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

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RICHARD BOOTH: Good morning. I am Professor Richard Booth, and this is the fourth annual business law conference at the University of Maryland School of Law. The theme of this year's conference is the duty to creditors in the zone of insolvency. The title, "Twilight in the Zone of Insolvency," is especially apt because this doctrine that started out being a footnote in 1991 has perhaps met its match in a decision in 2005. It remains to be seen whether the doctrine continues to have any legs in Delaware, but I suspect that it does. It is a ball that has been picked up by several courts, particularly bankruptcy court judges, and has led to what I view as a pretty incoherent body of law. That ought to give us plenty to talk about today.

Now I'd like to introduce my colleague Lisa Fairfax, who is also a professor here. She teaches in the business area. She will introduce the first panel.

LISA FAIRFAX: Thank you very much. It is a pleasure to be here as part of this conference. I would like to introduce the panel. First we will have the three presenters, and then several commentators will follow. When we get to the commenting stage, people can feel free to raise their hands and ask questions. But first let me introduce the panelists. To my right is Bob Lawless, who is the Gordon & Silver, Ltd., Professor of Law at the School of Law at the University of Nevada, Las Vegas.¹ He has written extensively in the fields of bankruptcy and corporate law, with a special interest on empirical studies. Next to him is Royce Barondes, an Associate Professor at the University of Missouri, Columbia School of Law, where he teaches contracts, business organization, and securities regulation. To my immediate right is Larry Hamermesh. He is the Ruby R. Vale Professor of Corporate and Business Law at Widener University School of Law in Wilmington, Delaware, and he teaches at Widener in the area of corporate finance, mergers and acquisitions, securities regulation, business organizations, and professional responsibility. Next to him is Russell Silberglied. He is a director in the restructuring and bankruptcy area of Richards, Layton & Finger in their business department. He divides his practice between bankruptcy litigation and bankruptcy reorganization work. He

1. Robert Lawless is currently a Professor of Law at the University of Illinois College of Law.

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also has a wealth of experience in bankruptcy litigation. Then next to him is Jonathan Lipson. He is an Associate Professor of Law at Temple University, where he teaches in the corporate and commercial law area, including a deal-based simulation.

With that, I will turn things over to our first presenter, who will be Russell Silberglied. After that will be Jonathan Lipson, with Royce Barondes finishing. And then we will have the two commentators.

RUSSELL SILBERGLIED: Well, good morning, everybody. It is an honor to speak here among so many of you, not only the lawyers, but also the law professors here, who are very distinguished. I am going to bring a slightly different perspective on some of these topics today than a lot of the people you are going to hear from. Perhaps part of that is that I am one of only two Delaware guys here, together with Larry Hamermesh, who's seated immediately to my left, and the only practicing bankruptcy lawyer here, at least on this panel. I think that perspective is important because the overwhelming majority of these cases wind up being litigated in bankruptcy court rather than the Delaware Court of Chancery. I think a lot of the professors here today would prefer to see some of these in the Court of Chancery, but the reality is that most get litigated in bankruptcy court, and I do not think that is really surprising if you stop to think about it.

Why does that happen? Because insolvent companies usually—but not always, of course—wind up in bankruptcy before too long. It does not have to happen that way, but it usually does. And obviously at that point something has gone terribly wrong, and that is when people start looking for deep pockets such as the D&O insurance carrier that protects the directors and officers. So I think that is probably why you are seeing these cases in bankruptcy court.

I think that this trend will only increase over time. Frankly, I think it is going to increase more with the recent [Senator Edward] Kennedy amendment to the bankruptcy law that has eliminated “KERPs,” or Key Employee Retention Plans.² It did not eliminate them; it just made them more difficult to get approved, which means that you are going to see fewer and fewer directors and officers staying with the company as it approaches bankruptcy and as it stays in bankruptcy. This, in turn, means that somebody else is going to be controlling the company, whether that is a chief restructuring officer, a bankruptcy trustee, or simply a new management for a debtor in possession. It is a lot easier to sue your former directors and officers than it is to sue your current ones. So I think this is something you are going to see with increased frequency over time.

The other perspective that I am going to give you today that is a little bit different is that I am probably the person here, maybe with Royce Barondes also, who has the least disdain for the concept of fiduciary duties being owed to creditors of insolvent companies. I am not saying I am the biggest proponent of it in history,

2. Bankruptcy Prevention and Consumer Protection Act of 2005, 11 U.S.C. 101 et seq. (2005).

but I have the least disdain for it. I think that this theory really has a very important purpose when used in the right situations. And I think that Vice Chancellor Strine has struck the right note and right balance in his *Production Resources*³ opinion that we are going to get into in some detail this morning.

As I understand it, I think most speakers here are going to say that Vice Chancellor Strine blew it. He blew a golden opportunity to say that these duties just do not exist, and I just do not agree with that. But this is the practice panel, not theory panel. We are going to be hearing a lot of theory later on in the day and some from other members of this panel today. My role is, perhaps, a little bit less ambitious. It is to take you through a review of the case law. What is the law? What do the cases say? The law is not necessarily what it should be. How did we get here? What does *Production Resources* say? We are going to parse through that in some detail and, I hope, at least introduce some of the theoretical concepts that we have today.

With that background, let us start with the basics. The fiduciary duties of directors generally—what are they? I am not going to go through, in great detail, all of the fiduciary duties. They are well known, and I suspect that they are known by most of the people here. Suffice it to say that there are three primary duties (not including disclosure, which is not particularly relevant here, other than one particular issue which we will talk about later). The primary duties are the duty of care, the duty of loyalty, and as more recently articulated, the duty of good faith. There is actually a lot of debate about whether a duty of good faith really is all that different from a duty of loyalty, but that is really not today's issue. I am not going to get into all of the ins and outs of what those mean. I think that those are very well articulated and very well understood.

