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Adapting to the New Shareholder-Centric Reality

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Rock, Edward B., "Adapting to the New Shareholder-Centric Reality" (2013). *Faculty Scholarship*. Paper 457.
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ARTICLE

ADAPTING TO THE NEW SHAREHOLDER-CENTRIC REALITY

EDWARD B. ROCK[†]

After more than eighty years of sustained attention, the master problem of U.S. corporate law—the separation of ownership and control—has mostly been brought under control. This resolution has occurred more through changes in market and corporate practices than through changes in the law. This Article explores how corporate law and practice are adapting to the new shareholder-centric reality that has emerged.

Because solving the shareholder–manager agency cost problem aggravates shareholder–creditor agency costs, I focus on implications for creditors. After considering how debt contracts, compensation arrangements, and governance structures can work together to limit shareholder–creditor agency costs, I turn to available legal doctrines that can respond to opportunistic behavior that slips through the cracks: fraudulent conveyance law, restrictions on distributions to shareholders, and fiduciary duties. To sharpen the analysis, I analyze two controversies that pit shareholders against creditors: a hypothetical failed LBO, and the attempts by

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shareholders of Dynegy Inc. to divert value from creditors through the manipulation of a complex group structure. I then consider some legal implications of a shareholder-centric system, including the importance of comparative corporate law, the challenges to the development of fiduciary duties posed by the awkward divided architecture of U.S. corporate law, the challenges for Delaware in adjudicating shareholder-creditor disputes, and the potential value of reinvigorating the traditional "entity" conception of the corporation in orienting managers and directors.

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INTRODUCTION

Suppose that the central problem of U.S. corporate law for the last eighty years—the separation of ownership and control—has largely been solved. Suppose further that the solution came mostly through changes in market and corporate practices rather than through changes in the law.

What should corporate law and practice focus on now? This Article opens a discussion about how corporate law should adapt to the new shareholder-centric reality that has emerged over the last thirty years by focusing on the implications for creditors.

Historically and comparatively, corporate law seeks to control three sorts of agency costs: those between managers and dispersed shareholders, between controlling and noncontrolling shareholders, and between shareholders and creditors.¹ Because the magnitude of these agency costs is interrelated, changes in the severity of one sort of agency cost will affect the severities of the others.² In shareholder-centric corporate law systems like the United Kingdom, creditor protection is a prominent feature.³ By contrast, in manager-centric corporate law systems, as in the United States over much of the last eighty years, corporate law's creditor-protection features seem to atrophy. What happens when a system shifts from being manager-centric to shareholder-centric? How can it adapt to the new reality and respond to the increased need for creditor protection?

In this Article, I argue that, since the early 1980s, the U.S. system has shifted from a manager-centric system to a shareholder-centric system. This shift has occurred primarily through changes in managerial compensation, shareholder concentration and activism, and board composition, outlook, and ideology, rather than directly through legal change.⁴ With respect to the most important decisions—such as changes in control—there is substantial reason to believe that managers and directors today largely “think like shareholders.”

If this is right—if we have evolved into a shareholder-centric system—then the shareholder-creditor agency cost problem should return as a central concern of corporate law. Further, to the extent that we have evolved into a shareholder-centric system through changes in practice rather than law, the law is unlikely to have kept pace. This Article analyzes how the U.S. corporate law system has adapted to, and can continue to adapt to, this new shareholder-centric reality and the shareholder-creditor agency costs that accompany it. I do not argue for changes in the law per se, but I do want to pose the question whether existing law is adequate to respond to the different kinds of problems that emerge. As I describe below, we have a variety of tools for responding to these changes: contracts, compensation,

¹ REINIER KRAAKMAN, JOHN ARMOUR, PAUL DAVIES, LUCA ENRIQUES, HENRY HANSMANN, GERARD HERTIG, KLAUS HOPT, HIDEKI KANDA & EDWARD ROCK, *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 35 (2d ed. 2009).

² See *infra* Part II.

³ See *infra* text accompanying notes 356-362.

⁴ This may partially explain why so few law professors seem to have noticed it.

governance arrangements, and legal doctrines (including fraudulent conveyance law, restrictions on distributions, and fiduciary duties).⁵

Do we have all the tools we need? Do we need to develop new tools? Do we need to use existing tools in new ways? Reasonable minds can differ on these important details, but what is clear, I think, is that we need to be alive to the characteristic forms of shareholder–creditor opportunism so that we can respond appropriately. In Part IV, after considering how contracts, compensation, and governance arrangements can and do respond to these challenges, I examine two controversies illustrating the kinds of behavior that can slip through the basic web of protections and pose challenges: a doomed leveraged buyout (LBO), and shareholder manipulation of complicated corporate subsidiary structures to divert value from creditors.

In a world in which managers' high-powered equity incentives make them think and act like shareholders, it is important to remind managers and directors that the goal of the exercise is to create valuable firms, not to maximize shareholder value as an end in itself. Focusing on creditors as a group, despite the conflicts that exist among them, can be a useful proxy for the wider social impact of maximizing *shareholder* value at the expense of *firm* value.

I. THE TRANSFORMATION OF THE U.S. CORPORATE LAW SYSTEM: THE WANING OF THE “SHAREHOLDER–MANAGER AGENCY COST PROBLEM”

The separation of ownership and control has been the master problem of U.S. corporate law since the days of Berle and Means, if not before.⁶ Beginning in the 1970s, scholars began to describe this in terms of “shareholder–manager agency costs.” In this Part, after a brief historical overview, I review the classic agency cost analysis and then consider the extent to which things have changed.⁷

⁵ See *infra* Part III.

⁶ See Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 923 (1984) (“[A]fter half a century, discussion of the corporate form still invariably begins with Berle and Means’ location of the separation of ownership and control as the master problem for research.”).

⁷ William Bratton and Michael Wachter come to a similar conclusion, from a different direction, regarding the waning of shareholder–manager agency costs. William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 675–88 (2010). Lynn Stout has been a prominent voice arguing against “shareholder value maximization.” See generally LYNN STOUT, *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC* (2012).

A. *A Brief Historical Background*

Between the Civil War and World War I, the United States followed a model of “financial capitalism” in which the large, capital-intensive businesses (railroads, oil, steel, communications, electricity, etc.) were financed and monitored by a concentrated group of banks led by the Morgan bank.⁸ The capital needs of large enterprises required the development of equity and debt markets and became the foundation of the U.S. capital markets. Because of these companies’ ongoing capital needs, their bankers exercised a great deal of influence, often placing directors on the boards, replacing underperforming managers when necessary, and keeping managers focused on profitably developing their companies.⁹ During this period, the agency costs of management in public corporations were relatively low, constrained by the monitoring by financial intermediaries.

After World War I and through the 1920s, this model broke down for a variety of economic reasons (e.g., growth of individual stock ownership) and political factors (e.g., progressive critiques and congressional investigations).¹⁰ By the time of the enactment of the Glass–Steagall Act in 1933, the United States had shifted toward “managerial capitalism.”¹¹ Freed from the banks by new regulations enforcing a separation of finance and commerce, no one substituted for J.P. Morgan and the other large, well-placed investors. Executives typically selected directors, who in turn did not effectively monitor the executives.¹² Product markets were largely insulated from international competition and thus permitted a great deal of managerial “slack” before threatening firm solvency. Shareholdings were widely dispersed with few mechanisms for overcoming barriers to shareholder

⁸ J. Bradford De Long, *Did J.P. Morgan's Men Add Value?: An Economist's Perspective on Financial Capitalism*, in *INSIDE THE BUSINESS ENTERPRISE: HISTORICAL PERSPECTIVES ON THE USE OF INFORMATION* 205, 205 (Peter Temin ed., 1991).

⁹ See *id.* at 214-18 (recounting the monitoring function Morgan's bankers performed when serving on boards of directors); see generally RON CHERNOW, *THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 1-161* (1990) (discussing the bank's rise during the years leading up to World War I).

¹⁰ See Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 *COLUM. L. REV.* 10, 31-53 (1991) (examining the economic, legal, and political pressures that led to the downfall of financial capitalism).

¹¹ For the classic historical account of the emergence of “managerial capitalism” in the United States, see ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* (1977).

¹² See Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 *J. ECON. PERSP.* 121, 123 (2001) (“The corporate governance structures in place before the 1980s gave the managers of large public corporations little reason to focus on shareholder concerns. . . . [B]efore 1980, management was loyal to the corporation, not to the shareholder.”).

collective action. Executive ownership of equity was very low, so executives did not have strong financial incentives to maximize firm value.

The period of the “managerial” firm transformed officers’ and directors’ understandings of their roles. They saw themselves as loyal to the corporation rather than to the shareholders. They flirted with the idea of being “trustees” of the corporate enterprise. They embraced the notion that they were supposed to manage the corporation for the benefit of all its stakeholders.

During this period, firms retained earnings beyond the immediate need for investment in profitable projects.¹³ This further insulated firms from capital market pressures, as they could fund investments without selling stock. As a largely unintentional and unnoticed side effect of managerialism, the shareholder–creditor agency cost problem slipped from view.

B. *The Classic Agency Cost Analysis*

Beginning more or less with Michael Jensen and William Meckling’s classic 1976 article, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, finance economists and law professors shifted their discussion from the “separation of ownership and control”—the phrase popularized by Berle and Means—to shareholder–manager “agency costs.”¹⁴ In reviewing these classic discussions, there are several strands of the analysis that found at least a certain degree of empirical support.

1. The Core Incentive Story

To start with, there is an incentive story. In a structure in which shareholders bear the residual risk while managers hold fixed claims, managers’ interests will diverge from those of the shareholders, with managers preferring a greater degree of financial certainty than diversified (and thus risk-neutral) investors.

The structure of compensation can affect firm value in several ways. First, pay structures will have a selection effect: performance-based compensation, its advocates argue, is likely to disproportionately attract higher-skilled and

¹³ See Philip G. Berger, Eli Ofek & David L. Yermack, *Managerial Entrenchment and Capital Structure Decisions*, 52 J. FIN. 1411, 1419–22 (1997) for evidence that firms with entrenched managers use less leverage.

¹⁴ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

less-risk averse managers.¹⁵ Second, they can have a lock-in effect: performance pay that vests over time, as well as long-term options, can help retain key employees.¹⁶ Finally, pay structures can have a behavioral effect: fixed pay may lead managers to seek quiet lives, while performance pay can motivate managers.¹⁷

Studies of managerial compensation during the 1960s and 1970s showed that managers were almost entirely compensated on a fixed basis with few equity-linked performance incentives.¹⁸ Thus, Brian Hall and Jeffrey Leibman report that, in 1980, annual chief executive officer (CEO) compensation was mainly in the form of cash salaries and bonuses, with only thirty percent of CEOs receiving new stock option grants.¹⁹

This lack of performance sensitivity led Jensen and Kevin Murphy to argue that, if CEOs are paid like bureaucrats, “[i]s it any wonder then that so many CEOs act like bureaucrats rather than the value-maximizing entrepreneurs companies need to enhance their standing in world markets?”²⁰

2. The “Free Cash Flow Problem”

In the classic analysis, the shareholder–manager conflict of interest leads managers to adopt a variety of different policies that are not in the interest of diversified shareholders. Thus, some argue that managers will have an incentive to retain excessive amounts of “free cash flow” (funds over and above current profitable investment needs) because doing so insulates managers from the market discipline resulting from the need to attract investment in new issuances of equity.²¹ The classic example cited by Jensen was the oil industry in the wake of the tenfold increase in price (and resulting recession) in 1973. Oil industry managers found themselves with huge amounts of free cash flow during a period of industry consolidation. Rather than distributing the excess cash to shareholders, they overinvested in the oil industry and made value-decreasing acquisitions in unrelated industries.²²

¹⁵ Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 4 (2002).

¹⁶ *Id.* at 15.

¹⁷ *Id.*

¹⁸ Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 257-58 (1990).

¹⁹ Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 663 (1998).

²⁰ Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It’s Not How Much You Pay, But How*, HARV. BUS. REV., May–June 1990, at 138, 138.

²¹ See, e.g., Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. (PAPERS & PROC.) 323, 323 (1986).

²² *Id.* at 326-27.

3. Managerial Empire-Building

Another reflection of managerial agency costs could be seen in inefficient levels of corporate acquisitions—or “empire-building.” Because managers of large enterprises are better compensated than managers of smaller enterprises,²³ managers have a private incentive to expand—even when doing so is not justified by the returns to shareholders.²⁴ A complementary explanation for costly diversifying acquisitions is that they may reduce the variance of a firm’s returns. This benefits managers, who depend on their firms for their high (largely fixed) salaries, even though shareholders can diversify more cheaply at the portfolio level.²⁵

A number of management theories developed that justified conglomerate mergers as offering a more efficient mode of enterprise organization. Some argued that professional managers replaced unsophisticated self-taught entrepreneurs.²⁶ Others argued that conglomerates facilitated divisional monitoring by a central office.²⁷ Still others argued that

the central office reallocated investment funds from slowly growing subsidiaries, which generated cash, such as insurance and finance, to fast growing high technology businesses, which required investment funds. In this way, each conglomerate created an internal capital market, which could allocate investment funds more cheaply and efficiently than the banks or the stock and the bond markets.²⁸

In fact, however, during the 1960s and 1970s, when diversifying conglomerate acquisitions were all the rage, the results for shareholders were disappointing.

²³ See Kevin J. Murphy, *Corporate Performance and Managerial Remuneration: An Empirical Analysis*, 7 J. ACCT. & ECON. 11, 32 (1985) (finding, empirically, that “in addition to shareholder return, sales growth is an important determinant of executive compensation”).

²⁴ Jensen, *supra* note 21, at 323.

²⁵ Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605, 606 (1981).

²⁶ For a brief overview, see HENRY MINTZBERG, *MINTZBERG ON MANAGEMENT: INSIDE OUR STRANGE WORLD OF ORGANIZATIONS* 153-72 (1989).

²⁷ See *id.* at 165-69.

²⁸ Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 SCIENCE 745, 746 (1990). *But see* Holmstrom & Kaplan, *supra* note 12, at 137-39 (arguing against the efficiency of internal capital markets).

4. Dispersed Ownership, Passive Shareholders, and Captured Directors

On the classic account, what makes these high levels of agency costs possible is a combination of dispersed ownership, which leaves shareholders passive, and directors who are appointed and controlled by the CEO.

These explanations found substantial empirical support. During this period, shareholding was at least as widely dispersed as it had been since Berle and Means' analysis in the early 1930s.²⁹ As an analysis of shareholders' collective action problems would predict, shareholders were in fact mostly passive. Finally, studies largely confirmed the assertions that CEOs controlled director appointments and that directors viewed themselves as serving at the CEO's pleasure.³⁰

5. Managerial Entrenchment and the Resistance to Hostile Tender Offers

Finally, in the classic account, the most potent engine of managerial accountability—the hostile tender offer—was undermined by management's defensive tactics, by structural features such as staggered boards, and by legal innovations upheld by Delaware courts, such as poison pills.³¹ Again, this account found support in contemporaneous developments.

6. Evidence on the Magnitude of Agency Costs

Agency costs can rarely be observed directly. In the classic agency cost analysis, the best evidence adduced for significant agency costs has been the magnitude of the premiums paid in change-in-control transactions and, in particular, those paid in management buyouts. For example, Jensen argued

²⁹ See, e.g., Brian Cheffins & Steven Bank, *Is Berle and Means a Myth?*, 83 BUS. HIST. REV. 443, 457 (2009) (citing “[a] number of studies done in the 1960s and 1970s indicat[ing], in the spirit of Berle and Means, that dispersed ownership was the norm” and noting this view remained the “received wisdom on ownership and control”).

³⁰ See JAY W. LORSCH WITH ELIZABETH MACIVER, *PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS* 20-23 (1989) (finding the composition of most boards to be “heavily influenced by the CEO”); MYLES L. MACE, *DIRECTORS: MYTH AND REALITY* 72-85 (1971) (detailing the strength of CEO control, attributed in part to control over board appointment).

³¹ See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 162-66 (1991) (describing tender offers as a method of control for shareholders, but noting that Delaware courts have routinely upheld management's defensive mechanisms against them).

that the high premiums (averaging fifty percent) in the 1980s-era leveraged buyouts were evidence of significant agency costs.³²

C. *Subsequent Developments: 1980 to the Present*

Just as the new shareholder–manager agency cost paradigm was sweeping academia, the world began to change. As I describe below, corporate law played a largely peripheral role, with market practices taking the lead. In this Section, I briefly summarize these dramatic developments across each of the dimensions identified in the classic agency cost account.³³

1. The Core Incentive Story

Compensation structures are now well-aligned with shareholder value. The biggest development since the 1980s is that CEOs now have large amounts of equity and equity-linked compensation. Jensen and Murphy’s original “CEOs are paid like bureaucrats” argument³⁴ was undermined in two ways. First, by looking at the effect of performance on CEOs’ stock and option holdings, one gets a much fuller view of the performance–compensation link than by simply comparing changes in salary and bonus to changes in firm value. Second, starting in 1980, firms began to provide their CEOs with large amounts of equity-linked compensation.

Thus, although it may have been correct in 1980 to say that CEOs were largely paid with cash salary and bonuses, the reality has changed dramatically. Between 1980 and 1994, the percentage of CEOs receiving stock options rose from 30% to close to 70%.³⁵ By 1999, 94% of S&P 500 companies granted options to their top executives.³⁶ By 1998, “the median values

³² Jensen, *supra* note 21, at 325; Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21, 31-32 (1988).

³³ This Section summarizes points made in much greater detail in a series of articles that Marcel Kahan and I have published over the last decade. See, e.g., Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473 (2003) [hereinafter Kahan & Rock, *Corporate Constitutionalism*]; Marcel Kahan & Edward B. Rock, *Embattled CEOs*, 88 TEX. L. REV. 987 (2010); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007) [hereinafter Kahan & Rock, *Hedge Funds in Corporate Governance*]; Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002) [hereinafter Kahan & Rock, *How I Learned to Stop Worrying*]; Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347 (2011).

³⁴ See Jensen & Murphy, *supra* note 20 and accompanying text.

³⁵ Hall & Liebman, *supra* note 19, at 663.

³⁶ Hall & Murphy, *supra* note 15, at 4.

of stock and options held by Standard & Poor's industrial CEOs and Standard & Poor's financial CEOs were \$30 million and \$55 million, respectively."³⁷ During the 1993–1998 time period, “the ratio of equity portfolio value to annual total pay was 30.3 on average for CEOs.”³⁸

More recent data confirm this trend. John Core and Wayne Guay examined the pay-performance relationship for the S&P 500 CEOs from 1993 to 2008.³⁹ After converting option values to stock equivalents, they find that the median CEO receives approximately \$5.2 million in annual compensation and holds the equivalent of approximately \$40.2 million in firm equity.⁴⁰ This yields a ratio of annual pay-to-“stock equivalent value” (a proxy for the effective equity holdings in the firm) of 14.5%.⁴¹ Put differently, the median CEO's equity ownership is roughly six times his or her annual compensation. This implies a very significant performance sensitivity with most of that sensitivity deriving from the CEO's equity holdings and relatively little from annual compensation.⁴²

Others have looked specifically at CEO incentives in the all-important change-in-control context. Here, too, incentives have changed. Susan Elkinawy and David Offenber, by comparing companies in which unvested stock and options vest on takeover with those in which they do not, and using a matched sample of nonacquired companies, show that premiums are significantly higher when the CEO's contract includes accelerated vesting.⁴³ Their study also finds that in 75% of the acquisitions in their sample period (2005–2009), the CEO's employment contract provided for accelerated vesting in a change of control.⁴⁴ In sum, then, the evidence is clear that, whatever the state of play in the 1960s and 1970s, CEO wealth is now strongly linked to shareholder value. Although one can find outliers, there is

³⁷ John E. Core, Wayne R. Guay & David F. Larcker, *Executive Equity Compensation and Incentives: A Survey*, FRBNY ECON. POL'Y REV., Apr. 2003, at 27, 28–29 (citing an earlier version of Hall & Murphy, *supra* note 15).

³⁸ *Id.* at 29 (citing John E. Core, Wayne Guay & Robert E. Verrecchia, *Are Performance Measures Other than Price Important to CEO Incentives?* 38 *tbl.1* (London Bus. Sch., Working Paper No. EFA 0418, 2000), available at <http://ssrn.com/abstract=214132>).

³⁹ See John E. Core & Wayne R. Guay, *Is Pay Too High and Are Incentives Too Low? A Wealth-Based Contracting Framework* (Jan. 28, 2010) (unpublished working paper), available at <http://ssrn.com/abstract=1544018>.

⁴⁰ *Id.* at 34.

⁴¹ *Id.*

⁴² See also Steven N. Kaplan, *Are U.S. CEOs Overpaid?*, ACAD. MGMT. PERSP., May 2008, at 5, 11 fig.5 (2008) (comparing CEO salaries with and without equity compensation).

⁴³ See Susan Elkinawy & David Offenber, *Accelerated Vesting in Takeovers: The Impact on Shareholder Wealth*, 42 FIN. MGMT. 101, 111 (2013).

⁴⁴ *Id.* at 106.

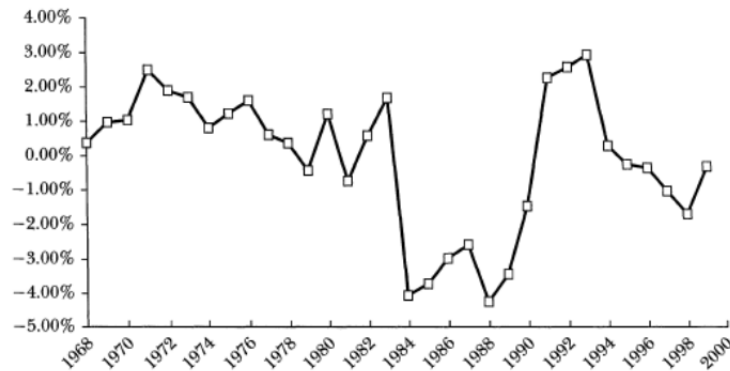
no empirical basis for assuming any general divergence between the CEO's incentives and shareholder value.

2. The "Free Cash Flow Problem"

Since 1980, there has been a dramatic reduction in retained earnings and an increase in corporate debt. From 1984 to 1990, approximately 3% of net public equity was retired each year, totaling around \$532 billion for the six years.⁴⁵ Figure 1, Bengt Holmstrom and Steven Kaplan's chart showing net equity issuances, is revealing:

Figure 1⁴⁶

Net Equity Issuance of U.S. Non-financial Corporate Business
(as percent of average total stock market value, 1968-1999)



Source: Flow of Funds Accounts of the U.S., author's calculation.

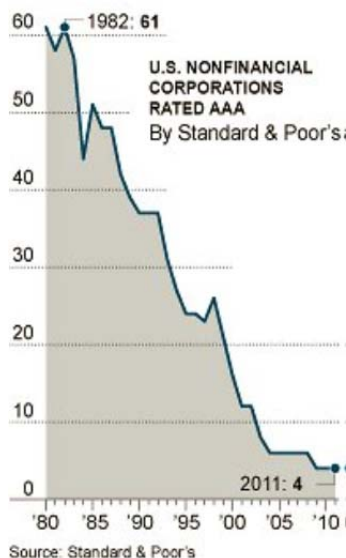
This widespread reduction of equity continued into the 2000s, peaking in 2007.⁴⁷ One effect of this massive increase in leverage is reflected in Figure 2, showing that between 1982 and 2009, the number of AAA-rated nonfinancial corporations had dwindled from sixty-one to four.⁴⁸

⁴⁵ Holmstrom & Kaplan, *supra* note 12, at 124-25.

⁴⁶ *Id.* at 125 fig.3.

⁴⁷ Bratton & Wachter, *supra* note 7, at 685-87.

⁴⁸ See also Richard John Herring, *How Financial Oversight Failed and What it May Portend for the Future of Regulation*, 38 ATLANTIC ECON. J. 265, 266-67 (2010) (noting the decline in AAA-rated nonfinancial firms).

