless, injured by inequitable conduct would be extremely small, *if extant.*'"[108]

Vice Chancellor Noble then turned to the question whether the standing analysis would somehow differ given the debtor's actual insolvency. The plaintiff apparently "placed heavy reliance" on *Production Resources,* arguing in effect that it, like the plaintiff there, was the victim of "'such a marked degree of animus'" by directors as to create an equitable cause of action.[109]

As with his analysis of duties in the "zone," Vice Chancellor Noble focused on the direct/derivative distinction. Here, the Vice Chancellor turned to the recent *Big Lots* decision for guidance.[110] Like *Gheewalla* and *Trenwick, Big Lots* involved a plaintiff who confronted serious doctrinal obstacles.[111] In *Big Lots,* the problem was that the "creditor"—who had been the debtor's prior owner—held a "payment-in-kind" (PIK) note that was not due until 2010—more than six years after the debtor went into bankruptcy and eight years after the acts that allegedly breached fiduciary duties to the plaintiff. The *Big Lots* defendants moved to dismiss based, in part, on the fact that the plaintiff was in reality asserting a derivative claim that could only have been brought by the corporate debtor's bankruptcy estate. The court agreed, holding that the plaintiff's claims were "'classically derivative.'"[112]

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[106] *Id.* at *12. This may be true. But, as discussed in Part IV *infra,* this arguably misapplies the *Tooley* standing test. Here, under *Tooley,* the creditor suffered the alleged harm, and would benefit from the recovery. *Gheewalla's* analysis is curious, a little like saying that creditors lack standing to bring *direct* claims because the claims are not *derivative*.

[107] *Id.* at *13.

[108] *Id.* at *13 (quoting Prod. Res. Group, LLC v. NCT Group, Inc., 863 A.2d 772, 790 (Del. Ch. 2004). "Indeed," he further observed, "it would appear that creditors' existing protections—among which are the protections afforded by their negotiated agreements, their security instruments, the implied covenant of good faith and fair deali g, fraudulent conveyance law, and bankruptcy law—render the imposition of an additional, unique layer of protection through direct claims for breach of fiduciary duty unnecessary." *Id.*

[109] *Id.* at *14 (quoting *Prod. Res.,* 863 A.2d at 798).

[110] *Id.* at *15.

[111] Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC, 2006 WL 846121 (Del. Ch. Mar. 28, 2006).

[112] *Id.* at *7 (quoting *Prod. Res.,* 863 A.2d at 776).

The *Gheewalla* court read *Big Lots* aggressively: According to *Gheewalla, Big Lots* "in substance, held that the scope of *potentially* cognizable direct claims assertible by creditors in the insolvency context is restricted to instances in which invidious conduct toward a particular 'creditor' with a 'clear entitlement to payment' has been alleged."[113] According to *Gheewalla*, the *Big Lots* decision "effectively limits direct claims, assuming *arguendo* that they are cognizable, by creditors of insolvent firms for breach of fiduciary duty to allegations of fact substantially similar to those pleaded by the plaintiff in *Production Resources*."[114]

This inquiry, according to the *Gheewalla* court, requires a two-step analysis. First, "the court must determine whether the plaintiff-creditor has pleaded facts demonstrating, with a high degree of certainty, that the creditor is entitled to payment and that the entitlement is either currently or imminently due."[115] If the plaintiff-creditor satisfies the first step, the *Gheewalla* court required a determination as to whether the plaintiff has pleaded a "direct claim implicating invidious conduct."[116] Applying this analysis, the *Gheewalla* court easily concluded that the plaintiff failed to allege facts satisfying the first step, namely that it was entitled to payment that was "*clearly and immediately* due."[117]

Like the other post-*Credit Lyonnais* cases, *Gheewalla* expressly relied on the priority-duty model, at least for certain purposes. Thus, limiting creditors to derivative claims "is relatively uncontroversial" because "having been effectively placed 'in the shoes normally occupied by the shareholders—that of residual risk-bearers' . . . [creditors] are the principal remaining constituency with a material incentive to pursue derivative claims on behalf of the corporation . . . ."[118] Yet, the same logic did not apply to recognize direct causes of action. Priority would thus cause creditors to step into the shoes of shareholders for purposes of some, but not all, duty claims.

II. The Puzzles of Directors' Duties to Creditors

The directors' duties cases—especially *Credit Lyonnais* forward—present two puzzles. First, as we have seen, all embed a link between priority and duty. Second, these are long, discursive opinions. Much of what they discuss is not obviously

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[113] N. Am. Catholic Educ. Prog. Found., Inc. v. Gheewalla, 2006 WL 2588971 at *15 (Del. Ch. Sept. 1, 2006) (quoting *Big Lots Stores*, 2006 WL 846121, at *6) (emphasis in original).

[114] *Id.* at *16.

[115] *Id.*

[116] *Id.*

[117] *Id.* at *16-*17 ("The Defendants rightly point out that NACEPF has failed to demonstrate, through the facts pleaded in the Complaint, or even in its brief, that 'it was not paid what it was owed under the Master Agreement, or that [NACEPF] performed under the terms of the Master Agreement in some way that triggered an unfulfilled obligation of Clearwire to pay [P]laintiff.'") (quoting Defendants' Reply Brief at 12-13).

[118] *Id.* at *12 (quoting *Prod. Res.*, 863 A.2d at 791) (footnote omitted).

necessary to address the legal problem in question. If the link between priority and duty is so problematic, and we do not really want to give creditors any meaningful right to sue, what purpose do these opinions serve?

A. The Puzzles of the Priority-Duty Model

The logic of directors' duties to creditors is organized around the priority-duty model, which in turn depends on the viability of the "residual claimant," the hypothetical person with the last claim to a debtor's assets. When a firm is solvent, this will usually be the common shareholder. An enormous body of theoretical work develops the claim that directors should cause firm activities to maximize value for shareholders.[119] Whether this same model works when a firm is in distress is, however, another matter—even though it lies at the heart of all of our cases saying that directors are fiduciaries for creditors of the distressed firm.

1. Finding the Residual Claimant

The residual claimant first appeared in the legal literature in an influential 1983 article by Judge Easterbrook and Professor Fischel, *Voting in Corporate Law*.[120] Here, Easterbrook and Fischel sought to explain why corporate shareholders have the right to vote when so many (e.g., Berle and Means) had argued that the right to vote was meaningless.[121] Easterbrook and Fischel's basic claim was that only the "residual claimant" has the proper incentives to make discretionary decisions regarding firm assets. Because "shareholders receive most of the marginal gains and incur most of the marginal costs" of corporate investment, "shareholders are the group with the appropriate incentives . . . to make discretionary decisions."[122]

Why do shareholders have the most to gain or lose at the margins? Easterbrook and Fischel do not say explicitly, but there is little doubt that priority in right of payment is behind their analysis. "When the firm is in distress," they argue, "the shareholders' residual claim goes under water, and they lose the appropriate

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[119] *See Directors' Duties*, *supra* note 5, at 1244.

[120] Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 392 (1983). This was the first major discussion of the topic by legal academics. The residual claimant had, however, been but one of many features of the view of the corporation as a "nexus of contracts," as famously espoused by such economists as Michael Jensen and William Meckling. *See id.* at 401 (citing, among others, Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)).

[121] Berle & Means argued that voting was meaningless because corporate managers—not shareholders—exercised real control over all or most important matters in the life of the firm. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 129 (1967). Easterbrook & Fischel, among others, rejected the Berle & Means prescription for this condition, "social control" of corporations. *See* Easterbrook & Fischel, *supra* note 120, at 397.

[122] Easterbrook & Fischel, *supra* note 120, at 403.

incentives."[123] Creditors, by contrast, "become residual claimants when equity holders' conduct exposes them to unanticipated risk."[124] Theirs is not principally a story about priority, but instead about control. For Easterbrook and Fischel, it would appear that control, reflected in the right to vote, is deeply enmeshed in residual claimant status. "Voting exists in corporations because someone must have the residual power to act (or delegate) when contracts are not complete."[125] When a firm is insolvent, they say, "creditors eventually acquire control, through provisions in bond indentures and other credit agreements or through operation of bankruptcy laws."[126] This occurs, they argue, because "voting rights flow to whichever group holds the residual claim at any given time."[127]

The residual claimant soon emigrated to the world of bankruptcy theory and became a central character in debates about the proper metes and bounds of corporate

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[123] *Id.* at 404. "Other groups," they continue, "such as preferred stockholders or creditors, will receive the benefits of new decisions and projects until their claims are satisfied; the shareholders get only what is left over." *Id.*

[124] *Id.* This is one of several curious claims in this article. First, if we limit the analysis to the universe they select—public companies—it will not be "equity holders" whose conduct exposes creditors to unanticipated risk; it will be directors and officers. Shareholders may approve certain high leverage, final-period transactions—e.g., mergers and perhaps acquisitions—but only if proposed by directors (and, as a practical matter, officers). *See, e.g.*, DEL. CODE ANN. tit. 8, § 251(c) (2007) (shareholders' right to approve merger agreements proposed by directors). Second, what does "anticipation" have to do with insolvency? Is the inference that creditors of insolvent firms would not be "residual claimants" if the risks *were* "anticipated"? What of creditors who anticipate nothing because—as with tort creditors—they did not choose to extend credit in the first place?

[125] *Id.* at 403.

[126] *Id.* at 404.

[127] *Id.* at 405. There are problems with this claim. First, it would appear to be empirically false much of the time. Absent a contract that expressly grants a creditor some form of control—a form that is highly unlikely to mimic that of shareholders—nothing about creditor status or bankruptcy as such assures a vote. Rather, *if* a distressed corporate debtor goes into bankruptcy, and *if* that bankruptcy case is under chapter 11 of the Bankruptcy Code, and *if* a plan of reorganization is proposed for the debtor, and *if* the creditor is classified in such a way as to qualify for a vote under section 1126 of the Bankruptcy Code, *then* the creditor-as-residual-claimant will have a vote. *See* 11 U.S.C. § 1126 (setting forth rules on voting on chapter 11 reorganization plans). An early and important study of the peculiarities of creditor democracy appears in David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganizations*, 78 VA. L. REV. 461 (1992). *See also Directors' Duties*, *supra* note 5, at 1231 & n.188 (discussing voting issues in chapter 11 cases).

Notice that Easterbrook and Fischel did not argue that directors owed *fiduciary duties* to residual claimants. We know from their 1993 article on fiduciary duty that they have little use for duty, at least as it is commonly understood. Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 426-27 (1993) (fiduciary duty is, they argue, a contract that happens to be "characterized by unusually high costs of specification and monitoring"). Rather, they view duty at most as a "gap filler," forming terms in the "corporate contract" that they impute to various corporate stakeholders.

reorganization.[128] Like Easterbrook and Fischel, the residual claimant's leading supporters in bankruptcy, Professors Baird and Jackson argued that this idealized character was the only party with the proper incentives to make optimal decisions for the firm in reorganization.[129] Holding the "marginal" claim, this person would gain or lose at the margin from discretionary firm decisions.[130]

Others disagreed, offering various reasons why this hypothetical person either made no sense or was simply unworkable.

- *Indeterminacy.* Many writers observed that it would be difficult, if not impossible, to ascertain at any given point in time who among the debtor's constituents may be the residual claimant.[131] Some valuation of the debtor would be required, and this would not necessarily be a cheap or useful undertaking.[132] Valuations can change during a case; would the identity of the residual claimant then also change?
- *Multiplicity.* What if—as seems highly likely—there is no single residual claimant or class of claimants, but instead multiple claimants who might plausibly be residual claimants?[133] They may compete amongst themselves;

[128] The residual claimant's durability has led Professor LoPucki to liken it to horror-movie staple Freddy Kruger. *See* Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study,* 82 WASH. U. L.Q. 1341, 1348 (2004) ("Like Freddy Kruger, the residual owner approach was mortally wounded in article after article, but would not die.").

[129] *See* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule,* 55 U. CHI. L. REV. 738, 775 (1988) ("[T]he law of corporate reorganizations should focus on identifying the residual owner, limiting agency problems in representing the residual owner, and making sure that the residual owner has control over the negotiations that the firm must make while it is restructuring.").

[130] *See* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance,* 83 CAL. L. REV. 1073, 1100 (1995) ("[T]he optimal solution" to financial distress would "vest decision making authority with the residual claimants, who gain or lose at the margin from the actions of the firm.").

[131] *See* Stephen J. Lubben, *The "New and Improved" Chapter 11,* 93 KY. L.J. 839, 856 (2004) ("Determining which creditor is at the bottom of the heap at any given time is a difficult exercise that does not lend itself to ex ante contracting, as asset values may change daily . . . .")

[132] *See, e.g.,* LoPucki, *supra* note 128, at 1345 ("To identify the residual owner presumably would require valuation of the firm. . . . Yet, valuation is notoriously expensive and difficult." (footnotes omitted)).

[133] *See id.* at 1343 ("The problem is not merely that single residual owners are difficult to identify. The problem is that they rarely exist."). Professor LoPucki's empirical study indicates that, at least in the case of large public-company reorganizations, there are multiple classes of potential residual claimants. "The existence of so many investor priority levels," he notes, "makes it likely that investors at more than one level will share residual owner status." *Id. See also* James H.M. Sprayregen, et al., *Chapter 11: Not Perfect, but Better than the Alternative,* 24 AM. BANKR. INST. J. 1, 60 & n.13 (2005) ("It is our experience that there is no single residual owner in a large complex chapter 11 case" and discussing the multiple classes of potential residual claimants in the *Conseco* bankruptcy). For their part, Professors Baird and Rasmussen

if someone (whether bankruptcy trustee or corporate director) is to act on their behalf, how should they choose? This was, in many respects, the heart of the problem that *Credit Lyonnais* attempted to address, since the residual claimant of a firm in the "vicinity" of insolvency is exceedingly difficult to identify.[134]

- *Institutional Choice.* There is another question regarding the valuation needed to identify the residual claimant: who should do it? The modern bankruptcy reorganization system exists in part to save bankruptcy judges from the onerous—perhaps impossible—task of valuation.[135] Can market actors be trusted to do so?[136] We have grown increasingly suspicious of government actors—e.g., judges—who might interfere with competitive markets. But does the market really want to value debtors simply to determine the identity of the residual claimant?[137]

Except when a firm is clearly solvent, or has an implausibly simple capital structure (akin to the one posited in Chancellor Allen's famous hypothetical), or is clearly insolvent and is being liquidated by directors (as in the early trust fund cases), identifying the residual claimant is exceedingly difficult. Nevertheless, the logic of the residual claimant has been an enduring fiction in our discussions about directors' duties to creditors.

