

Directors' Duties in Failing Firms

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Directors' Duties in Failing Firms

ABSTRACT

Despite many cases with seemingly contrary dicta, corporate directors of failing firms do not have special duties to creditors. This follows from the nature of fiduciary duties and the business judgment rule. Under the business judgment rule, the directors have broad discretion to decide what to do and in whose interests to act. There is some authority for a limited creditor right to sue on behalf of the corporation to enforce this duty. However, any such right does not make the duty one owed to creditors. The creditors individually may sue the corporation for breach of specific contractual, tort, and statutory duties, particularly on account of fraudulent conveyances. But the creditors are not owed general fiduciary protection even if they are subject to a special risk of abuse in failing firms.

INTRODUCTION

THERE HAS BEEN MUCH DEBATE ABOUT DIRECTORS' FIDUCIARY duties as a firm nears insolvency. Commentators generally agree that directors of solvent firms owe fiduciary duties only to shareholders, and not to creditors or other fixed claimants, who are left to their specific contracts.¹ The issue grows murkier when the firm nears insolvency and shareholders have little or no stake in the firm, a situation that will be referred to here as the "insolvency scenario." At this point, creditors arguably resemble residual claimants and would therefore seemingly have the same interest in the managers' maximizing the value of their interests that shareholders had during solvency.

Many cases have dicta supporting special director duties to creditors in this situation, or at least a special duty to balance the interests of shareholders and creditors. But on closer examination these cases resemble "shaggy dog" stories—long

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

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windups about the plight of creditors and encomiums about directors' responsibilities ending in narrower and more traditional holdings that leave the reader wondering about the relevance of the rest of the opinion. Despite the weakness of these cases as legal authority, the dicta stand as weapons for creditors and warnings to corporate managers about potential liabilities that may have real consequences in corporate transactions. It is therefore important to clarify the issues and rules and to correct misleading impressions the cases leave. This necessitates focusing on principles about the nature and scope of fiduciary duties.

In determining what duties directors owe creditors in this situation, it is not enough to ask for whose benefit the directors run the firm.² We also need to know when directors should be held liable and the nature of the remedy. The answers to these questions depend on two general principles—the scope of fiduciary duties and the business judgment rule.

A fiduciary relationship is a set of default rules that apply when a party delegates open-ended discretion over his property to another.³ The fiduciary must act unselfishly except to the extent the contract permits him to do otherwise. The remedy for breach is forfeiture of ill-gotten gain rather than merely damage to the beneficiary. Corporate directors clearly owe a fiduciary duty of unselfishness to the corporation, which is enforceable through an action brought by the corporation or derivatively on behalf of the corporation by a shareholder.⁴ If directors act self-interestedly, they breach their fiduciary duty to the corporation regardless of who the relevant claimants are.

Fiduciaries also have a duty of care. This duty is not uniquely fiduciary in that it also arises in non-fiduciary relationships and where there is no preexisting relationship.⁵ Corporate directors' duty of care is weaker than the duty of care in other situations because it is qualified by the business judgment rule. That rule proscribes judicial interference where it would create excessive timidity by directors and involve the courts in decisions in which they have limited expertise.⁶ The directors' duty of care, like the duty of loyalty, is enforced by or on behalf of the corporation.

The problem with the conclusion that directors have duties to the "corporation" is that the corporation is composed of contracts among claimants with varying and

2. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547, 549–50 (2003).

3. See Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 212. This article discusses a structural theory that looks to the nature of the relationship rather than to the characteristics of particular parties. The question concerns the type of relationship that ought to trigger the default rules of the fiduciary relationship. The parties' individual characteristics, such as their bargaining ability or information, relate to whether the default or customized rules of the relationship ought to be enforced, not what the default rules should be. For a theory emphasizing the importance of these characteristics, see Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189 (2003).

4. See *infra* Part III (discussing the right of a creditor to bring a derivative action).

5. See Ribstein, *supra* note 3, at 220–21.

6. See Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431, 1468–69 (2006).

possibly conflicting interests in the firm's wealth. With solvent firms this is not troubling—in that scenario, serving the firm's interests effectively means serving the shareholders because the value of the shareholders' interest in profits reflects the firm's economic well-being. In contrast, when the firm is in or near insolvency, the creditors resemble residual claimants because they will be entitled to much of what the corporation earns. The complication is that creditors split their residual claim with the shareholders, who are entitled to what the firm earns after paying the fixed claimants. Thus, the conflict between shareholders and creditors that was only in the background when the firm was solvent is now more evident. The shareholders, who still control the board, may want the directors to take risky actions with high payoffs that are now more likely to injure creditors. Moreover, creditors are in a worse position than the shareholders to protect themselves (other than through fiduciary duties) because they normally lack any meaningful power of control.⁷

The legal quandary of competing duties in the insolvency scenario disappears, however, in the face of the business judgment rule. It is no more appropriate for courts to interfere with directors' judgment in the insolvency scenario than at other times. The courts still lack expertise, and liability could still make directors too timid. Indeed, the business judgment rule is arguably more important as the courts face uncertainty as to not only the appropriate course of action, but whose interests are paramount.

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

The insolvency scenario also relates to duties corporate debtors owe their creditors individually. The main question in this regard is whether the creditors individually should have a general fiduciary-type remedy for conduct of this sort that does not fit within specific liability categories such as fraudulent conveyances. They should not, because this situation does not involve the broad delegation of discretion that characterizes a fiduciary relationship.⁸

In short, directors' duties around insolvency involve three distinct issues: the directors' duties to the corporation, the remedy for breach of these duties, and the corporate debtor's duties to creditors. Resolution of these issues requires an understanding both of the general nature of fiduciary duties and of the business judgment rule.

7. For discussions of how creditor-shareholder conflicts differ near insolvency, see *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 776–77 (Del. Ch. 2004), and Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1488–96 (1993).

8. See Ribstein, *supra* note 3, at 225.

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This Article proceeds as follows. Part I discusses the general structure of the fiduciary relationship and the business judgment rule, and how this analysis applies to solvent firms. Part II applies fiduciary duties and the business judgment rule to the insolvency scenario, showing that the question does not change in this context, but rather remains one of fiduciary duties and the business judgment rule. Part III discusses the distinct issue of the remedy for directors' fiduciary breaches in the insolvency scenario. Part IV untangles directors' duties from those of the corporate debtor to its creditors.

