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Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany, and Japan

Justin Wood*

I. Introduction

The ability of creditors to enforce fiduciary duties against directors when a corporation enters the zone of insolvency has emerged in the last decade as a major question in corporate governance scholarship and practice. Since United States ("U.S.") case law remains largely undeveloped in this area, an analysis of the approach to the agency cost problem in the zone of insolvency in other major jurisdictions could provide helpful guidance in shaping U.S. law. This article compares and analyzes director duties and creditor protections when corporations enter the zone of insolvency in the U.S., Germany, and Japan.

Conflicts of interest between creditors and shareholders intensify once a corporation enters the zone of insolvency. With the depletion of corporate assets, creditors begin to displace shareholders as residual claimants on a firm's assets. However, since shareholders maintain control rights prior to the institution of insolvency proceedings, the agency cost problem of shareholder opportunism vis-à-vis creditors intensifies during the zone of insolvency.

Although the need for law to provide creditors additional protection is debatable, each comparative jurisdiction responds to this agency cost problem by providing mechanisms of creditor protection. The U.S. and Germany provide creditor protection through a combination of standards, strategies, and increased creditor enforcement mechanisms. In contrast, Japan provides creditor protection through corporate governance practice that puts creditors at the helm of struggling firms. Relative to Germany and Japan's response, the U.S.'s response best addresses this agency cost problem by minimizing the conflict of interest between shareholders and

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creditors and allowing directors to maximize firm value.

Part II of this article discusses the agency cost problems prevalent in the zone of insolvency. Parts III, IV, and V outline the responses to this agency cost problem in the U.S., Germany, and Japan respectively. Part VI analyzes the extent to which each country's response addresses these agency cost problems. Finally, part VII concludes that the U.S. approach best addresses these agency cost problems by giving managers the flexibility to maximize firm value in the face of competing stakeholder interests.

II. Agency Cost Problems in the Zone of Insolvency

A corporation's entrance into the zone of insolvency magnifies the conflict of interest between shareholders and creditors. As insolvency looms, competition for limited (and likely diminishing) corporate resources intensifies between shareholders and creditors each seeking a return on invested capital. As a result, the specter of shareholder opportunism vis-à-vis creditors becomes an increasingly significant agency cost for firms approaching insolvency. Moreover, this agency cost is amplified because shareholders and creditors influence board decision-making through different mechanisms,[1] have access to different degrees of information about the company, and face collective action problems.

Four specific conflicts of interest between shareholders and creditors in the zone of insolvency magnify agency costs.[2] First, shareholders and creditors have different risk preferences for management's investment of corporate resources. Second, each party may attempt to siphon out the firm's assets. Third, shareholders and creditors may have divergent preferences regarding whether the company should liquidate or continue operating as a going concern. Finally, shareholders may have an incentive to under-invest corporate resources when only creditors will benefit from the return on investment. The remainder of this section discusses these conflicts of interest in greater detail.

A. Divergent Risk Preferences

Shareholders and creditors diverge in their risk preferences

1. In this context, shareholders influence board decision-making primarily through appointment and removal rights while creditors influence board decision-making primarily through negotiation and the threat of instituting debt collection or insolvency proceedings.

2. *See* Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1489 (1993).

regarding management investment of corporate resources when companies experience financial distress. Shareholders, as residual claimants of the corporation, fully benefit from management's investment activity that increases the value of the firm. In contrast, creditors, who typically hold fixed claims against corporate assets, do not benefit from successful investment activity beyond the value of their claims. Inside the zone of insolvency, this incentive structure creates a preference for greater investment of corporate resources in shareholders while creating a preference for minimal investment in other creditors.

Conversely, shareholders do not bear the full burden of unsuccessful investment activity undertaken by the corporation. As the lowest priority claimants, shareholders' expected return on equity diminishes as the corporation approaches insolvency. Facing the prospect of a low-to-zero return on equity, shareholders prefer that management gamble corporate resources in high risk investments in hopes of high returns. In contrast, creditors bear the full burden of a financially distressed company's poor investment decisions. Assets that are invested unsuccessfully are no longer available to satisfy creditors' claims. Thus, creditors have little to gain if the corporation undertakes risky investments with assets that could otherwise be used to satisfy their claims. Accordingly, shareholders prefer risky corporate investments that carry the possibility of large returns while creditors prefer low-risk investments to preserve the assets available.[3]

B. Incentives to Siphon Assets Out of the Firm

Shareholders and creditors both have strong incentives to siphon assets out of the firm when the corporation enters the zone of insolvency. In order to maximize their return on equity, shareholders may act opportunistically by seeking payment of dividends or other distributions.[4] Additionally, controlling shareholders and insiders may attempt to acquire corporate assets on favorable terms. Likewise, creditors will seek to maximize the return on their claims by pursuing the remedies provided by their lending contracts.[5] Such contractual remedies include the right to seize collateral that is subject to a security interest and the right to accelerate debt repayment. In addition to placing shareholder and creditor interests in direct conflict, this zero-sum race to siphon assets out of the firm could prevent management from entering investments that are beneficial to the company.[6]

3. *See id.* at 1489-90.
4. *Id.* at 1494.
5. *Id.*
6. *Id.*

C. *Divergent Liquidation Preferences*

When a corporation enters the zone of insolvency, shareholders and creditors typically differ in the preference of whether to keep the company in operation. Shareholders that will receive nothing upon the liquidation of an insolvent company have a strong incentive to keep the company operational as long as possible in the hope of turning things around. On the other hand, creditors tend to prefer the prompt, certain repayment available through liquidation over the uncertainty and risks involved in keeping the company operational.[7]

D. *Shareholders Incentives for Underinvestment*

In a company approaching insolvency, shareholders have no incentive for certain positive net present value investments when the benefits solely accrue to creditors.[8] To the extent that shareholders can influence management investment decisions in the zone of insolvency, they will discourage management from undertaking investments that will not increase their return on equity. This could lead to socially undesirable outcomes when management declines to invest in positive net present value opportunities from which shareholders may not benefit.[9]

III. U.S. Response to this Agency Cost Problem

A. *The U.S. System of Corporate Governance*

The U.S. approach to the agency cost problem surrounding the zone of insolvency is best understood in the context of the U.S. system of corporate governance. To establish this context, this section begins with a discussion of how the U.S. corporate governance system reflects the country's common law origins and market landscape. Next, this section briefly outlines the U.S. system of corporate governance, focusing on directors' fiduciary duties.

1. Legal Origin

The U.S. legal system is based on the common law tradition, in which judicial decisions are a major source of lawmaking.[10] This common law system is reflected in the corporate laws of each of the fifty

7. Lin, *supra* note 2, at 1494-95.
8. *Id.* at 1496.
9. *Id.*
10. Rafael La Porta, et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1119 (1998).

states. Accordingly, many corporate governance rules and standards, including directors' fiduciary duties, developed from the courts in equity.[11] Additionally, in comparison to civil law systems, common law countries provide stronger protection to both shareholders and creditors.[12]

2. Extralegal Landscape

Although numerous extra-legal factors influence how corporate governance laws operate in practice, this section focuses on patterns of share ownership and the ownership role of banks and other creditors. Share-ownership in the U.S. is widely dispersed and largely held by individual investors. Many shareholders in the U.S. are passive investors who do not actively monitor management or attempt to influence corporate policy other than through the election and removal of directors. Moreover, although institutional ownership and hedge fund activism is rising in the U.S., most individual shareholders of large public companies do not own large enough stakes to exercise a dominant influence over management.[13] Likewise, banks generally do not play a significant corporate governance role in the U.S.[14] Though banks may hold shares, they are primarily debt rather than equity creditors to U.S. corporations.