Figure 2⁴⁹

The sole remaining survivors are ExxonMobil, Microsoft, Johnson & Johnson, and Automatic Data Processing.⁵⁰

This decline in AAA corporate bonds does not reflect a general choice by firms not to issue debt. Although a few well-known and very successful firms with large retained earnings would have AAA-rated debt if they issued any (e.g., Apple), overall corporate debt is at a very high level. According to the Federal Reserve Flow of Funds, corporate debt has grown in all but two years since 1978.⁵¹ In absolute amounts, annual corporate borrowing has dramatically increased since the late 1970s.⁵² The result is that the corporate sector's outstanding debt has increased roughly ten times, from \$757 billion in 1978 to \$7300 billion in 2010.⁵³

⁴⁹ This chart is taken from Eric Dash, *AAA Rating Is a Rarity in Business*, N.Y. TIMES, Aug. 2, 2011, http://www.nytimes.com/2011/08/03/business/aaa-rating-is-a-rarity-in-business.html?_r=1&emc=eta1#.

⁵⁰ Ben Steverman, *Pfizer Loses its Triple-A Credit Rating*, BUSINESSWEEK (Oct. 16, 2009), http://www.businessweek.com/investing/insights/blog/archives/2009/10/pfizer_loses_its_triple-a_credit_rating.html.

⁵¹ BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS THIRD QUARTER 2011, at 7 tbl.D.1 (2011).

⁵² *Id.* at 8 tbl.D.2.

⁵³ *Id.* at 9 tbl.D.3.

Put differently, the “free cash flow problem” that figured so prominently in the classic account as evidence of high managerial agency costs has largely disappeared.

3. The Decline of Managerial Empire-Building

The fashion of diversifying into unrelated lines of business that was popular from the 1950s through the 1970s came to an abrupt end in the 1980s. With a change in antitrust policy, mergers between firms in the same industry (horizontal mergers) and between customers and suppliers (vertical mergers) were no longer considered per se suspect.

The 1980s saw an explosion of deconglomeration. Many conglomerates built during the 1950s and 1960s were acquired and broken up, with individual divisions typically sold to firms in the same industry.⁵⁴

Alongside these market developments, management theories changed. A return to specialization ensued, with “focus” as the key watchword. Some conglomerates were broken up by hostile or friendly takeovers, others by selling or spinning off divisions. The empirical evidence has been clear that spinning off unrelated businesses leads to a significant improvement in operating performance.⁵⁵ As one important study stated, “[T]he operating performance improvement is . . . consistent with the hypothesis that spinoffs create value by removing unrelated businesses and allowing managers to focus attention on the core operations they are best suited to manage.”⁵⁶

Since the 1990s, spinoffs have been a popular way to increase focus. Sears spun off Allstate in 1995,⁵⁷ AT&T spun off Lucent in 1996.⁵⁸ CBS carved out its radio operations in Infinity Broadcasting in 1998.⁵⁹ DuPont sold off Conoco in 1999 (and it subsequently merged with Phillips to

⁵⁴ See generally Holmstrom & Kaplan, *supra* note 12.

⁵⁵ See, e.g., Lane Daley, Vikas Mehrotra & Ranjini Sivakumar, *Corporate Focus and Value Creation: Evidence from Spinoffs*, 45 J. FIN. ECON. 257, 266 (1997); Hemang Desai & Prem C. Jain, *Firm Performance and Focus: Long-Run Stock Market Performance Following Spinoffs*, 54 J. FIN. ECON. 75, 90 (1999); James A. Miles & James D. Rosenfeld, *The Effect of Voluntary Spin-Off Announcements on Shareholder Wealth*, 38 J. FIN. 1597, 1605 (1983); Katherine Schipper & Abbie Smith, *Effects of Recontracting on Shareholder Wealth: The Case of Voluntary Spin-Offs*, 12 J. FIN. ECON. 437, 447 (1983).

⁵⁶ Daley, Mehrotra & Sivakumar, *supra* note 55, at 280.

⁵⁷ *Sears, Roebuck & Co. Spins Off Its Stake in Allstate Division*, WALL ST. J., July 3, 1995, at B2. Sears started Allstate in 1931 and, until it was spun off, the insurer had always been part of Sears. See *id.* Now, of course, Allstate is viewed as a completely separate company.

⁵⁸ *AT&T Sets Distribution of Rest of Lucent Shares*, WALL ST. J., Sept. 19, 1996, at B2.

⁵⁹ *Infinity Broadcasting Initial Public Offering Is Priced at \$20.50*, WALL ST. J., Dec. 10, 1998, at B23.

become the sixth-largest publicly traded oil company).⁶⁰ And there are many more examples.

4. Dispersed Ownership, Passive Shareholders, and Captured Directors

As Marcel Kahan and I have catalogued in detail elsewhere,⁶¹ the old story of dispersed ownership, passive shareholders, and directors under the thumb of an imperial CEO is no longer accurate.

Share-ownership concentration has continued its nearly inexorable rise, leading some informed observers, like Brian Cartwright, then Securities and Exchange Commission (SEC) General Counsel, to identify the “deretailization” of the stock market as one of the most important developments affecting the SEC’s role.⁶² The composition of institutional holdings has changed: assets have shifted from corporate defined-benefit pension funds (historically very passive) to mutual funds (which are much more willing to support shareholder activism).⁶³ Activist hedge funds have emerged as new players with high-powered incentives and receive support from more traditional institutions, in terms of both funds to invest and votes cast during confrontations with portfolio companies.⁶⁴ Finally, proxy advisory firms—Institutional Shareholder Services (ISS) and Glass Lewis—have emerged as information intermediaries and catalysts to shareholder action.⁶⁵

These pressures, combined with regulatory changes, have transformed the governance structure of large publicly held firms. Staggered boards—generally viewed as the most powerful antitakeover device—are in decline. Between 2003 and 2009 in the S&P 100, the number of companies with staggered boards declined from forty-four to fifteen.⁶⁶ That decline has spread to smaller companies as well.⁶⁷ Majority voting for directors has swept the field with boards caving in to shareholder demands.⁶⁸ “Say on

⁶⁰ *DuPont Completes Split Off of Conoco*, WALL ST. J., Aug. 13, 1999, at C19; *Phillips, Conoco Set Merger*, CNNMONEY (Nov. 19, 2001, 11:40 AM), http://money.cnn.com/2001/11/19/deals/Phillips_conoco.

⁶¹ See generally Kahan & Rock, *Embattled CEOs*, *supra* note 33.

⁶² Brian G. Cartwright, Gen. Counsel, SEC, Address at the University of Pennsylvania Law School Institute for Law and Economics: The Future of Securities Regulation (Oct. 24, 2007) (transcript available at <http://sec.gov/news/speech/2007/spch102407bgc.htm>).

⁶³ Kahan & Rock, *Embattled CEOs*, *supra* note 33, at 997-98, 1001-05.

⁶⁴ See generally Kahan & Rock, *Hedge Funds in Corporate Governance*, *supra* note 33.

⁶⁵ Kahan & Rock, *Embattled CEOs*, *supra* note 33, at 1005-07.

⁶⁶ *Id.* at 1008 tbl.2.

⁶⁷ *Id.* at 1009.

⁶⁸ *Id.* at 1010-11.

Pay” is now mandatory.⁶⁹ Through changes in listing requirements and much greater attention to the board’s monitoring functions, boards have become much more independent of CEOs than they were in the past. For example, it is no longer uncommon for outside directors to meet without the CEO present.⁷⁰

Increased CEO turnover is perhaps the most dramatic indication of change. Booz Allen estimates that between 1995 and 2006, annual CEO turnover has increased by 59% and performance-related turnover by 318%.⁷¹

The cumulative effects of these changes can be seen in how directors’ self-understanding of their roles has evolved (what one might call “director ideology”). Companies, shareholders, business schools, corporate law professors, and judges all seem to believe that the primary responsibility of directors is to maximize shareholder value. Whether in favor or opposed, the prevalence of this principle is widely recognized. Thus, a critical 2010 *Businessweek* article opened with the telling phrase, “If business school were a church, shareholder value maximization would be its religion.”⁷²

5. Managerial Entrenchment and the Undermining of Hostile Tender Offers

In the classic account, as described above, hostile tender offers could constrain managerial agency costs if only the law would let them. In practice, a workaround has been achieved through compensation contracts and greater board independence, rendering the legal barriers largely pointless.⁷³ In effect, a Coasean bargain was struck between shareholders and managers in which managers’ legal “entrenchment entitlement” was bought out.

⁶⁹ *Id.* at 1034-36.

⁷⁰ As required by the Sarbanes–Oxley Act, stock exchanges mandate at least one such meeting per year. See NASDAQ OMX, STOCK MARKET RULE 5605(b)(2) (2009); NYSE LISTED COMPANY MANUAL § 303A.03 (2009).

⁷¹ Chuck Lucier, Steven Wheeler & Rolf Habbel, *The Era of the Inclusive Leader*, STRATEGY + BUSINESS, Summer 2007, at 3; see also Steven N. Kaplan & Bernadette A. Minton, *How Has CEO Turnover Changed?*, 12 INT’L REV. FIN. 57, 83 (2012) (finding that CEO turnover at Fortune 500 companies since 1998 implies an average tenure of less than six years, which is substantially lower than in previous periods, especially compared to the average decade-long tenures of thirty years ago).

⁷² N. Craig Smith & Luk Van Wassenhove, *How Business Schools Lost Their Way*, BUSINESSWEEK (Jan. 11, 2010), <http://www.businessweek.com/stories/2010-01-11/how-business-schools-lost-their-waybusinessweek-business-news-stock-market-and-financial-advice>.

⁷³ See Kahan & Rock, *How I Learned to Stop Worrying*, *supra* note 33, at 902 (showing how contracts and institutional structures reduced the entrenchment effect of poison pills); Mark J. Roe, *Can Culture Constrain the Economic Model of Corporate Law?*, 69 U. CHI. L. REV. 1251, 1254-56 (2002) (noting that institutions may effectively “buy[] managers off from opposing takeovers”).

The mean CEO of an S&P 500 corporation now receives approximately \$5 million in annual salary and bonuses and holds approximately \$40 million in stock or its equivalent.⁷⁴ The CEO's change-in-control package typically includes 2.99 times salary and bonuses, plus acceleration of unvested stock options.⁷⁵ Finally, average CEO tenure is approximately six years.⁷⁶ So imagine that an average CEO in his fourth year receives an offer to buy the company for even a small premium above current market price, say twenty percent. What are the CEO's financial incentives with regard to the offer? If the company is sold, the CEO will receive \$15 million in change-in-control payments and an \$8 million increase in the value of his shares, for a total of \$23 million. If the company is not sold, the CEO will receive an additional two years of salary and bonus for approximately \$10 million. The choice is stark: \$23 million now, and a chance to do something else, versus working hard for the next two years for \$10 million.⁷⁷

If incentives are effective, then this set of incentives will result in underperforming management stepping aside voluntarily in response to even a small premium offer to buy the company. Put differently, incentive compensation contracts can substitute for hostile tender offers as a means of replacing bad managers with good ones. Despite Delaware's board-centric takeover jurisprudence from the 1980s that approved poison pills and deferred to board judgment, mergers and acquisitions have remained at very high levels.⁷⁸

The power of incentives can be seen in the practical irrelevance of even the most potent current antitakeover provision—namely, the charter-based staggered board combined with a poison pill, a combination that can allow a company to remain independent for a year and a half against a determined bidder.

First, the staggered board has become an endangered species because firms have given in to shareholder pressure with little resistance.⁷⁹ Second, even where they exist, staggered boards seem to have only minimal effects on changes in control. Lucian Bebchuk, John Coates, and Guhan Subramanian

⁷⁴ Core & Guay, *supra* note 39, at 36 tbl.3.

⁷⁵ Elkinawy & Offenberg, *supra* note 43, at 112 tbl.III.

⁷⁶ Kaplan & Minton, *supra* note 71, at 81.

⁷⁷ Dirk Jenter and Katharina Lewellen find that the likelihood of a bid rises by 50% as the CEO approaches the age of sixty-five. Dirk Jenter & Katharina Lewellen, *CEO Preferences and Acquisitions* 10 (CESifo Working Paper No. 3681, 2011), available at <http://ssrn.com/abstract=1975751>.

⁷⁸ See Kahan & Rock, *How I Learned to Stop Worrying*, *supra* note 33, at 897 (suggesting that the tactics described above made an end run around Delaware's takeover standard).

⁷⁹ See *supra* note 66 and accompanying text.

argue for judicial intervention to undermine the charter-based staggered board combined with a poison pill, based on a study of the effect of these boards on hostile bids during the period from 1996 to 2000.⁸⁰ They identify ninety-two hostile bids during this period, finding that of the forty-five bids involving companies with staggered boards, twenty-seven remained independent.⁸¹ By contrast, of the forty-seven hostile bids involving companies without staggered boards, only sixteen remained independent.⁸² In other words, in eleven companies, the staggered board arguably resulted in the company remaining independent when it might otherwise have been acquired.

To put this in context, there were approximately 3000 acquisitions between 1996 and 2000, about half of which involved companies with staggered boards.⁸³ During this period, there were only ninety-two hostile bids, only forty-five hostile bids against companies with staggered boards, and, of those, at most eleven in which a staggered board plus poison pill prevented sale. Academics' stubborn focus on the "problem" of managerial resistance to hostile takeovers is remarkable, considering the irrelevance of takeover defenses in a world in which managers are incentivized to think like shareholders.

6. Evidence on the Magnitude of Agency Costs

As noted above, some have viewed the magnitude of premiums in going-private transactions as evidence of managerial agency costs. It is now clear that there are a variety of explanations for premiums in going-private transactions, and the empirical evidence on whether these transactions in fact involve firms with excess free cash flow is mixed.⁸⁴ Private equity's high-powered incentives, combined with high-powered monitoring, can generate wealth unrelated to agency costs by facilitating restructuring decisions that are more difficult in public companies.

⁸⁰ See Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 925, 944-45 (2002).

⁸¹ *Id.* at 930, 932.

⁸² *Id.* at 930.

⁸³ Kahan & Rock, *Corporate Constitutionalism*, *supra* note 33, at 505.

⁸⁴ For a review of the evidence, see Charlie Weir, David Laing & Mike Wright, *Incentive Effects, Monitoring Mechanisms and the Market for Corporate Control at Going Private Transactions in the UK 7-8* (Feb. 28, 2003) (unpublished manuscript), available at <http://ssrn.com/abstract=379101>.

7. What Remains of the Classic Shareholder–Manager Agency Cost Problem?

If the core shareholder–manager agency cost problem now seems largely under control (even if there will always be outliers), what aspects remain? From a theoretical perspective, one can identify several remaining divergences, although the actual magnitude of these problems is unclear. First, incentives can be too effective even from a shareholder perspective: a CEO may have an incentive to sell the company even if it would be in the best interests of the shareholders to refuse all current offers.

Second, even if managers' incentives are aligned with shareholders, managers will still want to maximize their compensation. Management compensation can be too high even if its structure is appropriate. Third, if managers are overinvested in their own firms, they may manage more conservatively than diversified shareholders would wish.⁸⁵ Fourth, small and very small public corporations may still have high shareholder–manager agency costs because many of the levers of corporate governance that squeeze out agency costs in larger public corporations are missing.⁸⁶ Finally, end games raise issues that can be difficult to control. Even managers with an optimal compensation contract may still have an incentive to feather their nests when the company is being sold.

As interesting as these issues are, they are better characterized as “mopping up operations” than the grand battles against entrenchment and agency costs of the 1980s. The evidence summarized above, it seems to me, at least shifts the burden to the anti–agency cost crusaders to show that managerial agency costs remain significant.

II. SHAREHOLDER–CREDITOR AGENCY COSTS

Suppose I am right that the shareholder–manager agency cost problem has been brought under control through a combination of incentive compensation, board reforms, changes in the concentration of shareholdings,

⁸⁵ See Amihud & Lev, *supra* note 25, at 615 (presenting a study finding that manager-controlled firms pursue risk reduction through conglomerate mergers to a greater extent than shareholders may desire); Peter Tufano, *Who Manages Risk? An Empirical Examination of Risk Management Practices in the Gold Mining Industry*, 51 J. FIN. 1097, 1111-12 (1996) (arguing that conservative financial policies may be one way firms deal with risk). Risk-averse management can be combated by using option compensation to “add convexity” to compensation contracts. Core, Guay & Larcker, *supra* note 37, at 33. In other words, the large upside value of stock options can incentivize CEOs to adopt optimal strategies that their overinvestment in the firm may cause them to otherwise resist.

⁸⁶ Marcel Kahan & Edward B. Rock, *The Governance of Small Public Corporations* (manuscript in progress) (on file with author).

and changes in the willingness of shareholders to oppose management. What then? Is it the end of history for corporate law?⁸⁷ Should corporate law focus on additional tweaks to the system to try to wring out the remaining shareholder–manager agency costs, on the implicit assumption that any level of managerial agency costs is too high?

In our preoccupation with the classic “separation of ownership and control” or, more recently, the “shareholder–manager agency cost problem,” we seem to have forgotten what other corporate law systems have not: that there are *three* corporate law agency cost problems, not one.⁸⁸

Before turning to adaptive strategies, it is worth recalling the elements of the shareholder–creditor agency cost problem. At its core, the problem is that shareholders, holding the residual claim on the firm, have an incentive to externalize risk onto creditors and other fixed claimants. Risk can be shifted to creditors in at least four different ways.⁸⁹ First, firms can dilute their asset bases (“asset dilution”) by siphoning off corporate assets to shareholders. Second, firms can substitute more risky assets for less risky assets (“asset substitution”), increasing the riskiness of the firm, which benefits shareholders at the expense of creditors. Third, the firm can dilute creditors’ claims (“debt dilution”) by adding unanticipated new debt that is of equal or superior seniority to existing debt claims. Finally, the firm may refrain from issuing new equity, even when it has positive net present value projects, because of the priority of existing debtholders (“debt overhang” or “underinvestment”).⁹⁰

So long as managers are in control and think like fixed claimants, retaining free cash flow, creditors will be relatively secure. That is what a AAA credit rating means: “Obligations rated Aaa are judged to be of the highest quality, subject to the lowest level of credit risk.”⁹¹

⁸⁷ See generally Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

⁸⁸ See *supra* note 1 and accompanying text.

⁸⁹ For the following discussion, see KRAAKMAN ET AL., *supra* note 1, at 116–21 (discussing asset dilution, asset substitution, and debt dilution); Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118–19 (1979) (analyzing the areas of conflict between bondholders and stockholders).

⁹⁰ See generally Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977). See also Anat R. Admati, et al., *Debt Overhang and Capital Regulation* 31–32 (Stanford Univ., Rock Ctr. for Corporate Governance, Working Paper Series No. 114, 2012), available at <http://ssrn.com/abstract=2031204>.

⁹¹ MOODY’S INVESTORS SERVICE, RATING SYMBOLS AND DEFINITIONS 5 (2013), available at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

When shareholders are in control—either through a controlling shareholder or well-organized blockholders, or through equity-incentivized managers—there is less reason to worry about shareholder–manager agency costs. But the downside of shareholder control is that the incentive to externalize risk onto creditors comes to the fore. That is why corporate law, especially in systems that empower shareholders or in which controlling shareholders are common, has traditionally been concerned with creditor protection.

The interrelationship between the shareholder–manager and shareholder–creditor agency cost problems is well established theoretically and empirically in the finance literature. Teresa John and Kose John modeled the relationship between top-management compensation and capital structure.⁹² In 1993, right around the time that high-powered equity incentives became standard features of management compensation and the “shareholder empowerment” movement began to pick up steam, they presciently observed that:

It may be possible to fine tune the compensation structure to align managerial incentives with shareholders interest, minimizing agency costs of equity. However, such a compensation structure would induce risk-shifting incentives in the managers (i.e., when risky debt is outstanding, equity has a convex payoff structure such that shareholders gain by shifting into higher risk projects even when the incremental net present value is negative; see Jensen and Meckling (1976)). A management compensation designed carefully to minimize the agency costs of equity may give rise to high agency costs of debt.⁹³

Empirically, as even an incomplete review of the evidence shows, it is now clear that increasing the alignment of managers and shareholders can have a significant effect on bondholders. Higher CEO equity incentives are associated with higher bond yields.⁹⁴ The announcement of new option grants negatively impacts bond prices.⁹⁵ Bond return premiums and managerial ownership are correlated.⁹⁶ There is a positive relationship between

⁹² See generally Teresa A. John & Kose John, *Top-Management Compensation and Capital Structure*, 48 J. FIN. 949 (1993).

⁹³ *Id.* at 951.

⁹⁴ Chenyang Wei, *Covenant Protection, Credit Spread Dynamics and Managerial Incentives* 20 (Nov. 29, 2005) (unpublished manuscript), available at http://pages.stern.nyu.edu/~cwei/JobMarket_CovenantsSpreadCEOIncentive_ChenyangWei.pdf.

⁹⁵ Richard A. DeFusco, Robert R. Johnson & Thomas S. Zorn, *The Effect of Executive Stock Option Plans on Stockholders and Bondholders*, 45 J. FIN. 617, 622-25 (1990).

⁹⁶ Elizabeth Strock Bagnani et al., *Managers, Owners, and the Pricing of Risky Debt: An Empirical Analysis*, 49 J. FIN. 453, 461-64 (1994).

credit spreads and the Delta (the sensitivity of CEO wealth to stock price) and Vega (the sensitivity of CEO wealth to stock volatility) of a CEO's total portfolio of stock and options.⁹⁷

Better alignment brought about by the presence of powerful shareholders has similar effects. Shareholder control (as proxied by the presence of greater-than-five-percent blockholders) can substantially increase bondholder risk (reflected in bond yields and credit ratings), especially when a firm is exposed to takeovers.⁹⁸ The G index of shareholder rights developed by Paul Gompers, Joy Ishii, and Andrew Metrick⁹⁹ is associated with higher cost of bank debt¹⁰⁰ and higher bond yields.¹⁰¹ Even nonbinding shareholder proposals pushing for better pay-for-performance sensitivity are correlated with *negative* abnormal returns for bondholders, and the more leveraged the target company, the more negative the returns.¹⁰²

Which creditors does or should corporate law worry about? After all, creditors come in various forms, including senior secured creditors, bondholders, trade creditors, tort victims, and taxing authorities. In the first instance, just as the law ignores the heterogeneity of actual shareholders in analyzing shareholder-manager agency costs, so too it elides the differences among actual creditors because agency costs of any sort are costs, separate from who bears them. Second, the law often considers creditors as a group because they are a useful proxy for the wider nonshareholder social interests in firm success. Third, the extent to which creditors can protect themselves (and in so doing protect or not protect other creditors) is a complex question

⁹⁷ Naveen D. Daniel, J. Spencer Martin & Lalitha Naveen, *The Hidden Cost of Managerial Incentives: Evidence from the Bond and Stock Markets* 13-16 (Sept. 2004) (unpublished manuscript), available at <http://ssrn.com/abstract=612921>; Wei, *supra* note 94, at 8-10.

⁹⁸ See K.J. Martijn Cremers, Vinay B. Nair & Chenyang Wei, *The Impact of Shareholder Governance on Bondholders* 6-10 (June 2005) (unpublished manuscript), available at <http://pages.stern.nyu.edu/~cwei/The%20Impact%20of%20Shareholder%20Governance%20on%20Bondholders.pdf> (basing this finding on a sample from 1990 to 1997).

⁹⁹ See Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. Econ. 107, 114-19 (2003) (describing the construction of the "Governance Index").

¹⁰⁰ Sudheer Chava, Dmitry Livdan & Amiyatosh Purnanandam, *Do Shareholder Rights Affect the Cost of Bank Loans?* 26 (Maastricht Univ., EFA 2004, Paper No. 5061, 2008), available at <http://ssrn.com/abstract=495853>.

¹⁰¹ Mark S. Klock, Sattar A. Mansi & William F. Maxwell, *Does Corporate Governance Matter to Bondholders?*, 40 J. FIN. & QUANT. ANALYSIS 693, 708-09 & tbl.3 (2005).