I. FIDUCIARY DUTIES AND THE BUSINESS JUDGMENT RULE

The analysis of directors' duties in the insolvency scenario must begin with a general explication of fiduciary duties and the business judgment rule. Subpart A discusses the specific fiduciary duty of unselfishness. Subpart B discusses the directors' duty of care and the business judgment rule. Subpart C discusses whether this general theory of managers' duties supports fiduciary duties to creditors.

A. *The Fiduciary Duty of Loyalty*

Fiduciary duties are a set of implied contract terms that, in the absence of contrary agreement, accompany the open-ended power to manage another's property.⁹ The duty makes the delegation feasible because the risk of cheating otherwise would make it very costly to delegate complete control over one's property.¹⁰ The property owner might try to contract for a certain level of performance and penalize the fiduciary for not performing up to that level, but for the same reason that the owner had to delegate control, neither he nor a court could easily determine the standard of the fiduciary's conduct—that is, what an honest fiduciary should have produced.¹¹ Fiduciary duties solve these problems by having a judge review the fiduciary's conduct to determine whether he acted selfishly. As Justice Cardozo said in *Meinhard v. Salmon*,¹² for the fiduciary, "thought of self was to be renounced, however hard the abnegation."¹³ It is much easier for a court to measure a fiduciary's gain than to try to determine a performance benchmark and compute damages based on deviation.

9. See Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1046–47 (1991); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 799–802 (1983); Ribstein, *supra* note 3, at 215; J.C. Shepherd, *Towards a Unified Concept of Fiduciary Relationships*, 97 LAW Q. REV. 51, 75 (1981) (stating that the receipt of power is conditioned on the duty to use the power in the best interests of another); L.S. Sealy, *Fiduciary Relationships*, 1962 CAMBRIDGE L.J. 69, 74–78 (proposing four categories of fiduciary relationships, three based on control or delegation and one based on undue influence); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1402 (2002) (proposing a theory based on a fiduciary's control of a beneficiary's "critical resource").

10. See Ribstein, *supra* note 3, at 214.

11. See Cooter & Friedman, *supra* note 9, at 1048–51.

12. 164 N.E. 545 (N.Y. 1928).

13. *Id.* at 549.

Directors of publicly held corporations clearly fit into the paradigm of the fiduciary relationship. The corporation gives managers significant power to run the company, subject only to loose control by passive, diversified shareholders. Because neither the shareholders nor the courts can effectively oversee day-to-day management, the law ensures that, at minimum, the directors will be loyal to the corporation's interests. Unlike other settings, however, the need for managerial flexibility in the public corporation setting softens the fiduciary duty of loyalty to permit exoneration of conflicted directors if their conduct was authorized by disinterested directors or shareholders or they can show that it was fair to the corporation.¹⁴

Most importantly for present purposes, because the fiduciary standard looks only at whether directors can act in their own interests, the issue of whether directors can favor shareholders over creditors does not normally arise. The test for fairness in loyalty cases confirms the unimportance of differences among the firm's claimants by focusing on the corporate entity.¹⁵ Moreover, the duty of loyalty both in corporations¹⁶ and other business associations¹⁷ permits authorization by a vote of the equity holders alone. This supports measuring fairness in terms of the equity interests when these interests clash with the creditors'.

B. The Duty of Care and the Business Judgment Rule

Corporate directors also have a duty of care. This duty is not fiduciary in nature because a fiduciary does not commit all of its time to the beneficiary and the duty inherently does not require the fiduciary to disgorge gain.¹⁸ Moreover, the duty arises even where the duty holder does not have fiduciary-like open-ended management power.¹⁹

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

14. See DEL. CODE ANN. tit. 8, § 144 (2001).

15. See *id.* § 144(a)(3) (providing for enforcement of conflict of interest transactions that are "fair as to the corporation").

16. *Id.* § 144(a)(2) (providing for approval by "vote of the shareholders").

17. See UNIF. P'SHIP ACT § 103(b)(3) (1997) (providing for authorization of transactions by partner vote); UNIF. LTD. LIAB. CO. ACT § 103(b)(2) (1996).

18. See Ribstein, *supra* note 3, at 220; J.C. SHEPHERD, THE LAW OF FIDUCIARIES 49 (1981) ("the duty of care has absolutely no necessary connection with fiduciary relationships").

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

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sions because, although shareholders would capture most of the gain, managers would bear the risk.²⁰

The business judgment rule accordingly gives a lot of discretion to managers. For example, the American Law Institute Code provides that courts cannot impose liability for an informed and disinterested director decision that the director “rationally believes . . . is in the best interests of the corporation.”²¹ In other words, the director need not act “reasonably.” Indeed, the decision is insulated from review even if the court concludes in hindsight that it was irrational, as long as, at the time of the decision, the director rationally believed it was in the corporation’s best interests.²²

The operation of the business judgment rule can be illustrated by the famous case in which a Disney shareholder sued the board for hiring a chief executive, giving him generous termination provisions, and firing him only fourteen months later for admittedly ineffective management, paying him \$140 million for his trouble. The Delaware Supreme Court initially dismissed the complaint.²³ The Chancery Court upheld the complaint on remand after the plaintiff added allegations transcending mere lack of due care and amounting to bad faith—that is, conscious disregard of duty.²⁴ But the Chancery Court dismissed the case after the plaintiff failed to prove the allegations in a lengthy trial, and clarified the standard by opining that:

*the concept of intentional dereliction of duty, a conscious disregard for one’s responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.*²⁵

This lax standard applied because Disney, like most Delaware corporations, had taken advantage of a Delaware statutory provision permitting firms to opt out of the duty of care.²⁶ This leaves only the duty of loyalty and the duty of good faith. The only “appropriate” good faith standard that Chancellor Chandler was willing to stand behind was “intentional dereliction of duty.”²⁷

20. See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 93, 98–99 (Harvard Univ. Press 1991); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 113 (2004); Ribstein, *supra* note 6, at 1469.

21. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 4.01(c)(3) (1994).

22. *Id.* § 4.01(a).

23. *Brehm v. Eisner*, 746 A.2d 244, 248 (Del. 2000).

24. *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 278 (Del. Ch. 2003).

25. *In re Walt Disney Co. Derivative Litig.*, No. Civ.A. 15452, 2005 WL 2056651, at *36 (Del. Ch. Aug. 9, 2005) (citations omitted), *aff’d*, 906 A.2d 27 (Del. 2006).

26. DEL. CODE ANN. tit 8, § 102(b)(7) (2001).

27. *In re Walt Disney Co. Derivative Litig.*, 2005 WL 2056651, at *36.