Overlaying the fiduciary duties, importantly (whether you are talking about fiduciary duties to creditors or to the stockholders) is the business judgment rule. The business judgment rule is a judicially created presumption. It is not a conclusive finding, but a presumption in favor of the nonconflicted or disinterested director “that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”⁴ That is a direct quote from the *Aronson v. Lewis* case. I am not going to give you all the cites I have today, but that one in particular.

The Delaware Chancery Court has held that this is a very elemental precept that runs throughout decisions concerning fiduciary duties. But, of course, it is not conclusive. The business judgment rule can be rebutted by showing a breach of the duty of loyalty or care or good faith. Once the business judgment rule is rebutted, you have a very different standard. You are in “entire fairness” land, and there are many Delaware cases that recognize and actually say the standard review can be outcome-determinative because it is sometimes so difficult to prove entire fairness.

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

4. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

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I think that is very important to some of the things you are going to be hearing later today.

A lot of people are saying the concept of expansion of fiduciary duties to include creditors of insolvent companies is much ado about nothing. Whether you are talking about fiduciary duties to the stockholders or to the creditors—whatever they are—it does not matter because you have the business judgment rule. I agree with that much. When directors find themselves in the realm of owing fiduciary duty to creditors, you have the business judgment rule. But the business judgment rule is not conclusive, it can be rebutted. And it can be rebutted in cases with respect to creditors, presumably under the same standards that it can be rebutted in cases where the plaintiffs are stockholders—i.e., where they prove a breach of the duty of loyalty, the duty of care, or the duty of good faith. So to me, to say that none of this matters because you have the business judgment rule is to say that none of the cases dealing with fiduciary duties to stockholders to a corporation matter either because you have the business judgment rule. And a hundred years of corporate-law history has proved that that simply is not the case.

To whom are the fiduciary duties of the directors of the solvent company owed? Well, it is very well settled, at least in Delaware, that the duties of directors of the solvent company are to the corporation itself and its stockholders. It is very important that we do not forget about the corporation itself, as well as the stockholders of the corporation, because they are essentially the proprietors of the business enterprise, the ultimate beneficiaries of what the directors do.

Now, obviously, in states other than Delaware, there are certain other constituency factors; some of them actually take creditors into account. Some of them even go further and take into account duties to employees, the environment, the general welfare, or other constituencies. That is not Delaware, and of course Delaware is predominant as the state of incorporation for many companies. It is also not New York and a lot of other prominent jurisdictions. The directors of the solvent Delaware corporations owe no fiduciary obligation to creditors. And in fact some case law holds that to the extent that the directors of a solvent corporation favor creditors' interests over stockholders', that is a breach of fiduciary duty.

But it changes once the company is a troubled company. Let us talk about the lay of the land before the *Production Resources* opinion. First, to whom are the fiduciary duties owed? When a Delaware corporation is either in the vicinity of insolvency or actually insolvent, the duties of the directors expand. They do not shift. "Shift" is a dangerous word. They do not shift to creditors. That implies that the duties to stockholders have disappeared. That is wrong. The Delaware cases are quite clear: the duties expand to include creditors as well as stockholders. The question, of course, is when precisely are those duties triggered? When is a company insolvent? When is it in the zone of insolvency? These are important because a director needs to understand when the duties are expanded. We are going to get to that in a minute.

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First, what is the rationale for this whole theory in the first place? There are primarily two, although a lot of the cases may mix and match a little bit. One is a “trust fund theory,” which essentially states that the directors of a corporation and of an insolvent corporation are basically holding the company’s assets in trust for the benefit of creditors. To me that is a little bit overstated, but it is a theory that runs through a lot of the cases.

The other is the so-called “at-risk theory,” which basically says that as a company approaches insolvency, the corporate directors may, if they are only favoring the shareholders, be inclined to adopt a high-risk strategy to save value for the shareholders and put the creditors’ interests at risk. What we hear all the time is the famous slot machine hypothetical, where the stockholders are clearly out of the money and the creditors maybe are going to get seventy-five cents on the dollar as the company goes into bankruptcy or winds down. If you have only the interests of the stockholders in mind, zero is no different from zero is no different from zero in any circumstance. So why not take the remaining assets of the company, throw them in a slot machine and see if you hit the jackpot? And if you happen to hit the jackpot, great, the stockholders get something. If not, they would have gotten nothing anyway. I think that when you talk about that kind of slot machine fact pattern, you are really talking about the at-risk theory.

So, how do you balance the competing interests of stockholders and creditors if you are a director and you owe duties to both? The effort has to be to maximize the enterprise value, the total value of the corporation. But to whose benefit? The goals of the constituents obviously can conflict sometimes. Let me give you an example, and this may introduce some of the theoretical issues we are going to be talking about today. I am going to modify the facts a little bit from a famous Delaware Supreme Court opinion from about two years ago, *Omnicare v. NCS Healthcare*.⁵ Suppose a company has three weeks of operating cash left, at which time it is going to have no choice but to file for bankruptcy, in which case equity would be totally wiped out and creditors are going to take some haircut. A bidder emerges and says I offer to buy the company for exactly the amount of its debt and no more. So the creditors are thrilled. Instead of taking this haircut and getting seventy-five cents on the dollar, they are now going to get a hundred cents on the dollar if the deal closes. But equity would rather roll the dice. Zero is zero is zero, as I said a moment ago. So they say, well, if this new bidder is going to come in and offer a hundred cents on the dollar to creditors, maybe somebody else would like it for 105 cents on the dollar, which is five cents to the stockholders. So there would be an incentive for them to say, “Let us shop the company,” and that is a prototypical example of how these interests could diverge.