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dismiss this problem. "We do not rest on the idea that a single residual owner exists in every case. Hence, the argument that such creatures do not exist is neither here nor there." *See* Baird & Rasmussen, *supra* note 136, at 695 n.72.

[134] *See* discussion *supra* Part I.B.2.

[135] Peter Coogan characterized the valuation process as a "guess compounded by an estimate." *See* Peter F. Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 CASE W. RES. L. REV., 301, 313 n.62 (1982) (citing statement in H.R. REP. NO. 95-598, at 225 (1978), *reprinted in* 1978 U.S.C.C.A.N. 6181, 6184)).

[136] A number of scholars think so, even when a firm is in bankruptcy. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003); Douglas G. Baird & Robert K. Rasmussen, *Four (or Five) Easy Lessons from Enron*, 55 VAND. L. REV. 1787, 1808 (2002); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006) [hereinafter *Missing Lever*]; Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 758-59 (2002); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 917 (2003).

[137] Professor Blum noted that this basic question—whether valuation should be performed by markets or the government (bankruptcy judges)—has been a central question in bankruptcy reorganization for many years. *See, e.g.*, Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565, 602 (1950).

2. What We Talk About When We Talk about Priority[138]

Identifying the residual claimant is the not the only problem with the priority-duty model. Perhaps even more difficult is the slippery nature of priority itself. When we talk about priority, we tend to assume that we know what we are talking about. Priority is said to be "absolute," as in the "absolute priority rule" (APR). Although this glosses over some subtleties, the basic idea behind the APR is that senior dissenting creditors must be paid or provided for before junior parties (shareholders) may receive or retain property on account of their claims or interests.[139]

A full-blown history of priority is beyond the scope of this article. Priority is generally thought to derive from concerns about fraudulent conveyance, transactions that intentionally or effectively hinder, delay, or defraud creditors' collection efforts.[140] The modern conception of priority reflected in the APR can be seen as a response to perceived abuses in the railroad reorganizations that occurred through much of the 19th and first half of the 20th centuries.[141] These reorganizations

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[138] Apologies to Raymond Carver. *See* RAYMOND CARVER, WHAT WE TALK ABOUT WHEN WE TALK ABOUT LOVE (Vintage Books 1982).

[139] *See Directors' Duties, supra* note 5, at 1229-230 (discussing "absolute priority rule" and collecting citations). It is codified in section 1129(b) of the Bankruptcy Code which, among other things, provides that dissenting classes of unsecured claims either "receive or retain on account of such claim[s] property of a value . . . equal to the allowed amount of the claim; or . . . the holder of any claim or interest that is junior to the claims of such [dissenting] class will not receive or retain under the plan on account of such junior claim or interest any property." 11 U.S.C. § 1129(b)(2)(B) (2006).

[140] David Skeel and George Krause-Vilmar recently observed in a draft article that fraudulent conveyance doctrine is "[t]he Ur doctrine" from which a variety of other equitable creditor protections flow (including, in the case they consider, the recharacterization of insider loans). *See* David A. Skeel, Jr. & George Krause-Vilmar, *Recharacterization and the Nonhindrance of Creditors*, 2 (draft of Jan. 26, 2006 on file with author) (discussing Robert C. Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505 (1977)). Every state has some form of fraudulent conveyance law. *See* UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 2 (1918); UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 266 (1984), or a predecessor statute with similar effect. *See, e.g.*, VA. CODE ANN. § 55-81 (1995). The Bankruptcy Code also contains similar remedies for fraudulent transfers. 11 U.S.C. § 548 (2006).

[141] These reorganizations were, until 1933, governed largely by contract, not by the Bankruptcy Code or anything resembling it. In 1933, Congress enacted Section 77 of the Bankruptcy Act in order to address the "sudden evaporation of railroad earning power" that "was plunging thousands of miles of lines into insolvency." Reorganization of Railroads Engaged in Interstate Commerce, PUB. L. NO. 72-420, § 77, 47 Stat. 1474 (1933), *repealed by* Bankruptcy Reform Act of 1978, PUB. L. NO. 95-598, 92 Stat. 2549 (1978). *See also* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES 284 (1973) ("section 77 was originally added to the Bankruptcy Act in 1933 and completely rewritten in 1935 for purposes of rearrangement, simplification, and clarification."). A large body of literature was generated during this period contemplating the merits of the system as it developed at the time. *See, e.g.*, PAUL D. CRAVATH, THE REORGANIZATION OF CORPORATIONS, IN SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION (1917); Arthur H. Dean, *Corporate*

occurred not through bankruptcy as we currently understand it, but through the equity receivership, a process that was thought routinely to violate "absolute" notions of priority.[142]

Equity receiverships were said to be plagued by at least two evils. First, many—most prominently William O. Douglas[143]—argued that these reorganizations were controlled by insiders who profited at the expense of the railroads' various constituents, in particular widely dispersed unsecured (or undersecured) creditors.[144] Frequently, these insiders were professionals—investment bankers and lawyers—who may not have had shares in the debtor, but who nevertheless profited

Reorganization, 26 CORNELL L. REV. 537 (1941). Much of the recent literature on the residual claimant's control rights in bankruptcy rests on claims about the relative efficacy of railroad reorganizations. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporation Reorganizations*, 87 VA. L. REV. 921 (2001) [hereinafter *Control*]. A useful recent discussion of the realities of the railroad reorganizations appears in Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420 (2004) [hereinafter *Railroad*].

[142] As Dean explained: "The pattern, generally speaking, following the appointment of the receiver or receivers was for one or more of the various mortgage trustees to petition the receivership court for leave to foreclose the mortgage. The foreclosure action or actions [were] consolidated with the original general creditor's bill, and the receivers for the latter were then usually appointed receivers for the mortgage bondholders . . . Following the formulation of a plan by the committee, the court on motion fixed an upset price for the sale of the mortgaged properties. Generally, the creditors or the reorganization managers bid in the properties, using the [bondholders'] deposited mortgage securities as part payment for the foreclosure price, and borrowed or raised enough cash to pay non-assenting or dissenting creditors. An agreement was then entered into with a new corporation created for the purpose, whereby, in consideration for the transfer to it of (1) the properties foreclosed at the foreclosure sale and (2) cash or securities to the extent provided in the plan, the new corporation would issue its securities in accordance with the reorganization plan." *See* Dean, *supra* note 141, at 538-39.

[143] SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, PART I-VIII (1937-1940) (written under the direction of William O. Douglas). Douglas was then a Commissioner of the Securities and Exchange Commission.

[144] As Justice Cardozo explained: "There is little doubt that many of these receiverships were legitimate and helpful. None the less there resided in the practice a capacity for abuses which will be found reflected in the decisions of this and other courts. At times the receivership was used as an instrument of fraud or covin. . . . At times it had a tendency to intrench delinquency in power, and to stifle inquiry into acts of waste or spoliation." *See* Duparquet, Huot & Moneuse v. Evans, 297 U.S. 216, 218 (1936). *See also* Dean, *supra* note 141, at 540 ("many features of the equity receivership were criticized; the allegedly collusive nature of its inception; the delays; the disproportionate rate of expenses to debts when applied to small or medium sized corporations; the great opportunity for political patronage in the appointment of receivers and their counsel by judges . . . ."); E. Merrick Dodd, *Reorganization through Bankruptcy: A Remedy for What?*, 48 HARV. L. REV. 1100, at 1100-101 (1935)(claiming that a "tacit understanding among members of the banking fraternity" meant that the reorganization would be managed by "those particular investment bankers through whom the corporation had been accustomed to conduct its long-term financing").

in the form of "generous" fees.[145] Second, and for our purposes more important, these proceedings frequently defied conventional notions of priority by permitting shareholders to maintain an interest in the road even though certain creditors would take little or nothing.[146]

This defiance of priority norms led the Supreme Court to develop a theory of "absolute priority," articulated most famously in *Case v. Los Angeles Lumber*.[147] *Case* held that reorganization plans had to be "fair, equitable and feasible," and that these were "words of art"[148] that reflected the "'familiar rule' that 'the stockholder's interest in the property is subordinate to the rights of creditors. First, of secured, and then of unsecured, creditors.'"[149]

There is nothing terribly controversial about the APR or priority in general when one thinks about the liquidation of firms. It is easy to develop a strong case for the idea that in an actual, final-period distribution of firm assets, creditors should receive those assets or their proceeds before equity holders. This would be a "recognition event that collapses all future possibilities to present value."[150] Priority on this view would be reflected in a broad spectrum of rules, from bankruptcy[151] to prohibitions on the payment of dividends and other distributions while a corporation is insolvent,[152] to the closely related doctrine of fraudulent conveyance,

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[145] *See* David A. Skeel, Jr., *Vern Countryman and the Path of Progressive (and Populist) Bankruptcy Scholarship*, 113 HARV. L. REV. 1075, 1089 (2000) ("the Wall Street professionals who organized protective committees in order to negotiate the reorganization seemed to focus more on obtaining generous fees for themselves than on striking a good bargain on behalf of the scattered investors whom they purported to represent.").

[146] *Railroad*, *supra* note 141, at 1445 ("One of the most controversial features of receiverships was the frequency with which existing shareholders were able to maintain their position in the reorganized railroad, despite the failure to pay creditors in full.").

See also Dean, *supra* note 141, at 541. The classic discussion of this, and the "collusion" it implied, appears in *Northern Pac Ry. v. Boyd*, 228 U.S. 482 (1912). For a critical discussion of *Boyd*, see Douglas G. Baird and Robert K. Rasmussen, Boyd's *Legacy and Blackstone's Ghost*, 1999 SUP. CT. REV. 393 (1999).

[147] 308 U.S. 106 (1939).

[148] *Id.* at 115.

[149] *Id.* at 116 (quoting Louisville Trust Co. v. Louisville, New Albany & Chicago Ry. Co., 174 U.S. 674, 684 (1899)). Nor would side agreements between seniors and juniors (shareholders) be tolerated. "[A]ny arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation." *Id*.

[150] Baird & Rasmussen, *supra* note 141, at 936.

[151] The Bankruptcy Code's priority scheme applicable to most business bankruptcies is set forth in, among others, sections 507, 726 & 1129(b). 11 U.S.C. §§ 507, 726 & 1129(b) (2006).

[152] Section 174 of the Delaware General Corporation Law, for example, provides that directors who willfully or negligently approve the payment of a dividend in excess of the levels permitted by section 170 are jointly and severally liable for a period of six years following payment of the unlawful dividend to (i) the corporation and (ii) if the corporation dissolves or becomes insolvent, its creditors. DEL. CODE ANN. tit. 8, § 174 (2007). Section

which proscribes transfers by insolvents for less than fair value.[153] These are, in simple terms, rules designed to ensure that creditors do not become residual claimants, and to provide certain remedies for them in the event that they do.

In the absence of a liquidation, however, priority becomes a much more abstruse concept. Reorganization—the attempt to save rather than end the business—almost always involves negotiations among various constituencies. A critical question in these negotiations will be who controls all subsequent decisions: Do the stakeholders (however defined) trust current management (meaning directors and officers)? Have they lost confidence? What happens if different stakeholders (e.g., shareholders and creditors) have different views on this? To which stakeholders should directors listen? What happens if, after the fact, they listened to and acted for the wrong group? And, most important, is the residual claimant (if identifiable) presumptively the only one who matters here?

When we talk about priority, we may really be talking about control—and in particular control of the decisions that might (or might not) resolve firm distress.[154] Priority in this more complex—and I suspect more common—context would function as a construct around which various claimants negotiate about who controls decisions about how (or whether) to fix the corporate debtor. Indeed, its role as a mechanism for facilitating negotiation may be its greatest value. In perhaps our greatest article on priority in bankruptcy reorganization, Professor Blum observed that "[r]enegotiation through reorganization under a fair plan based on reorganization value may be the least unsatisfactory adjustment to economic instability."[155]

This, in a sense, is what *Credit Lyonnais* was really wrestling with. Because "[t]he possibility of insolvency can do curious things to incentives," Chancellor Allen told us, acting merely for the shareholder-as-residual claimant would be inappropriate, as it would "expos[e] creditors to risks of opportunistic behavior and

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2.02(b)(4) of the Model Business Corporation Act similarly penalizes directors for unlawful distributions. MODEL BUS. CORP. ACT ANN. § 2.02(b)(4) (2002).

[153] *See* discussion at *supra* note 140. A history of the fraudulent conveyance laws appears in Jonathan C. Lipson, *Secrets and Liens: The End of Notice in Commercial Finance Law*, 21 EMORY BANKR. DEV. J. 421, 435-50 (2005) [hereinafter *Secrets and Liens*].

[154] *Control, supra* note 141, at 922 ("the central focus of corporate reorganizations should not be upon priority rights. Instead, as in corporate law generally, it should remain upon how the firm's assets are used and who controls them."). *See also* LoPucki, *supra* note 128; Lubben, *supra* note 131. In a sense, this is the obverse of Easterbrook and Fischel's analysis of voting in the corporate context, discussed at Part II.A.1, *supra*.

[155] *See* Blum, *supra* note 137, at 602. "This," he went on, "perhaps is the most persuasive justification for our system of corporate reorganization." *Id. See also* Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651 (1974) ("The function of the absolute priority doctrine has in essence been to set guidelines for carrying on these negotiations.").

creat[e] complexities for directors."[156] Better to give directors a wide berth, to "conceiv[e] of the corporation as a legal and economic entity."[157] If directors act for the corporation "as entity" then the competing economic interests of the various stakeholders—including their priority—become secondary. While this may simply "punt"[158] the hard problems of directorial-effort-during-distress, it may, at least in Chancellor Allen's view, empower directors to chart "both [an] efficient and [] fair [] course . . . for the corporation."[159]

The residual claimant is not the only person who could exercise control, or for whom directors should act. Baird (with Rasmussen), for example, has apparently changed tactics, and now argues that control should not necessarily reside in shareholding management (a conventionally junior claimant) but in senior creditors.[160] Indeed, a number of writers observe that the senior creditor will be in possession and control of the debtor's assets, regardless of what we may say about the virtues of the residual claimant.[161]

Notice what this means: If seniors will, or should, exercise control, then unspecified directorial efforts will no longer be for the benefit of the most junior claimant. They will instead be for the benefit of seniors. Since senior status is so easy to create contractually, it is decreasingly an "absolute" feature of the rules that govern corporate financial distress. If directors of distressed firms should, or will in

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[156] *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns. Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108 n. 55 (Del. Ch. Dec. 30, 1991). *Compare* Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 791 (Del. Ch. 2004) ("In insolvency, creditors, as residual claimants to a definitionally-inadequate pool of assets, become exposed to substantial risk as the entity goes forward.").