The business judgment rule serves to exonerate the board even if it arguably acts in non-shareholders' interests. For example, in *Shlensky v. Wrigley*,²⁸ the court dismissed the minority shareholders' complaint against a majority shareholder for mismanagement based on defendant's failure to install lights in the firm's baseball stadium, even though every other major league team allegedly had done so.²⁹ The majority shareholder had said "that baseball is a 'daytime sport' and that the installation of lights and night baseball games will have a deteriorating effect upon the surrounding neighborhood."³⁰ The court reasoned:

*[W]e are not satisfied that the motives assigned to Philip K. Wrigley, and through him to the other directors, are contrary to the best interests of the corporation and the stockholders. For example, it appears to us that the effect on the surrounding neighborhood might well be considered by a director who was considering the patrons who would or would not attend the games if the park were in a poor neighborhood. Furthermore, the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighborhood from deteriorating. By these thoughts we do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision.*³¹

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

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

C. *Fiduciary Duties to Creditors*

The basic principles described in subparts A and B demonstrate that corporate fiduciaries do not have a special duty to a particular corporate constituency, including creditors. Rather, they have fiduciary and care duties to their principal, the corporation. This may sound like a meaningless cop-out because making the beneficiary of the duty a faceless entity seems only to defer determination of which

28. 237 N.E.2d 776 (Ill. App. Ct. 1968).

29. *Id.* at 781.

30. *Id.* at 778 (internal quotation marks omitted).

31. *Id.* at 780.

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interests matter. In fact, this characterization is consistent with the sharply limited nature of directors' duties. The duty is merely one not to act selfishly or to engage in the sort of egregiously nonmaximizing conduct that is subsumed by the business judgment rule.

The limitation on directors' duties is inherent in the business judgment rule and the jurisprudential considerations underlying the rule. Fiduciary duties do not tell directors what they "should" or "should not" do, but define the limits of judicial action based on director conduct. The courts are not in a position to effectively determine whether agents are doing a good job. If the parties want something more precise, they can define specific standards in their contract.

The limitations on directors' duties to creditors do not, contrary to the suggestions of some commentators,³² rest on differences between creditors and shareholders regarding their ability to contract for more specific protection. To be sure, debt is often held by a small number of sophisticated creditors who can act through a trustee, while equity is dispersed among thousands of small shareholders.³³ But these ownership characteristics are not inherent in the instruments. The distinctions may not apply to, for example, closely held corporations or public corporations held substantially by institutional shareholders who can act collectively or through intermediaries.³⁴

The most defensible distinction between debt and equity interests is that, given the open-endedness of the residual claim, it is inherently more difficult for equity holders to contractually specify duties than for debt holders.³⁵ Although shareholders have contracting options, such as terms that specify the firm's obligations to pay dividends,³⁶ standard-form credit and equity contracts differ regarding specificity of duties. This matters for fiduciary duties because a strong duty of loyalty is appropriate only when the agent delegates open-ended discretion to the principal. The creditors are better left to flexible enforcement of specific contract terms than broad fiduciary remedies.³⁷

This distinction, however, has little to do with the board's fiduciary duties. At most it suggests that equity holders, who effectively control the corporation

32. See Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. Bus. & TECH. L. 335 (2007), available at <http://ssrn.com/abstract=832504> (discussing venture capital and preferred shareholders' ability to protect themselves); Smith, *supra* note 9, at 1459–60 (discussing venture capital and preferred shareholders' ability to protect themselves).

33. See Bainbridge, *supra* note 32.

34. See *Unisuper Ltd. v. News Corp.*, No. 1699-N, 2005 WL 3529317 (Del. Ch. Dec. 20, 2005) (involving the interpretation of a contract between institutional shareholders and directors), *motion to certify appeal granted*, No. Civ.A. 1699-N, 2006 WL 207505 (Del. Ch. Jan. 19 2006).

35. See Bainbridge, *supra* note 32.

36. See Ribstein, *supra* note 6, at 1479.

37. See Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1248 (2006) (discussing creditors' significant control powers and arguing that "[r]ather than adding ill-defined fiduciary duties to the contracts that they write, a better course may be to ensure that such duties do not impede the exercise of contractual rights for which creditors have bargained").

through the board, should not have a fiduciary duty to creditors despite their ability to act opportunistically to creditors.³⁸ But it does not follow that directors should owe a duty to shareholders distinct from that to the corporation or creditors. Rather, the limits discussed above on courts' ability to make these judgments argue against courts forcing directors to choose between shareholder and creditor interests when the two conflict.³⁹

One difficulty with the foregoing analysis is that special duties to creditors might reenter the picture in determining whether directors have breached their duty of loyalty to the corporation. Creditors might argue that directors who are substantial shareholders are subject to a conflict of interest in acting for the "corporation" that justifies subjecting their decisions to special judicial scrutiny. Indeed, creditors might argue that the conflict exists in any case because directors owe their jobs to the shareholders. However, the directors' incentive to favor one group of claimants over another does not involve the risk of the sort of clear disloyalty that fiduciary duties address. More importantly, imposing a duty whenever a self-interest of this sort exists would require broad judicial interference in board decision-making contrary to the business judgment rule.

Even if directors' share ownership creates a direct conflict of interest, this still does not trigger fiduciary duties because it really involves a conflict between the shareholders (acting through the directors) and the creditors. As discussed above,⁴⁰ fiduciary duties by shareholders to creditors are inappropriate because creditors do not delegate fiduciary-like open-ended discretion to shareholders.

The directors' duty of loyalty might be implicated in the specific situation where directors represent creditors in making a decision that involves a conflict between shareholder and creditor interests. For example, *Blackmore Partners, L.P. v. Link Energy LLC*⁴¹ held that this situation was not involved because the investor the director represented was not only a creditor, but also equally an equity owner.⁴² If the investor had been solely a creditor, this might mean that the director was disloyal to the corporation and thereby breached his fiduciary duty to the corporation. Still, only a direct conflict of personal interests would justify overriding the business judgment rule's concern with broad-based judicial scrutiny of directors' acts.

38. See Ribstein, *supra* note 3, at 225.

39. Indeed, Professor Bainbridge eventually comes around to this point in recognizing that the business judgment rule is a rule of judicial "abstention" that keeps courts away from fine distinctions concerning whose interests directors must maximize. See Bainbridge, *supra* note 32, at 368. This is not, as Professor Bainbridge suggests, one of several reasons for the absence of a special duty to creditors—it is the only reason.

40. See *supra* note 3 and accompanying text.

41. No. Civ.A. 454-N, 2005 WL 2709639 (Del. Ch. Oct. 14, 2005).

42. *Id.* at *6–7.