What do you do when the interests collide? The case law says that you choose a course of action that best serves the entire corporate enterprise, which is a hard act

5. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

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to follow. Let me give you some examples, and hopefully this will help frame the issue. The Delaware Court of Chancery in the *Odyssey Partners v. Fleming*⁶ case held that the directors did not breach their fiduciary duties to stockholders in allowing a creditor to foreclose on the debtor's property, where the creditor agreed to voluntarily pay off the company's unsecured creditors in full.⁷ The court held that that was something that was permissible in weighing the stockholders and the creditor's interest.⁸ The stockholders, as a result, got nothing.

The most recent opinion, from just a few weeks ago, came to the same result. In *Blackmore Partners*,⁹ the court held that the directors did not breach their fiduciary duties in approving a sale that covered most of a company's debt but provided nothing to stockholders, because the board was disinterested and had fully shopped the company, with no superior offer emerging.¹⁰

At least in result, the Delaware Supreme Court decision in the *Omnicare* case came out to be the exact opposite conclusion, without really discussing duties to creditors.¹¹ The facts are similar to the ones in the hypothetical I gave to you, but there is a nuance: The buyer demanded a complete lockup and said, "I will not do this deal unless there is a complete lockup. I do not feel like dealing with a company that is going to auction itself." That was a deal point—no deal unless I get the total lockup. Well, right after the company agreed to the lockup to make sure it secured the bird in hand, a competing bidder came along and offered more, so something actually did come along to stockholders. The directors were not allowed to consider that offer as a result of the lockup. The Delaware Supreme Court held that this was breach of fiduciary duties to the stockholders—it was impermissible. So that is a little bit tough. And it is interesting that the Delaware Supreme Court did not really get into the issue that this benefited the creditors; that this company was, at a minimum, in the zone of insolvency.

And a third example: This is the *Equity-Linked v. Adams*¹² case, involving the Genta Corporation. This one really is preferred stockholders rather than creditors, but I think it is sufficiently similar to talk about it. In that case, the directors decided that they were going to adopt a high-risk strategy and the preferred stockholders were not pleased about that result. The company was in the zone of insolvency. It had no secured debt. The preferred stockholders wanted to liquidate the company, and the directors instead opted to take on new secured financing which, of course, wound up at a higher priority than the preferred stockholders' interests. So Genta took on this new layer of debt when it was already insolvent.

6. *Odyssey Partners, L.P. v. Fleming Cos., Inc.*, 735 A.2d 386 (Del. Ch. 1999).

7. *Id.* at 418.

8. *Id.* at 420.

9. *Blackmore Partners v. Link Energy, C.A. No. 454-N*, 2005 WL 2709639 (Del. Ch. Oct. 14, 2005).

10. *Id.*

11. *Omnicare*, 818 A.2d at 939.

12. *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997).

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The preferred stockholders argued that instead the board should be putting this company up for auction or doing something else to liquidate its assets so that the preferred stockholders could be paid in full.¹³ Chancellor Allen rejected this argument.¹⁴ The directors exercised their business judgment and were allowed to take the interests of stockholders and weigh them more heavily than the interest of the preferred stockholders and creditors. So those are some varying approaches that the courts in Delaware have given the issue.

In determining the zone of insolvency or the vicinity of insolvency, when are those duties triggered? Well, there are three possibilities: First, when the company files for bankruptcy, because you know that it is insolvent at that point (actually, that is not always the case, but it is most of the time). Second, when the company reaches “insolvency in fact,” which basically means it is insolvent even though it has not filed for bankruptcy. The third possibility is when the company is in the zone of insolvency.

The Delaware cases uniformly reject the concept of no duties owed until the company actually files for bankruptcy. The *Geyer*¹⁵ case, for example, specifically said this. So it is at least insolvency in fact, and it may be in the zone of insolvency. Of course, “zone of insolvency” is not well defined; people do not know what it means. Pam Huff will tell you later that the Canada Supreme Court jumped all over this as being an imprecise standard, so the directors could not possibly know what to do with it. It is a fair critique. But there is at least one case recently that did try to delve into what the standard means, *Pereira v. Cogan*,¹⁶ in the Southern District of New York, which said that it occurs when, “it cannot generate and/or obtain enough cash to pay for its projected obligations and fund its business requirements for working capital and capital expenditures with a reasonable cushion to cover the variability of its business needs over time.”¹⁷ That is the only standard that I have ever seen articulate what “zone of insolvency” means.

By the way, what does “insolvent” mean? That is also a debatable point, right? You have the Bankruptcy Code’s definition, which is the balance sheet test.¹⁸ You have some Delaware cases that agree with the balance sheet test approach, like *Allied Riser*.¹⁹ You have the inability to pay debts as they come due, which is also running throughout the state case law. You have the *Marvel*²⁰ decision in the Delaware District Court, which says just apply both of these tests.²¹ Does that mean “either or,” or does it mean “and?” It depends on the context. So we are not sure

13. *Id.* at 1042.

14. *Id.* at 1043.

15. *Geyer v. Ingersoll Publ’n Co.*, 621 A.2d 784 (Del. Ch. 1992).

16. *Pereira v. Cogan*, 294 B.R. 449 (S.D.N.Y. 2003).

17. *Id.* at 520.

18. 11 U.S.C. § 101(32) (2006).