[157] *Id.*

[158] *See Directors' Duties*, supra note 5, at 1224.

[159] *See Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at *108 n. 55.

[160] *Missing Lever, supra* note 136, at 1227-28 (arguing that institutional and bank lenders have control in reorganizations) (internal footnotes omitted). There are problems with this analysis, including that giving a lender contractual veto power over particular actions is not the same as giving the lender the actual right to control firm decisions. *See id.* at 1228-1230 (discussing use of secured credit to exercise control over a debtor). *See also* DOUGLAS BAIRD, THE ELEMENTS OF BANKRUPTCY 231-32 (4th ed. 2006) (suggesting that the absolute priority rule is not a critical consideration for today's large bankruptcies).

[161] *See, e.g.*, Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 797 (2004) ("The central theoretical argument of this Article is that control of the bankruptcy process, rather than formal rules of security and priority, is the key to understanding both secured-credit and bankruptcy law: Control is the function of bankruptcy; priority is the end for which it is employed"). *See also* Thomas E. Plank, *The Creditor in Possession Under the Bankruptcy Code: History, Text, and Policy*, 59 MD. L. REV. 253 (2000) (discussing idea of "creditor in possession"); Harvey R. Miller & Shai Y. Waisman, *The Creditor in Possession: Creditor Control of Chapter 11 Reorganization Cases*, 21 BANKR. STRATEGIST 1, 2 (2003) ("The exercise . . . of remedial rights given secured creditors upon the occurrence of default, in effect, puts those creditors in control of the debtor/borrower.").

fact, act for the benefit of seniors, what sense does it make to say that they have duties to "residual claimants" such as unsecured creditors? Why should we care about juniors when seniors will run the show?

B. The Doctrinal Relevance of Directors' Duties to Creditors

Priority is not the only puzzling feature of the directors' duties cases from and after *Credit Lyonnais*. A second puzzle reflects the gap between their rhetoric and their reality. Much of their ample discourse appears not to have been required by the questions presented. Moreover, cases like *Omnicare*—which are not viewed as involving duties to creditors—suggest that Delaware is reluctant to use this "doctrine" when it might actually determine outcomes. These cases say a great deal, but actually hold very little, when it comes to directors' duties to creditors.

1. The Directors' Duties Discourse

Consider first *Credit Lyonnais*. As discussed above, the central dispute in that case was about the bank's right to seat directors, as provided in a restructuring agreement that the controlling shareholder had entered into. There appears to have been little dispute that this agreement was enforceable and that the bank had the right to seat its directors. It was only because the controlling shareholder asserted that the bank-appointed directors had breached a fiduciary duty to him that the question of directors' duties arose at all. The discussion of directors' duties to creditors—in a lengthy footnote, no less—was in many ways extraneous to the issue at hand.[162] After all, the plaintiff, Parretti, was a shareholder—not a creditor.

So, too, with *Production Resources*. This was in essence a collection case involving a single creditor seeking repayment from a recalcitrant debtor. According to the complaint, before suing in Delaware, the plaintiff, PRG, had obtained writs of execution in Connecticut state court which were returned unsatisfied.[163] Meanwhile, the complaint alleged, NCT was engaging in fraudulent conveyances and conveying assets to the controlling shareholder, Salkind, that were also subject to competing security interests in favor of PRG.[164] Vice Chancellor Strine could have dismissed the duty claims without prejudice until a determination on these other matters was

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[162] Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns. Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108 n.55 (Del. Ch. Dec. 30, 1991).

[163] *See Production Resources Complaint*, *supra* note 60, at 10, ¶ 26.

[164] *Id.* According to the complaint, the debtor corporation NCT "acceded to a request by Ms. Salkind's attorney (which request appears to have been initiated by NCT) to take physical possession and control of various collateral which purportedly was previously pledged to her and as to which PRG claimed competing security interests." *Id.* By means of these transfers "and other artifices, NCT is now resorting to full-s[c]ale [sic] fraudulent conveyances in favor of its insiders and to the detriment of its other constituents, such as bona fide creditors." *Id.*

made.[165] He chose not to and instead issued his lengthy discussion of directors' duties to creditors based on the problematic priority-duty model.

The same can be said for *Trenwick* and *Gheewalla*. In *Trenwick*, for example, it appears that the plaintiff (the Litigation Trust) had no standing to pursue any *direct* claims of Trenwick America creditors because none were assigned to it under Trenwick America's plan of reorganization or otherwise.[166] Why wasn't the failure to convey the claims in the first place sufficient to resolve the question? Why the extended discussion about the direct/derivative distinction?

Perhaps more curious was the corporate debtor's financial condition. According to the Vice Chancellor, the plaintiffs failed to plead insolvency (or, apparently, the "zone").[167] If, as the Vice Chancellor observed repeatedly, neither Trenwick Parent nor Trenwick America was insolvent at and after the consummation of its acquisition and restructuring transactions,[168] it is not clear why any further discussion was needed. He could have ended about five pages in, when he noted that "the Litigation Trust has failed to plead facts supporting the inference that either [Trenwick Parent] or [Trenwick America] were insolvent at the time of the transactions challenged in the complaint."[169] Rather, he continued for forty-five more pages—nine times more discussion than appears necessary.

Gheewalla is an especially good example of an opinion ranging far from its instrumental goals. First, it was not even clear the plaintiffs were creditors,[170] or that the defendants were capable of acting in a directorial capacity.[171] Second, the court

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[165] *See* Ash v. McCall, 2000 WL 1370341, at *14 (Del. Ch. 2000) (giving plaintiff more time to amend complaint to allege sufficient facts indicating current directors failed to pursue a claim against former directors in a manner that is grossly negligent or self-interested).

[166] Trenwick Am. Litigation Trust v. Ernst & Young L.L.P., 906 A.2d 168, 190-91 (2006).

[167] A fair reading of the Amended Complaint confirms this. Amended Complaint, Trenwick Am. Litigation Trust v. Ernst & Young L.L.P., C.A. No. 1571-N (filed Sept. 20, 2005, Del. Ch.).

[168] *Trenwick Am. Litigation Trust*, 906 A.2d at 202 (2006) ("I reiterate that the complaint fails to plead facts supporting a rational inference that Trenwick America was insolvent before any of the challenged transactions would, when consummated, leave Trenwick America unable to satisfy its creditors.").

[169] *Id.* at 173.

[170] *Gheewalla*, 2006 WL 2588971, at *1 (characterizing plaintiff as "putative creditor"). *See also* discussion at Part I.C.3, *supra*. A similar observation can be made about the facts of the *Big Lots* case, on which much of *Gheewalla's* analysis rested. In *Big Lots*, the "creditor" had a "payment-in-kind" (PIK) note that was not yet due at any of the times relevant to its complaint. Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC, 2006 WL 846121, at *2 (Del. Ch. Mar. 28, 2006)). While we do not know the currency in which this PIK note would have been paid, it would appear not to have been money. Thus, even if the plaintiff received everything he bargained for, he would not have been "paid" in any conventional sense–his investment in the debtor would likely have continued in some different form.

[171] As discussed above, the three directors sued were not a majority of the board. *Gheewalla*, 2006 WL 2588971, at *1. Instead, the plaintiff claimed that the defendants effectively

devotes about half of its analysis to the question of standing in the case of a debtor in the vicinity of insolvency.[172] If, however, the court "accepted" the proposition that the debtor was *insolvent*,[173] the entire discussion about the "vicinity" is overkill. It is the obverse of *Trenwick's* problem: Whereas in *Trenwick*, the absence of meaningful distress leads us to question the relevance of any further duties-to-creditors doctrine, here the problem was the debtor's clear insolvency. If the debtor was already insolvent, then directorial action while in the "zone" seems extraneous.[174]

A logical inference would be that, so far as Delaware is concerned, talking about directors' duties to creditors is more important than recognizing them. Perhaps the most potent support for this thesis appears in the recent and controversial *Omnicare* decision, a case which suffers for its failure to recognize and apply directors' duties doctrine in a manner consistent with its development to that point.[175]

2. Omnicare — The Silencing of Vice Chancellor Lamb

NCS Healthcare (NCS) was an insolvent public Delaware corporation which, despite its financial condition, became the subject of a protracted bidding contest between two companies, Omnicare and Genesis. NCS rejected Omnicare's initial offers because, among other reasons, they were financially inadequate and would have required NCS to consummate the transaction through a bankruptcy filing.[176] Due to its "precarious financial condition,"[177] NCS' board believed that a more certain and lucrative transaction with Genesis was in the interests of the entire enterprise, a position it believed was supported, if not compelled, by *Credit Lyonnais*.[178] NCS thus entered into a merger agreement with Genesis which included a "draconian" exclusivity provision.[179]

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had the power to control Clearwire by virtue of their affiliation with Goldman Sachs, which was allegedly its "only source[] of funding." *Id.*

[172] *Id.* at *11-14.

[173] *Id.* at *18.

[174] If the distinction was factually important—because, for example, the directors took a course of action while in the zone that led to insolvency—the opinion certainly does not say so.

[175] Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003).

[176] *Id.*

[177] *Id.* at 922.

[178] The *Omnicare* Chancery Court opinion sets out in a footnote excerpts of testimony of one NCS director, Richard Osborne, which describes how distress apparently affected the board's decision-making process:

> Q. [By plaintiffs' attorney] In your role as a member of the special committee, did you think it was appropriate for NCS to enter into an exclusivity agreement with Genesis?
>
> A. [By NCS Director Osborne] We were in a situation where a promising opportunity was developing with Genesis. One that had the

Two NCS directors held a majority of NCS' voting power. "[A]cting in their capacity as NCS shareholders," they executed a specifically enforceable agreement to vote their shares in favor of an NCS merger with Genesis.[180] After NCS executed the exclusivity and voting agreements, Omnicare offered a superior proposal conditioned on the completion of due diligence.[181] Omnicare made a public tender offer and NCS's board withdrew its recommendation that the stockholders vote in favor of the NCS-Genesis merger.[182]

Chancery court had little trouble upholding the NCS-Genesis merger agreement when the plaintiff-shareholders sued to enjoin it.[183] Viewing the issue as one of business judgment, Vice Chancellor Lamb began his analysis by observing that the question before the court was not "whether one deal [was] better than the other."[184] By the time litigation began, it was clear that Omnicare's bid was better. Rather, the question was whether the directors "breached the fiduciary duties they owe to all the corporation's stakeholders" when they approved the Genesis merger agreement.[185]

NCS' insolvency was apparently an important, perhaps dispositive, fact for Vice Chancellor Lamb:

> Before turning to the analysis of the directors' decision-making process, it must be observed that the NCS directors were not operating in wholly normal circumstances. In fulfilling their responsibilities to manage the Company's "business and affairs," the Director Defendants certainly owe fiduciary duties to NCS and its

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> promise of substantial recovery for-for creditors . . . , and also the chance of a significant value for shareholders.
>
> The company continued to be circling insolvency. We had talked to 50-plus companies and none had resulted in a deal. We had OmniCare, who had repeatedly offered only bankruptcy and no recovery for shareholders.
>
> We were very mindful of our responsibility to all the stakeholders, but particularly given our perilous condition to the noteholders and senior debt. And of course in this case, because of the chance of recovery for shareholders, it was very clear to me that we should be extremely careful to nurture and preserve this opportunity given the circumstances.

In re NCS Healthcare, Inc., 825 A.2d 240, 259 n.44 (2002) (quoting Osborne Deposition at 107-08).

[179] *Omnicare, Inc.*, 818 A.2d at 923. The Supreme Court majority and dissenting opinions use the term "draconian" to describe the exclusivity provisions of the merger agreement no less than 8 times.

[180] *Id.* at 923, 926.

[181] *Id.* at 924.

[182] *Id.* at 926.

[183] *In re NCS Healthcare*, 825 A.2d at 256.

[184] *Id.* at 244.

[185] *Id.*

> stockholders. *But, as directors of a corporation in the "zone of insolvency," the NCS board members also owe fiduciary duties to the Company's creditors. There is no doubt that NCS was insolvent at all relevant times, as it was in default on and unable to repay approximately $350 million in debt.*[186]

Thus, Vice Chancellor Lamb reasoned, NCS' directors "were not entitled to consider only the interests of the stockholders, but instead had a fiduciary duty to take into account the interests of all of the [a]ffected corporate constituencies."[187]

The Delaware Supreme Court, in a rare split opinion, reversed the Chancery Court, holding that the board's approval of the NCS-Genesis transaction should have been reviewed not as a matter of business judgment, but instead under the more stringent *Unocal* analysis.[188] The court found that the merger agreement flunked *Unocal* because the deal protection devices were preclusive and coercive, and were not within the reasonable range of responses to the threat of losing the Genesis offer.[189]

Chief Justice Veasey (along with Justice Steele) dissented. The Chief Justice accused the majority of adopting "a new rule of law" prohibiting boards from acting "in concert with controlling stockholders to lock up" a merger.[190] He noted that at the time the lock-up provisions were agreed upon, Omnicare's best proposal would force NCS into bankruptcy, fail to pay all of NCS' creditors, or return anything to NCS' stockholders.[191] The Chief Justice viewed the lock-up as adding value to the

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[186] *Id.* at 256-57 (internal footnotes omitted; citing among other things, Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns. Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108 n.55 (Del. Ch. Dec. 30, 1991)).

[187] *Id.* at 257. Plaintiffs' counsel had argued that entering into the Genesis agreement itself constituted a breach of the duty of care. The Vice Chancellor found the argument "unpersuasive" because the directors knew that "without a competing deal from Genesis, Omnicare would [not] have . . . offered a deal" other than one through a bankruptcy case, a proceeding the directors decidedly wanted to avoid. The decision to go with the Genesis offer in these circumstances was "rational (and, indeed, reasonable)." *Id.* at 259.

[188] This would require the NCS directors to demonstrate first that, in causing the corporation to enter into the merger agreement, "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed" by showing their actions were taken in good faith after a reasonable investigation. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 935 (Del. 2003) (quoting Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985)). Second, it would require the NCS directors to show that the defensive measures taken in the merger agreement were "reasonable in relation to the threat posed." *Id.*

[189] *Omnicare, Inc.*, 818 A.2d at 936. The court reasoned that the devices were coercive because the NCS shareholders would be forced to accept the Genesis merger even though eighty percent of NCS public shareholders supported the Omnicare tender offer. *Id.* at 935-36. The deal protection devices in aggregate were preclusive because they "made it 'mathematically impossible' and 'realistically unattainable' for the Omnicare transaction or any other proposal to succeed, no matter how superior the proposal." *Id.* at 936.

[190] *Id.* at 940.