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II. DIRECTORS' DUTIES IN THE INSOLVENCY SCENARIO

Creditors' interests increasingly resemble equity claims as the corporation nears insolvency. The limitations on creditors' claims to specific obligations to pay principal and interest matter less as equity disappears and the value of the firm's debts approaches that of its assets. Specific contractual constraints on the shareholders' and directors' actions that adequately protect creditors of solvent firms may not protect them against the much broader set of actions that can harm creditors of insolvent or nearly insolvent corporations. Indeed, creditors in this situation arguably are even more appropriate beneficiaries of fiduciary duties than shareholders because creditors generally lack control powers.

It is important to emphasize that the question is not whether directors have fiduciary duties in this situation—they clearly continue to be fiduciaries, just as they were before insolvency. Rather, the question is whether the nature of the directors' duties changes as a result of insolvency, so that the directors are deemed to owe fiduciary duties to the creditors instead of, or in addition to, the shareholders.

The reasons for not changing fiduciary duties in the insolvency scenario relate to the practical limitations on fiduciary duties and the considerations underlying the business judgment rule. The fact that creditors' interests are more intense in this situation further complicates the task of balancing shareholders' and creditors' interests. For example, directors may have to choose between an alternative that has both a limited upside that satisfies creditors' claims and a limited downside and an alternative that might benefit shareholders and leave creditors with most of the downside risk. Moreover, a judicially imposed duty in this situation would add unpredictability and litigation risk because of the difficulty of defining when the duty applies—that is, whether the corporation was insolvent or near insolvency.⁴³ In order to protect themselves against litigation, prudent directors would have to extend the "zone" of insolvency to an amorphous penumbra over a sizable chunk of corporate decision making.

An alternative is to hold that directors owe duties of loyalty, care, and good faith to the corporate entity, requiring them to balance the interests of the shareholders, creditors, and other corporate constituencies.⁴⁴ Chancellor Allen's opinion in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*⁴⁵ seems to be an example of this approach. The Chancellor used the illustration of a solvent corporation with \$12 million in debt having as its sole asset a \$51 million judgment that has an expected value (taking into account the chances of affirmation, modifica-

43. For cases dealing with this definition problem, see *Pröd. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 782–84 (Del. Ch. 2004), and *Geyer v. Ingersoll Publ'n Co.*, 621 A.2d 784, 792 (Del. Ch. 1992).

44. For cases adopting this approach, see *In re Unifi Commc'ns, Inc.*, 317 B.R. 13 (Bankr. D. Mass. 2004), *Odyssey Partners, L.P. v. Fleming Companies, Inc.*, 735 A.2d 386, 410–12 (Del. Ch. 1999), and *Geyer*, 621 A.2d at 792.

45. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

tion, and reversal on appeal) of \$15.55 million.⁴⁶ Chancellor Allen noted that the creditors would be willing to accept any settlement offer above \$12 million. The shareholders might reject an even higher settlement, however, if there is a significant chance (say twenty-five percent) that the judgment would be affirmed. The Chancellor observed:

But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than \$15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.⁴⁷

Chancellor Allen did not, however, impose a duty on the board. He held that the managing creditors did not breach a duty to the ninety-eight percent shareholder by failing to sell corporate assets, despite the shareholder's need for capital, because sale would have brought a "fire-sale" price.⁴⁸ Allen's dictum deals with the business question of how the directors of an insolvent corporation should approach managing the firm. By contrast, the business judgment rule asks whether directors should be held liable or their decisions reversed when they take a particular action. Second-guessing the directors because they did not consider the majority shareholder's personal financial situation would compromise the business judgment rule's objectives of protecting reasonable risk-taking and preventing undue judicial interference. As discussed in Part I, liability depends on whether the directors have breached a duty of loyalty through self-interested conduct, or a duty of care, subject to the business judgment rule, or the even laxer good faith duty applied in *Disney*. From this perspective, the *Credit Lyonnais* dictum is relevant mainly in illustrating the difficulty of the directors' decision and the need for court abstention. *Credit Lyonnais* does not instruct courts to find a breach of duty whenever the board does not find precisely the right balance between shareholder and creditor interests.

46. *Id.* at *34 n.55.

47. *Id.*

48. *Id.* at *33-34.

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In light of this difficulty, it is not surprising that, despite judicial language like Chancellor Allen's in *Credit Lyonnais* suggesting that directors must balance the interests of various constituencies,⁴⁹ there are no cases holding directors liable simply for getting the balance wrong where they did not violate the generally applicable duties of loyalty, care, and good faith. The difference between the general dictum in the insolvency scenario calling for a balancing of interests and the much narrower holdings applying the business judgment rule in determining the directors' actual duties is evident from an analysis of a few of the more prominent cases.

Equity-Linked Investors, L.P. v. Adams,⁵⁰ eliminates any doubt about Chancellor Allen's support for applying the business judgment rule. This case held that the board could favor the interests of the common shareholders over those of preferred shareholders by obtaining an outside investment that diluted the preferred interest rather than opening the bidding to the preferred shareholders, who probably would have liquidated the company.⁵¹ Because preferred shares have some equity-like features, the argument for fiduciary duties is stronger here than in the creditor context. Yet Chancellor Allen noted the rule that creditors were owed only "contractual," not fiduciary duties,⁵² and applied this rule to preferred shareholders.⁵³ The court reasoned that "[w]hile the board in these circumstances could have made a different business judgment, in my opinion, it violated no duty owed to the preferred in not doing so. The special protections offered to the preferred are contractual in nature."⁵⁴

The case was complicated by the plaintiff's argument⁵⁵ that the transaction was a transfer of control that triggered the board's special duties under *Paramount Communications Inc. v. QVC Network Inc.*⁵⁶ to maximize shareholder value. The plaintiff was not seeking to apply some special fiduciary duty to fixed claimants, but rather to get favored treatment as an equity holder. Because the preferred shares' liquidation preference was below water, a favorable ruling would have let the preferred make a "credit bid" exceeding the bid the firm accepted. In other words, the court explicitly permitted the board not to maximize the value of the corporation as a whole and instead to maximize the value of the common shares' interest.⁵⁷ This enabled the board to follow through on its business plan to continue research and development rather than to liquidate. The court reasoned, "[w]here judgment is

49. See *id.* at *34.

50. 705 A.2d 1040 (Del. Ch. 1997).

51. *Id.* at 1041-43.

52. See *infra* note 104 and accompanying text.

53. *Equity-Linked*, 705 A.2d at 1042. For an application of fiduciary duties to preferred shareholders, including an analysis of *Equity-Linked*, see William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 922-45 (2002).