19. *Angelo, Gordon & Co. v. Allied Riser Commc’ns Corp.*, 822 A.2d 1065, 1067 n.4 (Del. Ch. 2002).

20. *In re Marvel Entm’t Group, Inc.*, 274 B.R. 99, 110 (D. Del. 2002).

21. *See id.* at 102, 109.

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even what “insolvency” means, actually; and zone of insolvency is in fact something else.

The business judgment rule definitely does apply in the DDC, or director duties to creditors cases; any number of cases have said so: *Equity-Linked*, in connection with the preferred stockholders, *Allied Riser*, and, most recently, *Production Resources*. So let us talk about *Production Resources* to the extent that I am not going to get cut off right now because I am running out of time, and then I will stop there.

It is the most recent case. It is the most detailed case. It is the one that is going to create the most talk. It is divided into dicta and holding. Ninety percent is dicta, ten percent is holding. The dicta, though, is extremely important. The first point: It appears to be a retreat from the zone of insolvency as a basis for liability to creditors. First of all, Vice Chancellor Strine repeatedly stated that the *Credit Lyonnais*²² opinion was supposed to create a shield for directors rather than a sword for creditors.²³ Second of all, he said it is unnecessary to expand the duties owed by directors when a company merely is in the zone of insolvency because other areas of law already protect creditors in such instances, such as fraudulent transfer laws, covenants in contracts, etc.²⁴ By the way, this last point might not be accurate with respect to all constituencies. I think we will hear more about this later. What about tort creditors? Do they get to negotiate? Of course not. Also, often trade creditors do such small business that they do not even have a contract or even if they do have a contract, it is not worth it to them to negotiate covenants. What does a covenant even mean in this context? Are you going to create fiduciary duties in a contract? How does the law of fraudulent transfer play in if you are not talking about a transfer? What if the duty that you are challenging is failure to act? That is not a transfer. It is very different, by the way, than in Canada where creditors have an oppression remedy. The oppression remedy does take into account all of those factors, but we do not have that in Delaware or in most states in the United States.

The court also took issue with the concept that the constituency to whom you owe fiduciary duties is fundamentally changed in the zone of insolvency. It said, no, you owe them to the corporation, primarily, and the business judgment rule does apply.²⁵

You would think that the case would come out exactly the opposite when you read all of the dicta, and then you get to the holding that says, “When a firm has reached the point of insolvency, it is settled that under Delaware law, the firm’s directors are said to owe fiduciary duties to the company’s creditors.”²⁶ It says that

22. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, 1991 WL 277613, *34 n.55 (Del. Ch. 1991).

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

24. *Id.* at 794.

25. *Id.* at 789 n.56.

26. *Id.* at 790–91.

this “does not completely turn on its head the equitable obligations of the directors to the firm itself.”²⁷ The Vice Chancellor’s language is uncharacteristically stated in the passive voice here. This is not a judge who minces his words, for anybody who knows him. But here he uses the words “are said to owe” and “is said to justify” and “it does not completely turn it on its head.”²⁸ One might reasonably ask whether he did this to imply that he believes that denominating these fiduciary duties to creditors is either not technically accurate, is confusing, or is not justified. He cannot do anything about it, however, because it was settled in previous cases. I think it may well be, but the holding, nevertheless, is that fiduciary duties are owed to creditors.²⁹

The other main holding is that these are derivative claims, not claims of creditors directly, which affects both standing—who has the right to sue—and whether the duties can be exculpated under section 102(b)(7) of the Delaware General Corporation Law.³⁰ The answer in the *Production Resources* case is yes, a resounding yes.

With respect to standing, the last point I will make is that standing is a lot less important than you would otherwise believe, because ninety-nine percent of these cases are litigated in the bankruptcy court. You do not need to get into derivative standing when you are in bankruptcy court. This is because if the debtor in possession wants to challenge a business decision, the debtor in possession is the corporation. It does not need derivative standing. If the bankruptcy trustee wants to bring these claims, the bankruptcy trustee itself has standing. If the creditor’s committee decides that the debtor in possession or the trustee should have been pursuing such claims and is not, and it wants to get the standing, it is settled under the recent *Cybergenics* case in the Third Circuit Court of Appeals, that the creditors committee can move for the appointment of standing.³¹ And the bankruptcy court will practically always grant that kind of standing to the creditors’ committee absent unusual facts. So I think it is less of a big deal than you otherwise might think from reading *Production Resources*, except in the rare circumstances where the insolvent company stays out of bankruptcy and the aggrieved creditor, for whatever reason, refuses to file an involuntary bankruptcy petition. I have other comments, but I am already over, so I think I will yield the floor at this point.

LISA FAIRFAX: Thank you very much. You did have a very large task of introducing the entire history of where we are up to now. Let me turn now to Jonathan Lipson.

JONATHAN LIPSON: I am Jonathan Lipson from Temple Law School. The basic point I want to make is that the doctrine of directors’ duties to creditors, what I call

27. *Id.* at 791.

28. *Id.* at 790–91.

29. *Id.*

30. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 2005).

31. Official Comm. of Unsecured Creditors of *Cybergenics Corp.* *ex rel.* *Cybergenics Corp. v. Chinery*, 330 F.3d 548, 580 (3d Cir. 2003).

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the DDC doctrine, is a mess. It is a mess partly because of cases like *Credit Lyonnais*, which I think have created a distraction by asking, “When is it that this duty arises?” This has distracted us from three more important, basic questions. First, why do we have these duties at all? Second, how should the duties be applied? And, third, if you cannot answer those questions affirmatively, maybe you should be asking whether directors should have any duties to creditors at all?