[191] *Id.* at 941.

transaction by allowing NCS and Genesis to "exchange certainties."[192] Because creditors could have forced NCS into bankruptcy at any time, if NCS rejected the lock-up provisions the board potentially risked losing Genesis as a bidder, thereby risking any return to shareholders.[193] If Genesis walked away from the deal and NCS' business prospects dimmed further, the board's refusal may have forced them to accept less desirable bids.[194]

Neither the majority nor the dissent in the Supreme Court opinion appear to think that the debtor's insolvency had bearing on the directors' conduct, or their review of that conduct. Indeed, the majority opinion simply ignores the Vice Chancellor's analysis on this key point. If the majority had in fact believed the rhetoric about duties to creditors, one might expect that, at minimum, the board would have been protected by the "spirit" of *Credit Lyonnais* – that the business judgment rule insulated their entity-saving tactic. Yet not a word was said about directors' duties to creditors.[195] From this we can infer that Delaware courts appear to be more comfortable talking about directors' duties to creditors and the priority-duty model than actually using them. If the Delaware Supreme Court will go out of its way to avoid using *Credit Lyonnais*' protective implications, the "doctrine" of

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[192] *Id.* at 942.

[193] *Id.*

[194] *Id.*

[195] Former Chief Justice Veasey later acknowledged that the fact that the business judgment rule should have applied "was particularly true because of the dilemma facing the NCS board in view of the specter of insolvency." *See* E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1459-460 (2005). In a later law review article, Vice Chancellor Strine (author of the *Production Resources* opinion) also addressed the problem the majority ignored:

> Equally interesting is to imagine what exposure the NCS board would have faced had they, in reaction to Omnicare's last-second, conditional expression of interest, refused to accede to Genesis's terms. Assume Genesis walked away and that Omnicare returned to its preferred strategy of a bankruptcy deal and refuses to offer a transaction giving full repayment to NCS's creditors. Eventually, Omnicare gets the company with no payment to the equity and only eighty cents on the dollar to the creditors. The creditors sue the NCS board for turning Genesis away because, they plausibly contend, the company was insolvent at the time the key decision was made. This alternative scenario was not considered in the majority opinion, nor was there consideration of the fact, because NCS was insolvent or nearly so, any risks that the board took to achieve a higher payment for the equity necessarily represented a much lower percentage of the company's total enterprise value than in the scenario of a thriving, profitable public company. Refusing to put at risk a deal guaranteeing full repayment to the creditors in exchange for an increase for the equity is, at the very least, more understandable in this setting, and there are non-frivolous legal arguments available to creditors that directors must consider creditor interests when the company is in the so-called "zone of insolvency" and, more certainly so, when the company is actually insolvent.

Strine, *supra* note 10, at 901 n.99.

directors' duties to creditors cannot have great legal force. It may be well and good to say that creditors become residual claimants to whom (or for whose benefit) directors owe duties. But, the Delaware courts seem to be saying, that is all it is—something good to say.

This may have led some academics to conclude that directors' duties to creditors have no significance, and are, in Professor Bainbridge's words, "much ado about little."[196] In many cases, Bainbridge thinks, the business judgment rule would insulate directors,[197] or creditors will protect themselves contractually.[198] Directors' duties to creditors will have no practical consequence. While these suppositions may in themselves be questionable,[199] the more important question is the most basic: If they are correct, and directors' duties to creditors are doctrinally irrelevant, why have the courts in cases from *Credit Lyonnais* to *Gheewalla* bothered to say so much about them?

III. The Expressive Functions of Directors' Duties to Creditors

The answer may be that the Delaware courts are trying to tell us something about the developing nature of the relationship between directors and corporate creditors, and the principles of priority, duty and contract that inform this relationship, even if they do not necessarily want to create liability rules in the process. They may, in short, be engaging the "expressive" function of law.

Traditional economic or imperative accounts of the interaction between people and law tend to assume that law works because it coerces.[200] More recent accounts, by contrast, imagine that we respond to law at least in part because of

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[196] *See* Bainbridge, *supra* note 9.

[197] *Id.* at 34-36. Professor Ribstein (with Kelli Alces) offers an elaboration on this view. *See* Larry E. Ribstein & Kelli A. Alces, *The Business Judgment Rule in Good and Bad Times*, J. BUS. & TECH. L. (forthcoming 2007) ("The legal quandary of who should be owed duties in the insolvency scenario disappears . . . in the face of the business judgment rule") (draft of Oct. 17, 2005 at 4, on file with author).

[198] Bainbridge, *supra* note 9 at 26 ("[c]reditors could protect themselves *ex ante* either by negotiating contractual limitations on corporate behavior, such as restrictions on the types of projects in which the firm may invest, or by negotiating for a share of the up-side, such as through the use of convertible debt securities.").

[199] For example, Norman Veasey, the former Chief Justice of the Delaware Supreme Court, would appear to have a different view than Bainbridge, characterizing the duties-to-creditors problem as "very challenging" *See* Veasey & Di Guglielmo, *supra* note 195, at 1429 & n.107 (2005). So, too, would the law firm of Wachtell, Lipton, Rosen & Katz, which has observed that "[d]irectors' choices [are] difficult ones" when a corporation is in financial distress. *Id.* (quoting Memorandum from Theodore N. Mirvis, Wachtell, Lipton, Rosen & Katz, Delaware Speaks to Directors of Troubled Companies (Dec. 1, 2004)).

[200] *Adjudication*, *supra* note 13, at 1045 ("One dominant answer [to the question of why people obey law] is that the threat of sanctions motivate legal compliance."). For a discussion of imperative theories of law, *see* JOSEPH RAZ, THE CONCEPT OF A LEGAL SYSTEM (2d ed. 1980).

what it says, both in its own terms and about us as its subjects.[201] Thus, we recognize that law—and in particular law made by courts—can have meaning and social force independent of the "holding" of a particular case. The directors' duties to creditors cases—especially from *Credit Lyonnais* forward—may be best understood as examples of expressive adjudication.

The notion that law generally performs an expressive function is not new,[202] but has in the past decade taken on a special force in helping us to understand why we have and obey laws even when they may not as a realistic matter be enforced or enforceable. This part describes the expressive theory of law, and how this theory helps to solve the puzzles of directors' duties to creditors. I also offer some thoughts on what the Delaware courts might be telling us.

A. Expressive Theories of Law

The expressive theory of law holds that "the expression of social values is an important function of the courts or, possibly, the most important function of courts."[203] This account of law is fuzzier, more nuanced than traditional explanations, and thus inherently easier to criticize.[204] Law may be expressive from the perspective of those who generate law, those who consume it, or—more likely—both.

If we are concerned about the generation of expressive laws, we focus largely on legislatures and courts.[205] Expressive theories of law would say that those who make law do so not merely because of the crudely causal results they expect

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[201] *Focal Point*, *supra* note 13, at 1650-51 ("The thesis is that the law influences behavior independent of the sanctions it threatens to impose, that law works by what it says in addition to what it does."); Sunstein, *supra* note 13, at 2022 ("Many people support law because of the statements made by law, and disagreements about law are frequently debates over the expressive content of law.").

[202] As Matthew Adler has observed, it dates back at least to the 1960s, when philosophers considered the expressive functions of criminal punishment. *See* Matthew D. Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. PA. L. REV. 1363, 1370 (2000) (citing Joel Feinberg, *The Expressive Function of Punishment*, 49 MONIST 397 (1965)). *See also* H.L.A. HART, PUNISHMENT AND RESPONSIBILITY (1968) (discussing the ways in which criminal law expresses social judgment).

[203] *See* Cooter, *supra* note 13, at 586 (footnote omitted).

[204] For a critique of such theories and an exchange, see Adler, *supra* note 202; Matthew D. Adler, *Linguistic Meaning, Nonlinguistic 'Expression' and the Multiple Variants of Expressivism: A Reply to Professors Anderson and Pildes*, 148 U. PA. L. REV. 1577 (2000); Elizabeth S. Anderson & Richard H. Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. PA. L. REV. 1503 (2000).

[205] *See, e.g.*, JOSEPH R. GUSFIELD, SYMBOLIC CRUSADE: STATUS POLITICS AND THE AMERICAN TEMPERANCE MOVEMENT 177 n.83 (2d ed. 1986); Dan M. Kahan & Donald Braman, *More Statistics, Less Persuasion: A Cultural Theory of Gun-Risk Perceptions*, 151 U. PA. L. REV. 1291, 1318 n.25 (2003); Dan M. Kahan, *The Secret Ambition of Deterrence*, 113 HARV. L. REV. 413, 416 n.18 (1999).

from those who fear its sanctions, but also because they wish to make more and perhaps richer statements about themselves, their institutions and the larger social setting in which law and legal messages are generated and transmitted. A popular example of this involves race discrimination: When legally sanctioned, it is wrongful both because of what it does and what it means.[206] Striking race discrimination, as in *Brown v. Board*,[207] is said to have had expressive consequences, value in virtue of the statements made in the judicial opinion itself, even if courts ultimately could not realize its aspirations.[208] Law matters because of what it says about those who make it.

Expressivism also considers the transmission of these statements to laws' consumers, and asks how and why we obey or respect laws even as we may believe they are unlikely to be enforced or enforceable.[209] Richard Pildes, for example, has argued that constitutional rights are not "trumps", but rather that the constitutional system "provides a more expansive conception of harm because it is more attuned than conventional rights theory appreciates to the social meanings of state action. Expressive harms, no less than material harms to these kind of individual interests, ground constitutional doctrine in many areas."[210] Law matters because of what it says to and about those subject to it, not merely what it does.[211]

The Delaware case law on directors' duties to creditors is best viewed as expressive law-making for several reasons. First, the important features of these cases are non-instrumental. *Credit Lyonnais* matters because of what it says about directorial discretion, not whether (or under what circumstances) directors will (or

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[206] "Much of the debate over school segregation," Cass Sunstein writes. "was also a debate about the meaning of laws calling for segregation." *See* Sunstein, *supra* note 13, at 2022 (1996). Professor Brest generated what is often considered the leading expression of this view:

> Decisions based on assumptions of intrinsic worth and selective indifference inflict psychological injury by stigmatizing their victims as inferior. Moreover, because acts of discrimination tend to occur in pervasive patterns, their victims suffer especially frustrating, cumulative and debilitating injuries.

Paul Brest, *The Supreme Court, 1975 Term--Foreword: In Defense of the Antidiscrimination Principle*, 90 HARV. L. REV. 1, 8 (1976).

[207] 347 U.S. 483 (1954).

[208] *See* Sunstein, *supra* note 13, at 2022 ("*Plessy v. Ferguson* asserted that [discriminatory] laws did not "mean" black inferiority; *Brown v. Board of Education* tried to respond to this assertion with empirical work suggesting the contrary.") (footnotes omitted).

[209] *See, e.g.*, E. ALLAN LIND & TOM R. TYLER, THE SOCIAL PSYCHOLOGY OF PROCEDURAL JUSTICE (Springer 1988); TOM TYLER, WHY PEOPLE OBEY THE LAW (Yale University Press 1990); Paul Robinson & John Darley, *The Utility of Desert*, 91 NW. U. L. REV. 453, 468- 70 (1997); Mark C. Suchman, *On Beyond Interest: Rational, Normative and Cognitive Perspectives in the Social Scientific Study of Law*, WIS. L. REV. 475, 486-90 (1997).

[210] *See* Richard H. Pildes, *Why Rights Are Not Trumps: Social Meanings, Expressive Harms, and Constitutionalism*, 27 J. LEGAL STUD. 725, 744-47, 755-60 (1998).

[211] Sunstein, *supra* note 13, at 2022. There are also attempts to argue that the expressive nature of law can have causal consequences. *See Focal Point*, *supra* note 13.

will not) be liable to creditors. The recent cases constraining *Credit Lyonnais'* doctrinal implications are similarly more useful for their explorations of the nature of director-creditor relations than for their particular holdings, telling creditors, in effect, not to get their hopes up.

Second, and perhaps more telling, is the sheer volume and nature of the verbiage. These are long, discursive opinions, academic in tone and perhaps intent. They are heavily footnoted.[212] They are often rich in hypotheticals and policy analysis. Although they are not law review articles, in many respects they read that way.

Third, these are hortatory opinions, akin to the corporate law "sermons" Professor Rock observed in his important article on the generation of governance norms, *Saints and Sinners: How Does Delaware Corporate Law Work?*[213] Here, Rock looked at the development of Delaware jurisprudence on management buyouts (MBOs) in the 1980s to see whether it would offer deeper insights into the ways that fiduciary duty rules and standards are generated and disseminated. He concluded that it did, often taking the form of "sermons" designed to "generate in the first instance the legal standards of conduct (which influence the development of the social norms of directors, officers, and lawyers)."[214] Like the MBO cases (and as discussed further below), the cases on directors' duties to creditors are based in part on exhortations about directorial behavior at the margins. They are, as Rock said of the MBO cases, "parables—instructive tales—of good managers and bad managers, of good lawyers and bad lawyers, that, in combination, fill out the normative job description of these critical players."[215] Even if the courts in the directors' duties to creditors cases are reluctant to generate a "rule" with a clear instrumental purpose, they nevertheless are attempting to express the values they want directors to internalize in this context.

Some may object to the expressive characterization. First, objectors might say, if I am correct that there is no "doctrine" in any meaningful sense, then what the important Delaware opinions give us is dicta, not rules (or perhaps even

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[212] *Credit Lyonnais* had a comparatively modest 56 footnotes but is, of course, most famous for its footnote 55. *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at *108 n.55. *Production Resources* has 96; *Trenwick* has 155; and *Gheewalla* has 166. I am not making an empirical claim that these cases necessarily have more footnotes than other cases, or that the number of footnotes by itself renders them expressive, only that much of the important analysis in these cases is located in a place far from the typical "holding."

[213] Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

[214] *Id.* at 1016. Professor Rock, along with Professor Wachter, further refined this in Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619 (2001), where they developed the idea of the "non-legally enforceable rule or standard." *See id.* at 1641.

[215] *See* Rock, *supra* note 213, at 1016.

standards).[216] Can something that is not a "rule" have expressive force? Wouldn't the demonstrated ambiguity of the Delaware courts' language on duties to creditors defeat whatever expressive attributes they may have? How can the Delaware courts be expressing anything about this if they don't know what they are trying to say?

The answer, I think, is that ambiguity in the message—noise in the signal—may distort the expression, but these courts are still trying to express something important. Indeed, I think expressivism may be an important—perhaps the only appropriate—manner in which courts can experiment with the values they hope may grow someday into norms and, perhaps, from norms to standards and rules. Courts that "make" law when it matters run the risk of overstepping judicial bounds, whether by ignoring precedent, competing with other branches of government, or both. Expressivism, however, creates space within which courts can explore the values that might be involved in the complex problems presented by priority, duty and contract without necessarily making a commitment that affects the current parties or even those who might otherwise be affected directly by the statements. Experimental, expressive statements may in the long run help courts to develop better rules and standards to guide, but not necessarily compel, behavior.

