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KELLI A. ALCES, LARRY E. RIBSTEIN, ALAN SCHWARTZ, SIMONE M. SEPE, D. GORDON SMITH, AND FREDERICK TUNG

Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies

THEORY AND POLICY

RICHARD BOOTH: Our next panel will be focusing on theory. The moderator for this panel is Gordon Smith, from the University of Wisconsin.

GORDON SMITH: I want to thank Rich for organizing this conference and the students and the law school for hosting it and putting it into a journal. I have learned a lot in the morning sessions and at the lunch talk. And I expect to learn even more here. I expect this to be every bit as exhilarating as the panels this morning.

We are going to start with Larry Ribstein and Kelli Alces, who have written a paper together.[1] Larry is going to set the stage and Kelli is going follow that up with some discussion of the paper. Larry is at the University of Illinois. Kelli is practicing in Chicago at Gardner Carton. After Larry and Kelli, Fred Tung will present his paper.[2] Fred is at Emory Law School in Atlanta. When Fred is done, we will hear from Simone Sepe. He is coming to us from Yale and is going to, I suspect, provoke some discussion with his paper.[3] I am not going to spoil the punch line, but just to let you know that you should pay attention during that.

I will follow up with a short presentation about venture capital, then we will have a commentary by Alan Schwartz. So take it away, Larry.

LARRY RIBSTEIN: Picking up with where Stephen Bainbridge left off, he wants to drive a stake through the *Credit Lyonnais* case.[4] I do not think we should drive a stake through it, I think we should understand it. The understanding goes to the basic distinction between what directors or corporations and so forth should do: how we should advise them to act, things they should avoid, and what are their legal duties.

1. Larry E. Ribstein & Kelli A. Alces, *Directors' Duties in Failing Firms*, 1 J. BUS. & TECH. L. 529 (2007).
2. Frederick Tung, *Gap Filling in the Zone of Insolvency*, 1 J. BUS. & TECH. L. 607 (2007).
3. Simone M. Sepe, *Directors' Duty to Creditors and the Debt Contract*, 1 J. BUS. & TECH. L. 553 (2007).
4. Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

The famous footnote 55 in the *Credit Lyonnais* case is just a discussion of how to act and possible outcomes that directors have.[5] But there was nothing, not a breath in the opinion about the directors' duties to act in a particular way. In that sense I agree exactly with where Steve ends up, which is that it is basically a business judgment issue. But I think that should be the starting point of the analysis, not the end point of the analysis. We should focus on the jurisprudential aspects of these duties. In other words, what are courts in a position to decree in terms of directors' conduct? The rest is just dicta. It has nothing to do with duties. Here is the punch line: basically this is a matter for the business judgment rule. And, in fact, this is the way former Justice Veasey put it in the Pennsylvania article,[6] which has been referred to already today, in the two paragraphs that he allotted in the article for discussion of this issue. He phrased it precisely in terms of the business judgment rule.[7]

The business judgment rule is a limitation on what courts are capable of doing. Courts are not capable of second guessing business judgment on a routine basis. If courts try to lay down the law on what directors should do, they will have all kinds of perverse results affecting directors' conduct. The business judgment rule says you do not micromanage what directors do. The directors can give away 140 million dollars. They can also make precise decisions between the extent to which they are going to go for creditors and the extent to which they are going to go for shareholders in particular cases. Whether the firm is in insolvency, on the lip of insolvency, near insolvency, in the zone of insolvency or completely insolvent, the business judgment rule is what applies.

There are some cases here about remedies. If the directors breached their fiduciary duty, then there is a remedy on behalf of the corporation.[8] In some cases, the creditors are the ones to bring this action on behalf of the corporation.[9] The remedy has nothing to do with the duties. You have heard some criticism of the idea of duties to the corporation. What does that mean? It is just another way of expressing the business judgment rule. We do not micromanage which interests the directors are acting for under the business judgment rule. The judges speak in a kind of judicial shorthand. Rather than articulating as regards shareholders or creditors, they talk generally about the corporation.

Finally, there are cases that really do involve the corporate debtor's duties to creditors. Does the corporate debtor have a fiduciary duty? This gets to the jurisprudential function of the business judgment rule as a constraint on the Court.

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5. *Id.* at 1155, n.55.

6. E. Norman Veasey & Christine T. Di Giuglielmo, *What happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399 (2005).

7. *See id.* at 1421–22.

8. *See, e.g.*, Selheimer v. Manganese Corp. of Am., 224 A.2d 634, 644 (Pa. 1966).

9. *See, e.g.*, Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 792 (Del. Ch. 2004).

What is a fiduciary duty? It is a duty to act unselfishly. In commercial dealings, it is a rare thing to say to a party that you have to act selflessly. So, we sharply confine the situations in which fiduciary duties apply. They apply only to situations in which one party delegates open-ended discretion to another. That does not describe the typical debtor-creditor relationship. And because the structure of the contract is set up that way, we do not imply fiduciary duties as a term of that contract.

So that is the story. This is all about what courts can do—the nature of the business judgment rule, the nature of the remedy, and the nature of fiduciary duties. It is not about all this complicated finance about what directors should do, what managers should do. That is not nothing or very little as Steve characterized it. It is important. But it has absolutely nothing to do with the question of what are the director's legal duties.

The next question is: is all of this consistent with the case law? That is what Kelli is going to talk about. And the bottom line is, yes. But I want to say something that maybe Kelli is not going to get to, which is, we look at state cases. There may be some law out there in bankruptcy courts. Some of you are going to say, I know this case in some bankruptcy court somewhere that is inconsistent, that says that there is a fiduciary duty. I do not care, because if that case is inconsistent with state law, it is wrong. The bankruptcy judges are supposed to apply state law. If it is some special bankruptcy doctrine, then it does not have anything to do with what I am talking about today. So, take it away Kelli.

KELLI ALCES: As we mentioned, the cases seem to converge on three points. First, fiduciary liability should be imposed sparingly and in strict observance of and deference to the directors under the business judgment rule. The application of the business judgment rule does not change upon the corporation's insolvency. Second, fiduciary duties are owed to the corporation, to the entity itself, and any group within the corporate enterprise may be preferred according to a good faith business judgment in favor of the corporation. Third, creditors should use contract and fraudulent conveyance remedies to remedy any injury suffered at the hands of directors of a corporation rather than turning to fiduciary duty liability.