54. *Equity-Linked*, 705 A.2d at 1042.

55. *Id.* at 1053.

56. 637 A.2d 34, 37 (Del. 1994).

57. See *Equity-Linked*, 705 A.2d at 1057.

inescapably required, all that the law may sensibly ask of corporate directors is that they exercise independent, good faith and attentive judgment, both with respect to the quantum of information necessary or appropriate in the circumstances and with respect to the substantive decision to be made.”⁵⁸

Reading *Equity-Linked* together with *Credit Lyonnais* clarifies that Chancellor Allen does not support a general duty to maximize corporate value in the insolvency scenario. Directors in the insolvency scenario, as in solvent corporations, need only avoid conflicts and otherwise receive broad protection under the business judgment rule. Just as this reasoning let the directors maximize the creditors’ interests in *Credit Lyonnais*, so could they prefer the equity’s interest over that of the debt-like preferred shares in *Equity-Linked*.⁵⁹

Other leading cases are consistent with the approach in *Credit Lyonnais* and *Equity-Linked*. A prominent example is *Production Resources Group, L.L.C., v. NCT Group, Inc.*,⁶⁰ in which Vice Chancellor Strine held that directors had no special duties to creditors that would justify not applying the Delaware fiduciary opt-out provision.⁶¹ Instead, the court held that any suit for breach of duty in the zone-of-insolvency continues to be one on behalf of the corporation, whether or not it is maintained by creditors.⁶² Whether the directors have breached their duties here, as elsewhere, depends on the business judgment rule. For example, the court said that directors may be liable if they destroyed the corporation in an attempt to preserve going concern value.⁶³ Such actions would go significantly beyond simply favoring the shareholders over the creditors.

Vice Chancellor Strine reaffirmed this position in *Trenwick America Litigation Trust vs. Ernst & Young, LLP*,⁶⁴ where he held, among other things, that the directors of a subsidiary did not breach their fiduciary duty to its creditors for taking on debt for the benefit of its parent corporation, which owned 100% of its stock, although the parent and the sub eventually became insolvent. The Vice Chancellor refused to find a special duty owed by the board to the creditors to avoid “deepening insolvency.”⁶⁵ Rather, he held that the subsidiary’s board continues to have a duty to the corporation, leaving it the discretion under the business judgment rule to enter into transactions that benefit its sole shareholder. The court concluded:

58. *Id.* at 1058.

59. In another post-QVC case, *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 918 (Del. 2003), the court went even further and held that the board, in effect, must prefer the shareholders by rejecting a deal that would have been more beneficial to the creditors.

60. 863 A.2d 772 (Del. Ch. 2004).

61. *Id.* at 777; see DEL. CODE ANN. tit. 8, §102(b)(7) (2001).

62. Similarly, *In re Scott Acquisitions Corp.*, 344 B.R. 283, 288 (Bankr. D. Del. June 23, 2006)(citing *Prod. Res. Group*, 863 A.2d at 791–92), noted that, while creditors of an insolvent corporation are owed fiduciary duties, “[t]hese duties . . . are typically derivative of the duties owed to the subsidiary corporation itself.” For a discussion of creditors’ right to maintain the suit, see *infra* Part III.

63. See *Prod. Res. Group*, 863 A.2d at 791 n.60.

64. 906 A.2d 168 (Del. Ch. 2006).

65. *Id.* at 174.

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If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law.⁶⁶

The Vice Chancellor added:

The judicial decisions indicating that directors owe fiduciary duties to the firm when it is insolvent . . . seem to me more a judicial method of attempting to reinforce the idea that the business judgment rule protects the directors of solvent, barely solvent, and insolvent corporations, and that the creditors of an insolvent firm have no greater right to challenge a disinterested, good faith business decision than the stockholders of a solvent firm.⁶⁷

In *Odyssey Partners, L.P. v. Fleming Companies, Inc.*,⁶⁸ minority shareholders alleged that the board breached its duty of loyalty by failing to adequately consider a Chapter 11 filing and thereby allowing the majority shareholder and major creditor of the corporation to foreclose on its security interest. The court reasoned, “[w]hen bankruptcy and foreclosure are compared, and the effects of both on the shareholders, creditors and other corporate constituencies balanced, the decision to proceed with the foreclosure cannot be said to have been made in bad faith or a manner that was disloyal to ABCO, taken as a whole.”⁶⁹ Thus, the court held that the board could favor the majority shareholder/creditor's interest, consistent with the business judgment rule that applies in or out of the insolvency scenario.

Blackmore Partners, L.P. similarly held that the board could favor creditors over equity holders by selling the firm's assets at a price that gave the shareholders nothing and thereby ignoring an alternative proposal that would have been better for equity interests.⁷⁰ The court distinguished a case in which the board had intentionally diluted the interest of a majority shareholder from a mere exercise of business judgment, noting that the board had good business reasons for its decision and was

66. *Id.* at 205.

67. *Id.* at 196 n.75.

68. 735 A.2d 386 (Del. Ch. 1999).

69. *Id.* at 420.

70. *Blackmore Partners, L.P. v. Link Energy LLC*, No. Civ.A. 454-N, 2005 WL 2709639, at *1 (Del. Ch. Oct. 14, 2005).

not guilty of gross negligence.⁷¹ Thus, its choices were “within the core of what is protected by the business judgment rule.”⁷²

Although the board does not have a fiduciary duty to reach a particular balance of creditor and shareholder interests in the insolvency scenario, creditors may have rights against the corporation and shareholders arising out of fraudulent conveyances. Creditors’ individual rights are discussed in more detail below in Part IV. The relationship between these rights and the directors’ duties to the corporation that are the focus of this section is illustrated by the following two cases.

Geyer v. Ingersoll Publications Co.,⁷³ is often cited as holding in favor of directors’ special duties to creditors in the insolvency scenario, but in fact adds nothing to the above cases. In *Geyer*, plaintiff alleged that a director caused the corporation to cancel management agreements for consideration paid to the director that rendered the corporation unable to make payments due plaintiff.⁷⁴ The issue was whether a non-shareholder creditor could assert personal jurisdiction over a nonresident director under a Delaware statute that provided for jurisdiction “in any action or proceeding against such director, trustee or member for violation of a duty in such capacity.”⁷⁵ The parties agreed that there was an “insolvency exception” to the general rule of no fiduciary duties to creditors, so the court was left to decide only whether the exception arose even without a statutory insolvency proceeding.⁷⁶ The court held that it did, and accordingly permitted the exercise of personal jurisdiction.⁷⁷ Because the case involved only personal jurisdiction, the court did not determine whether the duty was breached. More importantly, this case did not involve any special duty by the board to manage in the creditors’ interests close to insolvency. Instead, it involved a fraudulent conveyance-type transfer of the type discussed below in Part IV that breached the duty the defendant, who was also the corporation’s sole shareholder, owed the plaintiff creditor.