Second, I do not think expressivism means that law will lack force. The dicta of the Delaware opinions may be expressive, but it may also be a form of warning to corporate actors (directors, officers, professionals). Saying that the rule exists—even if it currently lacks conventional force—gives a court the ability to use it in the future if it believes circumstances warrant. The statement has *in terrorem* value because future actors will know it could shift from the expressive to the imperative if they deviate too far from the standards it articulates. Delaware's case law on duties to creditors has expressive force because of the threat embodied in the possibility that it may actually be used in extreme cases.

A second objection might observe that some of these opinions—*Credit Lyonnais* in particular—were not "published" in a traditional sense. That decision appeared originally only as a slip opinion,[217] and was not officially published. It achieved notoriety due principally to some media hand-wringing, notably an article by law professor John Coffee.[218] Indeed, many of the Delaware cases on directors' duties to creditors appear only in the unofficial, online versions. How expressive can these opinions be, if the courts are not even publishing them?

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[216] *See* discussion about dicta, *supra* note 8.

[217] Styled Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991), the case was initially available only as a slip opinion from the Delaware Chancery Court, and, according to Lexis personnel, was added to its database in 1995.

[218] John C. Coffee, Jr., *Court Has a New Idea on Directors' Duty*, NAT'L L. J., Mar. 2, 1992, at 18. Other early coverage included Daniel J. Winnike, *Credit Lyonnais: An Aberration or an Enhancement of Creditors' Rights in Delaware?*, 6 INSIGHTS, JULY 1992, at 31; *"Footnote of the Year" Has Lawyers Wondering About the Zone of Insolvency*, 24 SEC. REG. & L. REP. 388 (1992).

There are two responses. First, as noted above, these cases are expressive and experimental. While I think the courts in these decisions are trying to tell us something, they are also trying to sort out some very complex and difficult problems involving, among other things, the developing relationship between priority, duty and contract. If you want to muse in a public way, without necessarily creating too great a stir, this may be the way to do it.[219] Second, as a practical matter, these opinions have doubtless been available to the audience that cares. In part, this is true simply because the more recent ones appear online in unofficial versions. It is also due in part to the fact that the Delaware bar is a tightly-knit community that appears to have a fairly good handle on what its Chancellors and Supreme Court Justices are doing.[220]

It would be difficult to "prove" that these cases are "expressive." But given their puzzles and contours, I believe that is the best way to understand them. This, however, leads to a more basic question: If they are expressive, what is Delaware saying to us about directors' duties to creditors?

B. What Are They Trying to Tell us?

We can see at least four themes in the cases from *Credit Lyonnais* forward: (i) directors should have a wide zone of *ex ante* discretion when a firm is distressed; (ii) narratives of extreme behavior will describe the boundaries of acceptable conduct regarding corporate creditors; (iii) contract and other existing creditors' rights and remedies—not fiduciary duty—should almost always determine *ex post* disputes; and (iv) the Delaware courts themselves have an important educative and institutional role in generating these themes. While these are not the only stories these cases tell, they help solve the puzzles they create.

1. The Real Zone—Director Discretion

Scores of articles on directors' duties to creditors circle around the peculiar problems posed by the "zone" of insolvency.[221] But perhaps we've focused on the wrong zone. It may not be a zone of economic condition these courts wish to delimit, but rather a zone of directorial discretion they wish to dilate. If so, it is not unlimited discretion, and may require directors to consider creditors' interests more seriously than if they were acting solely for the benefit of shareholders.

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[219] Of course, if this is so, it may have backfired on Chancellor Allen, given the controversy *Credit Lyonnais* subsequently generated.

[220] *See* Rock, *supra* note 213, at 1013 ("The subjects of the study of U.S. corporate governance—the senior managers and directors of large, publicly held corporations, and the lawyers who advise them—form a surprisingly small and close-knit community.").

[221] Indeed, as noted in the author's footnote at the outset of this article, a whole symposium issue of a law review has been dedicated to the question. *See* Symposium, *Twilight in the Zone of Insolvency*, J. BUS. TECH. L. (forthcoming 2007).

Consider first *Credit Lyonnais.* Recall that some of the most influential aspects of the opinion appear in its famous footnote 55, where Chancellor Allen explored the presumed effects that distress would have on directors' willingness to undertake risk.[222] If directors were able to conceive of the distressed firm as an "entity" — rather than as, for example, a nexus of priority-determined claims and assets — then they might be able to act for the best interests of all:

> 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.[223]

Directors of the distressed firm should, in short, have the discretion to act as they see fit to attempt to solve the firm's troubles. By a parity of reasoning, this means that they would no longer be compelled to maximize firm value for shareholders. Thus, *Credit Lyonnais* may be seen as a caveat to cases like *Katz v. Oak Industries*, which seem to encourage high-risk behavior.[224] This might benefit shareholders in some cases; it might benefit creditors in others. But it would create deliberative space for directors that did not necessarily exist before that time.

What should directors do in these deliberations? Perhaps, if they take Chancellor Allen's approach literally, undertake something resembling the risk analysis posed in his hypothetical. The inquiry would thus no longer be one solely of value maximization for shareholders, but of the broader consequences for all corporate constituents, especially creditors whose interests might be affected by a particularly risky course of action. Perhaps more important, it would give directors

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[222] *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns. Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108 n.55 (Del. Ch. Dec. 30, 1991).

[223] *Id.*

[224] Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (citations omitted). As that court explained:

> 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 (even assuming that a transaction which one may refuse to enter into can meaningfully be said to be at his expense) does not for that reason constitute a breach of duty. It seems likely that corporate restructurings designed to maximize shareholder values may in some instances have the effect of requiring bondholders to bear greater risk of loss and thus in effect transfer economic value from bondholders to stockholders.

Similar sentiments are expressed in, *e.g.*, U.S. v. Jolly, 102 F.3d 46, 48 (2d Cir. 1996); 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, 303-04 (Del. 1988).

the rhetoric and the ability to neutralize (or at least ignore) excessive demands from any particular constituency. Directors of the distressed firm would not be acting as liquidators, as envisioned by the trust fund cases, but workout experts, negotiating the firm's future comparatively unconstrained by rigid application of duty doctrine. This zone of discretion may, in Vice Chancellor Strine's terms, have been the true "spirit" of *Credit Lyonnais*.[225]

The cases following *Credit Lyonnais—Production Resources, Trenwick,* and *Gheewalla*—make this explicit. As noted above, these cases constrained *Credit Lyonnais* by aggressively subjecting creditor claims of breach of duty to classic director defenses, such as the business judgment rule and exculpatory charter clauses. The expressive inference from these instrumental results is that directors should be at least as free from creditor attacks as they would be from shareholder attacks (and perhaps more so). If, as *Production Resources* suggests, "animus" is the fault line, the zone of discretion is quite broad.

Gheewalla explicitly wants to recognize a "zone" of director discretion, although the footprint may be considerably larger than was contemplated by *Credit Lyonnais*.[226] Recall that here, Vice Chancellor Noble believed that creditors should be permitted to assert derivative (but not direct) claims against directors, because if the firm were insolvent, they would have the proper incentives to enforce directorial duty, having stepped into "the shoes normally occupied by the shareholders—that of residual risk-bearers."[227]

> This exception for creditors in these limited circumstances arguably maintains the delicate balance achieved by the standing requirements for pursuit of derivative actions outside of this context—i.e., balancing the "Delaware prerogative that directors manage the affairs of a corporation with the realization that shareholder policing, via derivative actions, is a necessary check on the behavior of directors that serve in a fiduciary capacity to shareholders.[228]

Fully implementing the priority-based logic of the directors' duty cases would doubtless interfere with the "balance" supporting this prerogative. Better to say that directors have duties to creditors when the firm is insolvent, than actually to

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[225] *See* Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 787 (Del. Ch. 2004) (stating that the "spirit" of *Credit Lyonnais* was that the business judgment rule protected directors who in good faith pursue a less risky business strategy in order to insure satisfaction of corporate debt obligations).

[226] N. Am. Catholic Educ. Programming Found. v. Gheewalla, 2006 WL 2588971 (Del. Ch. Sept. 1, 2006). For a detailed description of *Gheewalla*, *see supra* Part I.C.3.

[227] *Gheewalla*, 2006 WL 2588971, at *12.

[228] *Id.* (internal footnotes omitted).

hold them liable for their breach. Exhortation preserves a zone of discretion that liability would constrict.

If discretion is part of the story the directors' duties cases want to tell, we then have another question: How, if at all, does this discretion differ from that created by operation of the business judgment rule? At least superficially, it doesn't, which may be why some writers end their analyses of these cases here.[229] The problem is that once we are dealing with creditors, the mix of norms, values and rules is much more complex and volatile than when we deal with shareholders. We know this is true because, as discussed further below, like it or not, the Delaware courts appear unwilling to limit their analyses of directors' duties to creditors to questions of business judgment. Rather, we find these cases performing other important expressive functions.

2. Narratives about Outliers—Saints and Sinners

Another expressive function these cases perform is, as noted above, to tell us about the boundaries of directorial behavior in the face of financial distress—behavior that is, by definition, outside the zone of discretion. Here, we return to Professor Rock's analysis of the "saints and sinners" who populated the case law that developed Delaware's jurisprudence on management buyouts.[230]

Like the MBO cases Professor Rock considered, the Delaware courts have used directors' duties cases to criticize exceedingly bad behavior that, in these cases, might harm creditors. *Production Resources* seems to be a good example of this.[231] Recall that here the debtor corporation took extraordinary steps to evade a legitimate money judgment against it. Salkind, the "sinner" in this story, had liens on all of the corporation's assets, as well as notes and warrants convertible into stock that would apparently have given her not merely control of the corporation but "more shares of NCT than are currently outstanding."[232] There was, according to Vice Chancellor Strine, "a pattern of improper self-enrichment" by those in control and loyal to Salkind. And, even though NCT was indebted to Salkind, her alleged capital infusions were "often put into the coffers of NCT subsidiaries precisely to frustrate the ability of [creditor] PRG to collect on its debt due it from NCT."[233] This amounted to a "marked degree of animus towards a particular creditor,"[234] a kind of bad faith

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[229] *See* Bainbridge, *supra* note 9, at 34-46; Ribstein & Alces, *supra* note 197, at 4 "("The legal quandary of who should be owed duties in the insolvency scenario disappears . . . in the face of the business judgment rule").

[230] *See* Rock, *supra* note 213.

[231] *See generally* Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004). For a detailed discussion of *Production Resources*, *see supra* Part I.C.1.

[232] *Id.* at 781.

[233] *Id.*

[234] *Prod. Res.*, 863 A.2d at 798.

that would simply be outside the bounds of acceptable corporate governance norms, at least vis-á-vis creditors.

But directors and other insiders are not the only sinners in these cases. Sometimes, those taken to task are the plaintiff-creditors, or, by implication their counsel. The complaint in *Trenwick,* for example, alleged lack of directorial diligence "by conclusory insult, not by fact pleading."[235] The complaint was, Vice Chancellor Strine observed, "entirely devoid of facts indicating that the board did not engage in an appropriate process of diligence . . . ."[236] In *Gheewalla,* Vice Chancellor Noble noted that a true understanding of the complaint was possible only if it was "shorn of excess verbiage."[237] Nor should we forget our old friend Parretti, the controlling shareholder in *Credit Lyonnais* whose machinations first gave Chancellor Allen the opportunity to start this entire discussion.[238]

Judges may not like to think of themselves as sermonizing. *Contra* Rock, they may rather view themselves as "policemen" than "preachers."[239] Yet in an equitable court, such as Delaware Chancery, the particulars of behavior surely influence judicial review. Moreover, this sermonizing may be an expressive response to the unstable and transitional nature of our thinking about directors' duties to creditors. As discussed in Parts I and II, above, we know we have a conceptual model on which directors' duties to creditors rests - priority in right of payment. Yet, we also know that we do not like many of the implications of this model.

One of Rock's key insights about the role of Delaware courts in resolving disputes emanating from the wave of MBOs in the 1980s was that they will use the narrative form, which is necessarily expressive, to generate norms when things are in flux.[240] In the case of duties to creditors, the decisions may be no more hortatory than in other contexts, but the exhortation plays a special role: It is helping to define boundaries of behavior that the "rules" can't. Delaware courts may want to talk about the saints and sinners here because the "canon," so to speak, has not yet been finished. Indeed, they are using these stories to write it.

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[235] *Trenwick Am. Litig. Trust*, 906 A.2d at 173.

[236] *Id.*

[237] *Gheewalla*, 2006 WL 2588971 at * 18.

[238] *See Directors' Duties, supra* note 5, at 1224 n.163 ("Reading between the lines, it would seem that Chancellor Allen was rightly disgusted with Parretti's behavior.").

[239] *See* Rock, *supra* note 213, at 1016 ("My intuition is that we come much closer to understanding the role of courts in corporate law if we think of judges more as preachers than as policemen.").

[240] *Id.* at 1019 ("Because MBOs of significant publicly held companies suddenly assumed prominence in the 1980s, they provide a case study in which we can watch Delaware corporate law in action: the development and articulation of standards of conduct and the communication of those standards to officers, directors, and lawyers.").

3. The Role of Contract

An important theme in the post-*Credit Lyonnais* cases explores the role of contract in sorting out breach of duty claims. In *Production Resources,* Vice Chancellor Strine recognized the force of contract, noting that "[c]reditors are often protected by strong covenants, liens on assets and other negotiated contractual protections."[241] This view was soon echoed by *Gheewalla,* which went one step further to note that creditors' many protections "at law" should generally preclude breach of duty claims:[242]

> "Indeed it would appear that creditors' existing protections—among which are the protections afforded by their negotiated agreements, their security instruments, the implied covenant of good faith and fair dealing, fraudulent conveyance law, and bankruptcy law—render the imposition of an additional, unique layer of protection though direct claims for breach of fiduciary duty unnecessary."[243]

In fairness, it is not clear that the "layer of protection" for creditors is so much "unique" as different. After all, shareholders can and do contract for protection all the time. Moreover, Delaware law gives them a variety of rights vis-á-vis the corporation and its directors that creditors would not have, including, for example, the right to vote for directors in the first place.[244] Nevertheless, there is something to be said for the intuition behind this view. We typically view equity—of which fiduciary duty is a species—as a sort of judicial last resort, a remedy when rights "at law" (contract or statute) fail. To be sure, the mere legality of a contract or other similar device (charter, bylaw) will not, of itself, assure that it passes judicial muster.[245] But it should at minimum create a strong presumption that equity will not later interfere.