3. Corporate Governance in the U.S.[15]

The U.S. system of corporate governance operates under the shareholder model. Under this model, directors operate the firm in a manner that maximizes economic value for shareholder investors. Under most circumstances, directors need not put the interests of other stakeholders above those of the shareholders. Moreover, this model places appointment and removal rights of directors solely in the hands of shareholders.

Under the corporate laws of all states, directors in a solvent corporation owe fiduciary duties to the corporation and its shareholders.[16] Directors owe two fiduciary duties to the corporation: the

11. *See* Franck Chantayan, *An Examination of American and German Corporate Law Norms*, 16 ST. JOHN'S J. LEGAL COMMENT. 431, 433-34, 436 (2002).

12. La Porta, et al., *supra* note 10, at 1116.

13. *See* Brian R. Cheffins, *The Metamorphosis of "Germany Inc.": The Case of Executive Pay*, 49 AM. J. COMP. L. 497, 498-99 (2001).

14. *Id.* at 500.

15. This discussion of corporate governance in the U.S. focuses on Delaware, the U.S. state with the most significant and well-developed corporate law.

16. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

duty of care and the duty of loyalty.[17] Shareholders are empowered to enforce fiduciary duties by bringing a derivative action on behalf of the corporation against directors.[18] Directors that discharge the duty of care and duty of loyalty in good faith will be entitled to the protections of the business judgment rule when faced with a shareholder action.[19]

Discharge of the duty of care requires that directors exercise an informed business judgment when making corporate decisions.[20] In determining whether a director exercised informed business judgment, a reviewing court will apply a standard of gross negligence.[21] This standard requires directors to adequately inform themselves as to the relevant facts and circumstances surrounding a proposed course of conduct. Additionally, directors must undertake reasonable deliberation prior to making a decision. Thus, in order to discharge the duty of care, directors must act with informed reasonable deliberation in making decisions on behalf of the corporation.[22] In practice, the force of the duty of care is mitigated by the ability of corporations to enact exculpatory charter provisions that insulate directors from personal liability for good faith breach of the duty of care.[23]

Discharge of the duty of loyalty requires directors to act "affirmatively to protect the interest of the corporation . . . [and] to refrain from doing anything that would work injury to the corporation."[24] Accordingly, directors may not advance personal interests, misappropriate corporate opportunities, or engage in self-dealing transactions at the expense of the corporation.[25] This duty does not operate as a *per se* ban on self-dealing transactions. Rather, directors engaging in self-dealing transactions must establish the entire fairness of the transaction to overcome the presumption of self-dealing.[26] Unlike the duty of care, corporations may not exculpate directors for breach of the duty of loyalty.[27]

Shareholders may bring a derivative action against directors on behalf of the corporation alleging breach of a fiduciary duty owed to the

17. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 2005 Del. Ch. LEXIS 113 (Del. Ch. 2005).

18. *See* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

19. *See id.* at 177.

20. Van Gorkom, 488 A.2d at 872-73.

21. *Id.* at 873.

22. *Id.* at 883.

23. *See, e.g.*, 8 Del. C. § 102(b)(7).

24. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (*quoting* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)).

25. James Gadsden, *Enforcement of Directors' Fiduciary Duties in the Vicinity of Insolvency*, 24-Feb. AM. BANKR. INST. L.J. 16, 16 (2005).

26. *Weinberger*, 457 A.2d at 710-11.

27. *See, e.g.*, 8 Del. C. § 102(b)(7).

corporation.[28] A derivative action brought by a shareholder operates both as a shareholder suit to compel the corporation to sue and as a suit by the corporation on its own behalf.[29] The ultimate decision to initiate litigation on behalf of a corporation rests with the board of directors.[30] Accordingly, a shareholder bringing a derivative action must first meet the procedural hurdle of either making a demand that the board sue or alleging that demand would be futile under the circumstances.[31] As a practical matter, derivative suits will only commence when a court finds the board's decision not to sue improper under the deferential business judgment standard or when the shareholder sufficiently alleges facts supporting demand futility.[32]

Directors who discharge the duty of care and duty of loyalty in good faith will be entitled to the protections of the business judgment rule when faced with shareholder litigation. The business judgment rule is a judicial presumption that directors, when making a business decision, "acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."[33] Accordingly, a reviewing court will not second-guess the business judgment of an informed, disinterested director who acted in good faith.

The business judgment rule operates both procedurally and substantively.[34] Procedurally, the rule places the initial evidentiary burden on a plaintiff shareholder to offer evidence that the board breached the duty of care, duty of loyalty, or otherwise did not act in good faith.[35] If the shareholder fails to carry this burden, the substantive protections of the business judgment rule attach, shielding the defendant directors from personal liability.[36] On the other hand, if the shareholder carries the initial evidentiary burden, the court will apply the entire fairness standard to determine director liability.[37] Accordingly, the *ex post* standards by which director decisions will be judged under U.S. law are relatively director-friendly, with policy goals of promoting risk-taking and entrepreneurialism.

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28. *See, e.g.*, Spiegel v. Buntrock, 571 A.2d 767, 773 (Del. 1990).
29. *Id.*
30. *Id.*
31. *Id.* at 773.
32. *Id.* In order to allege demand futility, a shareholder must allege facts that create a reasonable doubt as to either the independence of the board or the validity of the business judgment exercised in the transaction.
33. Aronson, 473 A.2d at 812.
34. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995).
35. McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000).
36. *Id.*
37. Cinerama, 663 A.2d at 1162.

B. *Defining the Zone of Insolvency in the U.S.*

The judicially-delineated boundaries of the zone of insolvency are "imprecise and hard-to-define."[38] As such, no precise test has been applied to determine whether a corporation is operating in the zone of insolvency.[39] Rather, reviewing courts will apply the more familiar tests of solvency in determining whether a decision took place in the zone of insolvency.[40]

Courts apply two tests to determine the solvency of a corporation.[41] The "balance sheet" test looks at a corporation's balance sheet to determine whether the fair market value of its liabilities is greater than the fair market value of its assets.[42] Some courts add to this the additional requirement that the corporation face "no reasonable prospect that the business can be successfully continued in the face thereof."[43] Alternatively, the "cash flow" or "equity" test assesses whether the corporation has sufficient cash flow to service its debts as they become due in the ordinary course of business.[44] A plaintiff need only plead facts sufficient under one of these tests to demonstrate a corporation's insolvency.[45]

Under either test, a reviewing court will review a corporation's solvency in hindsight and without deference to representations made in board meetings or in audited financial statements.[46] As a practical matter, this suggests that directors should assess a company's solvency conservatively and presume insolvency when a reasonable doubt exists.[47] The prudence of this conservative approach is buttressed by the reality that creditors, benefiting from plaintiff-friendly pleading standards, can get discovery in fiduciary duty claims in situations where a corporation is ultimately determined to be solvent.[48]

In summary, it is uncertain whether a corporation is operating in the

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38. Production Res. Group v. NCT Group, 863 A.2d 772, 789-90 n. 56 (Del. Ch. 2004).

39. John M. Sjovall, *What Duty Do Company Directors Owe to Banks and Other Creditors?*, 121 BANKING L.J. 4, 13 (2004).

40. *See generally* Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COMM. L.J. 295 (2004).