¹⁰² Steve Fortin et al., *Are Bondholders Happy with Shareholder Proposals? An Empirical Examination of Pay-Performance Activism* 29-32, 35-37 (Dec. 19, 2011) (unpublished manuscript), available at <http://ssrn.com/abstract=1975973>. The authors also provide some evidence that targeted firms engage in more risk-taking behavior after such proposals, with an increase in volatility that explains the negative bond reaction. *Id.* at 32.

that depends on assumptions about the efficiency of contracting and of markets, and thus enters at a later stage of the analysis.

III. ADAPTIVE STRATEGIES FOR CONTROLLING SHAREHOLDER–CREDITOR AGENCY COSTS

As Marcel Kahan and I have argued elsewhere, a variety of strategies are employed to control agency problems in corporations, including contracts, compensation, governance structures, and legal rules.¹⁰³ All of these strategies are used to control shareholder–creditor agency costs.¹⁰⁴ Before examining the role of litigation in controlling residual agency costs, it is important to consider the various “adaptive mechanisms” by which shareholder–creditor agency costs are and can be controlled.

A. *The Contracting Strategy*

The first line of defense will predictably be contracts, as the conflict between shareholder and bondholder interests is well known to investors, even if not always appreciated by corporate law scholars. Moreover, as described above, there is compelling evidence that greater alignment of manager and shareholder interests exacerbates the shareholder–bondholder conflict. These conflicts are addressed in two ways: covenants in debt contracts and pricing.

As described in Clifford Smith and Jerold Warner’s classic analysis, covenants can be divided into a number of categories: restrictions on the firm’s production/investment policy (including restrictions on disposition of assets); restrictions on distributions (including restrictions on the payment of dividends, share purchases, and other forms of distribution); restrictions on subsequent financing (including limitations on issuing higher-priority debt and guarantees); modification of payoffs (including sinking funds, conversion rights, and callability); and bonding activities (including required reports, specification of accounting standards, and officer certificates of compliance).¹⁰⁵ Michael Bradley and Michael Roberts divide covenants up into somewhat different baskets: prepayment (covenants that mandate early retirement of the loan, conditional on some event such as a

¹⁰³ Kahan & Rock, *How I Learned to Stop Worrying*, *supra* note 33, at 881-87; see also KRAAK-MAN ET AL., *supra* note 1, at 39 tbl.2-1 (dividing strategies to protect principals into “ex ante” and “ex post,” and “regulatory” versus “governance,” yielding a total of ten different strategies).

¹⁰⁴ For a very good, short survey, see Charles K. Whitehead, *Creditors and Debt Governance*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 68 (Claire A. Hill & Brett H. McDonnell eds., 2012).

¹⁰⁵ See generally Smith & Warner, *supra* note 89.

security issuance or asset sale); financial (limits placed on the level of different accounting variables); dividend (covenants that restrict distributions to shareholders unless certain conditions are met); and secured debt (limiting issuance unless issued *pari passu* with existing secured debt, also called “negative pledge” covenants).¹⁰⁶ As Smith and Warner argued, and others have argued since, many of these covenants can be understood as addressing various aspects of the shareholder–bondholder conflict.

Covenants appear in both private and public debt contracts in differing degrees, due to the very different contracting environments.¹⁰⁷ Private debt has relatively low costs of negotiation and, most importantly, renegotiation, because the number of parties is very small (often just borrower and lender). By contrast, public debt has very high costs of renegotiation. A straightforward transaction-cost analysis would correctly predict more intense contractual restrictions in private debt than in public debt.

The importance of covenants in private debt is further accentuated by the relative proportions of public and private debt, with the overwhelming amount of debt financing coming from private and intermediated bank lending. According to Joel Houston and Christopher James, the mean percentage of public debt in their sample is 17% of total debt, with most firms relying on intermediated (including bank) debt exclusively.¹⁰⁸ Bradley and Roberts confirm this in a much larger and more comprehensive sample, finding that between 1993 and 2001, private debt issuance was more than twice the amount of public debt, with most private debt consisting of 364-day facilities, revolving loans, and term loans.¹⁰⁹

Consistent with the transaction cost view, private debt contains far more covenants than public debt. Bradley and Roberts find that, for each category of covenant, more than 70% of the private debt contracts they sampled

¹⁰⁶ Michael Bradley & Michael R. Roberts, *The Structure and Pricing of Corporate Debt Covenants* 11-12 (May 13, 2004) (unpublished manuscript), available at <http://ssrn.com/abstract=466240>. See generally Avner Kalay, *Stockholder–Bondholder Conflict and Dividend Constraints*, 10 J. FIN. ECON. 211 (1982) (examining dividend covenants to support the theory that bond covenants are structured to control the shareholder–bondholder conflict).

¹⁰⁷ For a full discussion of the institutional differences between private and public debt, see Yakov Amihud, Kenneth Garbade & Marcel Kahan, *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 452-69 (1999). On the importance of private debt and the power wielded by its holders, see Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1227-28 (2006).

¹⁰⁸ Joel Houston & Christopher James, *Bank Information Monopolies and the Mix of Private and Public Debt Claims*, 51 J. FIN. 1863, 1871-73 & tbl.I (1996).

¹⁰⁹ Bradley & Roberts, *supra* note 106, at 8-9.

contain such a covenant.¹¹⁰ In public debt, by contrast, the incidence is never above 44%, and usually less than 25%.¹¹¹ Moreover, between 1993 and 2001, the frequency of covenants addressing additional debt, equity, and asset sales has increased dramatically: from 18% to 81% (additional debt), 32% to 94% (additional equity), and 25% to 75% (asset sales).¹¹² By contrast, during the same period the frequency of covenants in public debt declined.¹¹³

Not only are covenants very common, they also appear when expected. Ileen Malitz finds that the poorer a firm's financial condition, the more likely its debt will include covenants: large firms are less likely to have covenants than small (and higher risk) firms and the greater a firm's existing leverage, the more likely it is to have covenants in new debt.¹¹⁴ Similarly, firms that face higher shareholder-bondholder conflicts are more likely to include restrictive covenants in their debt.¹¹⁵ Robert Nash, Jeffrey Netter, and Annette Poulsen find that high-growth firms are less likely to give up flexibility in financing (payment of dividends and issuance of debt) than lower-growth firms.¹¹⁶ Marcel Kahan and David Yermack show that firms with more investment opportunities are less likely to include restrictive covenants and prefer to control agency problems through the issuance of convertible debt.¹¹⁷

The empirical evidence shows that creditor protection is priced in two senses: (1) creditor protection is associated with lower promised yields at issue; and (2) there is a significant negative relation between credit spreads and the degree of covenant protection, controlling for issuer and bond issue characteristics.¹¹⁸

At issuance, many studies find a negative relationship between the ex ante pricing of debt and the presence of covenants.¹¹⁹ Indeed, pricing can be

¹¹⁰ *Id.* at 13.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ Ileen Malitz, *On Financial Contracting: The Determinants of Bond Covenants*, FIN. MGMT., Summer 1986, at 18, 22-23.

¹¹⁵ See Joy Begley & Gerald A. Feltham, *An Empirical Examination of the Relation Between Debt Contracts and Management Incentives*, 27 J. ACCT. & ECON. 229, 243-44 (1999) (attributing restrictive covenants to the greater uncertainty faced by these firms).

¹¹⁶ Robert C. Nash, Jeffrey M. Netter & Annette B. Poulsen, *Determinants of Contractual Relations Between Shareholders and Bondholders: Investment Opportunities and Restrictive Covenants*, 9 J. CORP. FIN. 201, 229-30 (2003).

¹¹⁷ Marcel Kahan & David Yermack, *Investment Opportunities and the Design of Debt Securities*, 14 J.L. ECON. & ORG. 136, 149-51 (1998).

¹¹⁸ Wei, *supra* note 94, at 13-18.

¹¹⁹ See, e.g., Vidhan K. Goyal, *Market Discipline of Bank Risk: Evidence From Subordinated Debt Contracts*, 14 J. FIN. INTERMEDIATION 318, 334 (2005); Natalia Reisel, *On the Value of Restrictive*

quite sensitive to differences among firms and issues of bonds. Chenyang Wei finds that, while “higher CEO risk-taking incentive is associated with *higher* credit spreads for bonds with *low protection*[,] . . . higher CEO risk-taking incentive is associated with *lower credit spreads* for bonds with *high protection*.”¹²⁰ In other words, investors seem willing to pay for covenants that control CEO risk-taking. Post issuance, Wei provides evidence that covenants also affect credit spreads. For example, in the face of industry-wide or economy-wide shocks, bonds with strong covenant protection suffered substantially less than those with weak protection.¹²¹

The conflict between shareholders and bondholders is particularly prominent in LBOs. Thus, Arthur Warga and Ivo Welch show that, between 1985 and 1989, bondholder losses after LBO announcements ranged on average between 6% and 7%.¹²² Lindsay Baran and Tao-Hsien Dolly King, in a study of a sample of 182 buyouts from 1981 to 2006, find that bondholders suffer substantial losses and that their losses are larger the bigger and more prominent the private equity player (proxied by market share).¹²³ Interestingly, bondholders fare worse in club deals than in acquisitions by a single private equity firm,¹²⁴ perhaps because a group of private equity firms does not monitor a portfolio firm’s performance as effectively as does a single firm, or because they overpay, or both. The scope of their study allows Baran and King to show that the wealth-transfer effect was of significant magnitude through two separate buyout waves (the 1980s and the 2000s).¹²⁵

Creditors’ most powerful protection against loss from LBOs is a “Change in Control” (CIC) covenant that gives holders the right to sell the bond back to the issuer at a small premium to par upon a change in control. The use of CIC covenants has varied over time, usually in response to bondholder losses. Thus, Kenneth Lehn and Annette Poulsen show that event-risk covenants increased from 3% of newly issued bonds in 1986 to 32% in 1989.¹²⁶ Matthew Billett, Zhan Jiang, and Erik Lie find that, in the

Covenants: An Empirical Investigation of Public Bond Issues 5-7 (Dec. 2004) (unpublished manuscript), available at <http://ssrn.com/abstract=644522>.

¹²⁰ Wei, *supra* note 94, at 4 (emphasis added).

¹²¹ *Id.* at 18-20.

¹²² Arthur Warga & Ivo Welch, *Bondholder Losses in Leveraged Buyouts*, 6 REV. FIN. STUD. 959, 979 (1993).

¹²³ Lindsay C. Baran & Tao-Hsien Dolly King, *Going Private Transactions, Bondholder Returns, and Wealth Transfer Effects*, 34 J. BANKING & FIN. 1856, 1861 (2010).

¹²⁴ *Id.* at 1864.

¹²⁵ *Id.* at 1870-72.

¹²⁶ Kenneth Lehn & Annette Poulsen, *Contractual Resolution of Bondholder-Stockholder Conflicts in Leveraged Buyouts*, 34 J.L. & ECON. 645, 662 tbl.1 (1991).

1980s, only 13% of bond issues had CIC covenants, rising to 31% in the 1990s and 41% in the 2000s.¹²⁷ Because issuers often have multiple series of bonds, the percentage of issuers with CIC covenants in *any* bond can also be relevant, at least when the covenant is in a significant percentage of the outstanding bond principal. Billett, Jiang, and Lie also find that, between 1985 and 1987, fewer than 3% of bonds had CIC covenants.¹²⁸ By contrast, during 1989–2006, 13–33% had such covenants.¹²⁹ Focusing on the 2000s LBO wave, the authors find that 41% had CIC covenants, compared to 57% of a control sample of non-LBO firms.¹³⁰ Wei finds similar variance in the incidence of CIC provisions in public bonds: 0% for 1980–1984, 20.3% for 1985–1989, 25.9% for 1990–1994, 46.8% for 1995–1999, and 42.4% for 2000–2003.¹³¹ Moreover, riskier debt is more likely to have CIC protections, which is consistent with an expectation that riskier debt is more likely to be expropriated in takeovers.¹³²

There is substantial evidence that CIC covenants are effective in protecting bondholders from loss, at least in some market conditions. Baran and King find that holders of bonds with a CIC covenant trading at a discount enjoy significant gains in buyouts.¹³³ Billett, Jiang, and Lie, using bond-pricing data from the 2000s, find *losses* to bondholders without CIC covenants but *gains* to bonds *with* such covenants.¹³⁴ The differences are significant: bonds without CIC covenants lose, on average, 6.8%, while those with CIC protection gain 2.3%—a swing of around 9%.¹³⁵

Given the richness of the contractual resources for constraining shareholder opportunism, is contracting alone sufficient? Mark Roe and Federico Vezze concisely summarize the limits of a pure contractarian approach to debtor–creditor relationships: contracts are incomplete (and necessarily so, because of the impossibility of fully specifying state-contingent contracts) and must be interpreted; courts will be called upon to determine the extent to which a party is behaving opportunistically and going beyond what contract terms permit; and contracts between the debtor and a creditor or class of creditors will not adequately protect other parties whose information and

¹²⁷ Matthew T. Billett, Zhan Jiang & Erik Lie, *The Effect of Change-in-Control Covenants on Takeovers: Evidence from Leveraged Buyouts*, 16 J. CORP. FIN. 1, 6 tbl.2 (2010).

¹²⁸ *Id.* at 6.

¹²⁹ *Id.*

¹³⁰ *Id.* at 4.

¹³¹ Wei, *supra* note 94, at tbl.II.

¹³² Billett, Jiang & Lie, *supra* note 127, at 9.

¹³³ Baran & King, *supra* note 123, at 1861.

¹³⁴ Billett, Jiang & Lie, *supra* note 127, at 11.

¹³⁵ *Id.* If, because of interest-rate shifts, bonds are trading at a premium, a CIC covenant requiring the firm to buy back the bonds would not protect bondholders from loss.

collective action problems limit their ability to self-protect.¹³⁶ Finally, boom and bust credit cycles pose challenges: despite experience with the unfortunate consequences of inadequate protection, we witness the puzzling but recurring phenomenon of “covenant lite” or “no covenant” lending during periods of credit-market exuberance. It is not easy for a contractarian to explain why, when money is cheap, investors are willing to give it away without adequate protection.¹³⁷

B. *The Compensation Strategy*

As described above, the rise of equity-based compensation is a large part of the story of how we controlled the manager–shareholder agency cost problem. However, incentivizing managers to think like shareholders intensifies the shareholder–creditor problem. Compensation structures seem to be part of the problem; fortunately, they can also be part of the solution.

Jensen and Meckling’s original analysis suggested that the shareholder–creditor agency cost problem could be eliminated if executive compensation mirrored the debt–equity capital structure of the firm:

We have been asked why debt held by the manager (i.e., “inside debt”) plays no role in our analysis. We have as yet been unable to incorporate this dimension formally into our analysis in a satisfactory way. The question is a good one and suggests some potentially important extensions of the analysis. For instance, it suggests an inexpensive way for the owner-manager with both equity and debt outstanding to eliminate a large part (perhaps all) of the agency costs of debt. If he binds himself contractually to hold a fraction of the total debt equal to his fractional ownership of the total equity he would have no incentive whatsoever to reallocate wealth from the debt holders to the stockholders.¹³⁸

¹³⁶ Mark J. Roe & Federico Cenzi Venezze, *A Capital Market, Corporate Law Approach to Creditor Conduct* 21-23 (Harvard Law Sch. Pub. Law & Legal Theory Research Paper Series, Working Paper No. 12-34, 2013), available at <http://ssrn.com/abstract=2103217>.

¹³⁷ For an interesting analysis, see Albert Choi & George Triantis, *Market Conditions and Contract Design: Variations in Debt Contracting*, 88 N.Y.U. L. REV. 51 (2013), which suggests that changes in market conditions affect the usage and nature of covenants.

¹³⁸ Jensen & Meckling, *supra* note 14, at 352 (footnote omitted).

Jensen and Meckling's comments on optimal compensation structures, which lay fallow for many years, were recently formalized and explored by Alex Edmans and Qi Liu.¹³⁹

Others have also explored the properties of inside debt. Rangarajan Sundaram and David Yermack find that, when managers hold large inside-debt positions, the firm's likelihood of becoming insolvent is reduced.¹⁴⁰ Chenyang Wei and David Yermack, exploiting the better data now available on executive pensions and deferred compensation, explore investors' reactions to initial disclosures of CEOs' inside debt levels (i.e., pensions and deferred compensation).¹⁴¹ Other work shows that a firm can borrow at a lower cost when its CEO has a large amount of inside debt, compared to inside equity, and that fewer bond covenants are observed when the CEO receives a larger portion of his compensation in pension benefits (a form of debt).¹⁴²

Fred Tung, building on some of this literature, has argued for linking bank executives' compensation more directly to both equity and subordinated debt issued by the bank subsidiary of a bank holding company.¹⁴³ Some of the other proposals for restructuring banker pay, such as requiring that

¹³⁹ See generally Alex Edmans & Qi Liu, *Inside Debt*, 15 REV. FIN. 75 (2011) (advocating for the inclusion of inside debt in executive compensation).

¹⁴⁰ See Rangarajan K. Sundaram & David L. Yermack, *Pay Me Later: Inside Debt and Its Role in Managerial Compensation*, 62 J. FIN. 1551, 1583 (2007) (concluding that CEOs manage more conservatively when their personal debt-to-equity ratios are higher than their firms').

¹⁴¹ See generally Chenyang Wei & David Yermack, *Investor Reactions to CEOs' Inside Debt Incentives* (NYU Stern Sch. of Bus. Research Paper Series, Working Paper No. FIN-09-020, 2011), available at <http://ssrn.com/abstract=1519252> (finding that, upon disclosure, equity prices fall and debt values rise, while volatility falls for both).

¹⁴² Wei and Yermack provide a good summary of the findings:

Several recent working papers . . . generally find that, in many settings, firms face a lower cost of debt when the CEO has a high ratio of inside debt to inside equity compensation Chava, Kumar and Warga (2010) find a lower incidence of bond covenants when CEOs receive more of their compensation in the form of a pension, the largest type of inside debt. Bolton, Mehran and Shapiro (2010) study how inside debt can reduce risk-taking by bank CEOs and find event study evidence similar to ours, with a bank's credit default swap spreads becoming more narrow when it discloses large pension and deferred compensation holdings by its management. A related paper by Tung and Wang (2010) concludes that bank CEOs with large amounts of inside debt compensation exposed their firms to less risk and as a result performed better during the crisis.

Id. at 6-7 (citations omitted).

¹⁴³ See Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. 1205, 1245-47 (2011) (arguing that compensating bankers with subordinated debt would provide clearer signals and incentives).

managers hold shares for several years after leaving the firm,¹⁴⁴ may provide the same sort of alignment.

The virtues of including both debt and equity in managers' compensation contracts extend beyond the regulated financial institution sector. By including both elements, a compensation contract can help control the distortion in incentives created by relying exclusively on one or the other. Debt holdings temper managers' willingness to risk bankruptcy as the value of equity drops towards zero; equity incentivizes managers to increase firm value.

A key design question for mixed equity–debt executive compensation is the degree to which contracts must mirror firms' capital structure in order to control shareholder–creditor opportunism, and what the resulting costs to firms might be.¹⁴⁵ This is important because a firm's capital structure changes over time—in some cases quite dramatically. The existing research suggests that even a crude mix of equity (through stock and option ownership) and debt (through deferred compensation and pension benefits) can have powerful effects on the likelihood of bankruptcy and the cost of credit.¹⁴⁶ There are a wide variety of ways to introduce debt into incentive compensation, including the use of credit default swaps.¹⁴⁷

C. *The Governance Strategy*

In an important article, Doug Baird and Bob Rasmussen focus on the corporate governance structures created by the extensive rights given to senior creditors in complex lending agreements:

The presence of such an institutional lender fundamentally alters corporate governance. The lending agreement contains many affirmative and negative covenants that give the lender de facto control over every aspect of the business. Moreover, the complete control the lender has over the debtor's cash flow gives the lender veto power over every course of action, whether

¹⁴⁴ See, e.g., Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1925–28 (2010); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 249 n.3 (2010); Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term* 6–9 (Yale Program for Studies in Law, Econ. & Pub. Policy, Research Paper Series, Paper No. 374, 2009), available at <http://ssrn.com/abstract=1336978>.

¹⁴⁵ For a very good and accessible summary, see Alex Edmans, *How to Fix Executive Compensation*, WALL ST. J., Feb. 27, 2012, at R1.

¹⁴⁶ *Id.*

¹⁴⁷ See, e.g., Hans Bystrom, *Executive Compensation Based on Asset Values*, 32 ECON. BULL. 1504, 1505 (2012).

internal to the corporation or outside it. Decisions normally reserved for directors and stockholders—such as whether to sell a division, change the business plan, or replace the managers—require the lender's explicit blessing. Trip wires are tied to the performance of the business and its discrete units, and a general provision gives the lender the ability to call the loan in the event of any material adverse change. The purpose of these trip wires is not to force repayment of the loan, but rather to ensure that lenders have control over major decisions and the ability to insist on changes in management when the business encounter reverses.¹⁴⁸

Baird and Rasmussen, taking the conventional view of corporate governance as focused on controlling shareholder–manager agency costs, analyze the various ways in which private lenders are able to constrain *managerial* agency costs when the firm runs aground.

Relax their assumption that the conventional story is right, and consider the implications of the developments summarized earlier. If, as I argue, the shareholder–manager agency cost problem has been substantially replaced by a shareholder–creditor agency cost problem, the subtle and complex features of “debt governance” described by Baird and Rasmussen can be understood as constraining attempts by shareholders and their loyal managers to take advantage of creditors. Indeed, this understanding is bolstered by the triggering structure: the senior lenders' governance rights primarily come into play when the firm encounters financial distress—when the risk of shareholder–creditor opportunism comes to the fore. Moreover, the rough timing of the evolution of debt governance described by Baird and Rasmussen fits my story well. They trace the development of private-debt governance to Uniform Commercial Code Article 9 and revised Article 9 (effective 2001), which increased a senior lender's ability to secure a debt with all current and later-acquired corporate assets.¹⁴⁹ As such, their story is a story of the 1990s and 2000s, the periods during which, the evidence

¹⁴⁸ Baird & Rasmussen, *supra* note 107, at 1227-28 (footnote omitted). For an earlier analysis of debt's governance role, and the development of the notion of default clauses in lending agreements as “trip wires,” see George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, 1093-94 (1995). Triantis and Daniels write, “[Debt covenants] serve as trip wires for the lender's right to accelerate and enforce or to intervene in the borrower's decisions.” *Id.*

¹⁴⁹ Baird & Rasmussen, *supra* note 107, at 1228. On the development of the law under Article 9 and revised Article 9, and how these provisions affect a lender's ability to take security interests, see Steven L. Harris & Charles W. Mooney, Jr., *How Successful Was the Revision of UCC Article 9?: Reflections of the Reporters*, 74 CHI.-KENT L. REV. 1357, 1364-65 (1999). See generally Steven L. Harris & Charles W. Mooney, Jr., *Revised Article 9 Meets the Bankruptcy Code: Policy and Impact*, 9 AM. BANKR. INST. L. REV. 85 (2001).

described above shows, the shareholder–manager agency cost problem was substantially brought under control.¹⁵⁰

IV. GRAPPLING WITH RESIDUAL SHAREHOLDER– CREDITOR AGENCY COSTS

In the eighty years since Berle and Means posed the question, endless variants of the shareholder–manager agency cost problem have been analyzed. What do contemporary shareholder–creditor conflicts look like, now that managers largely think like shareholders and the world has at least partially adapted? In earlier parts, I examined ways in which the shareholder–creditor conflict is controlled by incentives, contracts, and governance. In this Part, I want to explore the available legal resources for controlling two residual shareholder–creditor conflicts that strike me as illustrative. The first type of conflict is a “last period problem,” illustrated by the rapid failures of some gigantic 2007 LBOs. The second type of conflict, illustrated by the recent battle at Dynegy, involves attempts by shareholders and shareholder-oriented managers to exploit complex corporate subsidiary structures to wrest value away from creditors during financial distress.¹⁵¹ As we will see, the same set of doctrinal resources, in different measures, can respond to both challenges. My interest in these case studies is to examine the tools available and how those tools interact with each other in controlling what seem to be examples of shareholder–creditor opportunism.