Of course, as with the zone of discretion, there are limits to the force of contract or other rights "at law." *Production Resources* is a good example of this. The plaintiff-creditors could have negotiated for any number of contractual creditor protections, including liens on the debtor's assets. The failure of those contractual mechanisms would lead to other remedies, including, most importantly, the right to seize those assets, or their value, even if the debtor went into bankruptcy. Yet, Vice

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[241] *Prod. Res.,* 863 A.2d at 790.

[242] *Gheewalla,* 2006 WL 2588971 at *13 ("Creditors are often protected by strong covenants, liens on assets, and other negotiated contractual protections.") (quoting *Prod. Res.,* 863 A.2d at 790).

[243] *Id.*

[244] DEL. CODE ANN. tit. 8, § 211(b) (2007).

[245] Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (". . . inequitable action does not become permissible simply because it is legally possible."); *see also* Strine, *supra* note 10.

Chancellor Strine tells us the directors' "marked degree of animus"[246] permitted—perhaps required—a different analysis. Mrs. Salkind's behavior was so nakedly vexatious to one creditor, and so outside the bounds of generally accepted commercial conduct, that the Vice Chancellor saw a role for equity.

The role of contract here, as elsewhere, leaves at least two classes of questions. First, is *Production Resources* really about outrageous conduct, or is it about contract? If the former, it should give directors a wide zone of discretion, bounded only by behavior analogous to that of "sinner" Salkind. If the latter, it should constrict that discretion to ward off the "opportunism" that concerned Chancellor Allen in *Credit Lyonnais*. As with so many other problems of private ordering, what we can know about today's rules depends on having some meaningful sense of the boundaries of contract.

Second, if the contractual boundary is "opportunism," what does that mean? How bad would a directorial decision have to be vis-á-vis creditors to warrant judicial scrutiny? Recall, for example, Chancellor Allen's footnote in *Credit Lyonnais* about the "profligate" nature of leveraged buyouts in the 1980s.[247] Although the "profligacy" of these transactions was not the articulated basis for the decision, the fact that it is mentioned suggests it might have mattered to Chancellor Allen.

If opportunism is the concern, some current transactions might give us pause. Consider first the wave of private equity buyouts.[248] A recent series in the *Wall Street Journal* observed that since 2003, companies have borrowed $69 billion primarily to pay dividends to private-equity owners, as compared to $10 billion in the prior six years.[249] In certain cases, these companies have been driven to bankruptcy or its brink by these borrowings.[250] While these companies are forced to renege on retiree payments, they nevertheless make large fee and dividend payments to the private equity firms that own them.[251] Is this the sort of

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[246] Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 798 (Del. Ch. 2004).

[247] Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns. Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *8 (Del. Ch. Dec. 30, 1991) (where court viewed transaction as "typical" of profligate nature of LBOs occurring at end of 1980s).

[248] *See, e.g.*, Charles Duhigg, *Can Private Equity Build a Public Face?* N.Y. TIMES, Dec. 24, 2006. ("Court documents detail legal brawls in which investors accuse [private equity firm] Cerberus of orchestrating secretive deals that transgressed legal and ethical boundaries, accusations the firm denies.").

[249] *See* Gregory Ip & Henny Sender, *In Today's Buyouts, Payday for Firms is Never Far Away*, WALL. ST. J., Jul. 25, 2006, at A1; Henny Sender, *Takeover Artists Quench Thirst*, WALL. ST. J., Jan. 5, 2006, at C1. ("The ink had barely dried on the sale documents about a year ago when the new private-equity owners of satellite operator Intelsat . . . paid themselves a $350 million dividend financed with newly issued Intelsat debt.").

[250] *See* Ip & Sender, *supra* note 249, at A14 (discussing bankruptcy reorganization of Dade Behring, Inc. and distress of Intelsat).

[251] *Id.*

opportunism that *Credit Lyonnais* would condemn? Or is it simply within the "animus"-bounded discretion suggested by *Production Resources*?

Similar questions can be asked about asset securitization under special "facilitation" acts, in particular Delaware's Asset-Backed Securities Facilitation Act (ABSFA).[252] An "asset securitization" is generally defined as "the structured process whereby interests in loans and other receivables are packaged, underwritten, and sold in the form of "asset backed" securities" typically to a "special purpose entity" (SPE) owned by the originator of the assets.[253] Some allege that these transactions are simply sophisticated forms of judgment-proofing devices which would inevitably harm involuntary or unsophisticated creditors.[254] They are, on this view, opportunism *"in excelsis."*[255]

Questions have long persisted about whether bankruptcy courts would respect such transactions.[256] Delaware's statute is an attempt to ensure that courts will have no choice, providing in essence that a properly worded conveyance contract will be effective under Delaware law—no matter what.[257] Because ABSFA

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[252] DEL. CODE ANN. tit. 6, §§ 2701A-2703A (2004). Other states have similar facilitation statutes, although none is quite as robust as Delaware's. *See* Alabama, ALA. CODE § 35-10A-2(a)(1) (2004); Louisiana, LA. REV. STAT. ANN. § 10:9-109(e) (2002); North Carolina, N.C. GEN. STAT. § 25-9A-102 (2002); Ohio, OHIO REV. CODE ANN. § 1109.75 (2002); Texas, TEX. BUS. & COM. CODE ANN. § 9.109(e) (Vernon 2002).

[253] COMPTROLLER OF THE CURRENCY: ADMINISTRATOR OF NATIONAL BANKS, ASSET SECURITIZATION: COMPTROLLER'S HANDBOOK (1997), *available at* http://www.occ.treas.gov/handbook/SS.HTM. *See also* TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES (1991 & Supp. 1995); STEVEN L. SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (3d ed. 2002).

[254] *See, e.g.*, Lynn M. Lopucki, The *Death of Liability*, 106 YALE L.J. 1, 92 (1996) (arguing that securitization is a method of judgment proofing). *Compare* Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 STAN. L. REV. 1 (1999), *and* Charles W. Mooney, Jr., *Judgment Proofing, Bankruptcy Policy, and the Dark Side of Tort Liability*, 52 STAN. L. REV. 73 (1999), *with* Lynn M. LoPucki, *The Irrefutable Logic of Judgment Proofing: a Reply to Professor Schwarcz*, 52 STAN. L. REV. 55 (1999) (debating judgment-proofing effect of securitization).

[255] I advert here to Professor Gilmore's observation about the development of negotiability doctrine which, in many respects, can be seen as the forerunner of securitization. *See* Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441, 461 (1979).

[256] In *In re* LTV Steel Co., 274 B.R. 278, 285 (Bankr. N.D. Ohio 2001), the bankruptcy court held on a motion for use of cash collateral that property purportedly sold in a securitization would nevertheless be available for use by the debtor's estate. *Id.* at 285 ("To suggest that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept. . . . [T]here seems to be an element of sophistry to suggest that Debtor does not retain at least an *equitable* interest" in the cash collateral.). I collect and discuss these cases in *Secrets and Liens, supra* note 153, at 467-74.

[257] ABSFA provides, "[n]otwithstanding any other provision of law," any property purported in the transaction documents to be transferred in a securitization transaction "shall be deemed to no longer be the property, assets or rights of the transferor." DEL. CODE ANN. tit. 6, §§ 2701A-2703A (2004).

applies to "[a]ny property, assets or rights purported to be transferred, in whole or in part,"[258] I have observed elsewhere that ABSFA would insulate intentional fraudulent transfers from judicial scrutiny.[259] If this statute insulates all securitization contracts under Delaware law from judicial scrutiny, what sort of opportunism can we expect to see from the directors of distressed firms engaged in such transactions?

4. The Role of Courts—The Educative Function of Directors' Duties to Creditors

A fourth expressive theme in these cases involves not statements about the parties or their relations (contractual or otherwise), but instead about the courts, themselves, and the role they play in generating norms in this context. These cases are, in a sense, about the educative function that the Delaware courts believe they should play in the puzzling world of directors' duties to creditors.

(a) The Educative Function of Law

That law may have an educative function is well known, and analytically similar to the claim that it has an expressive function.[260] Christopher Eisgruber has famously explored the widely-made but under-theorized, claim that the United States Supreme Court is an educative institution.[261] He wondered how this could be if the Court is not expert in pedagogy or "complex arguments like those that interest people who study philosophy professionally."[262] He concluded that the Court does educate, but not in traditional ways. It educates in its "inspirational" capacity,[263] its ability "to motivate people to act ethically, a capacity that may be entirely independent of philosophical expertise."[264] The Court does this in important cases

[258] DEL. CODE ANN. tit. 6, § 2703A(a)(1).

[259] *Secrets and Liens*, *supra* note 153, at 470. Needless to say, there are many doctrinal moves a court could make to evade the force of ABSFA, some of which I discuss *id.* at 470 n.231.

[260] Christopher L. Eisgruber, *Is the Supreme Court an Educative Institution?*, 67 N.Y.U. L. REV. 961 (1992).

[261] *Id.* at 962, nn.1, 2; Eugene V. Rostow, *The Democratic Character of Judicial Review*, 66 HARV. L. REV. 193, 208 (1952). *See also* ALEXANDER M. BICKEL, THE LEAST DANGEROUS BRANCH 26 (1962) (quoting Rostow with approval); ROBERT BORK, THE TEMPTING OF AMERICA 249 (1990) (quoting Rostow with approval); MARY A. GLENDON, RIGHTS TALK: THE IMPOVERISHMENT OF POLITICAL DISCOURSE 94-97 (1991) ("The opinion in the *DeShaney* case miseducates the public about the American version of the welfare state."); RALPH LERNER, THE THINKING REVOLUTIONARY 136 (1987) (judicial opinions should "transfer to the minds of the citizens the modes of thought lying behind legal language and the notions of right fundamental to the regime"); MICHAEL J. PERRY, THE CONSTITUTION, THE COURTS, AND HUMAN RIGHTS 112-13 (1982) (quoting Rostow); Robin West, *Foreword: Taking Freedom Seriously*, 104 HARV. L. REV. 43, 103 (1990) (commenting upon "the educative role of Supreme Court opinions").

[262] *Eisgruber*, *supra* note 260, at 967.

[263] *Id.* at 964.

[264] *Id.* at 967.

like *West Virginia v. Barnette*[265] and *Cohen v. California*[266] by making what he calls "ad hominem" arguments, arguments about group identity.[267]

The major Delaware opinions on directors' duties to creditors may perform an analogous function. While ethical action may not be a core expressed concern of the Delaware courts, proper behavior by corporate actors is. Cases from *Credit Lyonnais* through *Gheewalla* may be attempts by the Delaware courts to educate the corporate community—and perhaps other courts that would apply Delaware law — about behavior that is and is not acceptable when a firm is in distress. Moreover, there is literally an ad hominem quality to these opinions. As noted above, the "sinners" — Parretti, in *Credit Lyonnais*, Salkind, in *Production Resources*, perhaps the plaintiffs in *Trenwick or Gheewalla* — and their "sins" are heavily criticized. Perhaps part of the pedagogy of these opinions is to instruct by negative example.

We can take the educative analogy a step further by considering certain rhetorical features of the opinions. All of the major Delaware opinions rely heavily on two stereotypical educational devices: The hypothetical and the footnote. *Credit Lyonnais* uses both, setting forth in its "famous footnote" 55[268] a detailed hypothetical discussion of the "curious things" that "the possibility of insolvency can do."[269] As discussed above, this hypothetical sets up a simple probability model to assess the risks imposed by various investment (or litigation) decisions. By using an exceedingly simple model—a single reward with measurable risks—Chancellor Allen teaches us that the investment choice made by directors will affect not only

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[265] 319 U.S. 624 (1943). *Barnette* struck a rule requiring recitation of the pledge of allegiance. It is famous for Justice Jackson's stirring rhetoric about government's right to control speech and, by implication, thought:

> If there is any fixed star in our constitutional constellation, it is that no official, high or petty, can prescribe what shall be orthodox in politics, nationalism, religion, or other matters of opinion or force citizens to confess by word or act their faith therein. . . . Under the First Amendment the government must leave to the people the evaluation of ideas. Bald or subtle, an idea is as powerful as the audience allows it to be.

Barnette, 319 U.S. at 642. Yet, as Lessig has observed, the case is an "oddity" because "[g]overnment has always and everywhere advanced the orthodox by rewarding the believers and by segregating or punishing the heretics." *See Social Meaning, supra* note 13, at 946. It is curious that one case, *Barnette*, can be viewed as both educative and as conflicting with the government's power to educate.

[266] 403 U.S. 15 (1971) (stating that a person could not be convicted for wearing jacket bearing expletives on it in a courthouse consistent with First or Fourteenth Amendment; noting that he is entitled to public displays that do not specifically breach the peace).

[267] *Eisgruber, supra* note 260, at 972 ("a distinguishing trait of good teachers is an ability to deploy ad hominem arguments to good effect.").

[268] This was, among others, Vice Chancellor Strine's characterization of *Credit Lyonnais'* footnote 55. *See* Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 789 (Del. Ch. 2004).

[269] Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns. Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108-09 (Del. Ch. Dec. 30, 1991). *See* discussion *supra* note 212.

shareholders (presumptively the sole beneficiaries of director action when the firm is solvent) but also the "entire community of interests"[270] by virtue of the priority-duty model.

He may also be teaching us something about the simplifying assumptions that are acceptable to make, and perhaps the utility and propriety of using such assumptions. Recall that the hypothetical imagines directors facing three choices—high, medium and low risk—with corresponding payouts. His hypothetical assumes that creditors would prefer a low-risk decision, presuming that creditors are more conservative than shareholders (and, on a conventional view of the priority-duty model, would be paid first from the proceeds of the low-risk settlement). This suggests that it is appropriate to infer something about claimants' risk preferences from their place in the priority pecking order. Perhaps Chancellor Allen is teaching us that his model is not merely a convenient heuristic, but also a barometer for predicting investors' distinct, sometimes competing, aspirations for firm investment decisions.

Vice Chancellor Strine's *Production Resources* opinion also relies heavily on footnotes and, to a lesser extent, hypotheticals, although he would appear less inclined to draw inferences about risk preference from the priority-duty model. He acknowledges the temptation to "posit extreme hypotheticals involving directors putting cash in slot machines,"[271] but resists because "the real world is more likely to generate situations when directors face a difficult choice between pursuit of a plausible, but risky, business strategy that might increase the firm's value to the level that equity holders will receive value, and another course guaranteeing no return for equity but preservation of value for creditors."[272] Strine rejects this use of the priority-duty model because the "reality [is] that creditors are not monolithic and that different classes of creditors might have risk preferences that are greatly disparate, with some having interests more like stockholders."[273]

But the Vice Chancellor cannot entirely resist the temptation to hypothesize. In considering whether the plaintiffs had asserted a direct—not derivative—claim against NCT's directors, Vice Chancellor Strine stated that the allegation "can be analogized to a more general example":

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[270] *Id.* at *108-09.