*In re Unifi Communications, Inc.*⁷⁸ more clearly distinguishes the corporation’s duty directly to creditors from the board’s duty to the corporation. The corporate debtor’s trustee in bankruptcy alleged that the board breached its duties to the corporation by depleting corporate assets after it was insolvent in order to help a director “salvage his equity interest.”⁷⁹ The defendants opposed summary judgment by claiming that they had a limited duty to creditors that “requires only that the director not engage in self-dealing or other conduct that prefers any corporate con-

71. *Id.* at *5.

72. *Id.* at *8.

73. 621 A.2d 784 (Del. Ch. 1992).

74. *Id.* at 786.

75. DEL. CODE ANN. tit. 10, § 3114(a) (Supp. 2004).

76. *Geyer*, 621 A.2d at 787.

77. *Id.* at 794.

78. 317 B.R. 13 (Bankr. D. Mass. 2004).

79. *Id.* at 17.

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stituent over creditors.”⁸⁰ The court distinguished the cases cited by defendants, notably including *Geyer*, in which the plaintiffs were creditors. The plaintiff trustee argued that “[i]t is hornbook law that corporate directors owe the corporation they serve fiduciary duties of due care, loyalty and good faith. . . . Although at least some of those duties expand to include creditors when a company nears insolvency, there is an ever-present duty to the corporation itself.”⁸¹ The court noted that the trustee had no standing to bring an action specifically on the creditors’ behalf, so that the trustee’s claim had to be one on behalf of the corporation.⁸² Because the defendants failed to address the trustee’s argument about the duties owed the corporate entity, the court denied the defendants’ motion for summary judgment.⁸³

In re Global Service Group LLC,⁸⁴ decided around the same time as *Unifi* and involving the same type of alleged misconduct, clearly held that the directors’ decision to continue operating an insolvent company rather than liquidating was subject to the business judgment rule, and therefore did not result in liability absent “specific allegations that the fiduciary acted in bad faith or with fraudulent intent.”⁸⁵

These cases hold that directors’ duties to the corporation in the insolvency scenario, as in cases outside the scenario, are defined by the general duties of loyalty, care, and good faith, importantly qualified by the business judgment rule. Although some cases contain language indicating that the directors must pay particular attention to the creditors’ interests in this situation, or to the corporate entity, no holding is inconsistent with the general rule. Rather, the language about maximizing the “corporate” interest merely confirms the absence of judicial interference in any decision the directors choose to make as long as they avoid conflicts or deliberate harm.

III. REMEDIES

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

State corporate laws generally deny standing to creditors in derivative suits, though a trustee in bankruptcy can sue derivatively on behalf of the corporation.⁸⁶

80. *Id.* at 18.

81. *Id.* at 18–19 (citations omitted).

82. *Id.* at 17.

83. *Id.* at 19.

84. 316 B.R. 451 (Bankr. S.D.N.Y. 2004).

85. *Id.* at 461.

86. See Note, *Creditors’ Derivative Suits on Behalf of Solvent Corporations*, 88 *YALE L.J.* 1299, 1302–03 (1979).

The nature of the trustee's suit is identical to a standard shareholders' derivative action, in which the recovery also goes to the corporation rather than to individual plaintiffs. That the main beneficiaries of a corporate recovery at a particular point in time happen to be the creditors has no important consequences for either the duty or the remedy. Indeed, one reason for requiring a shareholder to sue derivatively rather than directly on behalf of the shareholders is to ensure that the shareholders do not appropriate the recovery to the exclusion of creditors.

Individual creditors may be able to sue derivatively in bankruptcy with the court's permission on breach of duty claims to the creditors that the creditors could bring outside of bankruptcy.⁸⁷ *Official Committee ex rel. Cybergenics Corp. v. Chinery*⁸⁸ authorized a creditors' committee to bring derivative claims based on alleged fraudulent transfers where the bankruptcy court held that the debtor's refusal to bring the claims was unreasonable. The bankruptcy court's finding was equivalent to a state court's finding that would allow a derivative suit to proceed over the board's objection.⁸⁹

Notwithstanding *Cybergenics*, the creditors' ability to sue derivatively in bankruptcy is unclear.⁹⁰ The Bankruptcy Code does not appear to authorize creditor derivative suits.⁹¹ The basic policy question is whether such suits are likely to maximize the value of the bankruptcy estate as opposed to restricting the right to sue to the trustee. In some cases, perhaps including *Cybergenics*, the trustee's refusal to sue is unreasonable. Even outside of bankruptcy, the creditors may have better incentives than the shareholders where the corporation is insolvent. Because a suit on behalf of an insolvent corporation may eventually be stayed or enjoined in bankruptcy⁹² and effectively taken over or released by the trustee,⁹³ this may reduce a contingent-fee plaintiffs' lawyer's incentives to sue on behalf of an insolvent, or nearly insolvent, firm. A substantial creditor might have better incentives to sue on behalf of an insolvent corporation than would the typical derivative plaintiff or even a substantial shareholder.

There are, however, strong arguments against allowing creditors of bankrupt firms to sue derivatively. Such suits may add costly complexity to bankruptcy pro-

87. See *infra* Part IV (discussing these claims).

88. 330 F.3d 548 (3d Cir. 2003). See *In re Commodore Int'l Ltd.*, 262 F.3d 96, 100 (2d Cir. 2001) (allowing creditors committee to sue derivatively with the approval of the bankruptcy court).

89. See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 783–84 (Del. 1981).

90. See Keith Sharfman, *Derivative Suits in Bankruptcy*, 10 *STAN. J.L. BUS. & FIN.* 1, 25–26 (2004).

91. See *In re Balt. Emergency Servs. II, Corp.*, 432 F. 3d 557, 562–63 (Bankr. 4th Cir. 2005) (denying standing where plaintiffs lacked debtors' consent and bankruptcy court authorization to sue and expressing doubt whether the Code permits derivative creditor standing in any case); *In re Fox*, 305 B.R. 912 (B.A.P. 10th Cir. 2004) (denying standing to bring a section 548 claim).