41. *Id.*

42. *Id.*

43. Production Res., 863 A.2d at 782 (*quoting* Sipie v. S & K Plumbing & Heating, Inc., 1982 WL 8789, at *2 (Del. Ch. 1982)).

44. Cieri & Riela, *supra* note 40; *see also Production Res.*, 863 A.2d at 782.

45. *Production Res.*, 863 A.2d at 782.

46. Cieri & Riela, *supra* note 40.

47. *Id.*

48. *Production Res.*, 863 A.2d at 789-90 n. 56.

zone of insolvency because its boundaries are not easily ascertainable by a board of directors or a reviewing court.

C. *The U.S. Response to the Agency Costs Problems in the Zone of Insolvency*

1. *Credit Lyonnais* and its Progeny: Directors' Duty to Creditors or a Shift to the Stakeholder Model?

The genesis of creditors' ability to bring breach of fiduciary duty claims against directors once a corporation enters the zone of insolvency can be traced to a 1991 decision by the Delaware Court of Chancery, *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.* ("*Credit Lyonnais*"). Here, the court merely mentioned the possibility that the duties of a director expand beyond the corporation and its shareholders in the zone of insolvency.[49] Savvy creditors' attorneys interpreted this language to stand for the proposition that fiduciary duties of directors shift to creditors once a corporation enters the zone of insolvency.[50] This led to a flurry of fiduciary duty claims by creditors attempting to recover as much as possible from insolvent corporations.[51] Some courts have allowed creditors to proceed with these claims.[52]

In a 2004 decision that revisited *Credit Lyonnais*, the Delaware Court of Chancery reined in creditors' ability to raise fiduciary duty claims against directors.[53] In *Production Res. Group v. NCT Group* ("*Production Resources*"), the court clarified that fiduciary duty claims against directors belong to the corporation at all times.[54] Thus, directors' fiduciary duties do not shift to creditors once a corporation enters the zone of insolvency.[55] However, when a corporation enters the zone of insolvency, the scope of interests that directors may take into account expands beyond merely shareholders to include other stakeholders, including creditors.[56] Moreover, creditors have standing to raise these

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49. 1991 WL 277613, *34 n. 55 (Del. Ch. 1991).

50. Mark N. Berman, *Delaware Court Reigns in Creditor Suits Against Ds & Os*, 24-4 AMER. BANK. L.J. 22, 22 (2005). As used in this context, "Reigns" is spelled incorrectly. The correct spelling of the word is "Reins." However, I see that even the bankruptcy journal spelled it incorrectly. Since it is used in the title of an article here, I don't see that it is imperative to mark it with [sic]. However, you will see that I changed "reign" to "rein" in the text of the article *supra* and *infra* where appropriate.

51. *See id.*

52. *See generally Production Res.*, 863 A.2d at 789.

53. *Id.*

54. *Id.* at 776.

55. *See id.* at 792.

56. *Id.* at 788.

claims upon the corporation's insolvency.

Credit Lyonnais involved the scope of a contractual duty of loyalty arising from an unsuccessful leveraged buyout.[57] Although the case involved contractual duty, the court considered the scope of corporate directors' common law fiduciary duties in the zone of insolvency in evaluating the contractual claims.[58] In doing so, the court stated that "where a corporation is operating in the vicinity of insolvency, a board of directors . . . owes its duty to the corporate enterprise."[59] In a footnote, the court added that in the zone of insolvency, directors should reach the best outcome when they "consider the community of interests that the corporation represents."[60] Accordingly, the court recognized that in proper business decisions, directors need not follow the course of action desired by the shareholders, the creditors, the employees, "or any single group interested in the corporation."[61]

In *Credit Lyonnais*, the court did not say that fiduciary duties shift to creditors once a corporation enters the zone of insolvency. Likewise, the court did not address whether creditors may bring fiduciary duty claims arising from director decisions in the vicinity of insolvency. These omissions left *Credit Lyonnais* open to two possible interpretations. First, the case could be interpreted as giving creditors (and other stakeholders) a sword to bring fiduciary duty claims against director decisions while the company was in the zone of insolvency.[62] Second, the language could be interpreted as giving directors a shield that protects them from shareholder challenges to decisions that take other stakeholders' interests into consideration.[63]

According to one commentator, *Credit Lyonnais* led to an "explosion" of fiduciary duty claims brought by creditors against directors of failed businesses.[64] These lawsuits certainly raised the eyebrows of corporate directors and influenced decision-making in struggling companies.[65]

Creditors' breach of fiduciary duty claims against directors survived a motion to dismiss in *Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc.*[66] In the complaint,

57. 1991 WL 277613 at *1-2.
58. *Id.* at *33-34.
59. *Id.* at *34.
60. *Id.* at *34 n. 55.
61. *Id.*
62. *See* Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45, 66 (1998).
63. *Id.*
64. Berman, *supra* note 50, at 22.
65. *See generally id.*
66. Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance

the creditors alleged that the directors breached fiduciary duties in approving a leveraged buyout transaction that rendered the corporation insolvent.[67] In its application of Delaware corporate law, the District of Delaware cited *Credit Lyonnais* for the proposition that directors operating in the zone of insolvency owe fiduciary duties to the corporation's creditors.[68] Accordingly, the court allowed the creditors complaint to proceed because the alleged breach took place while the company was in the zone of insolvency.[69]

Likewise, creditors' fiduciary duty claims against directors survived a summary judgment motion in *Weaver v. Kellogg*.[70] In response to the claims, the defendant directors argued that directors owe a duty to creditors only when the corporation is insolvent.[71] Rejecting this assertion, the Southern District of Texas reasoned that, under both Delaware and Texas law, directors of solvent corporations might owe a fiduciary duty to creditors in limited circumstances.[72] Accordingly, the court held that directors owe a fiduciary duty to creditors when the corporation is in the zone of insolvency or when the challenged transaction *led to* the corporation's insolvency.[73]

Production Resources outlines the proper scope of Delaware law regarding creditors' ability to raise fiduciary duty claims against directors in the zone of insolvency. In this case, a judgment creditor brought several fiduciary duty claims against a corporation's directors alleging, *inter alia*, mismanagement of the company and faithless behavior.[74] In evaluating the creditor's ability to raise these claims, the Court of Chancery outlined the framework under which creditors may bring fiduciary duty claims against directors. This framework interpreted *Credit Lyonnais* as providing a shield for directors who consider interests beyond those of shareholders in the zone of insolvency.[75] Accordingly, *Production Resources* restricts the ability of creditors to use fiduciary duty claims against directors as a mechanism to increase their recovery from insolvent corporations.

The court's analysis in *Production Resources* begins from the well-established principle that directors of a solvent firm must operate the

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Capital Group, Inc., 178 B.R. 956, 968 (D. Del. 1994).

67. *Id.*

68. *Id.*

69. *Id.*

70. Weaver v. Kellogg, 216 B.R. 563, 584 (S.D. Tex. 1997).

71. *Id.* at 583.

72. *Id.* at 584.

73. *Id.*

74. *Id.* at 777.