As far as director duties to insolvent corporations, everyone has talked a lot about the *Credit Lyonnais* case. That footnote outlines the different interests in the zone of insolvency, the impact to shareholders of the corporation. Chancellor Allen specifically says that it is a very difficult balance to strike and that it is not fair to ask the director to choose any one party in that particular situation to prefer.[10] Rather, the directors are only obligated to observe the duties to the corporation itself, to exercise an informed, good faith judgment to maximize the corporation's long-term wealth.

10. *Credit Lyonnais*, Civ. A. No. 12150, 1991 WL 277613, at *34 n.55.

Liability for a breach of fiduciary duty with regard to the particular decision of which interest to prefer is also subject to the business judgment rule. In *Equity Linked Investors v. Adams*,[11] the preferred shareholders wanted to liquidate the corporation and receive their share of the assets presently. The directors thought it would be in the best interests of the corporation and the common shareholders to pursue their research and development plans and long-term growth. The Court held the directors could prefer the common shareholders and the corporate long-term growth to the preferred shareholder's interests in the present value of the corporation. And the Court applied the business judgment rule in holding the directors must only exercise independent, good faith and attentive judgment, and there was no duty to maximize the current value of the corporation for the benefit of creditors when the corporation was insolvent.[12]

The Court also emphasized that the preferred shareholder's relationship to the corporation should be largely governed by contract. In several cases, creditors have sued for breach of fiduciary duty because the directors continue to operate the corporation in insolvency rather than filing Chapter 11[13] or liquidating the corporation.[14]

In *Odyssey Partners v. Fleming Company*,[15] minority shareholders sued for breach of fiduciary duty because the board did not file Chapter 11, but instead continued to operate the corporation. This allowed the majority shareholder creditors to foreclose on its security interest. The Court identified the business judgment rule finding no disloyalty or bad faith and saw no breach of fiduciary duty.

The Court allowed the directors to prefer the interest of the majority shareholder or creditors to those of the minority shareholders because the board, in the court's opinion, made a good faith decision that bankruptcy would have been worse for the corporation than foreclosure on the majority shareholder's security.

In re Unifi Communications[16] and *In re Global Services Group*[17] were both cases where creditors brought claims for breach of fiduciary duty because they claimed the directors were deepening the insolvency of the corporation. While *Unifi* was decided on technical procedural grounds,[18] in *In re Global Services Group*, the Court explicitly held that there was no cause of action for deepening the insolvency of the corporation and no breach of fiduciary duty without showing bad faith or fraudulent intent.[19]

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11. 705 A.2d 1040 (Del. Ch. 1997).
12. *Id.* at 1058.
13. *See, e.g.*, Odyssey Partners, L.P. v. Fleming Cos., Inc., 735 A.2d 386 (Del. Ch. 1999).
14. *See, e.g.*, *In re* Unifi Commc'ns, Inc., 317 B.R. 13 (Bankr. D. Mass. 2004).
15. 735 A.2d 386.
16. 317 B.R. 13.
17. 316 B.R. 451 (Bankr. S.D.N.Y. 2004).
18. 317 B.R. at 18–19.
19. *In re Global Serv. Group*, 316 B.R. at 461.

The Court continued to emphasize that: 1) directors owe a duty to the corporate entity as represented by any or all of the component parties' interests and, 2) there must be a showing of disloyalty, self-dealing or bad faith in order to impose breach of fiduciary duty liability given the business judgment rule.[20]

Geyer v. Ingersoll Publications[21] is often cited as allowing a specific fiduciary duty to creditors when the corporation is insolvent. But using this case to prove that point takes it out of context. *Geyer* supports the theory proposed here and confirms that creditors of an insolvent corporation are a part of the community of interest but does not say that directors are to prefer the interests of creditors to the exclusion of others during insolvency.[22]

This case involved a fraudulent conveyance claim and while fraudulent conveyance actions can be similar to those for breach of fiduciary duties, particularly when directors benefit personally from the fraud, the two claims are distinct. Fraudulent conveyance claims are more specifically defined and clearly preserve remedies for creditors and are not as open-ended as fiduciary duties. The standard remedy for a breach of fiduciary duty is a suit on behalf of the corporation.

In cases of insolvent corporations, some courts have allowed creditors to bring the claim for a breach of fiduciary duty derivatively on behalf of the corporation. The Second Circuit and the Third Circuit, in the case of the *Unsecured Creditors of Cybergenics Corporation on behalf of Cybergenics Corporation*[23] have allowed creditors to bring claims on behalf of the corporation in bankruptcy. But these claims were based on fraud; they were not claims for breach of fiduciary duty. And the Court allowed the creditors to bring the action on behalf of the corporation because the trustee or debtor in possession unreasonably refused to do so.[24] There are other courts that disagreed with allowing creditors to bring actions on behalf of the corporation in bankruptcy, citing Bankruptcy Code language that requires trustees or debtors in possession to bring avoidance actions and does not allow creditors do so.[25]

The court in *Production Resources* allowed creditors to sue the corporation outside of bankruptcy.[26] Here the creditors sued for appointment of a receiver because there were improper insider transfers that injured the corporation. The Court emphasized that the corporation is owed fiduciary duties and the firm owns the claim whether or not it is insolvent. Allowing creditors to bring the claim on behalf of the corporation simply ensures that the claims of the corporation are

20. *Id.*
21. 621 A.2d 784 (Del. Ch. 1992).
22. *Id.* at 787.
23. 330 F.3d 548 (3d Cir. 2003).
24. *Id.* at 552–53, 565–67.
25. *See, e.g.*, Hartford Underwriters Ins. Co. v. Planters Bank, N.A., 530 U.S. 1, 6 (2000).
26. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).

prosecuted by the party whose interests are most in line with those of the corporation.[27]

Through the claims they brought on behalf of the corporation, the creditors were availing themselves of duties owed to the corporation. The party to whom the duty is owed does not depend on the identity of the plaintiff in a breach of fiduciary duty claim. Rather it is more of a standing question. The plaintiff may be the most appropriate party to bring the breach of fiduciary claim, but the claim is still brought on behalf of the corporation.