A. *A Failed LBO*

Background legal rules both support contracting and act as a backstop to prevent fraud and opportunism. To get a sense of the role of these fundamental legal rules, consider the following hypothetical. This hypothetical, inspired by some of the failed LBOs of 2007 to 2008,¹⁵² is designed to

¹⁵⁰ Creditor governance of the sort described by Baird and Rasmussen raises the specter of “lender liability.” Roe and Venezze present an interesting “corporate law” approach to the legal treatment of creditor governance that has the potential to provide more certainty to creditors in controlling management behavior during financial distress, which is desirable in a world in which managers think like shareholders. See Roe & Venezze, *supra* note 136, at 19–20 (applying the corporate law doctrines of entire fairness review and business judgment deference to the creditor context).

¹⁵¹ For an in-depth analysis of one example of this type of conflict, see generally Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. CHI. L. REV. 605 (2011).

¹⁵² See Michael Simkovic & Benjamin S. Kaminetzky, *Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap Solution*, 2011 COLUM. BUS. L. REV. 118, 124 (2011) (“There has recently been a surge in fraudulent transfer litigation.”). The authors go on to

provide a best-case scenario for legal intervention in which some of the behavior verges on fraud.

* * *

Target Corp. is being sold at a very high price in a highly leveraged buy-out. Target's senior managers have substantial equity stakes through ownership of stock and options, as well as "inside debt" through deferred compensation and pension benefits. They plan to cash out and devote themselves to recreational activities once the sale closes. In the course of the sale process, they have directed the preparation of new projections that, to an impartial eye, would be found to be wildly optimistic or even fraudulent. The board knows that the juiced projections were prepared for the marketing effort, that they have minimal foundation, and that the buyers and their financing banks have been relying upon them without realizing just how juiced they are.

Suppose that, on the eve of approving the highly leveraged sale, or on the eve of the closing, Target's bankers tell Target's board that, as soon as the deal closes, the company will be insolvent, leaving some of the existing creditors unpaid. "Given the price that Buyer is paying for the shares, the amount of debt it is putting on the company, and the likely cash flow," say the bankers in a moment of candor, "there is no way it'll survive."

May the board, consistent with its duties, go forward with the deal? Suppose they were to do so, and the company fails shortly after closing; do the directors face any liability? Given that Target shareholders are thrilled with the price and will exit in the sale, must the board go forward with the deal? Should it choose not to, will it face any liability to Target shareholders?

* * *

Before turning to the legal treatment of this hypothetical, consider how it could slip through the web of adaptive constraints described above (contracting, compensation, and governance) and harm pre-LBO unsecured creditors (as well as employees, communities, suppliers, and customers). Existing senior lenders will be largely indifferent so long as they are paid

state, "There have already been several major cases brought and the data suggest that there are far more in store." *Id.* at 124 n.11 (citing 3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of TOUSA, Inc. (*In re TOUSA, Inc.*), 444 B.R. 613 (S.D. Fla. 2011), *aff'd in part, rev'd in part*, 680 F.3d 1298 (11th Cir. 2012); Tribune Media Servs., Inc. v. Beatty (*In re Tribune Co.*), 418 B.R. 116 (Bankr. D. Del. 2009); Complaint, *In re Lyondell Chem. Co.*, 402 B.R. 571 (Bankr. S.D.N.Y. 2009) (No. 09-10023 (REG)), 2009 WL 2350776).

back at closing. The new banks financing the LBO can be expected to recognize the misaligned incentives of selling managers and to conduct due diligence to assure themselves that the post-LBO company will be solvent (especially given the threat of a fraudulent conveyance challenge, as discussed below). There are, however, limits to the effectiveness of due diligence in protecting pre-LBO creditors, given the fundamental asymmetry of information between sellers and buyers. For bondholders, change-in-control covenants would have protected them, but during some periods of the business cycle, bonds are issued with minimal protection. Managers' financial incentives created by compensation structures are unlikely to protect creditors when the company is being sold and managers are exiting. Finally, private debt's governance levers will come in to play only *after* the firm is in financial distress.

Consider, now, how this failed-LBO hypothetical would be analyzed under U.S. law.¹⁵³ In appraising the adequacy of current U.S. approaches, it is worth keeping in mind Bayless Manning's summary of the core creditor-protection goals of corporate law:

If the hierarchical relationship of creditor to shareholder is to have any meaning at all, then the management must not be left free to shovel all the assets in the corporate treasury out to the shareholders when the corporation has insufficient assets to pay its creditors or when the shareholder distribution renders the corporation unable to pay its creditors. The central point is to avoid insolvency.¹⁵⁴

1. The Bankruptcy Approach: Fraudulent Conveyance

A large number of failed LBOs end up in bankruptcy courts. When this occurs, three categories of claims are often asserted: claims under the Bankruptcy Code to avoid fraudulent transfers and obligations and to recover amounts transferred; actions to subordinate the claims of the LBO-financing parties to the claims of pre-LBO creditors; and state law claims against the parties who effectuated or participated in the transaction, including breach of fiduciary duty, aiding and abetting breach of fiduciary duties, unjust enrichment, and recovery of illegal distributions.¹⁵⁵

¹⁵³ For a brief analysis under U.K. law, see *infra* text accompanying notes 349-364.

¹⁵⁴ BAYLESS MANNING WITH JAMES J. HANKS, JR., *LEGAL CAPITAL* 63 (3d ed. 1990).

¹⁵⁵ See, e.g., Complaint, *supra* note 152, at 97-126 (including these types of counts); see also 2 Report of Kenneth N. Klee, Examiner at 4-5, *In re* Tribune Co., No. 08-13141 (KJC) (Bankr. D. Del. July 26, 2010) [hereinafter Klee Report] (detailing the three claims categories).

Typically, the magnitude of the LBO debt—which occupies a senior position—will dwarf other claims. As a result, if the LBO debt remains senior, the LBO creditors will recover on all the claims asserted (including claims against themselves, for example, for aiding and abetting). On the other hand, if the pre-LBO creditors are able to avoid the LBO debt (or have it subordinated), they will move to the head of the line. Together, these considerations make the actions to avoid the LBO debt the “main event,” in comparison to which everything else fades into the background.¹⁵⁶

a. *The Basic Theory*

The outlines of the fraudulent transfer approach to an LBO track the language of the Bankruptcy Code’s fraudulent transfer provision § 548(b) and the parallel incorporation of state fraudulent transfer law through § 544(b).¹⁵⁷ There are several elements to the analysis.

First, there is the question of *what* can be avoided. Under § 548, the bankruptcy trustee may avoid any “transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition.”¹⁵⁸ In the LBO context, there are two principal potential applications of this provision: the transfer of cash by the Target firm to its shareholders, and the Target’s obligation to repay the banks who financed the transaction.

Second, there is the question of *the circumstances under which* transfers or obligations can be avoided. Under § 548, there are two separate possibilities. First, transfers or obligations may be avoided when they were incurred “with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted.”¹⁵⁹ This is the “actual fraud” or “intentional fraudulent transfer” prong, and it focuses on the transferor’s

¹⁵⁶ See Klee Report, *supra* note 155, at 4-10 (outlining potential actions to avoid and recover, comprising this “main event”).

¹⁵⁷ 11 U.S.C. §§ 544(b), 548(b) (2006). Section 548 generally parallels the structure of state law fraudulent transfer statutes and will be the focus of my discussion.

¹⁵⁸ *Id.* § 548(a)(1). State fraudulent transfer law, although overlapping with the Bankruptcy Code’s provision, may not be entirely duplicative. For example, the “reach-back” period may vary. See, e.g., DEL. CODE ANN. tit. 6, § 1309(1), (2) (2005) (allowing for a reach-back period of four years).

¹⁵⁹ 11 U.S.C. § 548(a)(1)(A).

intent and knowledge.¹⁶⁰ The effect of a transfer is generally taken to be indicative of intent.¹⁶¹

Alternatively, transfers or obligations incurred may be avoided if the debtor, voluntarily or involuntarily, “received less than a reasonably equivalent value in exchange for such transfer or obligation”¹⁶² and, also, was either “insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation,”¹⁶³ or “was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital.”¹⁶⁴ This is the “constructive fraud” prong. Because of the difficulties and uncertainty involved with proving intentional fraudulent transfer, the constructive fraudulent transfer prong is generally used to challenge failed LBOs.¹⁶⁵

Each of the elements of the constructive fraud approach must be satisfied. The first can be applied straightforwardly to the LBO context. Bankruptcy courts and doctrines commonly seek to focus on “substance” rather than “form” and are thus open to collapsing the various steps of the transaction, in appropriate circumstances. In determining whether to collapse the transactions, courts in the Third Circuit (most relevant because Delaware is in the Third Circuit) consider three factors: “First, whether all of the parties involved had knowledge of the multiple transactions. Second, whether each transaction would have occurred on its own. And third, whether each transaction was dependent or conditioned on other transactions.”¹⁶⁶ In the typical LBO—where each piece closes simultaneously and is mutually dependent, and where each participant knows how the transaction

¹⁶⁰ Klee Report, *supra* note 155, at 16.

¹⁶¹ See, e.g., *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1305 (3d Cir. 1986) (“[A] party is deemed to have intended the *natural consequences of his acts.*” (emphasis added)); see also *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1075 (3d Cir. 1992) (“In *Tabor Court Realty Corp.* we relied in part on the principle that ‘a party is deemed to have intended the natural consequences of his acts’ in upholding the district court’s finding of intentional fraud.”).

¹⁶² 11 U.S.C. § 548(a)(1)(B)(i).

¹⁶³ *Id.* § 548(a)(1)(B)(ii)(I).

¹⁶⁴ *Id.* § 548(a)(1)(B)(ii)(II).

¹⁶⁵ See *Moody*, 971 F.2d at 1064.

¹⁶⁶ *Mervyn’s L.L.C. v. Lubert-Adler Grp. IV, L.L.C.* (*In re Mervyn’s Holdings, L.L.C.*), 426 B.R. 488, 497 (Bankr. D. Del. 2010) (citations omitted); see also *The Liquidation Trust of Hechinger Inv. Co. of Del. v. Fleet Retail Fin. Grp.* (*In re Hechinger Inv. Co. of Del.*), 327 B.R. 537, 547 (D. Del. 2005) (“Each step of the Transaction would not have occurred on its own, as each relied on additional steps to fulfill the parties’ intent and merge”). For a full discussion of the case law, and whether bad faith must be shown to justify collapsing, see Klee Report, *supra* note 155, at 86-90.

is structured (if for no other reason than that it will be disclosed in the proxy statement)—these conditions will routinely be satisfied.

Consider first the payments to the shareholders. If one views the LBO as a distribution to shareholders that does not benefit Target, then it looks clearly to be at an undervalue. The corporation receives no benefit from receiving its shares back from its shareholders, as that does not bring any capital into the firm, and does not allow it to invest in any projects. Turning to the obligations incurred to the banks that financed the LBO, once the steps of the transaction are collapsed, and proceeds of the loan have been paid out to shareholders, it is hard to see how *Target* has received “equivalent value.”

The second element of constructive fraud requires that the transfer or obligation incurred have occurred when the firm was or was rendered “insolvent” according to one of the two standard measures of insolvency: balance sheet insolvency (liabilities exceed assets) or some version of an “equity insolvency” test such as the one contained in § 548—that is, “engaged in business . . . for which any property remaining with the debtor was an unreasonably small capital” or “intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor’s ability to pay as such debts matured.”¹⁶⁷ In the LBO context, this becomes the domain of expert financial testimony and is obviously fact-specific. The key question under any of the solvency tests is whether at the time of the transfer or obligation incurred, the firm was or became insolvent.¹⁶⁸

b. *Is the Current Framework Sufficient? Some Doubts About Exclusive Reliance on Fraudulent Transfer Law*

When fraudulent conveyance law was first applied to failed LBOs, it was controversial and seemed to many to be a poor fit.¹⁶⁹ Over time, fraudulent conveyance law has come to play an important role in bankruptcy cases. That said, from a corporate law perspective, it still seems odd that anyone would want fraudulent conveyance law to be the exclusive or even the primary framework for litigation over failed LBOs. While one could argue that we do not want managers to have multiple masters, and that the most

¹⁶⁷ 11 U.S.C. § 548(a). See generally Simkovic & Kaminetzky, *supra* note 152.

¹⁶⁸ Under 11 U.S.C. § 548(a)(1)(B)(i), the trustee may completely avoid any constructively fraudulent transfer. This is in contrast to §§ 548(c) and 550(a) where the avoidance is limited to the extent the debtor received less than equivalent value.

¹⁶⁹ See, e.g., Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 852 (1985) (“A firm that incurs obligations in the course of a buyout does not seem at all like the Elizabethan deadbeat who sells his sheep to his brother for a pittance.”).

efficient structure is to have managers act in the shareholders' interest and for LBO lenders to act in their own interests (and indirectly the interests of other creditors) by constraining the LBO sponsor, I am unconvinced. As I discuss below, the "single master" argument seems to exacerbate shareholder-creditor agency costs at precisely the critical moment. Further, it implies that directors should, or even must, approve my hypothetical LBO even when they know that it will render the firm insolvent, as it is indisputably in shareholders' interests to do so.¹⁷⁰

First, to the extent that the core "creditor protection" goal is, as Manning puts it, that "management must not be left free to shovel all the assets in the corporate treasury out to the shareholders when the corporation has insufficient assets to pay its creditors or when the shareholder distribution itself renders the corporation unable to pay its creditors,"¹⁷¹ focusing on the lenders rather than on the managers is to ignore the key actors. Even if the LBO lenders are aware that the transaction is a single unified transaction in which debt is being substituted for equity, they are neither the initiating parties, nor the actors with fiduciary duties to the corporation or with direct access to the relevant information, including projections. Indeed, because of competition with other lenders, it is likely that they are lending at market rates. The real justification for imposing obligations on them, backed by the threat of losing priority to older creditors in bankruptcy, seems to be to recruit them to force the LBO sponsors and the Target firm to adopt a sound financial structure.¹⁷²

To one steeped in Delaware's approach to corporate law—and to those with knowledge of how the same set of problems is handled in other corporate law systems—it is surprising that the analysis does not focus on the *directors'* decision to approve a transaction that distributes funds to the shareholders ahead of the creditors and results in the bankruptcy of the company.

Second, to impose liability on the LBO lenders is, in effect, to penalize some creditors for not adequately looking out for other creditors. This is in

¹⁷⁰ See *infra* text accompanying notes 234-236.

¹⁷¹ MANNING, *supra* note 154, at 63.

¹⁷² In so doing, it is analogous to imposing successorship liability in products liability cases as a way of forcing selling firms to make adequate provision for tort victims. See generally Edward B. Rock & Michael L. Wachter, *Labor Law Successorship: A Corporate Law Approach*, 92 MICH. L. REV. 203 (1993).

tension with the general principle that creditors do not have duties to look out for the interests of other creditors.¹⁷³

Third, the fraudulent transfer model—in focusing on the transferor and the transferee—would seem to demand that the transferee return the improper transfer. In the LBO context, that would require the shareholders to return the amounts received for their shares. Yet, in a world of intermediaries and custodial holding of securities, unwinding securities transactions can pose systemic risks. As a result, the Bankruptcy Code contains a broad limitation on avoidance powers that can be exercised on behalf of a bankruptcy estate when a transfer is a “settlement payment.”¹⁷⁴ This provision has been interpreted very broadly as barring the avoidance of LBO shareholder payments for claims asserted under § 548 of the Bankruptcy Code, other than those made with actual fraudulent intent.¹⁷⁵ Given the complexities of clawing back payments made to dispersed shareholders, corporate law’s strategy of providing directors with incentives not to make such payments in the first place makes sense.

Fourth, the heavy reliance on the fraudulent transfer framework has meant that a variety of cases that pose issues at the heart of corporate law’s creditor-protection function—that could provide the grist for the common law mill—do not do so. With bankruptcy focused primarily on priority, directors’ duties receive relatively little attention. At the same time, far less typical fact patterns—the creditor-regarding duty cases that actually arise in Delaware—become the basis upon which these duties are developed. This is not just a lost opportunity. It also distorts the development of doctrine and provides directors with a misleading and incomplete role description.

In the early 1980s, when management buyouts (MBO) first emerged in significant numbers, directors were confused about their duties.¹⁷⁶ Some thought their duty was to decide between the management group’s offer to buy the company and remaining independent. In a line of decisions, the

¹⁷³ See Douglas G. Baird, *Fraudulent Conveyances, Agency Costs, and Leveraged Buyouts*, 20 J. LEGAL STUD. 1, 22 (1991) (“A creditor has to care about whether the debtor will pay it back, not whether the debtor will pay back anyone else.”).

¹⁷⁴ 11 U.S.C. § 546(e) (2006).

¹⁷⁵ See, e.g., *Brandt v. B.A. Capital Co. (In re Plassein Int’l Corp.)*, 590 F.3d 252, 257-59 (3d Cir. 2009) (LBO of private corporation); *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545, 549-50 (6th Cir. 2009) (same); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 986 (8th Cir. 2009) (same); *Lowenschuss v. Resorts Int’l, Inc. (In re Resorts Int’l, Inc.)*, 181 F.3d 505, 516 (3d Cir. 1999) (LBO of public corporation). *But see* *Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604, 610 (11th Cir. 1996) (declining to apply § 546(e) to LBO payments).

¹⁷⁶ See generally Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 U.C.L.A. L. REV. 1009 (1997) (describing the evolution of directors’ duties through MBO case law).

Delaware courts ultimately made it clear that that was not the right way to think about what, in essence, would be a decision to sell the company. Rather, Delaware courts made it clear that directors in MBOs must allow some sort of “market test” before selling the company to the management group. Board practices changed.

There seems to be an analogous misunderstanding of directors’ duties with regard to highly leveraged transactions. There needs to be an analogous reorientation of directors’ perceptions. Although the injunction to “maximize shareholder value” is a decent shorthand description of directors’ duties during normal times, it gives the wrong message when the means of maximizing shareholder value—highly leveraged transactions—threaten the company with insolvency. As discussed below, because of the oddities of our judicial architecture, we do not have the same intensity of judicial attention, and that lack has led to insufficient attention in the case law specifying directors’ duties.

2. Delaware Corporate Law Doctrines

With most of the fallout from failed LBOs playing out in the bankruptcy courts and targeting LBO lenders, it is not surprising that corporate law doctrines and remedies have remained at the margins.¹⁷⁷ To the extent that corporate law will adapt to the reappearance of the shareholder-creditor

¹⁷⁷ Thus, in the bankruptcy cases, discussions of both fiduciary duty and improper distribution theories typically appear only after the main discussion of fraudulent transfer theories against the various defendants. In *In re Buckhead America Corp.*, which contains the fullest discussion of these theories, their analysis comes only after discussions of the fraudulent transfer claims (Section B), tortious interference (Section C), and “other claims relating to indentures” (Section D), before the final section that discusses the “alter ego theory of liability.” Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Grp., Inc. (*In re Buckhead Am. Corp.*), 178 B.R. 956, 961-75 (D. Del. 1994); see also *Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992, 1000-01 (S.D.N.Y. 1991) (improper distribution); *Weiboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488, 511-12 (N.D. Ill. 1988) (same); *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 584-85 (M.D. Pa. 1983) (majority shareholder duty), *aff’d in part, vacated in part sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986).

Similarly, the theories appear in court-appointed examiners’ reports in a somewhat marginal way. Thus, in Barry Zaretsky’s seminal report in the Revco bankruptcy, Report of Barry Zaretsky, Examiner at 117-24, *In re Revco D.S., Inc.*, 1990 Bankr. LEXIS 2966 (Bankr. N.D. Ohio Dec. 17, 1990) (Nos. 588-1308 to 588-1321, 588-1305, 588-1761 to 588-1812, 588-1820), he discussed claims under Delaware General Corporate Law sections 160 and 174, but relatively late in the report. See DEL. CODE ANN. tit. 8, §§ 160, 174 (2011) (corporation’s voting and ownership powers, and director liability, respectively). Likewise, in Kenneth Klee’s four-volume examiner’s report in the Tribune bankruptcy, the improper distribution claims do not appear until near the end of the second volume. See Klee Report, *supra* note 155, at 406.

agency cost problem, these doctrines will form the starting point—the “doctrinal resources” for addressing this new–old problem.

Restrictions on distributions to shareholders, whether through share repurchases or dividends, have a long and complicated history.¹⁷⁸ Before turning to the restrictions and liabilities under Delaware law, it is important to understand how these types of rules work. There are two kinds of legal tools for restricting distributions: limits on the *sources* of distributions and limits on the *effects* of distributions. Generally, three factors enter into the determination: the corporation’s cash flow, its earnings, and its net assets.¹⁷⁹

The traditional limitation on the source of distributions is that they must be out of “surplus,” a term of art.¹⁸⁰ There are two ideas behind this restriction. First, distributions should not be made to shareholders when the firm already owes more money to creditors and preferred shareholders than its assets are worth. Second, at least a portion of the equity capital is committed for the life of the firm and provides a cushion to protect creditors and others dealing with the firm. This cushion must thus be protected from distributions to shareholders. Although this class of restrictions is often referred to as a “balance sheet solvency test,” it is quite different from true accounting-based tests, and the “balance sheet” need not be prepared according to GAAP.¹⁸¹

How the “balance sheet insolvency” test is implemented has changed over time and varies from jurisdiction to jurisdiction. In contrast to the Model Business Code, Delaware takes a very traditional approach to restricting distributions. Under Delaware law, dividends and share repurchases can be funded out of “surplus,” which is defined as the amount of “net assets” in excess of “capital.”¹⁸² “Net assets” is defined as the amount by which total assets exceed total liabilities.¹⁸³ “Stated capital” cannot be less than the “par value” of all shares with “par value,” but may be more, at the board’s discretion.¹⁸⁴ If shares are issued without par value, as is permitted under Delaware law, the board will determine at the time of issue what portion will be considered “capital.”¹⁸⁵

¹⁷⁸ For the leading account, see BAYLESS MANNING, LEGAL CAPITAL, *supra* note 154.

¹⁷⁹ BARBARA BLACK, CORPORATE DIVIDENDS AND STOCK REPURCHASES §§ 1:3, 6:4 (2004).

¹⁸⁰ For a classic discussion of the concept of “surplus” and the confusion it engenders, see MANNING, *supra* note 154, at 74–78.

¹⁸¹ BLACK, *supra* note 179, § 1:3.

¹⁸² DEL. CODE ANN. tit. 8, § 154.

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*

A board may thus repurchase shares or pay dividends so long as total assets are greater than total liabilities plus capital.¹⁸⁶ When the market values of the assets and/or liabilities differ from the book value, the board may revalue the assets and liabilities (upward or downward) on the basis of such information as it considers reliable, with no specific method mandated by the courts.¹⁸⁷

The second type of limitation on distributions to shareholders looks not at the source of distributions but at their effect on creditors. These are known as “equity insolvency tests” and focus on the corporation’s cash flow. Here, the idea is to prohibit distributions when the corporation is unable to pay its debts as they come due, or would be rendered unable by the distribution.¹⁸⁸ Thus, for example, the Model Business Code provides, “No distribution may be made if, after giving it effect: (1) the corporation would not be able to pay its debts as they become due in the usual course of business”¹⁸⁹ Although Delaware’s statutes do not contain “equity insolvency” limitations, the case law does, as I discuss below.

Before turning to the application of Delaware doctrine, recall exactly what an LBO is. An LBO is an acquisition of a target company, through any of a variety of different structures, in which a significant portion of the purchase price is borrowed, with the loan ultimately secured by the assets of the target company.¹⁹⁰ Although there are a host of alternative structures available, the reverse triangular merger has become the standard approach for LBOs in the United States. To illustrate briefly, Buyer establishes an acquisition shell, NewCo, and, if a toehold position is desired, NewCo acquires it. After reaching terms with Target, NewCo merges with Target, with Target as the surviving corporation, and with Target’s shareholders receiving cash for their shares. Simultaneously at closing, funds are borrowed from Lender to pay Target’s shareholders, secured by Target’s

¹⁸⁶ *Id.* § 170(a)(1).