I am going to make two basic claims about the messiness of all of this. The first is that I think that we can understand the “why” and “how” piece of the mess as reflecting a doctrinal incoherence, a doctrinal competition. I think there are two competing doctrinal models at work in the cases. One can be characterized as a priority/subrogation model, and the other as a *sui generis* model. The priority/subrogation model means that because the firm is insolvent, creditors are treated like residual risk bearers. As residual risk bearers, they step into the shoes of shareholders and are owed the fiduciary duties that otherwise ran to shareholders. The problem is that courts are ambivalent about this and say and do things that suggest that that is not always the model they want to use. So something else may explain how and why directors owe these duties to creditors, which I call the *sui generis* model. Ambivalence about which model to use leads me to conclude that we really are not at all certain whether we should be recognizing directors’ duties to creditors.

My second claim is that the DDC doctrine is in transition. I think courts like *Credit Lyonnais* and *Production Resources* are trying to express the values and norms they want corporate actors to embody when the firm is in financial distress. This may be an example of the expressive function of law. Even though it is not a rule, Footnote 55 of *Credit Lyonnais*³² is important dicta because of what it says, not what it does. It is expressing some kind of view on the posture that directors should take toward creditors of the distressed firm.

My first claim is that there are two competing models of DDC doctrine: priority/subrogation on the one hand and *sui generis* on the other. The priority/subrogation model is something I described in an article I wrote a couple of years ago in the *UCLA Law Review*.³³ I basically said that if you look closely at what courts are doing in this arena, it appears they are making some very important link between priority in right of payment, on the one hand, and fiduciary duties on the other. This follows from the fact that ordinarily, when a firm is solvent, duties—whatever they may be—run to or for the benefit of shareholders because shareholders are the residual risk bearers.

When the firm is distressed, the thinking among the courts seems to be that those duties either shift or expand to embrace creditors because the creditors have

32. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, 1991 WL 277613, *34 n.55 (Del. Ch. 1991).

33. Jonathan C. Lipson, *Directors’ Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 *UCLA L. Rev.* 1189 (2003).

become the residual risk bearers. So in a sense, creditors are subrogated to the rights of the shareholders when a firm is in financial distress. As I said, I refer to this as financial distress because I agree with Russell that it is extraordinarily difficult to slice the world into categories of solvency, insolvency, and the vicinity of insolvency.

You can see this tension in both the rhetoric and the reality of the existing case law. In the case of the priority/subrogation model, you find lots of rhetoric saying things like this from *Wood v. Dummer*³⁴ in 1824: “stockholders have no right to any thing but the residuum of the capital stock, after payment of all the debts of the bank. The funds of their hands, therefore, have an equity attached to them, in favor of the creditors, which it is against conscience to resist.”³⁵ That is a classic priority concept, and it formed the basis for holding that the directors there had fiduciary duties to corporate creditors. You also see this in *Production Resources*. “By definition,” Vice Chancellor Strine says, “the fact of insolvency places the creditors in the shoes normally occupied by the shareholders—that of residual risk-bearers.”³⁶ This, too, is classic subrogation language.

I think you also see the subrogation/priority model in the reality of the DDC cases as well. The fact that Chancellor Strine applied the business judgment rule and an exculpatory charter provision under DGCL 102(b)(7)³⁷ suggests that he is thinking that these fiduciary duties exist (or do not) indifferent to the identity of the beneficiary. There are duties and there are restraints on these duties, he is telling us, and they may apply to creditors just as they would apply to shareholders.

The subrogation/priority model is all well and good, but there are also important limitations to it. I think the courts are rightly concerned about this model. And you see this reflected in both the rhetoric and the reality of a second model, which I call a *sui generis* approach to DDCs. Even though Vice Chancellor Strine says in *Production Resources* that creditors step into the shoes of stockholders, he also says creditors do not become residual claimants with interests entirely identical to those of stockholders.³⁸ He does not tell us what the differences are, or what courts are supposed to do with those differences. You see similar language in the *Musselman*³⁹ case: “During insolvency, a corporate director or officer does owe a limited fiduciary duty to the corporation’s creditors.”⁴⁰ Again, that shouldn’t be true if you really buy the priority/subrogation model. Obviously this court does not, and wants to limit DDCs accordingly.

34. *Wood v. Dummer*, 30 F. Cas. 435 (D. Me. 1824) (No. 17,944).

35. *Id.* at 439–40.

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

37. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 2005).

38. *Id.* at 792.

39. *Bank of America v. Musselman*, 222 F. Supp.2d 792 (E.D. Va. 2002) (emphasis added).

40. *Id.* at 799.

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One of the problems with the priority/subrogation model, and one of the reasons I think courts are reluctant to take it too seriously, is that we do not know what it means. It is particularly unclear when you think about the derivative versus direct claim distinction. There is rhetoric in the cases in particular in *Production Resources*, which leads you to conclude that Vice Chancellor Strine is a little confused as to whether the claims were derivative or direct. On the one hand, we have the application of the business judgment rule and the exculpatory charter clause, which suggest that DDCs are a derivative claim. Those rules, by definition, mean something only if the claims are derivative. On the other hand, he says stuff like this: "There might, possibly exist circumstances in which the directors display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor."⁴¹ Is that direct or derivative? I cannot tell you.

I think the reality is that we are ambivalent about the priority/subrogation model. We may not want it because it implies a bunch of duties that might be very troublesome in the distress context. Consider, for example, final period duties. We know that cases like *Revlon*,⁴² *Van Gorkom*,⁴³ and *Omnicare*⁴⁴ say that once it is the end game, directors' duties are very different from what they might otherwise be. Well, anybody who has ever been involved in a workout knows that workouts often precipitate bankruptcy or some other final-period negotiation. Bankruptcy often results in wiping out shareholders and changing management and control. So maybe final-period duties should apply to directors of the distressed company. Would that be good?