[271] As Professor Barondes observes, this hypothetical may not be so extreme, as it is the subject of at least one reported decision (the expressive implications of which are best left to the imagination). *See* Barondes, *supra* note 46, at 8 n.21 (discussing Dwyer v. Jones (*In re* Tri-State Paving, Inc.), 32 B.R. 2, 3-5 (Bankr. W.D. Pa. 1982), involving officers who gambled the debtor's funds in Las Vegas "to win enough money . . . to pay the corporate-debtor's creditors." The strategy failed. *See id.* at 4-5).

[272] *Prod. Res.*, 863 A.2d at 790 n.57.

[273] This is, I note, a point Strine makes in one of his lengthy footnotes. *See id.* at 789 n.56.

> Suppose that the directors of an insolvent firm do not undertake conduct that lowers the value of the firm overall, or of creditors in general, but instead take action that frustrates the ability of a particular creditor to recover, to the benefit of the remainder of the corporation's creditors and of its employees. Could this conceivably be a breach of the directors' fiduciary duties to the particular injured creditor and, if so, under what circumstances? Would that creditor have to show that the directors did not rationally believe that their actions (e.g., in trying to maintain the operations of the firm) would eventually result in the creation of value that would enable payment of the particular creditor's claim? To at least my mind, there are a myriad of policy considerations that would arise by the indulgence or non-indulgence of a fiduciary duty claim of this type and I am reluctant to ponder their viability without better help from briefing by adversarial parties.[274]

Vice Chancellor Strine concluded that at this stage he could resolve the motion to dismiss "without making any broad pronouncements that would have large policy implications."[275] In doing so he offered what sounds like a somewhat modest experimental view, denying the motion to dismiss the direct claims "on the established principle that when a firm is insolvent, the directors take on a fiduciary relationship to the company's creditors, combining that principle with the conservative assumption that there might, possibly exist circumstances in which the directors display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor."[276] Like a good educator, the Vice Chancellor "solves" the hypothetical by applying well-established ("conservative") principles to convey an instructive warning about where liability might arise.

(b) The Educational Role of Delaware Courts

While the Delaware directors' duties opinions may be expressive, generally, and even educative, we still face a question: Why Delaware? Recall that one of the two basic puzzles in these cases asks why the major cases involve so much discussion. A corollary would ask, Why these courts? After all, if serious financial distress typically results in a bankruptcy case, then creditors' fiduciary duty claims

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[274] *Id.* at 797-98.

[275] *Id.* at 798. The tail of this quote bespeaks the expressive nature of the *Production Resources* opinion. Vice Chancellor Strine implies that plaintiffs' counsel fell short by not providing "better adversarial briefing." *Id.* But, if the plaintiff's goal was to collect a contractual debt—and contract begins and ends the discussion—what exactly were they supposed to say?

[276] *Id.*

will, in the first instance, be sorted out by a United States Bankruptcy Court.[277] If Bankruptcy Courts are more likely than state (in particular, Delaware) courts to face these questions, what does Delaware think it has to add?

Perhaps the answer is that Delaware courts view themselves as especially—perhaps uniquely—adept at developing and teaching fiduciary jurisprudence. The lessons they would be teaching us have both substantive features—on director discretion, contract, and so forth—as well as on the role of the court itself. Here, we can infer at least two expressive/educative aspirations.

The first involves the reflexive nature of equity jurisprudence. Equity typically involves a greater judicial intervention than we expect when courts act at "at law," e.g., in upholding a contract. The Delaware courts generally view themselves as parsimonious in the development of equity, both for philosophical and practical reasons.[278] In part, this should be so that these courts can reserve to themselves the power and flexibility to craft rules and standards in the future.

Recall, for example, Chief Justice Veasey's dissent in *Omnicare*. Among the things that distressed him was the majority's conversion of an equitable option into a per-se rule (and perhaps an ill-advised one, at that). The "beauty of the Delaware corporation law," was that it created a "framework . . . based on an enabling statute with the Court of Chancery and the Supreme Court applying principles of fiduciary duty in a common law mode on a case-by-case basis."[279] The "bright-line, per se" ban that the Court had enacted was, in his words, a "judicially-created 'third rail' that . . . [became] one of the given 'rules of the game' . . . ."[280] Applied more generally, the Delaware courts might be forgiven for wanting to reserve to themselves the power to develop and teach these fiduciary principles, even in the context of director-creditor disputes.

Second, this would be consistent with market-based views of law as a "product." Perhaps the Delaware courts are taking seriously Professor Romano's claim that law is their product and that they must protect this franchise from competing producers.[281] In this context, those other producers necessarily—perhaps appropriately—include United States Bankruptcy Courts, over which Delaware courts have only indirect influence, at best. The Delaware courts may be concerned

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[277] Of course, these courts may elect to permit the parties to carry on a fiduciary duty litigation in state court. *See, e.g.*, Trenwick Am. Litig. Trust v. Ernst & Young L.L.P., 906 A.2d 168 (2006).

[278] *See* Strine, *supra* note 10, at 904 ("Unlike a legislature or regulatory agency, a court's ability to expand its window on the world is ethically and practically constrained").

[279] Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, at 939 (Veasey, C.J. dissenting).

[280] *Id.*

[281] *See* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985).

that federal bankruptcy law will erode their preeminence in corporate governance as have the federal securities laws under, for example, Sarbanes-Oxley.[282]

And perhaps they would be right to be concerned. As "this nation's arguably most important business court,"[283] they may well have developed a better sense of duty and norms in matters of corporate governance than any other single set of courts. Bankruptcy courts, by contrast, may be well versed in matters of priority and claims and contract, but fiduciary duty is not thought to be the specialty of bankruptcy judges. Thus, in the competition over who gets to establish corporate norms vis-á-vis creditors, Delaware courts may literally want their institutional voices—and their institutional choices—to dominate fiduciary discourse that might otherwise be generated by bankruptcy courts..

IV. What Remains Unsaid—Gaps and Opportunities

The doctrinal maneuvers of the post-*Credit Lyonnais* era may have given us important rhetoric that can be explained as expressive attempts to define and control developing corporate governance norms when a firm is in distress. But, these cases may also have instrumental consequences. In certain cases, these decisions may create unintended, or unacceptable, gaps in creditors' ability to sue directors of the distressed firm. In this section, I mention three, and then describe how the better expressive features of the Delaware cases nevertheless create opportunities to fill these gaps in normatively acceptable ways.

A. Direct v. Derivative Standing

The post-*Credit Lyonnais* case law is especially confusing on the question of standing. First introduced by Vice Chancellor Strine in *Production Resources,* the net effect of the analysis seems to be that, except for outlier cases ("animus"), creditors will have only derivative, not direct, standing under Delaware law.[284] This creates troubling gaps, as it appears to misapply Delaware's own law on the distinction

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[282] *See* Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the Challenges We (and Europe) Face,* 30 DEL. J. CORP. L. 673, 685 (2005) ("What will be more troubling [than Sarbanes-Oxley] is if the federal government continues to veer out of its traditional lane in the American corporate governance system."). A recent, ironic example of this competition occurred in the murky field of "deepening insolvency," a cause of action that appears to overlap with a claim that directors breached fiduciary duties to creditors. Five months after the Bankruptcy Court for the District of Delaware held that Delaware law would recognize such a cause of action, Vice Chancellor Strine issued the *Trenwick* decision—which, among other things, held that Delaware does not. *Compare* OHC Liquidation Trust v. Credit Suisse First Boston (*In re* Oakwood Homes Corp.), 340 B.R. 510, 531 (Bankr. D. Del. 2006) *with* Trenwick Am. Litig. Trust v. Ernst & Young, LLP, 906 A.2d 168 (Del. Ch. 2006).

[283] *See* Strine, *supra* note 10, at 878.

[284] Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 798 (Del. Ch. 2004).

between direct and derivative suits, and fails to account for the way bankruptcy law generally works in this context.

First, Delaware's current test for whether a claim is direct or derivative, *Tooley*, teaches that the distinction "must be based solely on the following questions: Who suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy?'"[285] In *Gheewalla*, Vice Chancellor Noble offered an elaborate discussion why creditors should not, as a practical matter, have standing to bring direct claims against directors—even though they would otherwise have "stepped into shareholders' shoes." "*[D]irect* claims by creditors would not help the corporate collective," he reasoned, "because the benefit would accrue to the creditor bringing the direct claim."[286]

This is doubtless true. But by ignoring the first part of the *Tooley* test—who was harmed?—he proves too much. Creditors are likely no different from shareholders for this purpose: If we assume they are rational and greedy, they all want to recover individually, and none wants to share with others who may be similarly situated. Yet, it would seem that many untoward directorial decisions can harm creditors directly—and not just the corporation. A decision not to pay certain creditors, or to undertake a very risky course of action, may well harm particular creditors without harming the corporate collective. This would certainly be direct harm; why should the recovery flow to the corporation rather than the victim?[287]

Second, it is well known that bankruptcy law makes a strong distinction between claims that belong to creditors versus those that belong to a bankruptcy estate. Under *Caplin v. Marine Midland Grace Trust Co.*, a bankruptcy trustee has no standing to assert claims on behalf of an estate's creditors.[288] There, a bankruptcy trustee sued an indenture trustee for failing to perform obligations on behalf of creditors under a trust indenture. The United States Supreme Court concluded that a bankruptcy trustee had no standing to bring such claims because, among other

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[285] Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004).

[286] N. Am. Catholic Educ. Programming Found. v. Gheewalla, 2006 WL 2588971 at *12 (Del. Ch. Sept. 1, 2006).

[287] Moreover, Vice Chancellor Noble's *ex post* orientation—who collects?—is largely irrelevant if what we care about is the *ex ante* incentive-effects of permitting suits against directors at all. In other words, Vice Chancellor Noble may have it exactly backwards: the *incentive* to enforce will likely be greater if you know you will collect for yourself (as in a direct suit), and not have to share (as in a derivative one). The "incentive" to enforce fiduciary duties—or not—should be the same, whether you are a creditor of a distressed firm or a shareholder of a healthy one.

[288] 406 U.S. 416, 434 (1972).

reasons, they simply were not causes of action that could have belonged to the debtor, and therefore its estate.[289]

Caplin did not distinguish "direct" from "derivative" creditor claims, but the distinction would now appear to matter. By saying, as *Gheewalla* does, that creditors can effectively assert only derivative claims, we are left with a gap: Being derivative, they should in the first instance belong to the corporate debtor—not the creditors. But, being creditors' claims, they should, under *Caplin*, be assertable only by creditors. Thus, we have the potential for rights (or claims) without remedies: derivative breach of duty claims that can be asserted by neither creditors (*Gheewalla*) nor bankruptcy trustees (*Caplin*).

Third, and related to the second, is the effect that rights of senior creditors must have on incentives to bring derivative creditor suits. Consider, for example, the all-assets security interest. If a senior creditor has a lien on all assets of a debtor, it would seem likely that that creditor—not the unsecured-creditor-plaintiffs—would have first priority in the derivative claim or its proceeds.[290] If so, and notwithstanding Vice Chancellor Noble's *Gheewalla* analysis, what incentive would unsecured creditors have to bring such a claim? Why would they want to enrich the corporate debtor's bank?

If the goal of *Credit Lyonnais* and its heirs is largely expressive, then perhaps cases like *Gheewalla* go too far. Putting to one side the problem noted above that much of its standing discussion is largely irrelevant, the decision—if given instrumental effect—tells directors that in fact they have no cause to worry about creditor suits, because neither creditors nor bankruptcy trustees can sue. Even if, in Vice Chancellor Noble's terms, creditors of the distressed corporation may have the "incentive" to sue, he has made it impossible for them to do so. How persuasive is judicial rhetoric if we know that it can never result in liability?

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[289] *Id.* at 429 ("Nowhere does petitioner argue that [debtor's estate] could make any claim against [indenture trustee]. Indeed, the conspicuous silence on this point is a tacit admission that no such claim could be made.").

[290] The character of the derivative claim under Article 9 of the Uniform Commercial Code (which would likely govern) is not entirely clear. It might be a "commercial tort claim," if it is a claim sounding in tort. U.C.C. § 9-102(a)(13) (definition of commercial tort claim). A close observer of the UCC would point out that a security interest can only attach to a commercial tort claim if it is specified in some detail, after the claim arises. *Id.* § 9-204(b)(2) (discussing attachment of "after-acquired" security interests in commercial tort claims). Of course, directors and management might cut an inside deal with the senior secured lender after commencement of the derivative action, amending the security agreement to take a security interest in the derivative claims. Such a deal may be struck, and may make us uncomfortable, for the same reasons as similar deals between junior and senior claimants concerned us in the railroad reorganizations discussed in Part II.A.2, *supra*.

B. **Exculpatory Charter Clauses**

I also question the propriety of subjecting creditors to exculpatory charter clauses authorized by, e.g., DGCL 102(b)(7). Recall that *Production Resources* explored this question, concluding that the "plain terms" of the statute subjected creditors' breach of duty claims to such charter provisions.[291] But this conclusion raises both doctrinal and policy issues.

As a doctrinal matter, I am not persuaded by this construction of § 102(b)(7). The statute specifically limits its purview to "the corporation or its stockholders." This presumably means that a charter can exculpate directors from liability for derivative and direct claims (that is, those held by the corporation or by shareholders).[292] But the statute does not mention creditors. If the Delaware legislature meant to include creditors, why did it not say so? One might infer under the *exclusio unius* principle that if Delaware wanted to include creditors, it knew how to do so.[293] Nor is it satisfactory to say that creditors' derivative claims are impliedly exculpable, subsumed within the exculpation of all claims of "the corporation." As we have seen, courts like those in *Gheewalla* seem inclined to treat all creditor claims as derivative, even if they are more properly direct.

Second, and perhaps more important, we justify the presence of an exculpatory clause in part by reference to notions of shareholder democracy.[294] Shareholders may lose their ability to recover from directors by virtue of such clauses, but we tolerate that because, among other reasons, they effectively agreed to it, and generally retain the right to change it if they want to. Shareholders can reasonably be said to have agreed to such provisions because they purchased shares issued by a corporation whose charter had such a provision. They might even have voted to amend the charter to add an exculpatory charter clause.