¹⁸⁷ Delaware also provides for “nimble dividends.” “In case there shall be no such surplus, [a company may declare and pay dividends] out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year.” *Id.* § 170(a), (a)(2). The idea behind this type of provision is that a troubled firm must be able to promise dividends to new equity if it is to issue stock and stave off failure.

¹⁸⁸ BLACK, *supra* note 179, § 1:3.

¹⁸⁹ MODEL BUS. CORP. ACT § 6.40 (2008).

¹⁹⁰ See David Gray Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73, 81-83 (1985) (describing various ways to structure an LBO).

assets.¹⁹¹ In order to complete the transaction, Target's board must recommend it and Target's shareholders must approve it.

The creditor protection issue in an LBO is clear: debt is substituted for equity. Target's shareholders are bought out, potentially leaving Target's pre-LBO creditors high and dry, with none of the proceeds of the loans (secured by Target's assets) invested in Target projects. LBOs thus raise the specter of "asset dilution"—the siphoning off of assets to the shareholders, leaving creditors worse off.

a. *Theory I: The Delaware Limitations on Share Repurchases*

Given what LBOs do, it is reasonable to view them as share repurchases. As noted above, Delaware adopts a "balance sheet insolvency" limitation on share repurchases. Delaware General Corporation Law (DGCL) section 160(a) provides (in relevant part):

Every corporation may purchase, redeem, receive, take or otherwise acquire, own and hold, sell, lend, exchange, transfer or otherwise dispose of, pledge, use and otherwise deal in and with its own shares; provided, however, that no corporation shall:

1) Purchase or redeem its own shares of capital stock for cash or other property when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation¹⁹²

¹⁹¹ As Carlson points out, there are numerous alternative modes of structuring the acquisition, all with the same outcome. *Id.* at 83. Modifying Carlson's description slightly, all of the following structures produce similar results, although they may have different legal consequences:

- Newcorp borrows from Lender and simultaneously uses the proceeds to purchase Target's stock, which is pledged to secure the loan.
- Newcorp borrows from Lender, uses the proceeds to buy Target's stock, and causes Target to guarantee the loan to Newcorp.
- Target borrows from Lender, with loan secured by Target's assets, and uses the proceeds to repurchase shares from shareholders other than Buyer.
- Newcorp borrows from Lender to acquire Target's shares. Target borrows acquisition funds secured by its assets and pays them out as a dividend to Newcorp to repay the loan. Each step closes simultaneously.
- Target borrows from Lender, secured by Target's assets, then relends to Newcorp, which uses the funds to purchase shares.
- Target with substantial subsidiaries arranges a loan to Target, secured by subsidiaries' assets or guarantees, and uses proceeds to buy shares.

¹⁹² DEL. CODE ANN. tit. 8, § 160(a).

In addition, there is a longstanding common law “equity insolvency” test that prohibits a corporation from repurchasing its shares when the corporation is or would be rendered unable to pay its debts as they come due.¹⁹³

DGCL section 174(a) imposes liability on directors for improper share repurchases, liability that cannot be exculpated under DGCL section 102(b)(7).¹⁹⁴ Because Delaware law contains both “balance sheet” and “equitable” insolvency limitations on share repurchases, if a hypothetical LBO that rendered the firm insolvent is viewed as a share repurchase, it would quite clearly violate DGCL section 160.¹⁹⁵

Section 172, however, provides directors with a defense when they rely in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of its officers or employees, or committees of the board of directors, or by any other person as to matters the director reasonably believes are within such other person’s professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation, as to the value and amount of the assets, liabilities and/or net profits of the corporation or any other facts pertinent to the existence and amount of surplus or other funds from which dividends might properly be declared and paid, or with which the corporation’s stock might properly be purchased or redeemed.¹⁹⁶

As with other parallel provisions, such as section 141(e),¹⁹⁷ such reliance must be reasonable.¹⁹⁸ Directors’ liability would thus depend on the reasonableness of their reliance on the information they had before them about the solvency of the post-LBO company. From a counseling perspective, this provides a clear incentive to make sure that the board has a strong basis for

¹⁹³ See, e.g., *SV Inv. Partners, L.L.C. v. ThoughtWorks, Inc.*, 7 A.3d 973, 987 (Del. Ch. 2010), *aff’d*, 37 A.3d 205 (Del. 2011).

¹⁹⁴ DEL. CODE ANN. tit. 8, §§ 102(b)(7), 174(a).

¹⁹⁵ For a leading federal case applying Georgia law, see generally *Munford v. Valuation Research Corp.* (*In re Munford, Inc.*), 97 F.3d 456 (11th Cir. 1996).

¹⁹⁶ DEL. CODE ANN. tit. 8, § 172.

¹⁹⁷ *Id.* § 141(e) (providing for directors’ good faith reliance on corporation records).

¹⁹⁸ See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 875 (Del. 1985) (noting that for purposes of section 141(e), a report may be relied upon only if it is “pertinent to the subject matter upon which a board is called to act, and otherwise . . . entitled to good faith, not blind, reliance”), *overruled in part on other grounds by Gantler v. Stephens*, 965 A.2d 695 (Del. 2009); see also *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1281 (Del. 1988) (warning that a board employing good faith reliance nevertheless has an “active and direct duty of oversight” in significant matters, including sales of control).

concluding that the post-LBO company would be solvent before approving a transaction that could or would be viewed as a share repurchase. In practice, this could be achieved by requiring a credible solvency opinion from Target's investment banker prior to approving the LBO, as is done in the United Kingdom.

b. *Theory II: Dividends and Reductions-in-Capital*

Share repurchases are just one of the ways in which managers may “shovel all the assets in the corporate treasury out to the shareholders when the corporation has insufficient assets to pay its creditors or when the shareholder distribution renders the corporation unable to pay its creditors.”¹⁹⁹ It can also be done by dividend or reduction of capital. Because the effects on creditors are the same, the restrictions are largely the same.²⁰⁰

i. The Analysis Under DGCL Section 174

Under sections 170 and 173, dividends may only be paid out of surplus or net profits.²⁰¹ As noted above, “surplus” is defined by subtracting “stated capital” and liabilities from assets. “Net profits” is a rather obscure concept, and dividends out of net profits are subject to limitations.²⁰² The idea is clear enough: even when the firm has had years of losses and no surplus, it may be necessary to promise dividends to attract new capital. The “net profits” provision makes it possible to pay dividends in those circumstances. But how, exactly, to interpret this provision is quite problematic.²⁰³

¹⁹⁹ MANNING, *supra* note 154, at 63.

²⁰⁰ This is why the Model Business Corporation Act treats distributions to shareholders in a unitary fashion. MODEL BUS. CORP. ACT §§ 6.40, 8.33 & cmt. (2008); BLACK, *supra* note 179, §§ 1:3, 6:4.

²⁰¹ DEL. CODE ANN. tit. 8, §§ 170, 173.

²⁰² In particular, section 170 provides

If the capital of the corporation, computed in accordance with §§ 154 and 244 of this title, shall have been diminished by depreciation in the value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares of any classes of its capital stock until the deficiency in the amount of capital represented by the issued and outstanding stock of all classes having a preference upon the distribution of assets shall have been repaired.

Id. § 170(a).

²⁰³ MANNING, *supra* note 154, at 82-84.

In the hypothetical LBO described earlier, the amounts distributed to shareholders are sufficiently large—and destructive of the firm’s solvency—that if the distribution is viewed as a dividend, it would likely be held to exceed even the most flexible interpretation of sections 170 and 173. Moreover, as with share repurchases, so too here there seems to be a principle that a firm cannot pay a dividend if it “diminishes the ability of the company to pay its debts, or lessens the security of its creditors.”²⁰⁴

The rest of the analysis follows the previous discussion. Under section 174, directors are personally liable for willful or negligent violation of section 173.²⁰⁵ Under section 102(b)(7), this violation is understood to be a breach of fiduciary duty that cannot be exculpated.²⁰⁶ Finally, for there to be a defense under section 172, reliance must be reasonable and in good faith.²⁰⁷ A dividend analysis thus does not add much to the share repurchase analysis.

ii. The Relevance of the Doctrine of Independent Legal Significance

A predictable response to the illegal stock repurchase and illegal dividend theories is appeal to the so-called “doctrine of independent legal significance” (ILS). Does the fact that my hypothetical transaction is structured as a merger insulate it from challenge as a stock repurchase or dividend? Historically, the ILS doctrine emerged out of the 1930s and firms’ inability to raise new capital due to accrued preferred stock dividends that made it impossible to promise dividends on new common stock.²⁰⁸ In *Federal United Corp. v. Havender*, the Delaware Supreme Court authorized the use of a merger with a wholly owned subsidiary in which the old preferred and its arrearages were cancelled and replaced by new preferred in the merged entity and some common stock.²⁰⁹ Although one could view the use of the merger provision as an evasion of the limitation imposed on charter amendments, the court instead took the position that “[t]here is a clear distinction between the situations recognized by the General Law and the modes of procedure applicable to each of them”²¹⁰

²⁰⁴ *In re Int’l Radiator Co.*, 92 A. 255, 255 (Del. Ch. 1914).

²⁰⁵ DEL. CODE ANN. tit. 8, § 174.

²⁰⁶ *Id.* § 102(b)(7).

²⁰⁷ *Id.* § 172.

²⁰⁸ For a concise historical summary, see WILLIAM J. CARNEY, *MERGERS & ACQUISITIONS: CASES AND MATERIALS* 109-10 (3d ed. 2011). For a more comprehensive treatment, see generally C. Stephen Bigler & Blake Rohrbacher, *Form or Substance? The Past, Present, and Future of the Doctrine of Independent Legal Significance*, 63 *BUS. LAW.* 1 (2007).

²⁰⁹ 11 A.2d 331, 333-43 (Del. 1940).

²¹⁰ *Id.* at 342.

This approach later became known as the “doctrine of independent legal significance.”²¹¹ In the area of preferred stock, it has been clear ever since that changes to preferred stock rights and preferences (which are part of the corporate charter) can be made either by charter amendment (in which case there is a class vote provided by statute²¹²) or by merger (in which case there is no class vote by statute unless specifically included in the certificate of designations²¹³). This longstanding interpretation of the statute eventually morphed into a rule of contract interpretation, with courts interpreting the certificate of designations—the contract between preferred stockholders and the firm—as only providing for a class vote in mergers when specifically mentioned.²¹⁴

The ILS doctrine spread from the preferred stock context to a more general interpretation of sections 251 and 271.²¹⁵ The Delaware courts have consistently held that a transaction structured as a sale of all or substantially all of a company’s assets under section 271, which complies with the procedural requirements of that section, cannot be attacked as invalid for not *also* complying with the procedural requirements of the merger statute (section 251), even if the resulting arrangement of corporate assets is identical to the result of a merger.²¹⁶ The reverse is also true: a statutory merger does not constitute a sale of assets and thus need not comply with the procedural requirements of section 271.²¹⁷ This same approach has been extended to purchases of stock for stock, and Delaware courts have consistently held that, although the outcome is identical to a section 251 merger, a transaction

²¹¹ See, e.g., *Langfelder v. Universal Labs., Inc.*, 68 F. Supp. 209, 211 (D. Del. 1946).

²¹² See DEL. CODE ANN. tit. 8, § 242.

²¹³ See *id.* § 251.

²¹⁴ See, e.g., *Rothschild Int’l Corp. v. Liggett Grp. Inc.*, 474 A.2d 133, 136 (Del. 1984) (“Preferential rights are contractual in nature and therefore are governed by the express provisions of a company’s certificate of incorporation. . . . [They] must also be clearly expressed and will not be presumed.”). See generally *Benchmark Capital Partners IV, L.P. v. Vague*, No. 19719, 2002 Del. Ch. LEXIS 90 (Del. Ch. July 15, 2002), *aff’d sub nom. Benchmark Capital Partners IV, L.P. v. Juniper Fin. Corp.*, No. 680, 2003 Del. LEXIS 237 (Del. April 16, 2003); *Warner Commc’ns Inc. v. Chris-Craft Indus., Inc.*, 583 A.2d 962 (Del. Ch. 1989); *Edelman v. Phillips Petroleum*, No. 7899, 1985 Del. Ch. LEXIS 459 (Del. Ch. Feb. 12, 1985). For a description of the shift from a rule of statutory interpretation to a rule of statutory and contract interpretation, see D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825, 837-40 (2004).

²¹⁵ See DEL. CODE ANN. tit. 8, §§ 251, 271.

²¹⁶ See *Hariton v. Arco Elecs., Inc.*, 188 A.2d 123, 125 (Del. 1963).

²¹⁷ See *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 113-14 (Del. 1952).

structured as an exchange of stock need not comply with section 251 procedures.²¹⁸

By placing the form of the transaction over its substance, the ILS doctrine has made an attractive shield against challenges. Although some might view ILS as a judicial wild card to be played when judges choose not to intervene for other reasons, there are clear doctrinal limits to its scope.²¹⁹ First, far from being a wild card, it has a narrow procedural focus. When the Delaware legislature came to codify it in the limited partnership context in 2009, it provided: “Action validly taken pursuant to 1 provision of this chapter shall not be deemed invalid solely because it is identical or similar in substance to an action that could have been taken pursuant to some other provision of this chapter”²²⁰

Second, from the beginning, it has been clear that ILS relates to challenges by preferred and common stockholders and *not* to creditor interests. Indeed, the Delaware Supreme Court has explicitly embraced the “de facto merger doctrine”—the doctrinal antithesis to ILS—to protect creditors.²²¹

The third limitation on the scope of ILS is the distinction drawn in Delaware jurisprudence between “legal” and “equitable” claims, a distinction that finds expression in the famous and oft-cited language from *Schnell v. Chris-Craft Industries, Inc.*: “[I]nequitable action does not become permissible simply because it is legally possible.”²²² This two-level analysis has led Delaware courts, in appropriate circumstances, to recharacterize transactions to protect vulnerable parties. Thus, for example, in *Gatz v. Ponsoldt*, the Delaware Supreme Court relied on tax law’s “step transaction” doctrine to recharacterize a complicated series of transactions that effected a “recapitalization.”²²³ This approach has figured in more recent Chancery Court opinions such as *LAMPERS v. Crawford*, in which Chancellor Chandler

²¹⁸ See, e.g., *Orzeck v. Englehart*, 195 A.2d 375, 377-78 (Del. 1963); *Field v. Allyn*, 457 A.2d 1089, 1097-99 (Del. Ch. 1983), *aff’d*, 467 A.2d 1274 (Del. 1983); *Fidanque v. Am. Maracaibo Co.*, 92 A.2d 311, 316 (Del. Ch. 1952).

²¹⁹ See, e.g., *Smith*, *supra* note 214, at 848 (“The doctrine of independent legal significance is a rule of judicial abstention.”).

²²⁰ Delaware Revised Uniform Limited Partnership Act, DEL. CODE ANN. tit. 6, § 17-1101(h) (Supp. 2012).

²²¹ See, e.g., *Orzeck*, 195 A.2d at 378 (“We do not intend to be understood as holding that the doctrine of *de facto* merger is not recognized in Delaware. Such is not the case for it has been recognized in cases of sales of assets for the protection of creditors or stockholders who have suffered an injury by reason of failure to comply with the statute governing such sales.”).

²²² 285 A.2d 437, 439 (Del. 1971). For a classic analysis, see Chancellor Allen’s opinion in *SICPA Holding S.A. v. Optical Coating Laboratory, Inc.*, No. 15129, 1997 Del. Ch. LEXIS 1 (Del. Ch. Jan. 6, 1997).

²²³ 925 A.2d 1265, 1280-81 & n.31 (Del. 2007).

rejected an ILS argument and relied upon the step transaction doctrine to recharacterize a cash dividend, designed to be payable only upon the effective date of a stock-for-stock merger, as part of the merger consideration and therefore triggering appraisal rights.²²⁴

The hypothetical LBO could be collapsed under any version of the step transaction doctrine, as each step is dependent on the simultaneous execution of the others, with everything closing simultaneously.

c. *Theory III: Would Approving the LBO Breach the Directors' Duty of Loyalty?*

The principles that underlie the share repurchase and dividend theories may provide the grounds for a more general fiduciary duty account. Indeed, as discussed in more detail below, when one takes seriously the reemergence of the shareholder-creditor agency cost problem, it may be that directors' understanding of their role should return from the contemporary exhortation to maximize *equity* value to the traditional goal of maximizing *firm* value. Given the role that fiduciary duty law plays in educating directors as to their duties,²²⁵ focusing on the duty of loyalty may be a useful strategy for reorienting directors.

Traditional Delaware corporate law principles are instructive here. First, Delaware corporate law cases often state that the directors owe fiduciary duties to "the corporation" or to "the corporation and its stockholders."²²⁶ But this latter formulation is somewhat misleading, as is illustrated by cases in which stockholders have conflicting interests. In those situations, directors may take whatever action best serves the corporation or the entire body of stockholders.²²⁷ It is thus more accurate to say, in accord with the traditional

²²⁴ 918 A.2d 1171, 1191-92 (Del. Ch. 2007); see also *Noddings Inv. Grp., Inc. v. Capstar Commc'ns, Inc.*, No. 16538, 1999 Del. Ch. LEXIS 56, at *24-25 (Del. Ch. Mar. 24, 1999) (relying on the step transaction doctrine to combine two transactions in order to analyze them as one under a warrant agreement), *aff'd*, No. 165, 1999 Del. Ch. LEXIS 324 (Del. Sept. 22, 1999).

²²⁵ *Rock*, *supra* note 176, at 1106.

²²⁶ See *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) ("While technically not trustees, [corporate officers and directors] stand in a fiduciary relation to the corporation and its stockholders."); see also *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) ("[D]irectors are charged with an unyielding fiduciary duty to the corporation and its shareholders."), *overruled in part* by *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009). For a sampling of citations, see E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761, 764 n.8 (2008).

²²⁷ See 2 EDWARD P. WELCH, ANDREW J. TUREZYN & ROBERT S. SAUNDERS, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 141.2 (5th ed. Supp. 2012) (citing cases).

position, that directors owe fiduciary duties *to the corporation, for the benefit of the shareholders as a group* (not “*and to the shareholders*”).²²⁸

Second, it is well accepted that when a firm is insolvent, directors owe fiduciary duties to the creditors.²²⁹ Again, a more precise description would be that the duties still run to the corporation but now *for the benefit of the creditors*.²³⁰

The traditional doctrine thus draws a line at the solvency–insolvency boundary. This, of course, raises the question of what happens as one approaches that line. As Chancellor Allen noted in his famous *Credit Lyonnais* opinion, shareholder incentives become distorted as the firm enters the “vicinity of insolvency”: “The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors.”²³¹ Indeed, this distortion of shareholder incentives is offered as an explanation for why, “[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.”²³² Chancellor Allen’s point here is, among other things, that the traditional view of the board’s duty as running to the corporation, and not directly to the shareholders, allows for the appropriate adjustment as the firm approaches insolvency, and that the board must be

²²⁸ See generally Deborah A. DeMott, *Shareholders as Principals*, in KEY DEVELOPMENTS IN CORPORATE LAW AND TRUSTS LAW: ESSAYS IN HONOUR OF PROFESSOR HAROLD FORD 105 (Ian Ramsay ed., 2002); see also Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1072, 1074 n.4 (1983) (noting that management and directors owe duties to the stockholders generally, and not to individual or group holders); Paula J. Dalley, *Shareholder (and Director) Fiduciary Duties and Shareholder Activism*, 8 HOUS. BUS. & TAX L.J. 301, 308–14 (2008) (exploring the legal contours of the fiduciary–stockholder relationship).

²²⁹ Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 790–91 (Del. Ch. 2004) (citing *Geyer v. Ingersoll Publ’ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992)), *overruled in part on other grounds* by *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

²³⁰ This principle is confirmed by the related procedural rules on standing to bring an action for breach of these fiduciary duties. Consider a claim that the directors’ breach of fiduciary duty has harmed the corporation. When a firm is solvent, shareholders may bring a derivative suit, and must satisfy its requirements, “because they are the ultimate beneficiaries of the corporation’s growth and increased value.” *Gheewalla*, 930 A.2d at 101. When a firm is insolvent, the creditors are eligible to bring a derivative suit because they become “the residual beneficiaries of any increase in value,” *id.*, although they too must satisfy (as yet largely undeveloped) procedural requirements.

Note, of course, that in either case—whether the firm is solvent or insolvent—the corporation itself may bring a suit against an officer or director for breach of fiduciary duty.

²³¹ *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).

²³² *Id.* at *108.

allowed to take creditor interests into account. Thus, when a firm approaches insolvency, independent directors acting in good faith will be shielded from liability when they act in the interests of the corporate entity, even if their actions do not maximize shareholder value.²³³

Henry Hu and Jay Westbrook reject this traditional way of thinking about fiduciary duties, arguing that it “is inconsistent with new financial learning and muddles the analysis of risk taking.”²³⁴ Instead, they argue for a strong form of the “no multiple masters” thesis—namely, that there should be no creditor-regarding duties so long as the corporation has not filed for bankruptcy because (a) maximizing corporate value will conflict with maximizing shareholder value, especially as the corporation encounters financial distress; and (b) when the corporation does encounter distress, the board should maximize shareholder value.²³⁵ This is because

the investment risk taking that would be optimal from the corporation’s standpoint—or from the managers’ or creditors’ standpoint—differs radically from shareholder-optimal risk taking. Simply put, risk taking that is optimal for the corporate entity itself (and most managers and creditors) is likely to be too cowardly from the standpoint of well-diversified shareholders.²³⁶

Hu and Westbrook’s argument is important because it recognizes the implications of a shareholder-value-maximization approach to director fiduciary duties. They are right that shareholder value and corporate value can, and will, diverge, especially as the firm encounters financial distress. They are also correct that shifting fiduciary duties as the firm becomes insolvent may somewhat undermine accountability. And finally, on their approach, the hypothetical is easily resolved: the board should approve the LBO, even when it knows that doing so will render the firm insolvent.

As we continue to dig out from the 2008 meltdown and reckon with the enormous social costs of financial distress, this 2007 view seems otherworldly. By embracing what seems to me to be a *reductio ad absurdum*, Hu and Westbrook approach a form of equity fetishism—maximizing equity value for its own sake and not as a tool for building valuable firms. By contrast, the traditional corporate law exhortation to maximize firm value is a very

²³³ See, e.g., *Prod. Res. Grp.*, 863 A.2d at 788 (noting the shield *Credit Lyonnais* provided for directors to pay the company’s bills “as a first priority”).

²³⁴ Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1359 (2007).

²³⁵ *Id.* at 1357.

²³⁶ *Id.*; see also *id.* at 1378 (“The overall effect is to exacerbate management’s aversion to risk and encourage excessive worry about the corporate entity’s success or failure.”).

useful reminder that doing so—and not maximizing shareholder value—is what corporate law is, and should be, about.

i. Was the Board's Decision in the Best Interest of the Corporation?

Let us now return to the opening hypothetical: suppose the board is confronted with an LBO that will render the firm insolvent. If we take a traditional “entity” view that the board of directors owes its fiduciary duty to the corporation—and resist the now conventional identification of the corporation with the shareholders—would proceeding with the transaction be in the best interest of the corporation? From that perspective, the board must consider both the potential benefits and the potential harms of the decision to the corporation. When the transaction at issue is an LBO that, as in our hypothetical, will render the firm insolvent, the analysis is surprisingly straightforward and unequivocal.