Finally, with regard to the corporation's duties to creditors, the *Katz v. Oak Industries* case[28] states the general rule that debtors do not owe fiduciary duties to creditors, and creditors are able to best protect their right through contract.

In *LaSalle National Bank v. Perelman*,[29] the debtor subsidiary borrowed money from the creditors and then turned the money directly over to the parent corporation, leaving the subsidiary with no capital. While fraudulent conveyance liability may have been maintained here, if the corporation had been insolvent, the court found no breach of fiduciary duty. The court noted it was hesitant to impose liability for a breach of fiduciary duty because the contracts specifically warned the creditors that the directors would take the action with the capital the creditors were contributing.[30] Contract rights and fraudulent conveyance rights are the dominant forms of creditor protection.

Finally, the court in *Production Resources* skeptically allowed certain limited circumstances that might justify a direct claim by a creditor for breach of fiduciary duty in insolvency such as self-dealing by directors that injured the creditors of the corporation or a case in which directors discriminated against one particular creditor's claims. Still, the court maintained it is best to refrain from finding fiduciary liability when contract terms would suffice.[31]

FREDERICK TUNG: I am Fred Tung and the title of my paper is *Gap Filling in the Zone of Insolvency*.[32] So here is the basic claim of my paper. First of all, I want to coin a new acronym: IFDC. IFDC stands for "Insolvency Fiduciary Duties to Creditors." My paper argues that, at least for commercial creditors, IFDC is at best unnecessary and at worse pernicious. This is a somewhat tentative conclusion, [referring to slide] as illustrated by the dotted red circle on the screen and the sort of slow emergence of the circle to overtake IFDC. In academic circles, we think about fiduciary duties as sort of a gap filling device to fill the gaps in the inevitably incomplete agency contract between firm managers and shareholders. When we

27. *Id.* at 792–93.
28. 508 A.2d 873 (Del. Ch. 1986).
29. 82 F.Supp. 2d 279 (D. Del. 2000).
30. *Id.* at 295.
31. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 801 (Del. Ch. 2004).
32. *See* Tung, *supra* note 2.

take that standard contractualist view and apply it to creditors, however, it does not fit that well for at least two reasons.

Number one, it is unclear that, at least for sophisticated creditors, their credit contracts have gaps that need filling. Number two, even if gaps exist, the standard rationale for IFDC—this notion of curbing overinvestment—is not convincing. So I want to have a quick six-minute discussion in three parts.

First, a quick run-through of this trend toward expanding fiduciary duties beyond the traditional shareholders-as-beneficiaries approach. Next, I want to make the claim that gap filling is a difficult rationale for IFDC. Finally, I will suggest that we think about repealing IFDC entirely.

By the way, when I say IFDC, I use it to incorporate all of the various notions including creditors among the class of beneficiaries that enjoy managerial fiduciary duties.

We have already talked a fair bit about the traditional notion that fiduciary duties shift once a firm is insolvent. We have also talked about *Credit Lyonnais* and the famous footnote 55 in which Chancellor Allen famously described this "vicinity of insolvency" where creditors are included in the community of interests that enjoy the benefit of directors' fiduciary duties.[33]

There is actually yet a third sort of cutting edge theory that its authors call FVM,[34] financial value maximization, that I think of as "more beneficiaries more of the time." The basic idea with FVM is that managers should not be out there maximizing the value of debt or maximizing equity. Instead, they ought to be maximizing the sum of the value of all of the financial claims against the company. This is basically Tom Smith's theory at the University of San Diego. His basic argument is that rational investors not only diversify, but they actually hold the market portfolio, the theoretical market portfolio of CAPM. Rational investors hold securities in proportion to what is out there in the market. For any given firm, the rational investor, according to Tom Smith, holds securities in the same proportion as each firm issues them.[35] If the firm is capitalized 30 percent debt and 70 percent equity, then the rational investor holds those securities in that same proportion.

Now, based on that assumption, Smith claims that financial value maximization (FVM) is the hypothetical bargain that rational investors would strike. They want to maximize the sum of the values of all of the claims on the firm because, of course, they would be indifferent as to redistribution between classes of securities. They are holding the market portfolio anyway. Therefore, they only care about maximizing the sum of the values of all of the claims, not the value of any particular class.

33. Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

34. *See id*; *see also* Tung, *supra* note 2, at 623–24.

35. Thomas A. Smith, *The Efficient Norm for Corporate Law: A Nontraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 217–18 (1999).

Related to Smith's FVM formulation, Alon Chaver and Jessie Fried sort of tack on a friendly amendment. They suggest that we should include in the calculus not just financial claims, but also performance creditors—that is, creditors of the company that expect contract performance from the company.[36] If we omit them from the FVM calculus, it will drive managers to make inefficient decisions.

That is the basic trend line for IFDC. Now, what about IFDC? I want to describe some reasons why creditors should not be included in the scope of managerial fiduciary duties. Number one, sophisticated credit contracts. It is not clear that for sophisticated creditors, gaps exist in their contracts. Not only do these creditors enjoy elaborate financial covenants and elaborate monitoring devices and elaborate reporting from the company, but the whole point of these protections is to focus on the down side.

The fall, the failure, the insolvency of the company is not a surprise. That is the whole point of the credit contract, especially after workout. The parties renegotiate, and the initial credit agreement is designed to facilitate that subsequent renegotiation. The bank tightens the covenants on the company, reigns in managers' discretion, and takes control of the cash. At that point, it does not seem plausible that gaps exist for courts to fill, or at least not much of the time in any event. The parties fill their own gaps.

The irony of *Credit Lyonnais*, of course, as was mentioned this morning is that that case involved a highly structured, highly elaborated workout agreement that was already in place before the deal descended into litigation.

The second problem with gap filling is that even if we believe there are some gaps in credit contracts, the standard rationale that we need to curb overinvestment is problematic for at least three reasons. The first is that IFDC is essentially an end game device to police *ex post* inefficiency in a contract. That is, we are afraid that managers are going to make wild bets to maximize value for stockholders when they are gambling with creditor's money, and they will do this even if there is negative expected value to the firm. That is the standard overinvestment rationale.

Well, one question that arises is, why only that contract? If we are worried about *ex post* inefficiency, that is a potential problem in every contract. So why is it that only the shareholder-manager contract deserves this kind of *ex post* judicial intervention to guard against *ex post* inefficiency?