92. See 11 U.S.C. §§ 105, 362 (2000); *In re Kmart Corp.*, 285 B.R. 679, 688 (Bankr. N.D. Ill. 2002); *In re Zenith Laboratories, Inc.*, 104 B.R. 659, 666 (Bankr. D. N.J. 1989).

93. See *Agostino v. Hicks*, 845 A.2d 1110, 1126 (Del. Ch. 2004) (finding derivative suit could be released by the bankruptcy court in its confirmation of the corporation's Chapter 11 plan through which the creditor became the sole shareholder).

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ceedings and interfere with orderly reorganizations and workouts.⁹⁴ Moreover, any problems with the trustee refusing to prosecute worthwhile claims can be dealt with by replacing the trustee.⁹⁵ In any event, given potential problems with creditor derivative suits, the bankruptcy court should play an active role in screening these suits.⁹⁶

Production Resources lends a little support to a creditor's right of action in state court. The court refused to dismiss a creditor's suit under the Delaware statute for appointment of a receiver.⁹⁷ The court held that suit by a creditor for a receiver was justified, particularly because the creditor lacked other remedies.⁹⁸ The court also reasoned that the identity of the plaintiff did not affect the nature of the remedy or of the directors' duties.⁹⁹ Thus, as discussed above,¹⁰⁰ because the suit was one to protect the corporation's rights, the directors were still protected by the Delaware fiduciary opt-out that applied to shareholder derivative suits.¹⁰¹

In sum, although there is some authority for creditor derivative suits in bankruptcy, the weight of authority and policy is against such actions. Moreover, even if such suits were allowed, this would not change the substance of directors' duties. The creditors would be suing to enforce directors' duties to the corporation rather than specifically to the creditors, whether in or out of the insolvency scenario.

IV. THE CORPORATION'S DUTIES TO CREDITORS

The discussion so far shows that directors have no special duties in the insolvency scenario. Although courts sometimes have appeared to hold that a board in this situation owes duties to the "corporation," which may include creditors, this is in fact no more than a characterization of the courts' limited scrutiny of board decisions under the business judgment rule.

The question remains whether courts should impose fiduciary duties to creditors on corporate debtors in the insolvency scenario. Such duties might seem appropriate to address the agency problem that arises when debtors have an incentive to engage in transactions whose risk is imposed on creditors while debtors reap potential rewards.¹⁰² This does not implicate the business judgment rule because liability is imposed on the corporation, or perhaps its owners, rather than on the

94. See Sharfman, *supra* note 90, at 20–22.

95. *Id.* at 23–25.

96. See *In re Balt. Emergency Servs. II*, 432 F. 3d at 562 (stating that "the bankruptcy court plays a vital gatekeeper role in determining whether derivative standing is appropriate in a given case").

97. *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 836 A.2d 772, 786 (Del. Ch. 2004).

98. *Id.* at 790–91.

99. *Id.* at 793–95.

100. See *supra* Part III and accompanying note 61.

101. For a similar holding, relying on *Production Resources*, see *Fleet National Bank v. Boyle*, No. Civ.A. 04CV1277LDD, 2005 WL 2455673, at *15–16 (E.D. Pa. Sept. 12, 2005), which held that a Delaware exculpatory clause protected defendants in the absence of a showing of bad faith or self-dealing.

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

corporation's managers. This issue tangentially relates to directors' duties to the corporation because recognizing a fiduciary duty by the corporate debtor effectively requires the corporation's agents to take the creditors' interests into account.

As discussed above,¹⁰³ this is not an appropriate situation in which to apply fiduciary duties because the nature of the creditors' contract makes it feasible for creditors to rely on specific contractual protections rather than open-ended fiduciary duties. It might seem that open-ended duties to creditors would be appropriate to the extent that creditors of insolvent corporations resemble residual claimants, however, the existence of a fiduciary duty should depend on the nature of the contract. Although most creditors' contracts arguably are designed for solvent companies, the contracts theoretically can be drafted to offer increased protection in the insolvency scenario, including increased creditor control.¹⁰⁴ Investors' decisions to rely on contracts that include specific obligations rather than an open-ended residual claims, therefore, should continue to control the result.¹⁰⁵

Consistent with this reasoning, courts generally have held that corporate debtors do not have fiduciary duties to the firm's creditors.¹⁰⁶ As Chancellor Allen explained in *Katz v. Oak Industries, Inc.*:¹⁰⁷

*Under our law—and the law generally—the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature. Arrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.*¹⁰⁸

Debtors do owe some specific duties to their creditors, particularly the duty to refrain from fraudulent conveyances and duties under the creditors' contract with the debtor. The fraudulent conveyance theory accommodates the need to deter debtor misbehavior with the need to limit judicial interference with contractual

103. See *supra* Part I.C.

104. See Lin, *supra* note 7, at 1502–06 (discussing creditors' ability to protect themselves in insolvency situations).

105. See Ribstein, *supra* note 3, at 215–18 (emphasizing that fiduciary duties arise out of the structure of the parties' relationship).

106. See *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1526, 1530–31 (S.D.N.Y. 1989), *vacated by* 906 F.2d 884 (2d Cir. 1990); *Simons v. Cogan*, 549 A.2d 300, 303–04 (Del. 1988); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986); *Harff v. Kerkorian*, 347 A.2d 133, 134 (Del. 1975). *But see* *Fox v. MGM Grand Hotels, Inc.*, 187 Cal. Rptr. 141, 142–43 (Cal. Ct. App. 1982) (holding in favor of fiduciary duties to creditors in connection with spin-off to common shareholders).

107. 508 A.2d 873 (Del. Ch. 1986).

108. *Id.* at 879 (citations omitted).

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obligations. Because creditors can contract for specific constraints on debtor conduct and share some of the risks of the enterprise, only a limited additional measure of protection is appropriate. Fraudulent conveyance liability, like the fiduciary duty of unselfishness, focuses on a particular category of clear misconduct for which the courts can fashion a remedy. The theory applies where the debtor takes an action that not only creates an extra risk for creditors, but does so where there can be no legitimate business purpose—for example where an insolvent corporation gives away its property. The remedy is a straightforward recovery of the assets, usually through an action by the trustee in bankruptcy acting for the debtor.

The fraudulent conveyance remedy is sometimes characterized as one for breach of fiduciary duty. For example, in *LaSalle National Bank v. Perelman*,¹⁰⁹ Marvel's note holders sued the directors in a Chapter 11 proceeding for breach of fiduciary duties to them based on paying the note proceeds to Marvel's parent, consistent with offering memoranda stating that Marvel would make such distributions. The court denied relief because the subsidiary was not insolvent at the time of the distributions.¹¹⁰ The court also noted that the offering memoranda explicitly contemplated such distributions.¹¹¹ The "fiduciary duty" characterization in this case confuses the issue—if the firm had been insolvent, fraudulent conveyance liability would have been appropriate.