Consider, first, the harm to the corporation: financial distress and bankruptcy. While obviously fact-specific, studies indicate that bankruptcy is costly to firms, with direct costs of around 3% and total costs of 20% to 30% of firm value.²³⁷

What is the benefit *to the corporation* of the hypothetical LBO? There would seem to be little or none. From a finance perspective, the main potential corporate benefit from an LBO is increased efficiency, driven by the disciplining effect of debt: managers are more likely to make hard choices (e.g., closing plants) if they must do so in order to avoid bankruptcy.²³⁸ That benefit, however, is lost if, as in the hypothetical, the LBO itself renders the firm insolvent. When that happens, the benefits of the transaction all flow to the shareholders.²³⁹

²³⁷ See Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067, 1087 (1984) (finding, from a small sample, that costs can exceed 20% but, on average, comprise 11% to 17% of firm value); Gregor Andrade & Steven N. Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*, 53 J. FIN. 1443, 1463 (1998) (finding total costs to be 10% to 20% of firm value); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 299 (1990) (finding direct costs around 3%).

²³⁸ Jensen, *supra* note 21, at 324.

²³⁹ See Steven Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 671-72 (1996) (“Because a solvent corporation has a fiduciary duty to creditors only where its action would cause insolvency, the term vicinity of insolvency should, therefore, only mean . . . that insolvency is one of the reasonably expected outcomes. Perhaps a better term for vicinity of insolvency therefore should be ‘contingent insolvency.’” (footnotes omitted)).

ii. Would the Directors' Breach of Fiduciary Duty Be Exculpated?

To complete the corporate law analysis, we need to consider what *sort* of breach of fiduciary duty is being alleged and whether directors would be exculpated under a DGCL section 102(b)(7) charter provision. Because such provisions are pervasive, the claim would have to be pled as a breach of the duty of loyalty. Does it fit?

Part of the fiduciary duty of loyalty is the duty to act in good faith.²⁴⁰ Moreover, section 102(b)(7) explicitly precludes exculpation for actions not in good faith.²⁴¹ How does Delaware understand “good faith”? The analysis most relevant to the hypothetical is the Chancery Court’s in *In re The Walt Disney Co. Derivative Litigation*, a case arising out of the dreadful decision to hire Michael Ovitz and his \$140 million termination payment.²⁴² Chancellor Chandler held that allegations that directors “consciously and intentionally disregarded their responsibilities, adopting a ‘we don’t care about the risks’ attitude concerning a material corporate decision,” adequately alleged a breach of the duty of good faith.²⁴³ The allegations implied that the directors “knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss.”²⁴⁴

Chancellor Chandler, in language specifically approved by the Delaware Supreme Court, elaborated on the concept of bad faith. He explained that bad faith may be shown

where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.²⁴⁵

²⁴⁰ See *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (“[A] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.” (quoting *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003))); see generally Leo E. Strine, Jr., et al., *Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629 (2010).

²⁴¹ DEL. CODE ANN. tit. 8, § 102(b)(7) (2011).

²⁴² 825 A.2d 275 (Del. Ch. 2003) (ruling on the motion to dismiss).

²⁴³ *Id.* at 289 (emphasis omitted).

²⁴⁴ *Id.* (emphasis omitted).

²⁴⁵ *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 755 (Del. Ch. 2005) (post-trial opinion) (footnotes omitted), *aff’d*, *Brehm v. Eisner (In re The Walt Disney Co. Derivative Litig.)*, 906 A.2d 27 (Del. 2006). The Delaware Supreme Court quoted the language above in *Brehm*, 906

In order to obtain a ruling under this standard that the officers' or directors' actions breached the duty of loyalty, one would have to argue that, in single-mindedly focusing on maximizing *shareholder* value and acting with indifference to the corporation's insolvency risk, they adopted a "we don't care about the risks' attitude concerning a material *corporate* decision."²⁴⁶ What strengthens the claim is that, in the hypothetical LBO, not one penny of the proceeds goes into firm projects. Instead, all the money raised by borrowing against firm assets was paid out to the pre-LBO shareholders and in fees. From the corporation's perspective, this could be viewed as the sort of "no win" proposition that provides strong evidence of a lack of good faith.²⁴⁷

As noted above, it is precisely this aspect of the traditional understanding of fiduciary duties to which Hu and Westbrook object.²⁴⁸ When, as in the hypothetical, there is a clear conflict between what is good for the corporation and what is good for the shareholders, Hu and Westbrook view acting in the interests of the corporation as a form of cowardice. Alternatively stated, the traditional view that the duty of loyalty runs to the corporation, if directors understand and internalize it, can orient directors when insolvency looms and the normal assumption that what is good for the shareholders is good for the corporation breaks down.

iii. The Fit with the Delaware "Zone of Insolvency" Cases

How does this "fiduciary duty" theory fit with the Delaware cases on the duties of directors "in the zone of insolvency"? The canon is quite compact and well-known: *Credit Lyonnais*,²⁴⁹ *Production Resources Group, L.L.C. v. NCT Group, Inc.*,²⁵⁰ *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*,²⁵¹ and *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*.²⁵² No Delaware case directly addresses the question of directors' duties when the decision itself renders the firm insolvent.

A.2d at 67, and *Stone*, 911 A.2d at 369. The fact that defendants prevailed after a six-week trial does not affect the validity of the Chancellor's articulation of the legal rule.

²⁴⁶ *In re Disney*, 825 A.2d at 289 (emphasis added).

²⁴⁷ *See Joy v. North*, 692 F.2d 880, 896 (2d Cir. 1982) (describing a "no-win" situation that led to allegations of lack of good faith).

²⁴⁸ *See supra* text accompanying notes 234-236.

²⁴⁹ *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, Civ. A. No. 12150, 1991 Del. Ch. LEXIS 215, at *108 n.55 (Del. Ch. Dec. 30, 1991).

²⁵⁰ 863 A.2d 772, 788 (Del. Ch. 2004), *overruled in part by* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

²⁵¹ 906 A.2d 168, 174 (Del. Ch. 2006), *aff'd sub nom.* *Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007).

²⁵² 930 A.2d 92, 103 (Del. 2007).

The *Credit Lyonnais* case arose out of the failed LBO of MGM by Giancarlo Parretti. Credit Lyonnais had financed MGM's escape from bankruptcy and had received governance rights.²⁵³ After a trial, the court concluded that Parretti had breached his agreements and that Credit Lyonnais was entitled to exercise its rights to remove him and his associates from the MGM board of directors.²⁵⁴ In the course of considering Parretti's claim that the bank and the management team breached a fiduciary duty of good faith and fair dealing owed to Parretti by "failing to facilitate sale transactions that Parretti sought in order to help him regain control," the court found that the "management group acted prudently with respect to these transactions from the point of view of MGM."²⁵⁵ The case, however, is mainly remembered for Chancellor Allen's provocative obiter dicta exploring the divergence of equity and enterprise incentives in the "zone of insolvency."²⁵⁶

Production Resources arose out of an attempt to collect a debt.²⁵⁷ Because the defendant, NCT, a limited liability company, continued operating even though it seemed to be insolvent, the plaintiff, PRG, a creditor, sought to protect its interests by appointing a receiver under DGCL section 291.²⁵⁸ PRG also alleged a breach of fiduciary duty against the NCT board, and, moreover, argued that because NCT was insolvent, PRG should be able to bring a direct claim, rather than having to satisfy the requirements for a derivative claim.²⁵⁹

The court granted the plaintiff's demand for appointment of a receiver.²⁶⁰ With respect to the fiduciary duty claims, the issue was whether the claims were derivative or direct. PRG conceded that the claims would have been derivative had the company been solvent because they were based on injury to the corporation.²⁶¹ But, PRG claimed, once the company became insolvent, the claims should become direct claims in the hands of the creditors.²⁶² Not surprisingly, the court rejected this argument and held that claims that are derivative in a solvent company remain derivative in an insolvent

²⁵³ *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at *7-9.

²⁵⁴ *Id.* at *10.

²⁵⁵ *Id.* at *107-08.

²⁵⁶ *Id.* at *108 n.55.

²⁵⁷ *Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 774 (Del. Ch. 2004), *overruled in part* by *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

²⁵⁸ *Id.* at 774-75.

²⁵⁹ *Id.* at 775.

²⁶⁰ *Id.* at 775-76.

²⁶¹ *Id.* at 776.

²⁶² *Id.*

company.²⁶³ Because neither party briefed the procedural issues that arise once the claim is characterized as derivative (e.g., whether demand by creditors is required), the court left those issues for another day.²⁶⁴

In the course of this analysis, then-Vice Chancellor Strine included a wide-ranging discussion that tried to make sense of and bring order to the literature on *Credit Lyonnais*, with a clear suggestion, again in dictum, that “*Credit Lyonnais* provided a shield to directors from stockholders who claimed that the directors had a duty to undertake extreme risk so long as the company would not technically breach any legal obligations.”²⁶⁵ The implication, of course, is that *Credit Lyonnais* did not provide creditors with a sword.

Trenwick arose out of the failure of a multinational insurance group.²⁶⁶ The case was brought by a litigation trust that emerged from the reorganization of the top U.S. subsidiary with the authority to bring claims belonging to the subsidiary (but not, according to the court, the subsidiary’s creditors’ claims).²⁶⁷ It brought claims against the parent company, alleging a variety of violations including breach of fiduciary duty, and against the directors of the subsidiary, alleging breach of the duties of care and loyalty.²⁶⁸

In the course of wrestling with (and ultimately dismissing) what seems to have been a badly drafted complaint, Chancellor Strine suggested, again in dictum, that directors of a wholly owned subsidiary may “owe a duty to the subsidiary not to take action benefiting a parent corporation that they know will render the subsidiary unable to meet its legal obligations.”²⁶⁹

In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, the most recent opinion bearing on directors’ duties to creditors, the Delaware Supreme Court addressed the issue of creditor standing.²⁷⁰ The court squarely rejected plaintiffs’ claim that creditors should have direct standing to bring fiduciary duty claims against directors when the corporation is either in the “zone of insolvency” or insolvent.²⁷¹ Rather, the court

²⁶³ *Id.*

²⁶⁴ *Id.* at 795-96.

²⁶⁵ *Id.* at 788.

²⁶⁶ *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 172 (Del. Ch. 2006), *aff’d sub nom. Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007).

²⁶⁷ *Id.* at 172-73. Insurance companies, like banks, are exempt from federal bankruptcy law and have a specialized insolvency regime.

²⁶⁸ *Id.* at 172-74.

²⁶⁹ *Id.* at 203.

²⁷⁰ 930 A.2d 92, 94 (Del. 2007).

²⁷¹ *Id.* at 103.

held, a claim that is derivative when the firm is solvent remains derivative when it becomes insolvent.²⁷²

As this quick review shows, Delaware has yet to address the key issue in my hypothetical, although there is supportive language in *Trenwick*, quoted above.

d. *Theory IV: Directors' Duty to Obey the Law?*

In the hypothetical, if the transaction went forward, the LBO could well be viewed as a fraudulent transfer, as discussed above. Indeed, the hypothetical contains suggestions of fraud:

In the course of the sale process, [senior managers] have directed the preparation of new projections that, to an impartial eye, would be found to be wildly optimistic or even fraudulent. The board knows that the juiced projections were prepared for the marketing effort, that they have minimal foundation, and that the buyers and their financing banks have been relying upon them without realizing just how juiced they are.²⁷³

Would directors, in knowingly approving an LBO that would constitute a fraudulent transfer, or knowingly presenting fraudulent projections, violate their "fiduciary duty to obey the law," and thereby breach their duty of loyalty?

Is there such a duty and, if so, what is its scope? In German corporate law, this is known as the "duty to legality."²⁷⁴ The ALI Principles of Corporate Governance explicitly limit profit maximization and shareholder gain: "Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business: (1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law."²⁷⁵ Section 4.01

²⁷² *Id.* Even though the holding of the case is quite narrow and technical, the case has been read as rejecting *any* fiduciary duties for the benefit of creditors in the zone of insolvency. This reading is largely based on the statement in *Gheewalla* that

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

Id. at 101. This statement is clearly dictum. Moreover, it does not address the core issue raised by "wrongful trading" theories—namely, actions taken that threaten to render the company insolvent.

²⁷³ See *supra* Section IV.A.

²⁷⁴ Florian M. Reinhart, *The Director's and Officer's Duty to Legality?* 2-4 & n.4 (Jan. 2012) (unpublished manuscript) (on file with author).

²⁷⁵ ALI, PRINCIPLES OF CORPORATE GOVERNANCE § 2.01(b) (1992).

states that a “director or officer has a duty to the corporation to perform the director’s or officer’s functions in good faith.”²⁷⁶ The comments make clear that “a director or officer violates the duty to perform his or her functions in good faith if he or she knowingly causes the corporation to disobey the law.”²⁷⁷ Similarly, DGCL section 102(b)(7) precludes exculpation for “a knowing violation of law.”²⁷⁸

Chancellor Strine has been particularly attentive to the “duty to legality” aspect of the duty of loyalty. As he stated in *In re Massey Energy*:

Delaware law does not charter law breakers. Delaware law allows corporations to pursue diverse means to make a profit, subject to a critical statutory floor, which is the requirement that Delaware corporations only pursue “lawful business” by “lawful acts.” As a result, a fiduciary of a Delaware corporation cannot be loyal to a Delaware corporation by knowingly causing it to seek profit by violating the law.²⁷⁹

What is the scope and content of this duty in Delaware law?²⁸⁰ Does it apply to all obligations of the corporation, including “private law” obligations to contracting parties, or is it limited to “public law” obligation? And, if limited to public law obligations, on which side of the private–public line does fraudulent conveyance fall?

The case law articulating the “duty to legality” seems to focus on public law obligations such as campaign finance laws,²⁸¹ bribery,²⁸² price fixing,²⁸³ mine safety regulations,²⁸⁴ off-label marketing of prescription drugs,²⁸⁵ and

²⁷⁶ *Id.* § 4.01.

²⁷⁷ *Id.* § 4.01(a) cmt. d.

²⁷⁸ DEL. CODE ANN., tit. 8, § 102(b)(7) (2011).

²⁷⁹ *In re Massey Energy Co. Derivative & Class Action Litig.*, No. 5430-VCS, 2011 Del. Ch. LEXIS 83, at *73-74 (Del. Ch. May 31, 2011) (footnotes omitted). For similar statements by Chancellor Strine, see *Desimone v. Barrows*, 924 A.2d 908, 934-35 (Del. Ch. 2007); *Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 788 n.52 (Del. Ch. 2004), *overruled in part by N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007); *Metro Comm’n Corp. BVI v. Advanced Mobilecomm Techs. Inc.*, 854 A.2d 121, 131 (Del. Ch. 2004). Vice Chancellor Laster has recently added his voice. *La. Mun. Police Emps.’ Ret. Sys. v. Pyott*, 46 A.3d 313, 352 (Del. Ch. 2012).

²⁸⁰ For a review of the case law, see Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 34-38 (2006).

²⁸¹ *Miller v. Am. Tel. & Tel. Co.*, 507 F.2d 759, 762 (3d Cir. 1974).

²⁸² *Roth v. Robertson*, 118 N.Y.S. 351, 353 (N.Y. Sup. Ct. 1909).

²⁸³ *Plate v. Sun-Diamond Growers of Cal.*, 275 Cal. Rptr. 667, 672 (Cal. Ct. App. 1990).

²⁸⁴ *In re Massey Energy*, 2011 Del. Ch. LEXIS 83, at *74.

²⁸⁵ *La. Mun. Police Emps. Ret. Sys. v. Pyott*, 46 A.3d 313, 353 (Del. Ch. 2012).

unfair labor practices.²⁸⁶ Chancellor Strine, in law review mode, likewise seems to focus on public law obligations.²⁸⁷

Assuming, then, that the “duty to legality” is in fact limited to public law obligations (criminal and regulatory) and does not impose a duty not to breach contracts of the corporation, how are fraud and fraudulent conveyance to be understood? To the extent that the hypothetical presents a credible claim of fraud, it would seem to fit comfortably within the existing doctrine. As Vice Chancellor Laster has noted, “Corporate misconduct involving fraud or illegality presents a different situation. Even under a pure *Caremark* monitoring theory”²⁸⁸

But what about knowingly approving a transaction that will constitute a fraudulent conveyance? Is fraudulent conveyance law “public” or “private”? In *In re Cybergensics*, the Third Circuit considered whether fraudulent conveyance claims in failed LBOs belong to the debtor (and thus were sold when all the assets of the debtor were sold) or to the creditors (and thus could be pursued for their benefit by a trustee, by the debtor in possession acting as a trustee or directly).²⁸⁹ In reaching the conclusion that fraudulent conveyance claims belong to the creditors, not the bankrupt corporation, Judge Rendell emphasized the extent to which fraudulent conveyance protects the “transferor’s creditors, whose efforts to collect their debts have essentially been thwarted as a consequence of the transferor’s actions.”²⁹⁰ In emphasizing fraudulent conveyance’s roots in fraud (or even criminal law),²⁹¹ the Third Circuit, in effect, located fraudulent conveyance claims on the public side of the line. By contrast, in the context of determining the scope of permissible bankruptcy jurisdiction and the limits imposed by the Seventh Amendment right to a jury trial, the U.S. Supreme Court, in

²⁸⁶ *Abrams v. Allen*, 74 N.E.2d 305, 306 (N.Y. 1947).

²⁸⁷ Strine, et al., *supra* note 240, at 652 n.69 (citing cases).

²⁸⁸ *Pyott*, 46 A.3d at 352 (referring to *In re Caremark Int’l Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996)).

²⁸⁹ See Official Comm. of Unsecured Creditors *ex rel. Cybergensics Corp. v. Chinery* (*In re Cybergensics Corp.*), 226 F.3d 237, 239 (3d Cir. 2000).

²⁹⁰ *Id.* at 241 (emphasis removed). But see Official Comm. of Unsecured Creditors of *Cybergensics Corp. ex rel. Cybergensics Corp. v. Chinery*, 330 F.3d 548, 555-69 (3d Cir. 2003) (en banc) (vacating the panel decision and wrestling with the question whether the Supreme Court’s opinion in *Hartford Underwriters Insurance Co. v. Union Planters Bank*, 530 U.S. 1 (2000), precludes derivative creditor standing to assert fraudulent conveyance claims). See generally Nancy Haller, Comment, *Cybergensics II: Precedent and Policy vs. Plain Meaning*, 56 ME. L. REV. 365 (2004) (evaluating the Third Circuit’s en banc decision).

²⁹¹ *In re Cybergensics*, 226 F.3d at 242 (citing Barry L. Zaretsky, *The Fraudulent Transfer Law as the Arbitrator of Unreasonable Risk*, 46 S.C. L. REV. 1165, 1168-71 (1995), as “explaining that fraudulent transfer law started as part creditor protection and part criminal law, but evolved into a law primarily for creditor protection”).

Granfinanciera, S.A. v. Nordberg, viewed fraudulent conveyance actions brought for the purpose of augmenting the estate against parties who have not submitted claims as “quintessentially suits at common law that more nearly resemble state-law contract claims” and thus “appear [to be] matters of private rather than public right.”²⁹²

If the “fraud” aspects of fraudulent conveyance are sufficient to put it on the “public law” side, then knowingly approving an LBO that is a fraudulent conveyance, like knowingly approving corporate action to defraud a third party, would breach directors’ duty of loyalty, even if selling the company for a sky-high price benefited shareholders.

B. *Shareholder Opportunism in Complex Corporate Structures: the Dynegy Battle*

The recent battle at Dynegy Inc. between shareholders and their loyal managers versus creditors provides a good context for better understanding the structure of actual conflicts and how they can be controlled. The Dynegy fight involves complex financial structures nested in a holding company structure with numerous layers of subsidiaries. Because such complexity plays a large role in the waging and controlling of current battles, it deserves closer attention.

Dynegy is in the wholesale power business.²⁹³ As of the end of 2010, it owned seventeen electric power plants in six states.²⁹⁴ Like many public corporations, Dynegy is, in fact, a group of companies, with the publicly held parent, Dynegy Inc., nothing more than a holding company at the top of a complex pyramid.²⁹⁵ As we will see, this common structure presents a variety of possibilities for shareholders to extract value from creditors.

The chart in Figure 3 is a simplified view of Dynegy before its August 2011 restructuring. Publicly held Dynegy Inc. owns all of the shares of

²⁹² 492 U.S. 33, 56 (1989); accord *Stern v. Marshall*, 131 S. Ct. 2594, 2616 (2011) (applying *Granfinanciera* in determining the scope of bankruptcy court jurisdiction and the limits imposed by Article III of the U.S. Constitution).

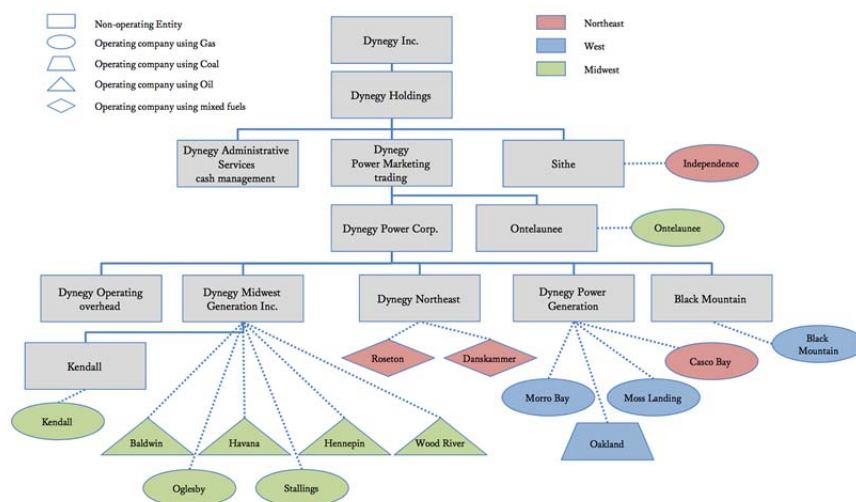
²⁹³ Dynegy’s power plants largely sell power on the wholesale energy markets operated by regional Independent System Operators (ISO), such as NYISO, or Regional Transmission Organizations (RTO). See Report of Susheel Kirpalani, Examiner 19, *In re Dynegy Holdings, L.L.C.*, No. 11-38111 (CGM), (Bankr. S.D.N.Y. Mar. 9, 2012) [hereinafter *Dynegy Examiner Report*]. ISOs and RTOs typically operate regional electricity grids, administer a region’s wholesale electricity markets, and provide reliability planning for the region’s bulk electricity system.

²⁹⁴ *Id.* at 20.

²⁹⁵ *Id.* at 22.

Dynegy Holdings, Inc. (DHI), which itself holds the shares of lower-level holding companies. The ultimate operating companies are at the bottom of the chart, five layers below the publicly owned parent.²⁹⁶

Figure 3²⁹⁷



Why do firms adopt a structure with numerous wholly owned subsidiaries and subsidiaries of subsidiaries?²⁹⁸ There are a variety of reasons.²⁹⁹ In some cases, the structure is adopted because the limited liability of the corporate form allows liabilities of subsidiaries to be contained. Sometimes it is necessary in order to do business in a foreign jurisdiction that bars branches or divisions of foreign firms. Sometimes it is necessary or useful in satisfying local regulatory requirements (e.g., licenses or, in the case of regulated utilities, the public utilities commission). Sometimes it is adopted because selling or buying a subsidiary is far easier than selling or buying

²⁹⁶ *Id.*

²⁹⁷ *Id.* at 21.

²⁹⁸ According to Richard Squire, the 100 largest U.S. public companies (by revenue) in 2010 reported an average of 245 major subsidiaries, with a median of 114. Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. CHI. L. REV. 605, 606 n.1 (2011).

²⁹⁹ For prominent contributions to this literature, see Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589, 621-22 (1975); Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 507-09, 516-17 (1976); Robert J. Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. PA. L. REV. 235, 235 & n.1 (1976). See generally Squire, *supra* note 298.

specific assets: a firm decides to acquire another firm and knows that someday it may wish to sell it. And sometimes the structure is adopted to facilitate financing: it allows the pledging of particular cash flows to repay debt taken on the security of specified assets. As we will see, although company structure raises few classic shareholder issues (at least when the subsidiaries are all wholly owned and solvent), it can raise a variety of shareholder-creditor issues.