What about duties of candor and honesty? Does either one apply to creditors? If you are a creditor of an insolvent firm, according to Vice Chancellor Strine you are stepping into the shoes of shareholders. Does anybody who's been involved in a workout want to tell a director or officer, "You have to tell the creditors each and every thing required by the duty of candor. You have to be completely candid with your creditors because they have stepped into the shoes of shareholders"? I am not sure we would want that. Indeed, Vice Chancellor Strine goes to pains to point out that negotiating aggressively with creditors may actually be required by fiduciary principles.⁴⁵

My second claim is that the inability to answer the "why" and "how" questions leads me to think that maybe the confusion reflects the fact that we do not yet know whether we should recognize DDCs at all. And so I think the DDC doctrine

41. *Prod. Res. Group*, 836 A.2d at 798.

42. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

43. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

44. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

45. *Prod. Res. Group*, 836 A.2d at 800 ("I do not rest my decision in any manner on the proposition that it is a breach of fiduciary duty for the board of an insolvent company to engage in vigorous, good-faith negotiations with a judgment creditor. That, in fact, might be the *duty* of a board, which necessarily has to balance the interests of all those with a claim to the firm's inadequate assets.").

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is in a transitional phase. There is a lot of theoretical literature out there that suggests that when things are in flux, when norms are in flux, when transactional forms are in flux, courts will engage in what is called the expressive function of judging. This is most prominently associated with Robert Cooter, who talks about it in a broader social context.⁴⁶ The basic idea is that courts often say things that aren't rules or even standards. Rather, they are expressing values and norms that they want people in a particular context to know and internalize.⁴⁷

Ed Rock, of the University of Pennsylvania, brought this into the corporate law context in a 1997 article entitled *Saints and Sinners*.⁴⁸ Here, Rock argued that Delaware courts were engaged in an expressive function when they addressed the new form of transaction known as the management buyout (MBO).⁴⁹ They generated the legal standards of conduct in MBOs, the social norms of directors, officers and lawyers, largely through what he calls "corporate law sermons."⁵⁰

Well, if that is true for MBOs and it is true for the function of the Delaware courts, generally, perhaps that is part of what is going on with respect to the DDC cases. Perhaps what we are seeing in these confused, complicated, contradictory, dicta-ridden cases like *Credit Lyonnais* and *Production Resources* are fiduciary duty sermons about DDCs.

That may tell you about why *Credit Lyonnais* and *Production Resources* got written at all. In *Credit Lyonnais*, for example, Parretti is the sinner, and the bank is the saint. In *Production Resources*, Mrs. Salkind, the shareholder, is the sinner, and the poor beleaguered judgment creditor is the saint. They were used to tell a story that these judges thought important to tell.

If you stop and think about them for a moment, it is not clear why Chancellors Allen or Strine had to write a single word in either of those cases, much less about director's duties. I have got about thirty-eight pages in my UCLA article about why *Credit Lyonnais* is the worst form of dicta because this is really a contract case.⁵¹ It was a workout agreement. Parretti stated to the bank, "I agree, you can seat your directors if thus and so happens."⁵² Thus and so happened, the bank sought to seat directors. Parretti objected which is why the case was under DGCL 225—it had nothing to do with directors' duties to anybody, least of all creditors. But if you want to sermonize on what directors should be doing, then you stick in a long and controversial footnote.

46. Robert Cooter, *Expressive Law and Economics*, 27 J. OF LEGAL STUD. 585 (1998).

47. *Id.*

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

49. *Id.*

50. *Id.* at 1016.

51. See Lipson, *supra* note 33.

52. *Id.* at 1209.

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The same seems to go for *Production Resources*. Because this is the year of living empirically,⁵³ I called Larry Vernon Proctor who was the lawyer for the plaintiff in *Production Resources*, and got him to send me the complaint. If you look at the complaint, it is clear that the case had very little to do with DDCs. This was just a nasty collection action in Connecticut. This was a fraudulent conveyance claim that was being prosecuted. There was also a security interest. The creditor had a lien on all of these assets. The creditor was protected six ways to Sunday. The creditor wasn't able to get the directors to do what it wanted, but it seems to me that it could have easily said that this is aiding and abetting a fraudulent conveyance. Maybe this is grounds for appointing a receiver or not. But why did Strine have to get into the duty discussion?

Well, the lawyer I spoke with said (and I am paraphrasing) "We walked into court to argue *Production Resources*; we weren't really prepared for all of this duty stuff at all. We thought it might be relevant. We pled it, but we did not think he was going to make a big deal about it." And, the lawyer said, that is all Strine wanted to talk about. Ninety percent of the opinion was about that. So maybe Strine is attempting to express something about DDCs.

But that leads to another question: If they are expressing something, what is it? What Rock said is that when courts develop jurisprudence about MBOs, they were trying to develop commonplace duties of good faith and due care. These are non-controversial ideas.

Here, perhaps courts are wrestling with the role that priority plays. To what extent should creditors truly be subrogated to the rights of shareholders? To what extent do concepts of good faith and due care apply to them? To what extent can investment decisions inappropriately expose creditors to loss?