75. *Production Res.*, 863 A.2d at 787-88.

firm in a manner that primarily maximizes value for shareholders.[76] Once the corporation enters the zone of insolvency, directors may take into account other stakeholders, including creditors, when managing the firm.[77] To this point, the court says that *Credit Lyonnais* merely emphasizes that "directors have discretion to temper the risk that they take on behalf of the equity holders when the firm is in the zone of insolvency."[78] Accordingly, *Credit Lyonnais* does not create "a new body of creditor's rights law" contrary to some interpretations.[79]

According to the court, once a firm enters the zone of insolvency, *Credit Lyonnais* holds that directors will be protected by the business judgment rule when a business decision considers the interests of stakeholders other than the shareholders.[80] The "context of high risk and uncertainty" that exists in the zone of insolvency allows directors to consider the "community of interest" of the corporate enterprise, not merely that of the shareholders.[81] Directors' fiduciary duties do not shift from shareholders to creditors in the zone of insolvency. Furthermore, the zone of insolvency does not confer standing on creditors to challenge directors' business decisions as a breach of fiduciary duty.[82]

This framework does not leave creditors without corporate governance protections. Once a firm becomes insolvent, directors owe fiduciary duties to creditors under Delaware law.[83] Thus, insolvency confers upon creditors standing to pursue fiduciary duty claims against directors.[84] Moreover, the broad grant of creditor standing extends to fiduciary duty claims alleging that director actions prior to insolvency caused a firm to become insolvent.[85] To the extent that director action in the zone of insolvency causes a firm to become insolvent, creditors may have standing to bring a fiduciary duty claim for after-the-fact insolvency.[86]

Although insolvency confers standing to bring fiduciary duty claims to creditors, such claims belong to the corporation and can generally only be brought by creditors through derivative actions.[87] Additionally, the fact that insolvency confers standing upon creditors to bring fiduciary

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76. *Id.* at 787.
77. *Id.*
78. *Id.* at 788.
79. *Id.*
80. *Production Res.*, 863 A.2d at 788.
81. *Id.*
82. *Id.* at 789.
83. *Id.* at 790-91.
84. *Id.* at 792.
85. *Production Res.*, 863 A.2d at 792-93.
86. *See generally id.*
87. *Id.*

duty claims derivatively does not affect the ability of shareholders to bring such claims.[88]

Production Resources suggests the possibility that an individual creditor could bring a direct fiduciary duty claim in limited circumstances.[89] The limited circumstances supporting a direct creditor action require director animus toward an individual creditor with a proven entitlement to payment.[90]

2. Creditor Protections in the Zone of Insolvency: Distilling the *Production Resources* Framework

U.S. corporate law responds to the agency cost problem of shareholder opportunism vis-à-vis creditors in the zone of insolvency with two regulatory strategies. The first strategy consists of an expansion of the *ex post* standard by which director action in the zone of insolvency will be reviewed. Under the *Production Resources* framework, once a corporation enters the zone of insolvency, the set of interests that directors may consider in making decisions expands to include creditors and other stakeholders. This addresses the conflict of interest between creditors and shareholders by deferring to the business judgment of directors. It gives directors the discretion to pursue the course of action that maximizes firm value regardless of the individual preferences of shareholders and creditors.

The second strategy gives creditors standing to challenge director action under these *ex post* standards. Once a company becomes insolvent, creditors have standing to bring fiduciary duty claims against directors. Additionally, creditors have standing to challenge director action that caused a company to become insolvent. Creditors can generally only bring such claims derivatively unless the claim alleges director animus toward a particular creditor. Finally, fiduciary duty claims brought by creditors are reviewed under the business judgment rule.[91] Thus, even though creditors have standing to raise fiduciary duty claims, a reviewing court will defer to the good faith business judgment of an informed, disinterested director.

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88. *Id.* at 792.
89. *Id.* at 798.
90. *Production Res.*, 863 A.2d at 798.
91. *See* Liquidation Trust of Hechinger Inv. Co. of Del. v. Fleet Retail Fin. Group, 327 B.R. 537, 548-49 (D. Del. 2005) (reviewing creditors breach of fiduciary duty claims under the business judgment rule).

IV. Germany's Response to the Agency Cost Problem in the Zone of Insolvency

A. *Germany's System of Corporate Governance*

Germany's system of corporate governance differs from the U.S. both structurally and substantively. Structurally, German companies are required to adopt a two-tier board of directors in an attempt to protect shareholder interests.[92] Additionally, Germany's system of codetermination requires employee representation on the upper-tier supervisory board, making German boards much larger than boards of comparable companies in the U.S.[93] Substantively, Germany operates under the stakeholder model, where directors manage the firm on behalf of shareholders, employees, and the larger community. Also, German banks play a more central role in corporate governance than their counterparts in the U.S.

1. Legal Origin

German law follows the civil law tradition, where legal rules come primarily from statutes and comprehensive codes.[94] In contrast to common law countries, civil law countries rely on legal scholars as opposed to judges to formulate law.[95] Additionally, compared to common law countries, civil law countries provide weaker protections to both shareholders and creditors but provide them with stronger enforcement mechanisms.[96]

2. Extralegal Landscape

Germany's pattern of share ownership and role of banks in corporate governance differ starkly from those in the U.S. In Germany, share ownership is highly concentrated. Families, institutional investors, insurance companies, and the state hold large blocks of shares.[97] These shareholders are more likely to exercise significant influence over management than are individual shareholders in the U.S. Likewise, banks play a significant corporate governance role in Germany. In addition to owning significant equity interests in public companies,

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92. *See generally* REINIER R. KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW 34-35 (2004).

93. *Id.* at 39-40.

94. La Porta et al., *supra* note 10, at 1118.

95. *Id.*

96. *Id.* at 1116.

97. *See* Cheffins, *supra* note 13, at 500.

banks hold and vote shares for individual shareholders.[98] This gives banks a significant voice in German boardrooms.[99]

3. Director Duties under Germany's Corporate Governance System

Germany's system of corporate governance operates under the stakeholder model. Under this model directors operate the firm for the benefit of the shareholders as well as other constituents, including employees and the community.[100] A German cultural norm suggests that management should give each corporate constituent's interests equal weight in decision-making.[101] However, in practice, management often aligns with banks and other powerful shareholders.[102]

German law requires corporations to adopt a two-tier, hierarchical board structure.[103] Shareholders and employees elect members of the supervisory board.[104] The supervisory board appoints and oversees the management board.[105] In turn, the management board conducts the affairs of the corporation.[106]

The exclusive powers to control and operate German corporations are vested in the management board.[107] In managing the affairs of the corporation, directors must act with the care of a diligent and conscientious manager.[108] Director liability to the corporation may be found where a director negligently or willfully breaches this duty.[109] Although this duty appears relatively broad, personal liability is rare as directors are protected by procedural safeguards and a deferential standard of review protects directors.[110] Accordingly, the threat of losing reelection to the board operates as a stronger constraint on German directors than the statutory duty of care.[111]

German law allows only the board to bring a lawsuit on behalf of

98. *Id.*
99. *See, e.g.*, Chantayan, *supra* note 11, at 445-46.
100. *Id.* at 444.
101. *Id.*
102. *Id.* at 445.
103. KRAAKMAN ET AL., *supra* note 93, at 35.
104. *Id.*
105. § 111 Aktiengesetz *translated in* HANNES SCHNEIDER AND MARTIN HEIDENHAIN, THE GERMAN STOCK CORPORATION ACT (2000) [hereinafter Aktiengesetz]; *see also id.*
106. § 76 Aktiengesetz; *see also* Chantayan, *supra* note 11, at 437-38.
107. *See* Chantayan, *supra* note 11, at 438.
108. § 93 Aktiengesetz; *see also* Theodor Baums & Kenneth E. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*, 53 AM. J. COMP. L. 31, 44 (2005).
109. *See* Baums and Scott, *supra* note 109, at 44.
110. *Id.* at 44-45.
111. *Id.* at 45.