The second problem with the overinvestment rationale is that IFDC generates inefficiencies of its own. If we are after creditor value maximization, in effect what we are doing is allowing creditors a veto over what might be efficient projects because they may pose too much risk to creditors. That is inefficient, as inefficient as the generic overinvestment problem that it is meant to solve. Moreover, IFDC-driven inefficiency is more difficult to contract around than contracting around

36. Alan Chaver & Jesse M. Fried, *Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813, 1816 (2002).

inefficiency with shareholder primacy. Finally, empirically it is not clear that over-investment is a real problem.

What about FVM? Well FVM is problematic for at least a couple of reasons. Number one, it purports to solve interclass investor conflict by simply assuming it away. It is a pretty strong assumption, it seems to me, that every investor holds the market portfolio. Even if that were right, FVM does not consider the possibility that creditors can actually fill their own gaps, and if I am right that some creditors can fill their own gaps, then applying FVM gets unwieldy pretty quickly.

Let us talk about repealing IFDC. I echo Steve Bainbridge's comments earlier today that there are a whole lot of people thinking it might not matter that much, that directors' behavior would not change with IFDC. Raincoat provisions, business judgment rule, the derivative context all suggests that maybe it really does not matter. We have other doctrines as well, specifically to protect creditors: fraudulent transfer law, veil piercing, equitable subordination. So maybe whether we have IFDC does not matter too much.

On the other hand, there may be some pernicious effects of IFDC that we should think about. First of all, again, inefficient investment decisions because of IFDC are going to be harder to contract around than shareholder primacy. Second, repeal of IFDC might end up encouraging more creditors to protect themselves with explicit contract provisions. Explicit provisions limiting managerial discretion operate better than after-the-fact IFDC standards imposed by judges. Explicit contracts operate better to limit managerial direction, and they generate less litigation.

At the end of the day, I think we should seriously rethink IFDC and consider the possibility that, at least for commercial creditors worried about overinvestment, we ought to give serious thought to the question of repealing IFDC.

SIMONE SEPE: The purpose of this panel is to understand whether, from a theoretical viewpoint, creditors should benefit from the attribution of directors' fiduciary duties. In the essay that I am going to illustrate, I take a law and economics approach to the matter.[37]

Traditionally, legal scholars have endorsed two opposite positions as to managerial fiduciary duties. On the one hand, there are the contractarian scholars, who claim that directors owe fiduciary duties just to shareholders. On the other, there are the so-called communitarians, who advocate, instead, a multi-fiduciary model in which directors owe duties to all stakeholders.

I buy the contractarian position. This is to say, I think that the contract is the right instrument to protect creditors' rights. However, I claim that in a corporate governance system dominated by the shareholder primacy rule (SPR) and in which managerial compensation schemes are often equity-based—what in the paper I term MECS—managerial opportunism and informational asymmetry may make the debt contract a suboptimal means to govern the debtor-creditor relationship.

37. *See* Sepe, *supra* note 3.

Put differently, I claim that, as currently devised, the contract fails to maximize the *ex ante* value of the parties' exchange.

Someone here does not agree that managerial opportunism is a problem. However, the economic literature—I am thinking, in particular, of Smith and Warner,[38] but also to some more recent literature I quoted in my essay[39]—has long pointed out that, in fact, it can be a problem. In particular, in the essay I am presenting, I focused my attention on a specific kind of managerial opportunism: asset substitution. This is the managers' tendency to increase the level of risk of corporate projects *ex post*, i.e., after the company has issued debt.

The second problem at the basis of the existing contractual inefficiency is that of asymmetric information. Such a problem arises because managers have private information on the projects they intend to pursue which is not observable and verifiable to creditors. In addition, because of the organizational paradigm based on SPR and MECS, managers also have very weak incentive to disclose this information to creditors. In fact, by concealing information, they can reserve a costless option to invest in riskier projects *ex post*. Finally, even if they disclosed information to creditors, because of the mentioned corporate governance paradigm, creditors would have difficulty considering such information credible.

I claim that these two market failures, managerial opportunism and informational asymmetry, generate two kind of social costs. First, they make parties write suboptimal covenants. Second, they lead the credit market to settle on a pooling equilibrium.

There are, basically, two ways to draft covenants to prevent asset substitution. First, parties can provide for general covenants, which are low-state contingent on the external state, that is, on the corporate activity. These covenants are easily verifiable by creditors, but tend to involve a high opportunity cost, what Jensen and Meckling referred to as "residual loss."[40] Take, for instance, the general common boilerplate covenant prohibiting the debtor to enter into new lines of business. Is this covenant efficient? I would say no, because it may rule out many business opportunities and, therefore, involve a high opportunity cost for the firm.

In alternative to general covenants, parties can write analytical covenants, which are, instead, highly state contingent. These second kind of covenants, however, are not as easily verifiable as general ones, and, for this reason, they involve high monitoring costs for creditors. Thus, in both cases, the debt contract would fail to govern efficiently the managerial opportunism problem, and this is a cost both parties bear.

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38. Clifford W. Smith, Jr. & Jerlad B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118–19 (1979).

39. *See* Sepe, *supra* note 3.

40. Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 337 (1976).

The second social cost is a consequence of the debt contract's inadequacy to govern the managerial opportunism problem. Indeed, the market is smart. Creditors are smart. Thus, they anticipate the contract's inefficiency and, in turn, charge higher interest rates. In addition, because of the lack of credible information on corporate risk, creditors are unable to distinguish good firms—firms that do not engage in asset substitution—from bad firms. Thus, the credit market pools firms together in general risk categories and charges interest rates that reflect the average risk increase pursued within each category.

The result is that good firms end up paying for bad firms, what in finance theory is called cross-subsidization. In addition, an adverse selection problem may arise, since bad firms may drive good firms out of the market. Finally, beyond a certain level of risk, creditors may start to ration credit, with the result that good projects might risk going unfunded.

The solution I propose to redress the current contractual inefficiency is a default duty to creditors combined with a textualist or literary interpretative regime of the debt contract. The duty I envisage is a little different from the fiduciary duties that directors owe to shareholders. It is straightforward—directors cannot increase the level of risk that creditors have bargained for in the contract. This is the deal.