I am a fairly cynical person. I think you might also see Delaware courts expressing something else, which is their desire to protect their franchise as the makers and disseminators of Delaware fiduciary law. This thought arose, in part, from a conversation we panelists had amongst ourselves about DDCs. The Delaware lawyers do not like it when the bankruptcy courts run around and make law on fiduciary duties. And, so, maybe the Delaware courts are concerned about competition. If so, this would go back to Roberta Romano's article where she said that the reason Delaware is so important is that if its law becomes clear and usable, it becomes efficient for lawyers to apply.⁵⁴ And so it is a product that the state of Delaware and the lawyers who practice under Delaware law have a vested interest in using. It is a very efficient mechanism and a product that has value.

53. See generally, Association of American Law Schools Annual Meeting, at <http://www.aals.org/am2006/> (last visited Feb. 2, 2007) (sponsoring 2006 annual meeting "Empirical Scholarship: What Should We Study and How Should We Study It?").

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

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If that is true, then maybe we are concerned that bankruptcy courts in the Southern District of New York or even in Delaware are in effect usurping Delaware's ability to control the generation of norms and values in the fiduciary conduct when a firm is in financial distress. So maybe that is also what they are trying to express: protecting their own franchise. I do not know.

There are other reasons I think DDC doctrine is misunderstood. I have only addressed two. And I will just leave you with what I think may be the most apt expression, so to speak, of Vice Chancellor Strine's view that DDC doctrine causes creditors to be subrogated to the rights of shareholders, brought to us by the renowned legal scholar Charles Barkley: "These are my new shoes. They are good shoes. They will not make you rich like me, they will not make you rebound like me, they definitely will not make you handsome like me. They'll only make you have shoes like me. That is it."⁵⁵

LISA FAIRFAX: Thank you very much.

ROYCE BARONDES: I gather my role on this panel would be to be the academic who is more in favor of these duties than some of my colleagues. As a general matter, it seems to me that there are multiple facets of fiduciary duties. It is not simply a question of duty of care. There are other facets like duties of loyalty applied to conflict-of-interest transactions. And it is important that there be consistent principles that are applied in these various contexts.

I have five major points that I am going to talk to you about today. The first is that the existence of an affirmative duty makes a difference. It allows creditors to sue third-party professionals for aiding and abetting liability, reversing the outcome under the *Wagoner* rule.⁵⁶ The second point is that whether we classify these claims as direct or representative is not the same thing as saying there is not a duty to a specific group. The third general point that I want to address is duty-of-care claims. The business judgment rule's application in the context of creditors asserting causes of action should, in my view, if anything, be stronger than the normal business judgment rule's application. And the principle for that is, any alternative rule creates options that are difficult to value and are therefore undesirable.

My fourth major point is that alteration of incentives on distress requires reconsideration of the principles used to restrain self-dealing during distress. That is, when a corporation is in distress, there may be lesser monitoring by shareholders of various kinds of conflict-of-interest transactions. We typically have a binary kind of judicial-review process. If some constituency approves the transaction, there is a much more limited review of the transaction by the court than if the constituency did not. And the question that I am proposing we think about for a little bit is, what constituency should that be when a corporation is in distress? That is, we may

55. Brainy Quote, http://www.brainyquote.com/quotes/authors/c/charles_barkley.html (last visited Feb. 2, 2007).

56. *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 120 (2d Cir. 1991).

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decide ultimately that we need a single constituency that is the one whose approval subjects the transaction to more restricted judicial review and the one whose interests the directors are to promote. But whether we do that or not requires separate thought.

The last point I am going to address is the duties of candor and application of the principles of *Malone v. Brincat*⁵⁷ in the context of distress. And in this circumstance I am going to propose that when a debtor is in distress, there should be a presumption that affirmative misstatements were made for purposes of influencing creditor action, causing one element of the tort of fraud to be presumed to have been met. Those are my five basic points.

The first point: Does the existence of this duty make a difference? I believe it can make a difference in an important way in two contexts, because aiding and abetting a breach of fiduciary duty also gives rise to liability. Applying this principle, the existence of a fiduciary duty owed to creditors on distress allows courts to fill two gaps currently in debtor-creditor law—one concerning fraudulent transfers and another concerning fraud in connection with distress or insolvency.

As to fraudulent-conveyance claims, consider, for example, a lawsuit against a third party who has no direct relation with a creditor—an outside law firm that aids and abets management in a fraudulent conveyance to managers—aiding and abetting liability could provide a theory under which an outside law firm that represents managers who are recipients of a fraudulent conveyance could be liable.

The reason this is important is that traditionally courts have said there is no aiding and abetting liability under a fraudulent conveyance but there is aiding and abetting liability if you aid and abet the breach of the fiduciary duty. So, if the managers are engaged in a breach of fiduciary duty, the law firm would have aided and abetted a breach of fiduciary duty. Where there is a fiduciary duty owed to the creditors of a distressed firm, there could be a viable cause of action against the law firm that assisted the directors in breaching their fiduciary duties in engaging in a fraudulent conveyance. This is one circumstance in which whether this duty exists or not makes a difference.

The second, I think, is even more important, involving the *Wagoner* rule. Let me give you some illustrative facts from a real case. An outside accounting firm participates in the preparation of a private-placement memorandum in connection with a firm that is engaged in one big Ponzi scheme. The accounting firm has allegedly engaged in the fraudulent provision of professional services. The *Wagoner* rule has the following application in this context: If all the managers have participated in this Ponzi scheme, the company itself does not have a direct cause of action against the accounting firm. The reason for that is that all the insiders are participating in it, and their activity is charged to the corporation. So the corporation does not have a valid cause of action against the accounting firm. If the firm now goes insolvent,

57. 722 A.2d 5 (Del. 1998).

the corporation still does not have a valid claim against the accounting firm. Under the *Wagoner* rule, the trustee steps into the corporation's shoes. The corporation does not have a valid cause of action, so the trustee does not have a valid cause of action.