the corporation.[112] Additionally, lawsuits challenging actions of the management board or against directors individually may only be brought by the supervisory board.[113] Thus, unlike the U.S. system, shareholders of German corporation's typically do not bring derivative actions challenging director action. Moreover, the supervisory board faces disincentives to bring litigation against the management board since the corresponding allegations often question the supervisory board's performance.[114]

Recent changes to German law have given shareholders more power to challenge director action.[115] First, shareholders can force the corporation to bring litigation against directors with a majority vote at the shareholders meeting.[116] Depending on the defendant, a lawsuit brought under this provision will be run by the management board, the supervisory board or an independent representative.[117] Second, shareholders with sufficient holdings may bring derivative actions alleging serious legal violations or violations of the corporate charter.[118] However, shareholders often lack incentives to bring such actions.[119]

As a practical matter, the incentives and legal hurdles involved in litigation against directors lead to the reality that directors rarely face personal liability for breach of fiduciary duty.[120] As one commentator has noted, German managers "almost never [face] . . . liability for a breach of the duty of care" unless the breach involves a violation of law.[121]

Directors faced with litigation for a breach of fiduciary duty benefit from a fairly deferential standard of review. A director has the burden of proving that they acted as an appropriate manager would.[122] Although this is a higher standard than the U.S. business judgment rule, which puts the initial burden on plaintiffs, German courts have looked to the business judgment rule in defining this standard.[123] Accordingly,

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112. § 78 Aktiengesetz; *see* Chantayan, *supra* note 11, at 443.

113. § 112 Aktiengesetz; *see also* Chantayan, *supra* note 11, at 443.

114. *See generally* Baums and Scott, *supra* note 109, at 52.

115. Baums and Scott, *supra* note 109, at 52.

116. § 147(1) Aktiengesetz.

117. *Id.* at § 147(2); *see also* Baums and Scott, *supra* note 109, at 52. The supervisory board will run litigation against the management board, the management board will run litigation against the supervisory board, and a special representative will run the litigation in limited circumstances.

118. § 148(1) Aktiengesetz.

119. *See* Baums and Scott, *supra* note 109, at 52.

120. *Id.* at 45.

121. *Id.*

122. § 93 Aktiengesetz.

123. *See* Mark E. Nance and Bernd Singhof, *Banking's Influence over Non-Bank Companies After Glass-Steagall: A German Universal Comparison*, 14 EMORY INT'L L.

German directors properly discharge their fiduciary duties when they act on an informed basis, in good faith, with the reasonable belief that the action is in the best interest of the company, and do not pursue an excessively risky course of action.[124] Additionally, German directors benefit from the ability to consider the interests of other stakeholders in making a decision for the corporation.

B. Defining the Zone of Insolvency in Germany

The parameters of the zone of insolvency under German law are amorphous and difficult to define. Like the judicial decisions in the U.S., legal rules in Germany attempt to delineate situations where a corporation is approaching insolvency prior to the initiation of insolvency proceedings.[125] Accordingly, German law lists three distinct situations where a corporation is considered approaching insolvency.

First, German law treats a company that experienced substantial annual losses as approaching insolvency.[126] The threshold of losses under this test is equal to one-half the share of capital on the annual balance sheet.[127] Secondly, a corporation may be approaching insolvency when it is unable to make payments when payments are due.[128] And, finally, over-indebtedness is an indication that a corporation is approaching insolvency as well.[129]

C. Germany's Response to the Agency Cost Problems in the Zone of Insolvency

German law addresses the agency cost problems encountered in the zone of insolvency by providing creditors additional corporate governance protections when a company approaches insolvency. These corporate governance protections can be organized into two categories. First, legal rules impose specific duties on directors as a company approaches insolvency. Second, directors are personally liable to creditors for failure to discharge the duties created in the zone of insolvency.

1. Director Duties as Corporation Approaches Insolvency

When each of the statutory conditions defining "approaching

REV. 1305, 1410 (2000).

124. *Id.*

125. *See generally* § 92 Aktiengesetz.

126. § 92(1) Aktiengesetz.

127. *Id.*

128. *Id.* at § 92(2).

129. *Id.* at § 92(3).

insolvency" are met, German law imposes specific duties on directors. Once a corporation becomes over-indebted or is otherwise unable to make payments when due, members of the management board have a statutory duty to limit payments.[130] Any payment made after the occurrence of insolvency or over-indebtedness must be consistent with the general duty of care. Accordingly, directors may only make payments that are "consistent with the care of a diligent and conscientious manager."[131]

This duty to limit payments protects creditors by preventing managers from siphoning off the firm's assets to shareholders in the form of dividends or share repurchases. Additionally, it protects existing creditors by allowing payments consistent with the duty of care. Finally, it protects creditors by preserving the order of payment priority that exists in insolvency proceedings. This is achieved by preventing management from making preferential payments to favored creditors unless consistent with the duty of care. Likewise, the management board must initiate insolvency proceedings once a corporation becomes over-indebted or unable to make payments when due.[132]

Aktiengesetz, the German Stock Corporation Act, requires management to initiate insolvency proceedings without undue delay.[133] Although undue delay is not defined, insolvency proceedings must be initiated within three weeks after the corporation becomes over-indebted or unable to make payments when due.[134] This duty to initiate insolvency proceedings protects creditors in several ways. First, it prevents directors from gambling with corporate assets by undertaking risky investments when the company is nearing insolvency. Second, it provides notice to existing and potential creditors of the company's financial distress. Third, by initiating insolvency proceedings quickly, it preserves the priority of payment established by the insolvency regime, preventing payments to preferred creditors.

Once a corporation experiences losses equal to half of the share of capital on the annual balance sheet, the management board must call a shareholders meeting.[135] At the meeting, management must provide the shareholders with notice of the corporation's financial distress.[136] This duty to call a shareholders meeting provides protection to both shareholders and creditors by providing prompt notice of the company's

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130. *Id.*
131. § 92(3) Aktiengesetz.
132. *Id.* at § 92(2).
133. *Id.*
134. *Id.*
135. *Id.* at § 92(1).
136. § 92(1) Aktiengesetz.

financial distress. Although primarily aimed at notifying shareholders, creditors will benefit as well, since many banks are also shareholders.

2. Directors' Personal Liability to Creditors for Failure to Discharge these Duties

In addition to imposing specific duties on directors once a corporation enters the zone of insolvency, German law provides additional creditor protection through director liability. Directors can be found personally liable to creditors for failure to discharge statutory duties and for failure to adhere to capital maintenance rules.[137]

Creditors' ability to recover from directors personally provides two forms of protection. First, the threat of personal liability gives directors stronger incentives to discharge duties owed to creditors and to adhere to capital maintenance rules. Second, the ability of creditors to recover from directors' personal assets increases the likelihood that creditors will salvage something when the corporation cannot satisfy their claims.

Creditors may pursue personal liability claims against directors only when the creditor cannot recover from the corporation itself.[138] As a procedural matter, claims brought by creditors are direct, with creditors seeking damages individually rather than on behalf of the corporation.[139] This differs from the approach in the U.S., where creditors must pursue derivative claims under most circumstances.[140] However, once insolvency proceedings have been instituted, creditors' claims are brought by the trustee of the estate, rather than individual creditors.[141] Also, since these claims belong to creditors and not the corporation, exculpatory provisions limiting directors' personal liability to the corporation do not prevent the creditors' ability to recover from directors.[142]

German law allows creditors to recover personally from directors who violate certain enumerated duties. Section 93(3) of the Aktiengesetz lists nine situations through which creditors may asset claims against directors. In financially distressed companies, creditors can pursue directors for, *inter alia*, repayment of contributions to shareholders, payment of interest or dividends to shareholders, distributing assets of the company, making payments once the company is over-indebted, and

137. *Id.* at § 93(5); *see generally* KRAAKMAN ET AL., *supra* note 93, at 90.