As a default rule of law, parties could determine the scope of the duty by specifying the debt contract, that is, by specifying the level of risk they accept in the contract. From this perspective, parties could also decide to exclude the duty altogether. Thus, the proposed model, unlike the current fiduciary paradigm, is substantially contractual in nature.

The second instrument I propose to increase efficiency is a regime of textualist interpretation of the debt contract, which mandates that creditors accept any risk they have not contractually limited or excluded. Now, these two legal instruments, the duty and the textualist interpretative regime, work together, but, for the sake of simplicity, I will discuss first the duty and then the literary interpretative regime. The duty has three basic functions. First, it limits the managerial opportunism problem. Second, it puts incentives on the directors to disclose credible information to creditors. Third, it serves as a bonding mechanism.

The duty would prevent managerial opportunism because, by making managers personally liable to creditors for the *ex post* increase of the investment's risk, it would deter them from exercising investment options for which they have not paid. Second, the duty would serve to make the information disclosed by managers credible. Indeed, knowing that managers bear personal losses for the duty's breach, creditors would be more likely to rely on such information. In addition, the duty would also induce managers to disclose more information. This, however, will be clearer once I expound upon the textualist interpretative regime. Finally, the bonding mechanism function served by the duty should be clear. Because the breach of the contractual provisions concerning creditor's accepted risk would constitute a breach of the duty itself—provided that such a breach also results in a default on

payment—the duty would induce the director to stay in the contract. In such a way, monitoring costs to verify directors' compliance with the contract would be reduced.

The overall result would be that creditors, being able to rely on the bonding mechanism provided by the duty, could write more state-contingent contracts, which would deter managerial opportunism without imposing a high opportunity cost on the corporate debtor. In addition, because the contract would become a more credible signal on corporate risk, the credit market could price debt on the basis of the specific risk of firms rather than the average risk, as it happens now. Indeed, rating agencies, which directly influence how debt is currently priced, also rate firms' underlying risk by putting them in risk categories and calculating the average risk of each category.

A textualist interpretive regime would also be essential to increase contractual efficiency. First, it would give both parties further incentives to specify the contract. Second, it would reduce uncertainty in legal relationships.

As to creditors, the proposed regime would work as a sort of penalty default. Indeed, creditors would be induced to specify the contract more to avoid the presumption that they have accepted any risk they have not excluded by contract. As to the directors' position, however, one could argue that, under the proposed interpretative regime, they would have no interest at all to disclose information to creditors. In fact, by avoiding to disclose information, directors could limit their liability and reserve further investment options. Instead, I argue that, even though it might seem counterintuitive, this approach would ultimately prove self-defeating for directors themselves. In fact, creditors would react to such information-hiding behavior by asking to include general covenants, which, under a literary interpretive regime, tend to exclude a wide range of investment options and, therefore, to broaden the area of directors' liability. In order to adjust the area of their potential liability, then, directors would also have incentive to disclose credible information and to negotiate more state contingent provisions.

The second reason justifying the adoption of a literary interpretive regime is that I do not think the implied covenant of good faith is a good gap filler. Under the proposed model, if the third adjudicator was allowed to re-determine *ex post* whether creditors have accepted a specific risk, she could ultimately determine also the scope of the duty to creditors. In turn, rational directors would react by entering an underinvestment policy, and this is not desirable from a social viewpoint.

To conclude, I have a question. The *Production Resources* decision at some point says, "so long as the directors honor the legal obligations they owe to the company's creditors in good faith, as fiduciaries they may pursue the course of action that they believe is best for the firm and its stockholders."[41] The question I have is probably

41. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 787 (Del. Ch. 2004).

for subsequent debate, but, can directors act in good faith while they are breaching a contractual provision of the contract? I think they cannot.

GORDON SMITH: When Rich invited me to participate in the conference, he asked if I might say something about venture capital start-ups. I spend a lot of my time thinking about that subject. In addition to being at the law school at the University of Wisconsin, I am part of an interdisciplinary group called INSITE, which is the Initiative for Studies in Technology Entrepreneurship, and we spend a lot of time thinking about technology-based firms and their financing.

I was interested in the panel just before lunch, in particular the suggestion that perhaps fiduciary duties do not apply to venture-backed companies. So I wanted to talk about that issue.

Let's begin with a simple bifurcated capital structure: common stock on the one hand and debt on the other. We think about common stock as having certain control rights and certain financial rights. The most interesting right of control that we have been talking about today is control of the board of directors. As for financial rights, common stockholders have a residual claim; they get what is left over after everybody else is paid.

On the other side are the debt obligations. How do the creditors protect themselves? Through contractual control rights, typically negative covenants or perhaps the ability to take control of the Board of Directors under certain circumstances. Their claims are the fixed claims, although many folks in the legal academy now talk about the residual nature of those claims, too. The question we have had on the table here is the following: why do we need fiduciary protection for creditors? The duty and the need for protection all tends to revolve around the supposed existence of incomplete contracts.

Fred tells us the debt contracts are not really incomplete, or, at least, that they are trivially incomplete. But if debt contracts are meaningfully incomplete, that is, if debtors cannot protect themselves fully through contracting, then we may want some mechanism to protect them, and the mechanism may be fiduciary law. I want to suggest the existence of an alternative means of protecting creditors in venture-backed startups, namely, preferred stockholders. The preferred stockholders are, especially in the venture capital context, a hybrid of the common stockholders and the creditors of the corporation. Preferred stockholders in venture-backed companies have control rights that are substantially greater than traditional preferred stock. They typically get not only the kind of negative covenants that we observe in debt contracts, but they also tend to receive some board representation, often outright control of the board of directors, depending on how many rounds of financing they have contributed. Their financial claim is also mixed. They usually have the right to preferred dividends, and they also tend to have liquidation preferences. So if a company becomes insolvent, the preferred stockholders would be paid before the common stockholders were paid.

On the other hand, the preferred stock in venture-backed companies typically is convertible into common stock, so the preferred stock has the same sort of residual flavor as the common stock if the companies were successful. Thus, the preferred stockholders lie in between the common stockholders and the creditors in the zone of insolvency. So what happens in that context?