We cannot say the same of creditors. Absent director and shareholder agreement, creditors have no right to vote for or against charter amendments generally, including those that would add an exculpatory charter clause.[295] Nor is it credible to say that creditors are deemed to have accepted an exculpatory charter

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[291] Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 793 (Del. Ch. 2004).

[292] DEL. CODE ANN. tit. 8, § 107(b)(1) (2007).

[293] Consider, for example, § 174, which provides that directors will be liable for the declaration of dividends that impair capital "to the corporation, *and to its creditors in the event of dissolution or insolvency* . . . ." DEL. CODE ANN. tit. 8, § 174(a) (emphasis supplied). When Delaware wants to specify rights and remedies of creditors, in other words, it does so explicitly. It is not clear why exculpatory charter clause rules that would limit these rights and remedies should be any different.

[294] *See* Mary Siegel, *Fiduciary Duty Myths in Close Corporate Law*, 29 DEL. J. CORP. L. 377, 464 (2004) (noting controlling shareholders could, as shareholders, approve an exculpatory provision).

[295] Under DEL. CODE ANN. tit. 8, § 242(b), creditors have no power to add or delete an exculpatory clause. Only shareholders have this power (following, I would note, a resolution adopted by directors, "declaring its advisability.").

clause merely by extending credit. I would be surprised if many factor the presence of such a clause into lending contracts. Nor could a lender realistically require any but the most desperate firms to eliminate such provisions as a condition to the loan. If one of the expressive lessons of Delaware's case law on directors' duties to creditors is that we should respect well-formed contracts, the absence of contract draws into question the application of exculpatory charter clauses to creditors. Should creditors be bound by a provision they did not plausibly choose or have a realistic opportunity to modify?[296]

C. Involuntary Creditors

The inability to modify debilitating charter provisions is most troubling when we recognize that not all creditors choose to extend credit. Most will have done so voluntarily, of course. Where creditors contract (or have the meaningful opportunity to do so *ex ante*), duty claims make little sense and should rarely lie. They will (and should) be displaced by the terms of the contract or other creditors' remedies. As discussed in Part III.B.3, above, the Delaware cases on duties to creditors rely increasingly on the notion that creditors have (or will have had) the opportunity to negotiate for all the contractual protection they want. This is consistent with Delaware courts' more general embrace of freedom of contract. Thus, Delaware courts often say that parties can contract around fiduciary duties that might otherwise be imposed under Delaware common law.[297]

Moreover, certain creditors—chiefly senior institutional lenders and banks—will have structured or financed many of the transactions that are likely to create the greatest problems in the future (high leverage, securitization). Should they—of all people—be allowed to assert claims against directors of the very corporations they aided in transactions they now claim violated some fiduciary duty?

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[296] I do not view application of the business judgment rule—also a feature of *Production Resources*—as problematic in the same way. First, it is a way that courts presume that directors have caused no (or no meaningful) harm to the corporation. The exculpatory charter clause, by contrast, has force chiefly when there has already been harm. It says that the directors will have no liability, even if their gross negligence does harm the corporation. Second, and more important, it is a product of judicial invention—not shareholder vote. Neither shareholders nor creditors can create the protection of the business judgment rule. As noted, exculpatory clauses exist only if added to the charter; they (unlike the business judgment rule) can be removed by shareholder (not creditor) vote.

[297] Take the example of preferred stock. Cases like *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997) say that directors may act for the benefit of common stockholders, even though the action may harm preferred stockholders. Not being residual claimants (common stockholders), Chancellor Allen held there that preferred creditors were limited to the terms of their contract with the corporation. 705 A. 2d at 1042. ("[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.").

Of course not.

The corollary, however, is that we should take directors' duties to creditors most seriously when creditors lack the opportunity to contract. Involuntary creditors, in particular tort claimants and terminated low-level employees, would not realistically have bargained with the debtor, *ex ante*, about either the extension of credit or the level of risk they were willing to take in relation to the debtor's assets. In most cases, they cannot assign or otherwise liquidate their claims ("exit").[298] If I am correct that we increasingly tolerate contractual exceptions to "absolute" priority, the mere fact that these claimants are unsecured creditors provides no great assurance that they will have any meaningful recovery if the debtor is distressed.[299] Indeed, it would appear that contract increasingly assures that they will end up a corporation's true residual claimants—or worse.

This could have real bite. If, for example, companies make products that create serious harm, incur massive tort liability, yet fail to take action to prevent or remedy this harm, and insolvency results, leaving tort creditors unpaid, perhaps a breach of duty claim should lie. Today, cases like *Gheewalla* would appear to make that all but impossible. Recall that *Gheewalla* indicated that creditors could pursue breach of duty claims against directors of a distressed firm only if they were either derivative or, if direct, the creditor had effectively obtained a judgment against the corporate debtor.[300] We have already seen that limiting creditors to derivative claims creates serious problems, including that recoveries on such claims would likely be captured by senior (e.g., secured) creditors. If creditors must obtain a judgment to bring a direct breach of duty claim, we can effectively exclude many tort creditors, whose claims are often contingent and unliquidated when a bankruptcy case is commenced.

The consequences are both inefficient and unfair. As to the economics, it is well understood that the ability to externalize costs leads to inefficient, sloppy investing. Translated to this context, if directors of distressed firms have no reason to fear breach of duty suits from tort creditors, we would understand if they felt tempted to cause their corporations to make harmful products. Directors should be expected under these circumstances to take short-run, value-maximizing strategies that may create long-term costs if those costs are borne only by parties legally incapable of asserting claims against the directors who created or permitted the harm in the first place.

The current plight of involuntary creditors offends one of the expressive lessons of *Credit Lyonnais*. Recall that a key message of the case was about opportunism: "the possibility of insolvency can do curious things to incentives,

[298] *See Directors' Duties*, *supra* note 5, at 1242-1248 (discussing certain creditors' inability to sell or assign claims against corporate debtor).

[299] *See generally id.*

[300] For a detailed description of *Gheewalla*, *see supra* Part I.C.3.

exposing creditors to risks of opportunistic behavior and creating complexities for directors."[301] While we want directors to have wide discretion to manage the firm when it is in distress, we also want them to have due regard for the claims of creditors, especially if we take the priority-duty model as seriously as we say. It is difficult to imagine more tempting targets of opportunism than involuntary creditors—especially if directors know they are virtually immune from liability to them.

Conclusion

It should by now be apparent that in all but a few special cases, directors' duties to creditors create serious problems if treated in conventional doctrinal terms. Indeed, but for the expressive attributes of *Credit Lyonnais* and progeny, I think the cases make little doctrinal sense. Courts—whether those in Delaware or otherwise—should say that ordinarily, directors have no worries about personal liability to creditors. Perhaps they should, as in *Production Resources,* continue to rattle the saber a bit in extreme cases. But with limited exceptions, they should encourage parties to rely on well-formed contracts—and not provide windfalls or unbargained-for protections to creditors.

The exceptions—that involuntary creditors may deserve the protection of fiduciary duty when a firm is distressed—is a point I have made elsewhere, and will not belabor here.[302] The point here has been to explore why courts—and in particular, Delaware courts—say so much about directors' duties to creditors, when they do not need to or do not appear to mean what they say. The answer appears to be that these courts are engaged in an expressive exercise, an attempt to work out the very complex interaction between priority, duty and contract. While recent decisions may have gone a bit too far, the better norms expressed by these cases create the opportunity for judging in this context that is both efficient and fair. Let us hope the Delaware courts—and those who look to Delaware for guidance—believe their rhetoric.

Postscript

As this Article was going to press, the Delaware Supreme Court issued an opinion affirming the Chancery Court's decision in the *Gheewalla* case discussed in parts I.C.3 & IV.A, above.[303] In *Gheewalla,* the Chancery Court held that, as a matter

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[301] Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns. Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108 n.55 (Del. Ch. Dec. 30, 1991).

[302] *See Directors' Duties, supra* note 5.

[303] N. Am. Catholic Educ. Programming Found., Inc. v. Rob Gheewalla, _ A.2d _, 2007 WL 1453705 (Del. May 18, 2007) *aff'g* 2006 WL 2588971 (Del. Ch. Sept. 1, 2006). For ease of reference, I will cite in this postscript to the Supreme Court opinion as "*Gheewalla Supreme*

of law, creditors cannot pursue direct claims against directors of a distressed corporation. The Supreme Court not only affirmed this holding, but may have gone beyond it, in at least two ways.

First, the Supreme Court suggested that, as a matter of law, creditors cannot pursue *any* duty claims against directors that arise when a corporation is in the "zone of insolvency." The lower court had assumed that creditors could pursue *derivative* duty claims arising during this pre-insolvency period.[304] The Supreme Court apparently disagreed: "When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by *exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners*."[305] This language is broader than the stated holding of the opinion: "[W]e hold that the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert *direct* claims for breach of fiduciary duty against the corporation's directors."[306] But if, as the Supreme Court later says, directors of a corporation in the "zone" are to act "in the *best interests of the corporation*," and to maximize value for "*shareholders*," creditors should have no basis for asserting any duty claims—direct or derivative—against directors.

Second, the court apparently narrowed the duties that directors do owe to or for the benefit of corporate creditors when the firm is actually insolvent. The lower court had tracked *Production Resources*' subrogating language about the effect of insolvency, namely that it causes creditors to "step into the shoes of" shareholders.[307] According to the *Gheewalla* Supreme Court, however, creditors only "take the place of the shareholders as the residual beneficiaries of *any increase in value*."[308] This implies a narrower frame of duty than was suggested by *Production Resources* or *Credit Lyonnais*.

Court," and to the Chancery Court opinion as "*Gheewalla Chancery Court*." For reasons that are not clear, Westlaw mounted two identical versions of the Supreme Court opinion, the second cited at 2007 WL 1454454. I will cite only to the first.

[304] *See Gheewalla Chancery Court*, 2006 WL 2588971, at * 12, n. 112 ("the Court merely presumes, in the text above, that standing would be available to creditors of corporations in the vicinity of insolvency to assert derivative claims on behalf of the corporation.").

[305] *See Gheewalla Supreme Court*, 2007 WL 1453705, at *7 (emphasis added).

[306] *See id.* at *2 ("we hold that the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors.").

[307] *See Gheewalla Chancery Court*, 2006 WL 2588971, at * 12 (creditors of the insolvent corporation are "placed 'in the shoes normally occupied by the shareholders—that of residual risk-bearers'" (quoting Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 791 (Del. Ch. 2004))).

[308] *See id.*

The Supreme Court's rationale reflects concerns about directorial discretion to maximize value and negotiate with creditors. "To recognize a new right for creditors to bring direct fiduciary claims against [an insolvent corporation's] directors," the court explained, "would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors."[309] This would suggest that value maximization—even at the expense of creditors—may be acceptable after all. Moreover, directors should be unburdened by fiduciary constraints when negotiating with creditors. "Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation."[310]

There is, as discussed in Part II.B.1, something odd about *Gheewalla*. It is not clear that the plaintiff was a creditor,[311] or that the defendants were capable of acting in a directorial capacity.[312] The Chancery Court devoted about half of its analysis to the question of standing in the case of a debtor in the vicinity of insolvency.[313] But it is not clear why this matters if the corporation here was actually *insolvent*. The plaintiff's real goal may have been to reach Goldman Sachs, the defendants' employer, and a large investor in the corporation. If so, fiduciary duty may have formed only a small part of the real dispute. One might be forgiven for thinking that *Gheewalla* was taken to the Supreme Court as a pretext for addressing—and limiting—directors' duties to creditors.

What does *Gheewalla* mean? It might mean an end to the expressive experimentation undertaken by the Delaware Chancery Court discussed in this Article. Now, we know that directors of Delaware corporations may be unburdened by any duties to corporate creditors when the firm is in the zone of insolvency, and have a quite limited duty to corporate creditors even if the firm is insolvent.

This is likely to present little problem, as and to the extent creditors are parties to well-formed contracts. But, like the *Gheewalla* Chancery Court decision discussed in Part IV above, the *Gheewalla* Supreme Court opinion leaves gaps. Among other things, the *Gheewalla* Supreme Court ignores the fact that (i) directorial acts or omissions may directly harm creditors in the same ways that they directly harms shareholders; (ii) bankruptcy law and the rights of senior lienholders will interfere with unsecured creditors' ability to pursue derivative claims; (iii) it is not

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309 *See Gheewalla Supreme Court*, 2007 WL 1453705, at *8.

310 *See id.*

311 *See Gheewalla Chancery Court*, 2006 WL 2588971, at *1 (characterizing plaintiff as "putative creditor"). *See also Gheewalla Supreme Court*, 2007 WL 1453705, at *1 (same).

312 The three directors sued were not a majority of the board. *Gheewalla Chancery Court*, 2006 WL 2588971, at *1. Instead, the plaintiff claimed that the defendants effectively had the power to control the corporation by virtue of their affiliation with Goldman Sachs, which was allegedly its "only source[] of funding." *Id.*

313 *See id.* at *11-14.

clear how creditors could satisfy the pre-suit demand requirement of Rule 23.1;[314] and (iv) most important, contract cannot and will not protect involuntary (e.g., tort) creditors.

Gheewalla may be telling us that Delaware does not care about these gaps. It may mean that Delaware does not take seriously the "opportunism" that concerned Chancellor Allen in *Credit Lyonnais* or the "animus" that concerned Vice Chancellor Strine in *Production Resources*. This would be ironic. Recall that in *Production Resources*, Vice Chancellor Strine viewed directors' duties to creditors as "not unproblematic" because they "[a]rguably . . . involve[] using the law of fiduciary duty to fill gaps that do not exist."[315] The corollary, however, is that duty should fill gaps to remedy inequitable conduct when there is no meaningful remedy at law. *Gheewalla* nevertheless uses fiduciary doctrine to make this more difficult. We can only hope this is not the last word on the subject.

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[314] As discussed in text at note 68, *supra* Delaware's Rule 23.1 requires shareholders pursuing a derivative action to make demand on the board before pursuing the claim on behalf of the corporation. Perhaps here demand is to be excused as a matter of law because the rule speaks only of *shareholders* (not creditors) and it would be futile to imagine that a corporation would pursue directors on behalf of creditors' claims. We cannot say, because the Supreme Court failed to address the issue. Nevertheless, as discussed above, this was an issue that concerned Vice Chancellor Strine in *Production Resources*. *See* Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 795-96 (Del. Ch. 2004) ("For example, assuming that a claim that creditors are asserting is one belonging to the firm, does that mean that creditors must plead demand excusal under Rule 23.1? The parties have not burdened me with input on this precise question.").

[315] *See Prod. Res.*, 863 A.2d at 789-90.