138. § 93(5) Aktiengesetz; *see also* Susan-Jacqueline Butler, *Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures*, 17 ARIZ. J. INT'L & COMP. L. 555, 569 (2000).

139. Butler, *supra* note 139, at 570.

140. *See* Part III C, *supra*.

141. § 93(3), (5) Aktiengesetz.

142. *Id.*

extending additional credit.[143] However, the code specifies that directors are only liable to creditors under a gross negligence standard.[144] In addition to the situations enumerated in § 93(3), creditors may bring claims against directors for gross violations of the duty of care.[145]

Directors are subject to personal liability to creditors for failure to adhere to capital maintenance rules at any time.[146] Although director liability under this provision is irrespective of whether the corporation is in the zone of insolvency, as a practical matter, creditors are not encouraged to bring a claim against a director under this provision unless the company is in financial distress. Directors face per se liability to creditors under this provision.[147]

V. Japan's Response to the Agency Cost Problem in the Zone of Insolvency

A. *Japan's System of Corporate Governance*

1. Legal Origin

Like Germany, Japan is a civil law country. The Japanese Commercial Code initially developed from the German civil law system but was substantially influenced by American law following World War II.[148] Notwithstanding this American influence, Japanese corporate law lacks the flexibility of the American system.[149] Since Japan is a civil law country, Japanese judges are constrained to legal analysis under the Commercial Code and cannot fashion the equitable remedies available in U.S. courts.[150]

2. Extralegal Landscape

Share ownership patterns and the role of banks significantly influence Japanese corporate governance practice. Like share ownership in Germany, share ownership in Japan is concentrated. Unique to the comparative countries, the stock of many Japanese countries is held in a system of cross-ownership with banks and relational corporations.

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143. *Id.*
144. § 93(5) Aktiengesetz.
145. *Id.*; *see also* Butler, *supra* note 139, at 570.
146. *See* KRAAKMAN ET AL., *supra* note 93, at 90.
147. *Id.*
148. *See* La Porta et al., *supra* note 10, at 1119.
149. *See* Zenishi Shishido, *Japanese Corporate Governance: The Hidden Problems of Corporate Law and Their Solutions*, 25 DEL. J. CORP. L. 189, 195 (2000).
150. *Id.*

Additionally, like German banks, Japanese banks hold substantial ownership stakes in Japanese firms. Main banks, which function both as major lenders and significant shareholders, play an important role in Japanese corporate governance.[151]

Two types of cross-ownership patterns are prevalent in Japanese firms. First, many Japanese corporations hold shares of other companies under implicit, long-term mutual shareholding agreements.[152] This loose form of cross-ownership constitutes approximately two-thirds of share ownership in Japan.[153] Second, Japanese corporations affiliate through sophisticated, tightly-woven cross-ownership patterns called *keiretsu*.[154] In addition to mutual shareholding agreements, *keiretsu* are linked through mutual directors, product markets, and banking relationships.[155] Both systems of cross-ownership stabilize management by ensuring that large blocks of shares are in friendly hands, minimizing the threat of hostile takeover.[156] Additionally, cross-ownership mitigates the conflict of interest between shareholders and creditors by ensuring many shareholders are also creditors.

While banks generally play a significant role in Japanese corporate governance, the role of the main bank predominates. Main banks function as both the principal lender to a Japanese corporation and a major shareholder.[157] Additionally, main banks sit at the center of *keiretsu*.[158] In good times, main banks play a significant monitoring and informational role in corporate governance.[159] In bad times, the role of main banks spans from the provision of financial and advisory assistance to restructuring or merging a failing company.[160] The relational role of main banks means that few unsuccessful companies are liquidated in Japan.[161] However, main banks often replace the management of failing companies, making them significant players in the zone of insolvency.[162]

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151. Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 HARV. INT'L L.J. 3, 22 (1996).

152. *See id.* at 25; *see also* Shishido, *supra* note 149, at 210-11.

153. Milhaupt, *supra* note 151, at 25.

154. *Id.*

155. *Id.*

156. *Id.*; *see also* Shishido, *supra* note 149, at 210-11.

157. *See* Milhaupt, *supra* note 151, at 22.

158. *Id.* at 25.

159. *Id.* at 22.

160. *Id.*

161. *Id.*

162. Milhaupt, *supra* note 151.

3. Director Duties under the Japanese Corporate Governance System

Like the German system, Japan operates under the stakeholder model of corporate governance. The Japanese stakeholder model is reflected more in practice than in the law on the books.[163] The stakeholder model is best observed in the Japanese cultural norm of the "company community," which consists of directors, managers, and employees.[164] Unlike the role of the employee under Japan's corporate laws on the books, employees play a central role in the company community and corporate governance in practice.[165]

The Japanese Commercial Code articulates the fiduciary duties that directors owe to the corporation and its shareholders.[166] Like U.S. directors, Japanese directors owe a duty of care and duty of loyalty to the corporation.[167] Also, like U.S. shareholders, Japanese shareholders can enforce fiduciary duties through derivative litigation under Japanese law. However, unlike in the U.S., Japanese fiduciary duties are seldom enforced through shareholder litigation, leaving the case law largely undeveloped in this area. Notwithstanding the level of enforcement, the Commercial Code provides personal liability for a director's breach of fiduciary duty.[168]

In managing the affairs of the corporation, Japanese directors must discharge both the duty of care and the duty of loyalty. The duty of care obliges directors to manage the affairs of the corporation with the care of a good manager.[169] The duty of loyalty requires directors to perform their duties faithfully and in compliance with the law, the corporate charter, and shareholders' resolutions.[170] Although current debate surrounds whether these statutory duties are distinct, Japanese courts have found directors liable under both provisions.[171]

Japan allows shareholders to enforce fiduciary duties through derivative actions against directors.[172] Like derivative actions in the

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163. *See* Shishindo, *supra* note 149, at 202.
164. *Id.*
165. *Id.*
166. Art. 254-3 Commercial Code; *see also* Shishido, *supra* note 149, at 199 n. 45.
167. *See* Bruce E. Aronson, *Learning from Comparative Law Teaching in U.S. Corporate Law: Director's Liability in Japan and the U.S.*, 22 PENN ST. INT'L L. REV. 213, 221 (2003).
168. Art. 266 Commercial Code; *see also* Aronson, *supra* note 167, at 221.
169. Art. 254 Commercial Code; *see also* Aronson, *supra* note 167, at 221.
170. Art. 254-3 Commercial Code; *see also* Hideki Kanda & Curtis J. Milhaupt, *Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law*, 51 AM. J. COMP. L. 887, 888 (2003).
171. *See* Kanda & Milhaupt, *supra* note 170, at 894-97.
172. Shishido, *supra* note 149, at 197.