Venture capitalists have an interesting position vis-à-vis fiduciary law. The Delaware courts said repeatedly that preferred stockholders typically should not receive fiduciary protection.[42] There are cases in which preferred stockholders have been given fiduciary protection,[43] but, by and large, the default position of the courts is in favor of no fiduciary protection for preferred stock.[44] In that case, they are very much like debtholders outside the zone of insolvency in that they are forced to rely on their contractual protections, not on fiduciary protections.

When you look at the contractual protections, the courts in Delaware have said that we are going to read preferred stock contracts narrowly.[45] In this regard, the preferred stockholders are at a disadvantage vis-à-vis creditors. In reading debt contracts, the Delaware courts embrace the contractual duty of good faith and fair dealing, but that duty is ignored in the preferred stock context. (I take it that Simone would just assume do away with this duty within the zone of insolvency and would read contracts strictly.)

Given that the courts in Delaware read the preferred contract strictly, how do preferred stockholders protect themselves? They protect themselves in one of two ways: (1) board control, and (2) staged financing, which gives preferred stockholders the ability to cut off further financing to the firm and to force the firm's hand. These structural control mechanisms serve the same purpose as fiduciary law. That is, they obviate the need for fiduciary law in the zone of insolvency, both for creditors and preferred stockholders, because the interests of the preferred stockholders and the creditors have much in common at this stage. Both claimants want to preserve the assets of the corporation.

When a company is in the zone of insolvency, both creditors and preferred stockholders have little interest in investing additional assets into the company, and, to the extent possible, both would like to extract value from the company. The implication is that preferred stockholders tend to have a shorter fuse than common stockholders.

The preferred stockholders are likely to be eager to move on to the next venture and try their hand there, not to roll the dice in this particular venture. In that way

42. *See, e.g.*, HB Korenvaes Inv., L.P. v. Marriot Corp., Civ. A. No. 12922, 1993 WL 205040, at *5 (Del. Ch. 1993).

43. *See, e.g.*, *In Re* FLS Holdings, Inc. S'holders Litig., Civ. A. No. 12623, 1993 WL 104562 *4–5, (Del. Ch. 1993).

44. *See HB Korenvaes*, 1993 WL 205040, at *5.

45. *See* D. Gordon Smith, *Independent Legal Significances, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825, 840–42 (2004) (discussing the court's criticism of strict construction).

they would be similar to creditors who, in the zone of insolvency, are saying, "Okay, let us call it quits and see if we can get the money out. We will all go and start some new game somewhere else."

So when we look at the timeline from the initial bargain to the zone of insolvency and then to the payoff, somewhere in between the zone of insolvency and the payoff, somebody has to make some judgments about whether this firm keeps going and tries to make the debt pay off, or whether they stop. My suggestion here is that the venture capitalists have a strong incentive to stop things at that point. And that is exactly what the creditors want. As a result, the creditors may receive some protection, structurally from having venture capital investors.

ALAN SCHWARTZ: First, we might want to ask, what is the social goal? What does society want companies to do? Generally the answer, at least one of the answers I am going to focus on is, society should want companies to maximize social wealth. What does that imply for our discussion? Well, it implies that you want control rights in the firm to be exercised by those with the best incentives for maximizing social wealth. From this point of view, control rights should be a function of the solvency of the firm. So if the firm is solvent, the equity has an incentive to maximize its own share, thereby maximizing value for everybody.

But if the firm is insolvent, the equity then tends to have bad incentives. They have an incentive to over-invest: to take negative net present value projects that might get the firm out of trouble if they succeed. The equity also has an incentive to under-invest; it will reject a project that may have positive net present value but will not get the equity out of trouble. When the equity is choosing among projects that have positive net present value, they will tend to choose a higher variance project over a lower one, even if the high variance project may have a lower mean.

So from this point of view, when the firm is in trouble or close to in trouble, the equity has poor incentives, while the creditors then have better incentives. If the directors do actually represent the creditors faithfully, and the creditors do not want the firm to over-invest, the directors would reject negative net present value projects. Also, creditors do not want the firm to under-invest. Good directors will have the firm take every positive value project. Finally, while creditors may prefer projects with lower variance and lower mean, the creditors nevertheless would choose positive net present value projects. The wisdom in modern theoretical finance holds that control rights should shift from the equity to the debt when the firm is in trouble. A good debt contract would effect such a shift.

Now, from this point of view, we can talk about the fiduciary duty that firms may owe the creditors. One way to view that fiduciary duty is that it is essentially a way to shift control rights to the debt because it will obligate the directors to represent the debt. The fiduciary duty to creditors then would be a good thing because it would get decisions made by the people who really have the best incentives to get maximizing behavior.

Now, I think that there has been some comment here that the duty is difficult to enforce, the business judgment rule applies and the like. I think the duty is problematic, but not for those reasons. The business judgment rule, as was said, does not really apply when the directors have a conflict, which there is here. So the combination of the possibility of a conflict situation and the existence of the fiduciary duty essentially will beat a summary judgment motion or a motion to dismiss by the directors.

Any time that a board is making decisions when they know that a plaintiff can get past a motion to dismiss or summary judgment motion, the board is going to change its behavior. I think, for example, the advice that was detailed this morning by Carl Metzger—what do I tell my clients?—is essentially the standard advice that is now given. You tell your clients to do many things that will affect their behavior because you are worried about somebody getting past these motions.

As a personal example, I had the great misfortune of chairing the board of a Delaware company that was in the zone of insolvency. We were selling infrastructure to the telecom industry and our six major customers decided to suspend their capital acquisition programs. That put us in a difficult spot. We had excellent Delaware counsel and excellent New York counsel. And I said what are we supposed to do? They basically gave us the advice that Carl Metzger handed out this morning.

There is a basic jurisprudential point here: there is an inevitable mutation from standards into rules. The fiduciary duty of creditors is a standard and it is very hard for people to live with standards, so rules that are more concrete tend to emerge. For example, in the acquisitions context, suppose the firm is up for sale or wants to buy another firm. There is a set of rituals that you have to go through: the lawyers tell you that you have ask certain questions; hold meetings for a long time; review documentation from bankers; hire bankers to advise you. If you go through all of these hoops, you are going to be okay; you can do whatever you want to do. The interesting thing about the lawyer panel this morning is that we can see emerging another set of rituals for firms that are in financial distress. If the directors of these firms go through the hoops that their very able lawyers tell them to go through, they too can avoid being sued.