In the case of Dynegy, most of the public debt was issued by the top-level subsidiary, DHI, with the cash flows necessary to pay bondholders coming through dividends from the lower level operating subsidiaries (as DHI itself has no operations).³⁰⁰ DHI also had bank debt and lease guaranty obligations. As of July 30, 2011, DHI had approximately \$1.5 billion in bank debt, \$3.5 billion in public bond debt, and \$550 million in lease obligations. Although the bank debt contained a variety of affirmative and negative covenants and events of default, the bond debt was largely “covenant lite.” DHI’s bond debt was not guaranteed by Dynegy or by the DHI subsidiaries. The main protective covenant restricted DHI and its subsidiaries from granting liens unless the DHI senior notes were secured on equivalent terms as the new secured debt. Importantly, there were no covenants restricting the transfer of DHI’s assets, or restricting dividends from DHI, or financial tests such as EBITDA ratios.

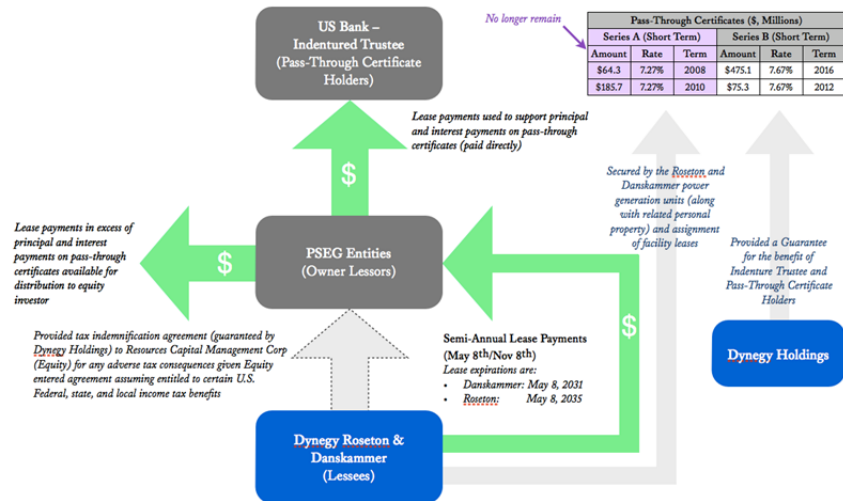
Moving down the corporate structure, one arrives at the Roseton and Danskammer facilities—formerly of Central Hudson Gas—that Dynegy acquired in 2001 using long-term financing provided by a sale-leaseback transaction.³⁰¹ In particular, four of the six power plants comprising those facilities were sold in an asset-backed sale-leaseback transaction with Danskammer O.L. L.L.C. and Roseton O.L. L.L.C., subsidiaries of PSEG. Dynegy subsidiaries Dynegy Danskammer and Dynegy Roseton became lessees under leases that expire in 2031 and 2035, respectively. The transaction was financed by a combination of equity and pass-through trust certificates issued by the PSEG entities and secured by a mortgage on the underlying power plants. DHI guaranteed the lease payments and performance obligations, with restrictions against DHI selling all or substantially all of its assets, with the acquirer, in such a case, being obligated to assume

³⁰⁰ For the following discussion on Dynegy’s public debt structure, see Dynegy Examiner Report, *supra* note 293, at 22-25.

³⁰¹ For the following discussion on Dynegy’s lease guaranties, see *id.* at 24.

the guarantee (the “successor obligor” clause).³⁰² Below is the examiner’s graphic showing the financing structure.

Figure 4³⁰³



Then financial disaster struck. The price of electrical energy crashed, driven by a collapse in natural gas prices and reduced demand due to the economic slowdown.³⁰⁴ The Roseton and Danskammer facilities were no longer able to generate sufficient revenues to meet their lease obligations.³⁰⁵ By June 2010, Dynegy’s stock had dropped to \$3.85 per share.³⁰⁶ In August 2010, Dynegy and Blackstone entered into a merger agreement at \$4.50 per share.³⁰⁷ In October 2010, Seneca, a hedge fund, bought a 9.3% stake, while Carl Icahn reported approximately 10%.³⁰⁸ Both Icahn and Seneca opposed the Blackstone offer as inadequate. In November 2010, on the eve of the

³⁰² Intragroup guarantees are very common. See Squire, *supra* note 298, at 606 n.2 (noting that, in 2010, 63% of the largest U.S. companies (by revenue) reported using intragroup guaranties).

³⁰³ Dynegy Examiner Report, *supra* note 293, at 25.

³⁰⁴ See Dynegy Inc., Annual Report (Form 10-K), at 4 (Mar. 8, 2011).

³⁰⁵ See Dynegy Examiner Report, *supra* note 293, at 71.

³⁰⁶ See Dynegy Inc., Annual Report (Form 10-K), at 46 (Mar. 8, 2012).

³⁰⁷ Dynegy Examiner Report, *supra* note 293, at 26.

³⁰⁸ Hillary Canada, *The Morning Leverage: Icahn Enters the Dynegy Ring*, WALL ST. J. (Oct. 12, 2010), <http://blogs.wsj.com/privateequity/2010/10/12/the-morning-leverage-icahn-enters-the-dynegy-ring>.

shareholder vote, Blackstone increased its offer to \$5.00 per share, a price the shareholders still rejected.³⁰⁹

Soon thereafter, Icahn, who by now owned around 14.5%,³¹⁰ announced a tender offer for all outstanding shares at \$5.50 per share.³¹¹ Seneca opposed Icahn's offer as still inadequate.³¹² In February 2011, shareholders rejected Icahn's tender offer.³¹³

In the wake of two rejected acquisition proposals, Dynegy's management resigned and its directors announced that they would not stand for reelection.³¹⁴ The board was expanded to include Icahn and Seneca nominees, interim management was installed, and Icahn and Seneca assumed effective control.³¹⁵ At the same time, it was clear that Dynegy would breach the covenants of its bank debt unless it restructured.³¹⁶

At this point, Dynegy began to pursue a complex and audacious plan to free value for shareholders from the claims of creditors. It proceeded in several phases.³¹⁷ The first step was to reorganize the operating subsidiaries so that the coal-fired generating facilities would be held by Dynegy Midwest Generation Corp. ("CoalCo") while the gas-fired facilities would be held by Dynegy Power Corp. ("GasCo"). These two new entities would be indirect wholly owned subsidiaries of DHI and structured as "bankruptcy remote" entities with limits on the dividends that could be paid. A new credit facility, to replace DHI's old credit facility that was approaching default, would be arranged, using GasCo and CoalCo as collateral.³¹⁸ The unprofitable Danskammer and Roseton facilities would be left behind.

PSEG, the counterparty in the Danskammer and Roseton sale-leaseback transaction, challenged the restructuring under the successor obligor clause.³¹⁹ In essence, PSEG argued that the restructuring, by allowing GasCo and CoalCo to take on additional debt for the benefit of DHI, and

³⁰⁹ Dynegy Examiner Report, *supra* note 293, at 26.

³¹⁰ Naureen S. Malik, *Big Dynegy Holder Opposes Icahn-Backed Buyout Bid*, WALL ST. J. (Dec. 20, 2010), <http://online.wsj.com/article/SB10001424052748703886904576031632596026972.html>.

³¹¹ Dynegy Inc., Annual Report (Form 10-K), at 45 (Mar. 8, 2011).

³¹² Malik, *supra* note 310.

³¹³ Annual Report, *supra* note 311, at 45.

³¹⁴ Dynegy Examiner Report, *supra* note 293, at 27-28.

³¹⁵ *Id.* at 27-28, 32.

³¹⁶ *Id.* at 33.

³¹⁷ Here I follow the Examiner's Report which, despite extensive redactions, is the most complete description available. *Id.* at 49-50, 59-67.

³¹⁸ *Id.* at 71.

³¹⁹ For the following discussion on the legal challenges to the restructuring, I draw on the Examiner's Report. *See id.* at 72-83.

by moving the valuable gas- and coal-fired facilities into bankruptcy-remote entities while leaving the impaired Danskammer and Roseton facilities behind, undermined the value of DHI's guarantee of the Danskammer and Roseton lease obligations.³²⁰

The Delaware Chancery Court rejected PSEG's claims for several reasons. First, it held that the successor obligor clause, by its terms, only bound DHI and not the DHI subsidiaries, in contrast to other provisions that applied to both DHI and its "Principal Subsidiary."³²¹ Because the restructuring did not involve the transfer of all or substantially all of DHI's assets—namely, the stock that it held in lower-level holding companies—it did not violate the successor obligor provision.³²²

Second, because DHI continued indirectly to own 100% of GasCo and CoalCo, the reorganization did not transfer any assets away from its ultimate ownership.³²³ DHI, according to the defendants and to the Chancery Court, would continue to hold all of the power plants it held before, so the guaranty would be no less secure.³²⁴

Finally, the court rejected PSEG's claim that transferring the valuable generating facilities away from Danskammer and Roseton constituted a fraudulent conveyance. According to the court, the transfer was not a fraudulent conveyance because: (1) it was not a transfer (because the assets remained indirectly owned); (2) DHI did not receive less than equivalent value (for the same reason); and (3) plaintiff could not establish that DHI was or would be rendered insolvent by the transfer.³²⁵ Indeed, the court pointed out, the reorganization would allow DHI to replace its old credit facility, avoid default, and extend the maturity of the senior secured debt by around four years.³²⁶

With the Chancery Court refusing to grant an injunction, the reorganization went forward, creating separate coal and gas "silos" with a new intermediate holding company, DGI, as in Figure 5.

³²⁰ *Id.* at 72-74.

³²¹ Roseton O.L., L.L.C. v. Dynegy Holdings, Inc., No. 6689-VCP, 2011 WL 3275965, at *11-13 (Del. Ch. July 29, 2011).

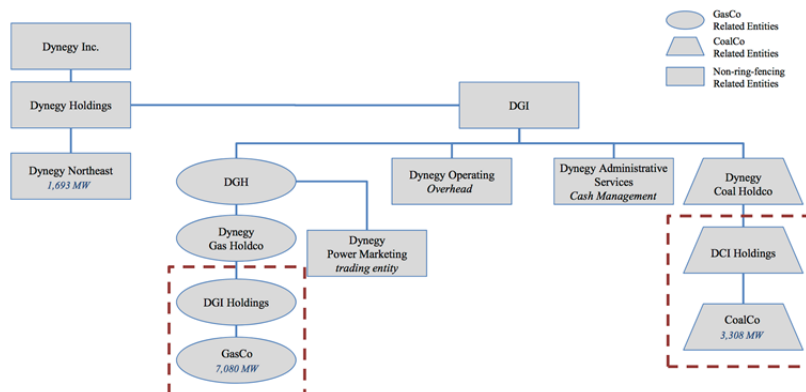
³²² *Id.*

³²³ *Id.* at *11.

³²⁴ *Id.* at *11-12.

³²⁵ *Id.* at *14-17.

³²⁶ *Id.*

Figure 5³²⁷

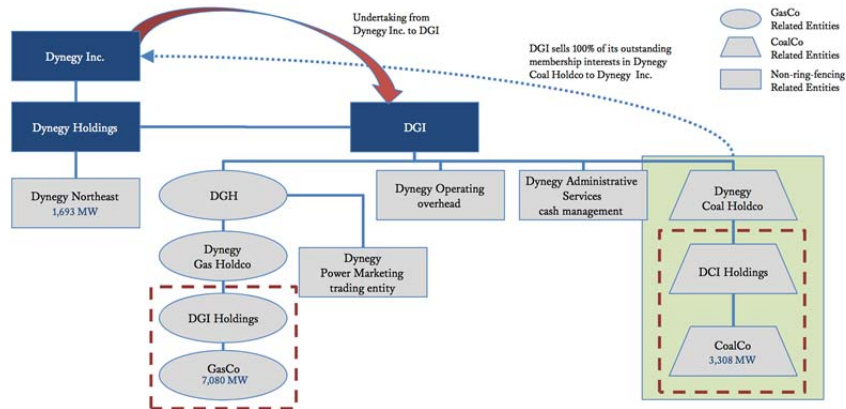
At this point, the reorganization plan moved to phase two: transferring the CoalCo assets out from under DHI to become a subsidiary of the publicly held parent, Dynege Inc.³²⁸ Here, the goal seems to have been to insulate these assets from DHI's obligations, to preserve value for shareholders in the event of an (inevitable) DHI bankruptcy, and possibly to put pressure on DHI bondholders to accept DHI's exchange offer.

³²⁷ Dynege Examiner Report, *supra* note 293, at 67.

³²⁸ The discussion of phase two follows the Examiner's Report. *See id.* at 86-95.

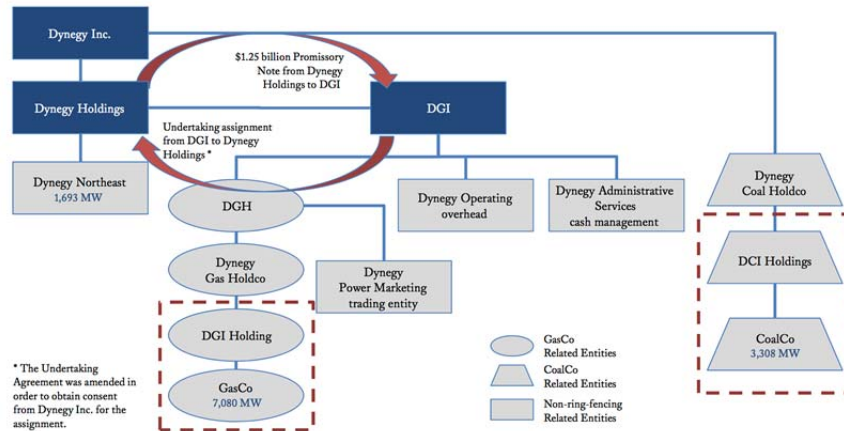
As Figure 6 shows, the coal assets were transferred to Dynegy Inc. in exchange for an “undertaking” from Dynegy Inc. to DGI, a newly formed subsidiary of DHI.

Figure 6³²⁹



Next, Dynegy and DHI entered into an amended and restated undertaking which replaced DGI with DHI as the recipient of payments made. This was achieved by DGI assigning the undertaking to DHI in exchange for a note payable to DGI, as per Figure 7.

329 *Id.* at 84.

Figure 7³³⁰

A key provision in the amended undertaking, inserted when it was transferred from DGI to DHI, allowed Dynegy to reduce its obligations under the undertaking by reducing DHI's obligations under its outstanding bonds, including by sponsoring an exchange offer at a discount.³³¹

On September 15, 2011, Dynegy announced an exchange offer for \$1.25 billion in DHI-issued bonds. In response, DHI bondholders sought to enjoin the exchange offer and to undo the transfer of CoalCo away from DHI.³³² The complaint, filed in the N.Y. Supreme Court against Dynegy, DHI, overlapping Dynegy and DHI directors, and others, alleged intentional and constructive fraudulent conveyance, unlawful distribution, unlawful dividend, and breach of fiduciary duties of care, loyalty, and good faith.³³³

The exchange offer failed to gain sufficient support and was terminated on November 3, 2011.³³⁴ On November 7, 2011, DHI and other subsidiaries (but not Dynegy Inc.) filed for bankruptcy under Chapter 11.³³⁵ With the bankruptcy filing, the action moved to bankruptcy court, where an examiner,

³³⁰ *Id.* at 87.

³³¹ *Id.*

³³² Peg Brickley & Matt Wirz, *Bondholders Sue Dynegy, Challenge Restructuring*, WALL ST. J. (Sept. 22, 2011), <http://online.wsj.com/article/SB10001424053111903791504576586850956560150.html>.

³³³ Complaint at 2-3, *Avenue Invs. L.P. v. Dynegy Inc.*, No. 652599/2011 (N.Y. Sup. Ct. Sept. 21, 2011).

³³⁴ Dynegy Examiner Report, *supra* note 293, at 101.

³³⁵ Mike Spector, *Dynegy Files for Unusual Bankruptcy*, WALL ST. J., Nov. 8, 2011, at B1.

Susheel Kirpalani, a bankruptcy lawyer at Quinn Emanuel Urquhart & Sullivan, L.L.P., was appointed and asked to complete an independent investigation of the events leading up to the bankruptcy. In a lengthy report, Kirpalani summarized the various stages of the transaction and examined potential claims.³³⁶ His analysis provides a very useful guide to how existing doctrines can be employed to control shareholder opportunism.

The key transaction was the transfer of CoalCo away from DHI. CoalCo's cash flows were thereafter unavailable to satisfy claims of DHI creditors, including claims under DHI's guaranty of the Roseton and Danskammer leases. The key question thus became whether the value of the undertaking was reasonably equivalent to the value of CoalCo. Kirpalani concluded that the value of the undertaking, to the extent it could be valued, was far less than the value of CoalCo. A second key finding was that DHI was either insolvent or rendered insolvent by the transfer of CoalCo—a finding contested by the defendants.³³⁷

With these two factual findings, Kirpalani concluded that the transfer constituted both an intentional and a constructive fraudulent conveyance. In addition, he concluded that the directors of DHI, who had also worked for Dynegy and thus faced a clear conflict of interest, breached their duty of loyalty to DHI by considering only the interests of Dynegy and its shareholders, when their duties ran, instead, to the creditors of DHI. Finally, he relied on a corporate law doctrine not explored above and found that the DHI directors, by transferring the opportunity to repurchase the DHI bonds at a discount to Dynegy in exchange for no consideration, usurped a DHI corporate opportunity. Although claims of illegal distributions and illegal dividends were made in the September N.Y. Supreme Court complaint,³³⁸ the examiner did not express an opinion on those claims.

A good lawyer, Kirpalani relied on a variety of alternative legal approaches. Intentional and constructive fraudulent conveyance theories formed an important part of Kirpalani's analysis, but he did not stop there. Once he concluded that there was a strong showing that DHI, the debtor, had been (or became) insolvent at the time of the transfers, he relied on fiduciary duty law to attack the conflict of interest of the overlapping directors:

No rational board of directors would have transferred CoalCo to an unrelated, third party on the terms and conditions under which DGI (and [DHI])

³³⁶ See generally Dynegy Examiner Report, *supra* note 293. Unless otherwise noted, the following discussion draws from this report. *Id.* at 1-11.

³³⁷ *Id.* at 3-5.

³³⁸ Complaint, *supra* note 333, at 2-3.

transferred it. Dynegy Inc. got much better terms than any third party would have gotten with respect to the initial Undertaking, and even better terms in the amended version of the Undertaking.³³⁹

Had the DHI directors been independent of Dynegy and its controlling shareholders, it would have been a somewhat harder argument to make, although still strong.

In another way as well, the report highlights the value of deploying multiple legal approaches. Dynegy and its shareholders primarily focused on complying with the terms of the “covenant lite” debt issued by DHI, seemingly believing that they would be in the clear if they complied with the terms of those contracts. And, in fact, the examiner, like the Delaware Chancery Court, concluded that the first step of the reorganization—rearranging the coal and gas assets separate silos and leaving the troubled Roseton and Danskammer facilities behind—did not violate the successor obligor clause or any other terms of the indenture.³⁴⁰ The examiner argued, however, that compliance with the indenture alone is not sufficient, because

creditors of insolvent corporations have the right to avail themselves of non-contractual protections, such as fiduciary duties, “[b]ecause, by contract, the creditors have the right to benefit from the firm’s operations until they are fully repaid, it is they who have an interest in ensuring that the directors comply with their traditional fiduciary duties of loyalty and care.”³⁴¹

Finally, the Dynegy dispute shows the value of the bankruptcy law providing for the appointment of an examiner with the power to investigate, make findings, and act as a mediator.³⁴² The examiner’s report was issued on March 9, 2012.³⁴³ On March 12, the bankruptcy court ordered mediation under the supervision of the examiner in his role as plan mediator.³⁴⁴ On March 20, 2012, defendants filed a preliminary response to the examiner’s report.³⁴⁵ On April 4, 2012, DHI reached an agreement with nearly all its creditors that shifted the CoalCo assets back to DHI, and provided unsecured

³³⁹ Dynegy Examiner Report, *supra* note 293, at 136.

³⁴⁰ *Id.* at 2.

³⁴¹ *Id.* at 139 (quoting *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 195 n.75 (Del. Ch. 2006)).

³⁴² 11 U.S.C. §§ 1104, 1106 (2006 & Supp. IV 2011).

³⁴³ Dynegy Examiner Report, *supra* note 293, at 159.

³⁴⁴ Order Approving Settlement, at 7, *In re Dynegy Holdings, L.L.C.*, No. 11-38111 (CGM) (Bankr. S.D.N.Y. June 1, 2012).

³⁴⁵ *Id.*

creditors with a 99% stake in the parent, Dynegy Inc., effectively wiping out existing shareholders.³⁴⁶ On June 1, 2012, the bankruptcy court approved the settlement.³⁴⁷ Finally, on September 5, 2012, the bankruptcy court approved the plan of reorganization.³⁴⁸

V. IMPLICATIONS AND CHALLENGES: IS THE CURRENT FRAMEWORK ADEQUATE?

In the preceding section, I surveyed the existing framework's robust resources for controlling shareholder-creditor conflicts in two key contexts. As the variety of contractual and noncontractual measures shows, we already have a wide variety of tools available. On the other hand, to the extent that we have become a shareholder-centric system through changes in practice, not changes in law, it is necessary to consider whether the law has kept pace, as well as alternative approaches.

A. *The Importance of Comparative Corporate Law: The United Kingdom*

The United Kingdom provides an important comparison to the United States. Both have large numbers of widely held or "dispersed ownership" corporations. Yet, although the economies are relatively similar, U.K. corporate law is far more "shareholder-centric" than board-centric Delaware corporate law. This can be illustrated by a variety of different provisions. The core, fundamental decisionmaking body under U.K. law is the shareholders acting in the general meeting.³⁴⁹ U.K. shareholders have the power to elect directors, and importantly, the power to remove directors, with or without cause, before the expiration of their terms of office.³⁵⁰ This is important because shareholders, without board acquiescence or special provision in the articles of incorporation, additionally have the power to call a general meeting.³⁵¹ These provisions eliminate the entrenchment made possible by staggered boards.³⁵² Shareholders may force the company, at its

³⁴⁶ Joseph Checkler, *Dynegy Reaches a Pact with Lenders*, WALL ST. J., Apr. 5, 2012, at B3.

³⁴⁷ See generally Order Approving Settlement, *supra* note 344.

³⁴⁸ Joseph Checkler, *Judge Confirms Dynegy's Plan to Exit Bankruptcy*, WALL ST. J., Sept. 6, 2012, at B9.

³⁴⁹ PAUL L. DAVIES & SARAH WORTHINGTON, *GOWER & DAVIES' PRINCIPLES OF MODERN COMPANY LAW* 435-499 (9th ed. 2012).

³⁵⁰ Companies Act, 2006, c. 46, § 168 (Eng.).

³⁵¹ *Id.* §§ 303-305.

³⁵² John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727, 1737 (2007).

own expense, to circulate resolutions to be voted on at the annual general meeting.³⁵³ In addition, shareholders enjoy mandatory preemption rights.³⁵⁴ The shareholder-centric character of U.K. law is particularly striking in the control context. Under the Takeover Code, directors must remain largely passive when a tender offer is made for the company's shares and cannot take any "frustrating action" without shareholder approval.³⁵⁵

U.K. law may be shareholder-centric, but it *also* imposes robust creditor-regarding duties, primarily under the rubric of "wrongful trading."³⁵⁶ Section 214 imposes liability if "at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation," and did not take "every step with a view to minimising the potential loss to the company's creditors as . . . he ought to have taken."³⁵⁷ My LBO hypothetical presents an easy case. The directors knew that there was no reasonable prospect of avoiding insolvency because that is what the bankers told them, and they cannot claim that they took every step with a view to minimizing the potential loss to creditors because, in the hypothetical, they took none.³⁵⁸

With a knowledge standard of "knew or ought to have concluded" that is interpreted according to the "objective" standard of a "reasonably diligent person having both (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that that director has,"³⁵⁹ one can understand directors' concerns with personal liability. On the other hand, and important to understanding the balance struck, while directors face personal

³⁵³ Companies Act, 2006, c. 46, §§ 338–340 (Eng.).