U.S., Japanese shareholders must first make a demand that the board sue on behalf of the corporation.[173] However, Japanese law gives directors less discretion in determining whether to bring litigation than does U.S. law.[174] Additionally, recent reforms have made it easier and cheaper for shareholders to file derivative actions, leading to an increase in shareholder litigation.[175] Despite this increase in shareholder litigation, it remains a weak constraint on director action. As one commentator has noted, shareholders "have seldom sought ex post judicial enforcement of the fiduciary duties of management."[176]

The infrequency of shareholder litigation in Japan has produced a relatively thin body of case law interpreting director duties.[177] However, recent case law suggests that courts will apply a director-friendly standard of review similar to the U.S. business judgment rule.[178] Additionally, although Japan operates under the stakeholder model, no judicial decision expressly authorizes Japanese directors to consider the interests of stakeholders other than the shareholders in making business decisions.[179] The Japanese Commercial Code does not contain mechanisms limiting or exculpating directors from personal liability.[180]

B. *Defining the Zone of Insolvency in Japan*

Unlike the U.S. and Germany, Japan's corporate law does not delineate specific triggers that modify director duties to creditors. Rather, the creditor protections in the Japanese legal system operate irrespective of whether the company is in the zone of insolvency. However, reason dictates that creditors will attempt to recover from directors in law as opposed to from the company in contract in situations where the corporation cannot satisfy the creditor's claim. Thus, it follows that Japan's creditor protections will only be necessary after a corporation has entered the zone of insolvency.

C. *Japan's Response to the Agency Cost Problems in the Zone of Insolvency*

An analysis of the Japanese approach to the agency cost problems prevalent in the zone of insolvency requires a look at both the law on the

173. *See generally id.*
174. *Id.* at 197-98.
175. *Id.* at 197.
176. Milhaupt, *supra* note 151, at 20.
177. *Id.* at 33-34.
178. *See id.* at 33 (discussing case that upheld director action under a business judgment rule).
179. Shishido, *supra* note 149, at 199.
180. Milhaupt, *supra* note 151, at 34.

books and at how corporate governance in distressed companies plays out in practice. First, this section will look at the single legal strategy Japan has adopted to address this agency cost problem. Next, this section will turn to the realities of corporate governance in distressed Japanese firms in an attempt to explain the law's minimal response.

Japan provides little creditor protection in the form of regulatory strategies to address the problems of shareholder opportunism vis-à-vis creditors in the zone of insolvency. Under limited circumstances, the Japanese Commercial Code confers standing upon creditors to sue non-executive directors personally for lack of oversight of management.[181] Liability under this duty to monitor doctrine requires gross negligence on the part of the director.[182] However, in practice, no creditor has prevailed against a director of a large corporation under the duty to monitor doctrine.[183] Moreover, the doctrine focuses more on the supervision of subordinate employees, rather than general oversight of the board of directors, further mitigating its utility in this context.[184] Although it is seldom used, this regulatory strategy protects creditors by providing them recourse to go after grossly negligent directors personally when the company cannot satisfy their claim.

In practice, main banks exert significant corporate governance control once companies approaching insolvency. Once companies experience financial distress, main banks direct corporate actions, replace management, and determine whether to restructure, merge, or liquidate the company. This reality means that legal strategies protecting creditors in the zone of insolvency are largely unnecessary, since the struggling corporation's largest creditor will be calling the shots.[185] Moreover, because of the cultural norm disfavoring litigation, additional legal strategies would not likely provide stronger protection to creditors in practice.

VI. Analyzing Each Jurisdiction's Response to the Agency Cost Problem

Each comparative jurisdiction addresses the agency cost problem of shareholder opportunism vis-à-vis creditors prevalent in the zone of insolvency through either regulatory strategies or corporate governance practice. The U.S. and Germany respond to this agency cost problem

181. Art. 266 Commercial Code; *see also* KRAAKMAN ET AL., *supra* note 93, at 90.
182. *See* KRAAKMAN ET AL., *supra* note 93, at 90.
183. *Id.*
184. *See* Bruce E. Aronson, *Reconsidering the Importance of Law in Japanese Corporate Governance: Evidence from the Daiwa Bank Shareholder Derivative Case*, 36 CORNELL INT'L L.J. 11, 26-27 n. 69, n. 70 (2003).
185. *See* Milhaupt, *supra* note 151, at 22-23.

through a combination of regulatory strategies that shift the scope of director duties to include creditors and provide creditors standing to enforce these duties once a company enters the zone of insolvency. In contrast, Japan provides one marginally useful legal response. However, strategies implemented in Japanese corporate governance practice address this agency cost problem.

The U.S. implements two regulatory strategies to protect creditors in the zone of insolvency. First, the scope of the *ex post* standard by which director liability for business decisions expands once a company enters the zone of insolvency to allow directors to consider the interests of creditors and other stakeholders. Second, once a company becomes insolvent, creditors have standing to raise fiduciary duty claims against directors for decisions in the zone of insolvency that led to the corporation's insolvency. Likewise, Germany implements two legal strategies that protect creditors once a corporation enters the zone of insolvency. First, as a company approaches insolvency, director duties expand to include required actions aimed at protecting creditors. Second, Germany gives creditors standing to enforce breaches of these duties. In contrast, Japan's strongest creditor protection comes from the practice of main banks dominating corporate governance in the zone of insolvency. Although Japan has legal rules aimed at protecting creditors in struggling companies, these rules are rarely used in practice. Overall, the legal and practical response adopted by each comparative jurisdiction provides differing levels of creditor protection and director flexibility.

A. Analytical Framework

This article applies an analytical framework that compares each county's legal strategy under three factors. First, it determines whether the strategy minimizes the conflict of interests between shareholders and creditors, which would reduce the agency cost problems in the zone of insolvency. Second, it asks whether the strategy maximizes firm value, creditor value, or shareholder value. Third, this framework looks at the clarity and predictability that the legal strategy provides to directors, creditors, and shareholders. Of the three factors, the minimization of conflicts of interest and the ability to maximize firm value carry the greatest weight.

B. Minimization of Creditor and Shareholder Conflicts of Interest

The agency cost problems in the zone of insolvency are magnified by four specific conflicts of interest between shareholders and creditors.[186] These specific conflicts of interest are divergent risk preferences, shareholder incentives to siphon assets out of the firm, liquidation preferences, and shareholders incentives for underinvestment.[187] The U.S. legal response to the agency cost problems in the zone of insolvency addresses three of these four conflicts of interest.

First, by allowing managers to consider the interests of both shareholders and creditors, the impact of divergent risk preferences between these groups is mitigated. This allows management to use its expertise to pursue the course of action it feels is best for the corporation as an economic entity. Moreover, the U.S. strategy protects managers who enter transactions for the benefit of the firm in good faith.

Second, granting creditors standing to sue directors for breaching the duty of loyalty once the company is insolvent gives creditors the ability to protect themselves against shareholders siphoning assets out of the firm. By removing a manager's incentive to undertake this socially undesirable action, this strategy minimizes the conflict of interest.

Third, allowing management to pursue the interests of creditors in the zone of insolvency mitigates the impact of shareholder incentives for underinvestment. Managers will be more likely to undertake transactions that will only benefit creditors since they will not lose the protection of the business judgment rule.

The legal response in the U.S. does not adequately address the divergent liquidation preferences between creditors and shareholders. This leads to costly valuation litigation as creditors and shareholders squabble over whether a company should be liquidated or reorganized.

The German legal strategy addresses two of these conflicts of interest by preventing management from undertaking risky transactions or siphoning out assets to shareholders. By granting creditors standing to sue directors for grossly negligent business decisions in the zone of insolvency, managers will be unlikely to undertake excessively risky transactions. Likewise, the risk that managers will siphon corporate assets out to shareholders is eliminated by barring such transactions in the zone of insolvency. However, Germany's legal response, which provides little management flexibility, does not minimize the conflicts of interest created by divergent liquidation preferences and shareholder incentives for underinvestment. By forcing managers to initiate insolvency proceedings, shareholders will have little say in whether the company liquidates or reorganizes. Likewise, by barring most transactions once a company enters the zone of insolvency, managers

186. *See generally* Part II *supra*.
187. *Id.*

will be unlikely to undertake investments whose benefits only flow to creditors.