The bottom line, however, is that while the lawyers can keep their clients out of trouble, the underlying problem remains, which is that the clients, that is the Board of Directors, have conflicting incentives; they cannot fully faithfully represent the debt. Thus, the fiduciary duty to creditors is unhelpful in the same way that fiduciary duties about acquisitions are unhelpful: the duties do not actually affect acquisition or investment behavior but rather they affect the way the firm goes about doing things, whether those things are efficient or not.

This leaves the question whether contracts can help? This question is important because contracts are really what we have left. To be sure, the contract is going to be a somewhat limited solution. Here, I have to disagree with Mr. Tung. In the contract theory sense, contracts are incomplete when they do not condition on the

investment behavior of the firm, and they do not condition on very many possible *ex post* states of the world. Contracts may specify a set of reporting obligations, but they generally do not control the relevant behavior of the firm. A fully complete contract would do that.

Simone, in his paper, tries to make contract more effective and I think he has an imaginative proposal. There is a question that we can ask whether if a creditor is going to permit everything that they do not prohibit, they can prohibit enough to actually make a really big dent in the social problems that we have identified. But certainly, Simone's paper is a step in the line of trying to make contract as effective as we can make it in a world in which asymmetric information necessarily makes contracts incomplete.

I want to suggest that a contract can be effective, but it would be more effective if courts would enforce more contracts. So I am going to start with what courts do enforce and then make a suggestion of what they could enforce. One thing that we know is that covenants can be helpful because firms that get into financial distress trip them. This forces renegotiation. In these renegotiations, the contracts are changed and creditors control the firm's investment behavior more strictly.

That is actually a good thing because it means the creditors have more power. But there is a question whether bankruptcy courts, in particular, would enforce all of these contracts. So, for example, there are contracts that require firms to auction themselves to the market because they do not meet their numbers in a specified period of time. Auctions, from this point of view, may be a good thing because if you auction the firm off, you have eliminated the control of the old people and the new people who buy it have incentives to maximize value.

I want to suggest a couple of more radical things. One is that the bankruptcy code enforce ipso facto clauses in bankruptcy.[46] An ipso facto clause is a clause that conditions the continued participation of, say, a supplier or a customer on the solvency of its contract partner. That clause is not enforceable so that a firm that files for bankruptcy can assume the contract despite such provisions. If you had ipso facto clauses, then the solvent contract partner would exit when the other side gets into financial distress, but the solvent partners could be bought to stay in if the firm is only in financial distress and has a good project. If it has good projects, it will ultimately have liquidity. A firm that has only bad projects cannot buy participation by solvent parties, but such a firm should be liquidated. So the right of suppliers and customers to exit would provide a channeling function for firms; it causes them to choose positive value projects from those that are available. But these ipso facto clauses are not enforceable today.

The last thing I want to suggest is that while there can be renegotiation *ex post*, with respect to which bankruptcy procedure a firm will enter, parties cannot say in

46. *See* Yeon-Koo Che and Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, 15 J. L. ECON. & ORG. 441 (1999).

the debt contract that a firm should use one or the other bankruptcy procedure. Some bankruptcy procedures would be more efficient than others, depending on the *ex post* state. For example, if a firm becomes distressed in the industry in which it would be something of an outlier—the other firms are solvent—then the best thing to do would be to sell the firm promptly to other people in the industry and get the people who made the bad decisions out of there. On the other hand, if the firm becomes distressed in a period when the general industry is distressed, reorganization might be better because there might not be enough liquidity for other interested firms to buy the particularly distressed firm. So which bankruptcy procedure you would want to use is state contingent, but contracts that condition on the state of the firm *ex post* and its chosen procedure also are unenforceable.

To summarize, I like the motivation behind having a fiduciary obligation of directors and creditors when the firm is insolvent or in the zone of insolvency because that is along the path of shifting control rights to the debt, which has better incentives to maximize value in a distress situation. Because of the able efforts of very good lawyers, however, these fiduciary duties are not going to be very effective in changing the firm's substantive behavior. So the best shot that we have is the contracts that the creditors and the firm write *ex ante*. The firm has an incentive *ex ante* to offer creditors the *ex post* maximizing contract because that will produce the lowest interest rates for the firm. The firm would like, at the time when the firm is solvent, to offer to the credit market those contracts that increase the creditor's returns because they reduce the firm's interest rate.

In conclusion, the main problem is that contracts could be effective in improving the investment incentives of insolvent firms, but the bankruptcy code and the courts restrict contracting behavior in the service of what they regard as *ex post* fairness. These are misguided efforts; if contracts were less restrained, the social problem that we are talking about, which is a real problem, would be better approached.

GORDON SMITH: Larry?

LARRY RIBSTEIN: I had two quick comments to make on a couple of the speakers, actually, the first one is for Gordon Smith. One of the things you said was wrong. You said it all comes down to the creditors' inability to protect themselves. I do not think that is true. Even if we assume that creditors cannot protect themselves, it really comes down to whether the courts would step in. That gets to the jurisprudential considerations that I was talking about.

The second point is on Alan's talk. One of the jurisprudential problems here is—can the courts come up with a rule or a standard that provides the appropriate incentives? The answer is no. Fiduciary duty protection works if you are talking about the standard shareholder's situation. It does not work in the creditor's situation, because of the nature of the contract.

FREDERICK TUNG: I was actually very surprised when Alan said he disagreed with me. So, let me ask you a question, Alan. You said that the reason that renegotiation

cannot fill the gaps is because a lot of contracts will not be recognized in bankruptcy. But if many firms do not go into bankruptcy, there would be many firms in the zone of insolvency for which renegotiation is a plausible gap-filling device. And if that's right, then are you suggesting that a shift of fiduciary duties to creditors is or should be amended so that the rule cannot be contracted around? At some point, creditor behavior by contract suggests that they opt out of the default rule. Although courts have not, of course, characterized it that way, I wonder whether you think that they cannot contract out and it is a mandatory rule.

ALAN SCHWARTZ: Let me say, I think there are actually two things in your question. The first one that I disagree with may be terminological. That is, in the contract theory world, a contract is incomplete if the *ex ante* contract does not solve the problem. So when a contract is incomplete, the parties are going to rely on renegotiation *ex post*, when uncertainty is cleared up.