The corporation's duty to its creditors should be distinguished from the directors' duties in managing the corporation's assets. Consistent with the principles discussed above, self-dealing and waste account for all of the cases Laura Lin characterized as breaches of fiduciary duties to creditors:

*(1) withdrawing assets from the insolvent corporation as alleged payment of claims that the directors had against the corporation, such as loans to the company or unpaid commissions; (2) using corporate funds to pay off the company's loans that the directors had personally guaranteed; (3) engaging in transactions, usually without fair consideration to the company, for the benefit of its parent corporation or related entities; (4) pocketing the proceeds of a sale of all corporate assets to a third party or otherwise transferring property to a related entity, leaving the former corporation insolvent; and (5) other forms of self-dealing in which the directors use assets of the insolvent firm for their own benefit, such as pledging stock owned by the corporation as collateral to finance the directors' personal stock purchases.*¹¹²

109. 82 F. Supp. 2d 279 (D. Del. 2000).

110. *Id.* at 290–91.

111. *Id.* at 295.

112. See Lin, *supra* note 7, at 1513–14 (citations omitted).

Lin argues “[a] common theme prevalent in these cases is the resemblance to fraudulent conveyances or voidable preferences under bankruptcy law.”¹¹³ Even if that is the case, it does not explain why some remedy other than fraudulent conveyance or voidable preference is appropriate, particularly where the conduct does not meet the tests for liability under those theories. In fact, these cases do not stretch the boundaries of more specific remedies to the extent they involve claims brought by the corporation against directors who breached their fiduciary duty to the corporation in dealing with corporate assets. By contrast, a fraudulent conveyance or preference claim is one by creditors against the debtor, shareholders, or others who received corporate assets in violation of the corporate debtor’s duty to the creditors. Lin found it hard to fit the above categories into conventional fiduciary duties only because she assumed that the directors’ fiduciary duty was owed specifically to the shareholders.¹¹⁴ As discussed throughout this Article, however, neither the duty of loyalty nor the business judgment rule requires a distinction between the duty to the shareholders and the corporate entity.

The sole remaining question is whether there are any circumstances in which the creditors may individually bring a non-derivative fiduciary action against either shareholders or directors that is not based on a fraudulent conveyance or violation of other specific statutory or contractual duties of the corporate debtor to its creditors. In *Production Resources*, the court made clear that most of the creditor’s claims were on behalf of the corporation, although the action was not formally a derivative action.¹¹⁵ However, the creditor did sue individually for breach of fiduciary duty based on an alleged promise to sell stock owned by the debtor’s subsidiary in order to pay the judgment owed to the plaintiff. The court said that, in addition to the question of whether this was properly brought as a derivative claim, there was also

*utility in applying fiduciary duty law quite cautiously, to avoid unduly benefiting creditors by enabling them to recover in equity when they could not prevail on legal tort or contract claims. At the same time . . . the fact of [the corporation’s] insolvency might influence the application of traditional torts, like common law fraud, by enabling [the creditor] to recover for cases of material omission.*¹¹⁶

In other words, although the court acknowledged the slight possibility that an individual creditor might have a fiduciary duty claim that was outside the bounds

113. *Id.* at 1514 (citations omitted).

114. *Id.* at 1486–88.

115. *Prod. Res. Group, LLC v. NCT Group, Inc.*, 863 A.2d 772, 792 (Del. Ch. 2004).

116. *Id.* at 801 n.88.

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of specific creditor remedies, the scope of any such relief would be narrow.¹¹⁷ If the creditor of a corporation in or near insolvency can recover, it would most likely be under a traditional fraud or other theory whose application is shaped by the circumstances, including the corporation's insolvency. In *Trenwick America Litigation Trust vs. Ernst & Young, LLP*,¹¹⁸ Vice Chancellor Strine noted that, even if fraudulent conveyance or contract remedies were not available:

*the creditors' frustration does not mean that there is a gap in the remedial fabric of the business law that equity should fill. Rather, it means that we remain a society that recognizes that reward and risk go together, and that there will be situations when business failure results in both equity and debt-holder losing some money.*¹¹⁹

Similarly, in *North American Catholic Educational Programming Foundation v. Gheewalla*,¹²⁰ the court held that there was no direct creditor action for breach of fiduciary duty, noting:

*creditors' existing protections—among which are the protections afforded by their negotiated agreements, their security instruments, the implied covenant of good faith and fair dealing, fraudulent conveyance law, and bankruptcy law—render the imposition of an additional, unique layer of protection through direct claims for breach of fiduciary duty unnecessary. Moreover, any benefit to be derived by the recognition of such additional direct claims appears minimal, at best, and significantly outweighed by the costs to economic efficiency. One might argue that an otherwise solvent corporation operating in the “zone of insolvency” is one in most need of effective and proactive leadership—as well as the ability to negotiate in good faith with its creditors—goals which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors.*¹²¹

V. CONCLUSION

Corporate directors do not have special duties to creditors, whether or not the corporation is in or near insolvency. Although there are contrary dicta, courts'

117. *Id.* at 801. This was confirmed in *Fleet National Bank v. Boyle*, No. Civ.A. 04CV1277LDD, 2005 WL 2455673, at *16 (E.D. Pa. Sept. 12, 2005), which held that plaintiff had not met the *Production Resources* grounds for a direct action based merely on allegations that the board gave a creditor preferential treatment without allegations of self-dealing or intentionally hindering payment.

118. 906 A.2d 168 (Del. Ch. 2006).

119. *Id.* at 199.

120. Civ.A. 1456-N, 2006 WL 2588971 (Del. Ch. Sept. 1, 2006).

121. *Id.* at *13.

holdings clearly support this point. Directors have duties of care and loyalty to the corporation, but these duties leave them with broad discretion to decide what to do and in whose interests to act. There is limited authority for creditors' right to sue to enforce the directors' duties to the corporation, but the creditors' right does not change the fact that the duties are owed to the corporation. The creditors also may sue the corporation for breach of specific contractual, tort, and statutory duties, particularly including the duty to refrain from fraudulent conveyances. However, this does not amount to a fiduciary duty owed by the corporation, shareholders, or directors to creditors. Courts should clarify these principles to remove questions concerning directors' discretion to manage failing firms.