Although the Japanese legal response does little to address the conflicts of interest created in the zone of insolvency, corporate practice in Japan reduces three of these conflicts. The conflicts of interest created by divergent risk preferences, liquidation preferences, and shareholder incentives for underinvestment are all reduced by the role of the main bank and the system of cross-ownership. Once companies become financially distressed, main banks step in and exert strong influence over directors. Accordingly, directors will be unlikely to undertake excessively risky transactions with close bank monitoring. Likewise, directors will be likely to undertake transactions whose benefits only flow to creditors because they exert such a strong influence. Since many creditors are also shareholders, the conflict of interest created by divergent liquidation preferences is reduced. The reality that corporate liquidations are rare in Japan's economy further reduces the impact of liquidation preferences. However, Japanese practice does little to address each party's race to corporate assets. Rather, as a company approaches insolvency, main banks and trade creditors, who are also shareholders, will likely exert control over corporate assets.

In summary, the U.S. legal response and Japanese corporate practice minimize the conflicts of interest creating agency costs in the zone of insolvency to a greater extent than the German legal response. Moreover, directors in the U.S. and Japan have greater flexibility to reduce these conflicts or prefer one party's interest over the other.

C. *Maximizing Firm Value*

The policy of maximizing firm value is superior to maximizing creditor or shareholder value.[188] Maximizing firm value theoretically maximizes value for all stakeholders, including creditors and shareholders. Moreover, it provides management more flexibility to determine the best strategy for the corporation. Thus, management can determine whether the best approach in a struggling company is a workout with creditors, reorganization, or liquidation.

A strategy that maximizes firm value attempts to promote the welfare of all stakeholders. Because firm value can be maximized

188. For an argument supporting the superiority of maximizing firm value, *see* Lin, *supra* note 2, at 1496-1500 (arguing that value maximization promotes an efficient allocation of resources and maximizes social welfare); *but see* Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813, 1825-26 (2002) (arguing that firm value maximization is problematic because it does not account for performance creditors).

through either liquidation or operation of the firm as a going concern, this strategy provides the flexibility to choose the best outcome. In contrast, a strategy that requires the maximization of firm value to either shareholders or creditors at the expense of the other could lead to a socially undesirable outcome. Thus, strategies that allow firm maximization are preferable to strategies that, as a policy matter, place one stakeholder's interests above the other's.

The U.S. strategy gives directors the discretion to determine the best manner in which to operate the firm in the zone of insolvency. Directors will be insulated from personal liability if they discharge their fiduciary duties in good faith with the belief that the action taken is in the best interests of any stakeholder. Accordingly, this gives directors, who have the best information about the company's financial position, the flexibility to pursue the course of action most likely to maximize firm value.

In contrast to the U.S. strategy, the German strategy requires directors to initiate insolvency proceedings and limits directors' ability to enter transactions. This strategy maximizes firm value for creditors at the expense of shareholders and other stakeholders. Initiating insolvency proceedings immediately protects creditors by preventing the firm from worsening its financial position. Moreover, director liability to creditors for undertaking certain transactions reduces directors' willingness to undertake transactions that could benefit all stakeholders. Like Germany's overall system of corporate governance, this legal strategy is much more risk adverse than the U.S. strategy.

Although the Japanese legal strategy promotes maximization of creditor value, Japanese practice allows stakeholders to pursue a course of action that maximizes the value of the firm. As Japanese main banks take the reins of struggling companies, they create incentives to pursue the course of action that best maximizes firm value and overall social welfare. This is often achieved through restructuring and merger. Liquidation, even when socially-optimal, occurs less-frequently as main banks occasionally collect above-market interest rates from firms in their corporate groups in exchange for an implicit commitment to support the firm during periods of financial distress.[189] Thus, Japanese practice in the zone of insolvency is somewhat inferior to the U.S. legal strategy because of sub-optimal levels of efficient liquidation.

In summary, both the U.S. legal strategy and Japanese practice are superior to the German legal strategy by promoting the maximization of firm value and overall social welfare.

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189. *See* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277, 1297-98 (1991).

D. *Clarity and Predictability*

Ideal strategies and practices provide clarity and predictability to directors, shareholders, and creditors. Directors need to know how to discharge their fiduciary duties when the corporation enters the zone of insolvency. Likewise, shareholders and creditors need to know how to monitor directors and how to enforce breaches of fiduciary duty.

Clarity and predictability are marginal at best under the U.S. regulatory strategy. Although the *Production Resources* framework clearly outlines director duties in the zone of insolvency, to the extent that courts in other jurisdictions interpret *Credit Lyonnais* differently, the status of director duties in the zone of insolvency is unclear. This lack of clarity is magnified by the reality that director liability will often be reviewed by bankruptcy courts and district courts that lack the level of sophistication of the Delaware Court of Chancery with respect to corporate law. Moreover, this lack of clarity makes it difficult for directors to predict when they will face claims of personal liability. Likewise, without a more developed body of case law, creditors and shareholders do not have clear guidance as to when director action in the zone of insolvency supports a claim of liability. This is apt to lead shareholders' lawyers to raise such claims whenever remotely possible because of the outside shot that one will prevail.

In contrast to the U.S., Germany's statutorily defined duties provide clarity and predictability to directors, shareholders, and creditors. Director duties are clearly elucidated in the statutes, giving directors guidance on how to discharge their duties once a company approaches the zone of insolvency. Moreover, situations where creditors may bring claims against directors are also clearly defined.

Japanese practice falls closer to the U.S. in terms of clarity and predictability. Since litigation by creditors is rare, directors can generally expect them not to raise such claims. However, such claims could increase as Japanese capital markets become more open to foreign investment because foreign creditors do not share the Japanese cultural distaste for litigation. Moreover, clarity and predictability is diminished by reality since few legal rules guide the discharge of director duties in the zone of insolvency, directors must look to main banks to determine how to operate the company.

In summary, Germany's regulatory strategies in the zone of insolvency provide greater clarity and predictability than that of the U.S. and Japan.

VII. Conclusion

In conclusion, each comparative jurisdiction addresses the agency cost problem of shareholder opportunism vis-à-vis creditors by providing additional protections to creditors. The U.S. provides creditor protection primarily through the use of the standards strategy. Once a corporation enters the zone of insolvency, standards of *ex post* director liability expand to allow directors to consider the interests of creditors and other stakeholders. Moreover, U.S. law gives creditors standing to enforce fiduciary duty claims for director actions that led to the company's insolvency.

Germany provides creditor protection through the use of both legal rules and standards of director liability. Legal rules trigger specific director duties and obligations upon certain conditions of financial distress. Directors face potential liability to creditors if they breach these duties.

In contrast, Japan's primary mechanism of creditor protection comes from the powerful role that main banks play in corporate governance. Although Japan provides creditor protection through legal rules, such rules are seldom enforced. Rather, the largest creditors of Japanese corporations protect their interests in the zone of insolvency through monitoring and the ability to replace management.

Of the three distinct approaches, the U.S. approach best addresses the agency cost problems present in the zone of insolvency. The U.S. approach allows managers to minimize conflicts of interest between shareholders and creditors and provides management the flexibility needed to pursue the optimal goal of firm maximization.