So if you want to view renegotiation as a gap filler, then in that sense of the word, it would be. But in the lexicon that I am familiar with, renegotiation and a complete contract are alternatives.

I think the second thing I said, the renegotiation, sometimes it will help. That is, the parties often can privately solve their problems. The firm will agree not to do X, but the firm will agree to do Y. Then the firm will get a little more liquidity and hopefully get through its difficulties. With respect to mandatory rules, fiduciary obligations are mandatory. You cannot contract out of fiduciary duties. What you can do sometimes is specify the standards by which the duties could be judged. For example, in the UCC, you cannot contract out of the duty of good faith, but you can confine a little bit with the judicial application of that duty.[47] My concern is that fiduciary duties to creditors will become like duties of good faith—these standards mutate into rules. The rules essentially specify inputs to behavior rather than outputs.

So if you have the appropriate input, like you have the right meeting and you ask the right questions, then the output is not assessed by the courts because they recognize, as Larry said so forcefully, courts recognize that they cannot make these decisions. So, essentially, the duties force firms into using different inputs but these do not affect the substantive behavior.

So my view is that fiduciary duty is a mandatory rule. I think it should remain a mandatory rule. But it is not going to solve the problem we are talking about today.

RUSSELL SILBERGLIED: I will direct the question to Fred. Are you saying that the fiduciary duty is to indeed involuntary creditors (e.g. somone exposed to asbestos) and is acceptable because they do not have the ability to contract?

FREDERICK TUNG: You know, to be honest I had not thought about that question. I was sort of taking the Bainbridge approach. I was not trying to drive a stake

47. *See, e.g.*, Milne Employees Ass'n v. Sun Carriers, Inc., 960 F.2d 1401, 1411 (9th Cir. 1991).

through the heart of the creditor, maybe something bigger than a needle and something smaller than a stake.

But that mainly focused on commercial creditors and the basic idea that if gap filling is the idea, then it does not really work that well in the context of sophisticated creditors.

ROBERT LAWLESS: This question is for Alan. If we give more power to the individual creditors to solve these problems, like with contract, are we creating another problem that needs to be solved with creditors?

ALAN SCHWARTZ: I think it would depend on the contract. I mean, I think there are problems—I am not sure that is the one. Generally, the contracts that I am concerned about are contracts with secured creditors who agree to inject more liquidity into the firm if they get some changes in behavior or changes in fees or something like that. Sometimes the secured creditor's interests are in conflict with those of other creditors. So you may get some small creditors who would be disadvantaged by the contracts that I want to enforce. The question is—how you can cope with that?

The courts are sometimes sensitive to this problem. For example, they will not enforce stay waivers. And the reason for that is that if the firm has some possibility of surviving, a stay waiver and foreclosure essentially destroys that possibility and hurts everybody.

So I am in favor of not enforcing contracts such as stay waivers. But courts should enforce auction contracts because auction contracts just raise a big pot of money and everybody benefits. There have been some persuasive articles here, urging that majority-voting rules would eliminate that problem or reduce it. I think those articles make sense to me.

ROBERT LAWLESS: Some of those bankruptcy rules are there to solve that problem.

ALAN SCHWARTZ: Exactly. You have, in bankruptcy, majority rules, two-thirds rules. But before bankruptcy, unanimity rules. And if you like, people to order their affairs privately, those bankruptcy rules should be transferred back to the pre-bankruptcy context.

ROGER LANE: When I was on the floor you posed the hypothetical to me, so I thought I would return the favor. The question comes from a very specific place, that usually when the issues arise in litigation, it is the unsecured debt that is getting hammered which usually does not bargain with the firm in a meaningful sense with protection.

So the hypothetical comes to me, let us suppose a board that is dominated by designees of equity and subordinated debt and the company is insolvent. Let us make it easy, let the company not go into the zone, let us say the company is insolvent, in fact. The company proceeds to rack up 50 million dollars of unsecured debt. Should there be a claim there?

ALAN SCHWARTZ: Did the firm have any debt in the first place?

ROGER LANE: Let us assume it had loads of secured and subordinated debt and by the time you get to a chapter filing, you can satisfy the secured, maybe you can get something to the subdebt which is represented on the board. But the unsecured is taking nothing.

ALAN SCHWARTZ: I think in that hypothetical that you posed that would violate a covenant.

ROGER LANE: Of the secured?

ALAN SCHWARTZ: Or of the subordinate.

ROGER LANE: But not of the unsecured. It is the unsecured that I am focusing on. Should the unsecured have a fiduciary duty claim?

GORDON SMITH: This is *Equity-Linked Investors*[48] basically, right? The case talked about the fiduciary rights of preferred stockholders, not unsecured debt.

ROGER LANE: Correct.

GORDON SMITH: So unless you think that unsecured debt deserves more protection than preferred stock, which you might if you are sitting on the Delaware Chancery Court or the Supreme Court, then the answer would be the board can do that.

ROGER LANE: Even though the board is wholly aligned with equity and subdebt.

GORDON SMITH: One of the things that I kept thinking this morning as I was listening to the panels was about my colleague Neil Komesar[49] who speaks a lot about comparative institutional analysis. One of the things that Neil harps on is that we have to be attentive to the various mechanisms that can resolve the problems that we are trying to face and realize that the pursuit of perfection can be dangerous.

In this case, I think that imposing fiduciary duties is an attempt to try to correct a problem that might best be left to contracting or other market forces and to the courts. So the question I always wonder about is what you are gaining by adding a fiduciary obligation here? And my answer would be, not much. You may actually be losing a lot.

LARRY RIBSTEIN: You supposed that the directors have a conflict, because they were aligned with the shareholders rather than the creditors. I think that presupposed the answer to the question. The only reason they would have a conflict is if you say there is some fiduciary type of obligation to the creditors, and that gets us back into that issue. The basic point is that saying that there is a conflict presupposes the existence of a fiduciary duty to creditors and gets you into the question of whether there should be one. The answer is no because it is the court's inability to come up with a rule that provides the right incentives.

48. 705 A.2d 1040 (Del. Ch. 1997).

49. Burrus-Bascom Professor of Law, University of Wisconsin.