³⁵⁴ *Id.* § 561.

³⁵⁵ PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS, Rule 21.1, at I13 (10th ed. 2011), available at <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf>; see also *id.* Gen. Principle 3, at B1. For background on this prohibition, see Armour & Skeel, *supra* note 352, at 1773.

³⁵⁶ Insolvency Act, 1986, c. 45, § 214 (Eng.). For a concise but comprehensive overview of directors' creditor-regarding duties in the United Kingdom and on the continent, see Paul Davies, *Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency*, in THE LAW AND ECONOMICS OF CREDITOR PROTECTION: A TRANSATLANTIC PERSPECTIVE 303 (Horst Eidenmüller & Wolfgang Schön, eds. 2008).

³⁵⁷ Insolvency Act, 1986, c. 45, § 214(2)-(3) (Eng.).

³⁵⁸ See EILÍS FERRAN, PRINCIPLES OF CORPORATE FINANCE LAW 40-41 (2008) (discussing the requirements of section 214); DAVID KERSHAW, COMPANY LAW IN CONTEXT: TEXT AND MATERIALS 296-97 (2009) (discussing "shadow directors" in the context of section 214).

³⁵⁹ Insolvency Act, 1986, c. 45, § 214(4) (Eng.).

liability for wrongful trading, the court determines what contribution the person shall make, if any, to the company's assets. In addition, the wrongful trading provision only applies in insolvent liquidation and not when there are reorganizations through other procedures such as administrations, schemes of arrangement, or workouts.³⁶⁰ Because of a variety of other differences between the United States and United Kingdom, the level of enforcement is quite low.³⁶¹ Even so, by all accounts, directors are very conscious of the potential for wrongful-trading liability and the provision has been criticized for potentially chilling entrepreneurial activity and hurting creditors by inducing firms to cease trading prematurely in order to avoid potential director liability.³⁶²

Yet, this legal and reputational risk can be managed. KKR and Blackstone have large London offices and private equity is alive and well in the United Kingdom. How does the presence of a "wrongful trading" provision with the potential for director liability affect the process and structure for an LBO? Deals are said to be less leveraged than in the United States and, prior to approving a transaction, target boards typically require a solvency opinion from their bankers.³⁶³ What makes the U.K. approach such an interesting comparative case is that it shows how one recognizably similar system has defined directors' creditor-regarding duties, how deal lawyers adjust, and how it potentially contributes to reducing extreme leverage—even as differences in complementary institutions might make one reluctant to transplant the United Kingdom's "wrongful trading" provision to Delaware.

Comparative corporate law can also be useful in addressing the optimal mix and development of tools: Is it better to broaden the restrictions on distributions to shareholders or rely on the traditional view that directors owe fiduciary duties to the corporation (rather than the shareholders

³⁶⁰ Horst Eidenmüller, *Trading in Times of Crisis: Formal Insolvency Proceedings, Workouts and the Incentives for Shareholders/Managers*, in *THE LAW AND ECONOMICS OF CREDITOR PROTECTION*, *supra* note 356, at 241, 251.

³⁶¹ PAUL L. DAVIES WITH SARAH WORTHINGTON, *GOWER & DAVIES' PRINCIPLES OF MODERN COMPANY LAW* 223-24 (8th ed. 2008). The low level of enforcement has been attributed to difficulties in financing wrongful-trading actions: liquidators, short on funds, are apparently reluctant to spend money on any but the strongest cases; secured creditors are not willing to finance cases because the law is clear that recoveries all go to benefit the unsecured creditors; finally, the cause of action cannot be assigned to an entrepreneurial lawyer as doing so would be "champertous" and thus illegal. *Id.*

³⁶² See generally *Re Cont'l Assurance Co. of London plc* (in liquidation) (No. 4), [2001] 2 B.C.L.C. 287 (Ch.). For a review of the criticisms, see Davies, *supra* note 356, at 317-27.

³⁶³ Interview with William F. Charnley, Partner, King & Spalding L.L.P., in Oxford, Eng. (June 7, 2011).

directly)? This is a complicated question that has arisen in other corporate law systems and that is beyond the scope of this Article.³⁶⁴

B. *The Divided Architecture of U.S. Corporate Law and the Specification of Directors' Fiduciary Duties*

A striking feature of the small set of Delaware cases dealing with the duties of directors in or near bankruptcy is the fact that there are so few of them. Directors' creditor-regarding fiduciary duties are underspecified, especially in comparison with the United Kingdom's approach. This is partly a result of the United States' distinctive divided architecture of corporate and insolvency law. Delaware courts adjudicate disputes in solvent corporations, while bankruptcy courts have jurisdiction over most insolvent firms. Although many of the underlying rights enforced in bankruptcy are determined by state law,³⁶⁵ the forum and procedures by which they are enforced are a matter of federal bankruptcy law. This leads to a variety of oddities and complexities.³⁶⁶

The United Kingdom, with its unitary, rather than divided judicial architecture, offers an interesting comparison case. Unlike in the United States, a single group of judges—the Chancery Division of the High Court—hears both “Company Law” matters and insolvency cases, including the winding up of companies.³⁶⁷

³⁶⁴ I owe this point to Assaf Hamdani, who argues that Israel, an economy characterized by controlling shareholder structures, shows the value of expanding restrictions on distributions by, for example, giving creditors the right to sue derivatively to enjoin distributions in solvent firms, over relying on fiduciary duties.

³⁶⁵ See *Butner v. United States*, 440 U.S. 48, 55 (1979) (“Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.”).

³⁶⁶ David Skeel has written incisively on the division of labor between corporate law and bankruptcy, and its effects, which he refers to as “vestigialization.” See generally David A. Skeel, Jr., *Bankruptcy Boundary Games*, 4 BROOK. J. CORP. FIN. & COM. L. 1 (2009); David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994). As a bankruptcy specialist, he has primarily focused on how this division of labor has slowed the development of bankruptcy doctrine (e.g., the development of state preference law, rules governing derivative suits by creditors in bankruptcy, and corporate voting in bankrupt corporations). As he points out, when all insolvent firms end up in bankruptcy court, there is little incentive for states to keep their state law insolvency procedures up to date, or to pay much attention to doctrines that govern issues that arise exclusively in bankruptcy. This section continues that inquiry, but with a corporate lawyer's focus on directors' duties.

³⁶⁷ Compare Company Act, 2006, c. 46, § 1156 (Eng.) (defining “the court”), and Insolvency Act, 1986, c. 45, § 117 (Eng.) (granting the court jurisdiction to wind up companies), with CHANCERY

The U.S. architecture has dramatically influenced the development of the common law of corporations.³⁶⁸ First, the different courts understand their roles differently. Bankruptcy is, fundamentally, about restructuring debtor–creditor relations, and not about the adjudication of state-created rights and duties.³⁶⁹ This core function sets the tasks of the bankruptcy court and bankruptcy practitioners, which include the following: staying collection efforts; sorting out creditors’ claims; designing plans of reorganization (in the case of Chapter 11); and moving forward with dispatch. State law fiduciary duty claims against directors (who are not parties to the bankruptcy) can enter this process as part of maximizing the assets of the debtor’s estate, but, with the important goal of quick resolution and exit, they will necessarily be treated as secondary concerns. The tasks of Delaware Chancery Courts and the Supreme Court are entirely different. Although accustomed to deciding matters quickly in order to allow transactions to proceed, a key part of the Delaware courts’ mission is to define and articulate the duties of directors.

These differing institutional roles combine with the divided architecture to create selection bias. Delaware courts focus primarily on the rights of shareholders and bondholders in *solvent* corporations because those are the main types of cases they see. Bankruptcy courts primarily focus on unsecured versus secured creditor issues in *insolvent* corporations because those are the cases they see. Directors’ creditor-regarding duties—prominent in unitary systems like the United Kingdom—fall between the two poles.

Second, bankruptcy courts, like federal district courts sitting in diversity, are limited in their ability to develop corporate law’s creditor-protection features systematically because these are part of *Delaware* corporate law, not *federal* bankruptcy law. As in other situations when a court applies non-forum law, anything a bankruptcy court or a district court says about Delaware corporate law is essentially a guess about how the Delaware Supreme Court would decide. By contrast, when a bankruptcy court applies

GUIDE 2013, ch. 20, available at <http://www.justice.gov.uk/guidance/courts-and-tribunals/courts/chancery-division> (treating proceedings under the Chancery Division).

³⁶⁸ It is important to realize the large extent to which Delaware corporate law is common law. Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1591–97 (2005). See generally Rock, *supra* note 176.

³⁶⁹ See *N. Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 71 (1982) (Brennan, J.) (plurality opinion) (“[T]he restructuring of debtor–creditor relations, which is at the core of the federal bankruptcy power, must be distinguished from the adjudication of state-created private rights, such as the right to recover contract damages that is at issue in this case.”).

the Bankruptcy Code's fraudulent transfer jurisprudence, it is applying bankruptcy law.³⁷⁰

Finally, and most importantly, a unitary system keeps both shareholder and creditor issues in front of the same set of judges. When judges have cases raising both types of issues, they are more likely to focus on the conflict between shareholder and creditors interests, especially at the solvent-insolvent boundary.

Delaware courts have the expertise but not the cases. Bankruptcy courts have the cases but do not have the necessary corporate law expertise, time, or incentives. Amending the Delaware constitution to permit bankruptcy courts to certify questions to the Delaware Supreme Court would provide some useful insight.³⁷¹ This sensible change has the potential to increase the flow of cases, but it is not clear by how much. Because certification interrupts the flow of the case, bankruptcy judges can be expected to use it sparingly, instead relying on the parties to brief the issues and then deciding the issue themselves. In addition, answers provided on a necessarily incomplete record may be of uncertain value. Without the benefit of a full factual record, the Delaware Supreme Court is less able to engage in the common law-making process as it considers how Delaware law should evolve in the face of changing conditions. Finally, bankruptcy has some compensating institutions which make appeal to Delaware less pressing. In particular, the power to appoint an expert examiner to analyze potential claims and provide advice to the court is extremely valuable. As the *Dynegy* case shows, an able examiner, with expertise in both bankruptcy law and Delaware law, can help bankruptcy judges bridge the two systems.

C. *Delaware's Role as Impartial Umpire*

Delaware's preeminence as a corporate law jurisdiction is explained in part by the excellence of its courts in adjudicating conflicts. Delaware's fans

³⁷⁰ In a unitary system such as the United Kingdom's, with the same judges hearing corporate law and insolvency matters, there will be a much more continuous development in both corporate and insolvency law. Insolvency focuses the mind wonderfully and raises core corporate law duty issues in a context in which breaches arguably caused real harm. Strikingly, a significant number of important U.K. company law cases are insolvency cases. *See, e.g.*, *Salomon v. Salomon & Co.*, [1896] A.C. 22 (H.L.) (appeal taken from Eng.) (corporation as legal person); *Re Bluebrook Ltd.*, [2009] EWHC (Ch) 2114, [2010] 1 B.C.L.C. 338 (Ch.) (related party transactions and valuation); *Regentcrest plc (in liquidation) v. Cohen*, [2001] 2 B.C.L.C. 80 (Ch.) (good faith duty); *Re D'Jan of London Ltd.*, [1993] B.C.C. 646 (Ch.) (duty of care); *In re City Equitable Fire Ins. Co.*, [1924] 1 Ch. 407 (director fraud).

³⁷¹ *See generally* Henry duPont Ridgely, *Avoiding the Thickets of Guesswork: The Delaware Supreme Court and Certified Questions of Corporation Law*, 63 SMU L. REV. 1127 (2010).

(including me) believe that incorporation in Delaware benefits shareholders because its law and courts do better than any alternative jurisdiction in striking the balance between shareholders and managers, and between controlling and noncontrolling shareholders. Does Delaware do as good a job policing shareholder–creditor conflicts? There may be reason for concern.

There is an intriguing strand of finance research that purports to identify a link among legal rules protecting creditors, capital structure, and market valuation. John Wald and Michael Long report that U.S. manufacturing firms incorporated in states with stronger payout restrictions use less debt.³⁷² Yaxuan Qi and Wald find that firms incorporated in states with stronger payout restrictions are less likely to include creditor-protective debt covenants that constrain payouts, limit additional debt, or restrict the sale of assets.³⁷³ Sattar Mansi, William Maxwell, and Wald find that firms incorporated in states with more restrictive payout rules have better credit ratings and significantly lower yield spreads than firms incorporated in less restrictive states.³⁷⁴

These studies are flawed because there are no significant differences in restrictions on distributions to shareholders in different states.³⁷⁵ But that

³⁷² John K. Wald & Michael S. Long, *The Effect of State Laws on Capital Structure*, 83 J. FIN. ECON. 297, 315-16 (2007).

³⁷³ Yaxuan Qi & John Wald, *State Laws and Debt Covenants*, 51 J.L. & ECON. 179, 203 (2008).

³⁷⁴ Sattar A. Mansi, William F. Maxwell & John K. Wald, *Creditor Protection Laws and the Cost of Debt*, 52 J.L. & ECON. 701, 716-18 & n.31 (2009).

³⁷⁵ For the basics of stock repurchase and dividend regulation, see *supra* subsection IV.A.2. In these studies, the authors take the “minimum asset-to-debt” ratio for a distribution as the measure of the stringency of the state law restrictions on distributions. See, e.g., Mansi, Maxwell & Wald, *supra* note 374, at 707. These studies find that in Delaware this constraint equals 0, in New York it equals 1, and in California it equals 1.25 (Delaware, New York, and California are the three main jurisdictions and drive all the results). *Id.* The most significant finding is that creditors have greater confidence in firms incorporated in New York or California, with robust limitations on distributions to shareholders, than those incorporated in Delaware, with no significant restrictions. *Id.* at 721. But, contrary to the authors’ assertions, there is little interstate variation in the legal rules restricting distributions to shareholders, even though there are some differences in statutory language.

As noted above, one traditional limitation on the source of distributions is that they must be out of “surplus”—a term of art meaning the value of the firm’s assets exceeds its liabilities plus some cushion, a type of “balance sheet solvency” test. The only difference between states is their definition of the “cushion”: Delaware and New York use the traditional “stated capital” approach, in which the cushion is the aggregate “par value” plus additional amounts designated by the board of directors. BLACK, *supra* note 179, §§ 2:23 (Delaware), 2:33 (New York). California substituted the reliance on par value with a mandatory 25% cushion, with a variety of subrules for what is included in the calculation of assets and liabilities. *Id.* § 3:12. States that follow the Model Business Corporation Act likewise dispense with par value, but do not include the 25% cushion (a position that California adopted in 2011). *Id.* §§ 3:1–3:8. There is no reason to think that aggregate par

only makes the studies more interesting: they have found statistically significant differences among states, with creditors apparently preferring New York and California over Delaware. Indeed, it seems that U.S. manufacturing firms incorporated outside of Delaware are less leveraged; are less likely to include creditor-protective debt covenants that constrain payouts, limit additional debt, or restrict the sale of assets; and have better credit ratings and significantly lower yield spreads.

This “Delaware effect” seems to be real. What could be causing it, if it is not a result of different legal rules on distributions to shareholders? One possible interpretation of the results is that creditors view Delaware courts as “equity courts” in which equity holders (i.e., shareholders) systemically do better than creditors.

This is consistent with other findings. Ted Eisenberg and Geoff Miller argue that New York is to contracting what Delaware is to incorporation: the preferred choice of discerning consumers. Using a large sample of corporate contracts, Eisenberg and Miller show that New York law is the overwhelming choice of law for financing contracts, and for other types of major business contracts as well.³⁷⁶ Moreover, New York is the designated forum in 41% of contracts with a forum selection clause, with Delaware designated in only 11% of such contracts.³⁷⁷

New York’s success in attracting major corporate contracts is not accidental. According to Eisenberg and Miller, New York competes for major commercial contracts in much the same way as Delaware competes for

value in Delaware or New York corporations is systematically higher or lower than California’s 25% cushion, as applied.

The real difference among state statutes, not mentioned in the finance studies, is the presence of an “equity solvency” limitation. California, New York, and states following the Model Business Corporation Act all include a provision prohibiting distributions if, as the Model Business Code states, “after giving [the distribution] effect: (1) the corporation would not be able to pay its debts as they become due in the usual course of business.” MODEL BUS. CORP. ACT. § 6.40(c) (2008); *see, e.g.*, CAL. CORP. CODE § 501 (West 1990); N.Y. BUS. CORP. LAW § 510(a) (McKinney 2003). Although the Delaware code does not contain any such provision, it was long ago adopted by case law. *See, e.g.*, *SV Inv. Partners v. ThoughtWorks, Inc.*, 7 A.3d 973, 987 (Del. Ch. 2010), *aff’d*, 37 A.3d 205 (Del. 2011). In addition, state and federal fraudulent conveyance rules contain overlapping restrictions (albeit without director liability).

It is thus hard to identify any actual difference in the restrictions imposed on boards of directors in paying dividends or repurchasing stock. As far as I can tell, lawyers advising boards of directors on distributions to shareholders do not give different advice based on state of incorporation.

³⁷⁶ Theodore Eisenberg & Geoffrey P. Miller, *The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies’ Contracts*, 30 CARDOZO L. REV. 1475, 1489 (2009).

³⁷⁷ *Id.* at 1504 tbl.11.

corporations, namely, by offering “a menu of substantive rules that are desired by the contracting parties and by providing prompt, efficient, and reliable procedures and institutions for resolving disputes.”³⁷⁸

Finally, these findings are consistent with the politics of Delaware corporate law. Casual empiricism suggests that corporate law in Delaware, while influenced by shareholder interests and managerial interests, does not have an equally well-organized creditor lobby.³⁷⁹ This contrasts with New York, where creditor interests are well-organized and active in ensuring that New York remains a center for commercial law.³⁸⁰

Should Delaware be concerned that investors believe it favors equity over debt? Perhaps Delaware should worry, if inadequate creditor protection raises a firm’s cost of capital and thereby affects the desirability of Delaware law.

D. Our “Model” of the Corporation

Two ways of thinking about corporations (what in some contexts are called “models”) coexist somewhat uneasily within corporate law: the “entity” model, which views the corporation as a social institution; and the “property” (or even “contract”) model, which views the corporation as nothing more than the property of its shareholders.³⁸¹ Each can claim preeminence in different eras, with the property model dominant in the 19th century, the entity model emerging with the rise of managerialism in the 1930s, and the property model reemerging during the 1980s.³⁸² Each

³⁷⁸ Geoffrey P. Miller & Theodore Eisenberg, *The Market for Contracts*, 30 CARDOZO L. REV. 2073, 2073-74 (2009); see also THE CHIEF JUDGE’S TASK FORCE ON COMMERCIAL LITIGATION IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS TO THE CHIEF JUDGE OF THE STATE OF NEW YORK 9-14 (2012), available at <http://www.nycourts.gov/courts/comdiv/PDFs/ChiefJudgesTaskForceOnCommercialLitigationInThe21stpdf.pdf> (recommending improvements to retain New York’s status as “an attractive forum for commercial litigation”).

³⁷⁹ Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 680 (2005) (“[C]orporation law in Delaware is influenced by only the two constituencies whose views are most important in determining where entities incorporate: managers and stockholders . . . [I]t is . . . fair to say that both groups have a lot of clout, and that Delaware corporate lawmakers seriously consider each group’s perspective on all key issues.”).

³⁸⁰ See Eisenberg & Miller, *supra* note 376, at 1492 (noting that New York’s dominant role in finance contracts “likely is reinforced by the location of large banks in New York”).

³⁸¹ See William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 266-72 (1992). In a very interesting recent article, Justice Jack Jacobs has pointed out the misalignment between the current model implicit in Delaware case law—that of passive, helpless, and ignorant shareholders—and the reality of concentrated shareholders. See Jack B. Jacobs, *Does the New Corporate Shareholder Profile Call for a New Corporate Law Paradigm?*, 18 FORDHAM J. CORP. & FIN. L. 19, 21 (2012).

³⁸² See generally Allen, *supra* note 381.

finds support in features of Delaware law.³⁸³ Somewhat counterintuitively, the more the reality becomes shareholder-centric and descriptively conforms to the “property” model, the more important the “entity” view of the corporation becomes for law and practice, especially when the business judgment rule and exculpation provisions protect directors from liability.

These sorts of “models” can be both positive and normative. When used prescriptively, the basic understanding of the corporation orients fiduciaries in the performance of their duties and courts in the review of that performance. For example, an entity view of the corporation is important for compensation committees as they consider how to structure compensation: it reminds them that the goal of the exercise is to create valuable firms.

The entity view is more broadly important in orienting managers and directors, serving as a counterweight to their self-interests. When managers owned little or no stock in their firms, requiring them to manage for the entity’s benefit reinforced their tendencies to confuse self-interest with duty-fulfillment. The great virtue of Jensen and Meckling’s deflationary and reductionist “nexus of contracting” view was that it put pressure on the managerialist model that had provided a cover story for management entrenchment. Exhorting fiduciaries to maximize shareholder value, by contrast, pushed them to look beyond their interest in keeping their jobs to the interests of the shareholders, whose interests (unlike creditors’) were not already aligned with their own.

The problem is that when managers start to think like shareholders, a normative model that enjoins fiduciaries to focus exclusively or predominantly on shareholder interests will only reinforce their self-interested tendencies. When the key questions involve conflicts among the various stakeholders in the firm—shareholders versus creditors and controlling versus noncontrolling shareholders—a different normative model is required.

In these circumstances, the entity view becomes critically important, not because a corporation is “really”—from some metaphysical or conceptual perspective—an entity rather than an aggregate, but for normative and instrumental reasons. When key conflicts exist between controlling and noncontrolling shareholders, the entity view, by encouraging the board to serve the interests of the corporate entity rather than the controlling

³⁸³ For example, the rules governing standing in derivative suits emerge out of the “entity” conception of the corporation, a conception in which fiduciary duties are owed to the corporation itself. By contrast, doctrines like *Revlon* “duties” are more consistent with a model that views the corporation as nothing more than a network or nexus of contracts with fiduciary duties owed to the shareholders.

shareholder, provides useful guidance and a valuable counterweight. Likewise, when key conflicts exist between equity and debt, and when managers have robust equity incentives, enjoining the board to serve the interests of the corporate entity rather than equity will provide useful counterbalancing pressures that challenge the human tendency to confuse self-interest with right conduct.

CONCLUSION

The world has changed. The old picture of the managerial corporation in which managers, compensated like bureaucrats, entrench themselves at the expense of helpless and passive shareholders is dead and should be buried. Managers now largely think and act like shareholders.

In thinking about disputes among participants in the corporation, we should stop assuming that there is a significant divergence of interests between passive shareholders and entrenching managers. Given the changes in the world, it would be more plausible to assume that managers think like shareholders, for better and for worse. But, more to the point, there is no reason to *assume* anything: it is easy enough to prove what managers' actual incentives are. The relevant information is all disclosed.

When managers' interests are aligned with shareholders' interests, a misalignment opens up between shareholder–manager interests on the one side and creditor interests on the other. When this happens, creditors might plausibly claim that shareholders and managers are seeking to transfer value from creditors in a way that impairs firm value. It is, of course, a separate matter whether the attempt infringes on any legally cognizable creditor interests. But, when interpreting creditor–firm contracts, applying traditional, legal limitations on distributions to shareholders, and analyzing new situations that arise, courts would do well to be on the lookout for opportunistic behavior.

We should remember that “shareholder value maximization” is only a tool for building valuable companies and a rich society. Like any tool, it can be overused. As shown above, the law contains a variety of legal tools to temper the focus on equity value—to introduce “cooling rods” into the “reactor core” to prevent meltdown. Having lived through the financial meltdown of 2008, we should all be a bit more cautious about strategies that increase risk or depend on an assumption that bankruptcy costs are trivial. Paying attention to creditors can be a useful proxy for the universe of nonshareholder interests.

Ultimately, I am arguing less for changing the law than for changing the conversation. Rather than yet another permutation of old shareholder-versus-manager debates, we should look around at what the actual conflicts are and consider what to do about them.