Some of the outside creditors in this circumstance do traditionally have a direct cause of action. That is, those people who purchased—who made investments pursuant to a private placement memorandum that was fraudulent—would have a cause of action. But in this particular case—it is a Second Circuit case, *Hirsch v. Arthur Andersen & Co.*⁵⁸ in 1995—there were about \$10 million in outstanding claims. Just under \$7 million of them were to the private-placement memorandum investors, and \$3 million were for other creditors. The other creditors cannot sue for fraud under the private-placement memorandum. They would, under traditional doctrine, be stuck with whatever the trustee could recover. If the trustee was prevented in bringing a lawsuit, traditionally those other creditors are out of luck.

Now, those other creditors might be able to bring a fraud claim. A problem with their trying to bring a fraud claim in this circumstance is that fraud claims are limited in a number of ways. For example, there needs to be a foreseeable plaintiff. So these other creditors, in order to recover, had to say they were foreseeable victims of the fraud of the accounting firm. And in addition, fraud requires that you have heard a statement and relied on it. Each of these creditors would need to prove that. There are going to be many of these creditors who will not be able to prove the elements of a fraud claim successfully.

So a reason this principle is important is that if the managers who are engaged in this Ponzi scheme breach a fiduciary duty to the creditors—which, at least for purposes of my discussion I am going to assume that they have—the outside accounting firm can be liable under principles of aiding and abetting liability. The elements of this aiding and abetting claim are: There exists a fiduciary relationship, a breach of fiduciary duty, and the knowing participation in that breach by defendants who are not fiduciaries. So not very much needs to be proved. This is a theory that allows recovery as long as the corporation owes a direct fiduciary duty to the creditors when the corporation is in distress. Presumably at some point before the Ponzi scheme unraveled, the corporation was in the vicinity of the insolvency. This would have provided a theory under which those creditors might have recovered.

My first point is that the existence of an affirmative duty is desirable to cut back on the application of the *Wagoner* rule, which would say that the trustee cannot bring certain claims in a bankruptcy proceeding. My second major point involves conflation of a representative action and there being no obligation to a particular constituency. One might argue that historically these fiduciary duties are derivative and the result is that there is no obligation to promote any particular constituency's interest. Management just does whatever it wants absent waste or, to put it another

58. 72 F.3d 1085 (2d Cir. 1995).

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way, management does not have any obligation to someone other than the corporation as a whole. My view is that this is inaccurate because there are lawsuits that must be brought in a representative capacity that may nevertheless be for the specific benefit of a nonstockholder. For example, Delaware General Corporation Law section 174(a) provides that directors have joint and several liability for willful or negligent payment of unlawful dividends, and the obligation is to the corporation and to its creditors in the event of dissolution or insolvency.⁵⁹

So there is a claim that is directly owed to the class of creditors, but authority indicates that this is a claim that can be brought only by creditors in a representative capacity; it cannot be brought by a creditor individually. So the summary of this point is that one cannot assert that where fiduciary-duty claims are representative there are no duties owed to a specific group like creditors. That is inconsistent with, for example, the dividend principle I was talking about.

My third basic point involves duty-of-care claims. If creditors had extensive duty-of-care claims, it would create an undesirable option. And the reason is that covenants give creditors control. Financial distress allows acceleration of indebtedness. The possibility that indebtedness will be accelerated allows creditors to control management. If creditors have bargained for these type of control rights, it is highly undesirable to allow them to, after the fact, assert that the corporation was not managed properly, giving them the right separately to bring a cause of action for breach of duty where they had the opportunity to control and did not.

The reason that this kind of option is problematic is that it is difficult to value. A difficult-to-value option will not simply be priced in, but it will create aggregate costs in investigating the value of the option. Let us say, for example, the option is worth five percent on average. So creditors should generally provide a five percent discount by virtue of the option that is created by being able to bring a duty-of-care claim. In some debtors the option will be worth more; in other debtors, it will be worth less. Creditors will worry that they will win in a "winner's curse" situation. That is, creditors will not be perfectly informed, and creditors will extend credit with a five percent discount, reflecting the value arising from the ability to bring a challenge to management decisions, to debtors who really shouldn't get that five percent discount. To avoid extending the discount to debtors for which the option to challenge management decisions *ex post* is less valuable, creditors will have to investigate the personal assets of the firm. That creates increased costs in investigation.

So my general conclusion in this regard is that allowing a 102(b)(7) provision to limit the liability to creditors is desirable. And if anything, the business judgment rule's application should be stronger, i.e., more extensively preventing challenges to business decisions, and not weaker in the context of claims by creditors.

59. DEL. CODE ANN. tit. 8, § 174 (Supp. 2006).

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My fourth point involves approval of transactions implicating loyalty. One formulation might be that because shareholders alone vote and approve conflict-of-interest transactions, one measures fairness of transactions in terms of the impact on equity. It seems to me that statement has it entirely backwards. Shareholder approval is required under section 144,⁶⁰ but it is merely a mechanism to eliminate historical avoidability of conflict-of-interest transactions.

There is, in addition to this statutory provision, a judicially crafted power. That is, Delaware courts have, on their own, said that even if shareholders approve, a court still retains the power to consider the fairness or lack of fairness of an interested-party transaction. Now, because *Credit Lyonnais* has noted the impact that distress has on incentives within corporations in distress, that illuminates the fact that we need to assess whether this separate, sort of *sui generis*, principle allowing a court to re-review the fairness of a transaction requires additional consideration in the context of distress.

My view is that it would be highly undesirable within the context of distress if managers were permitted to say, "Well, doing this transaction, this sale of business, or whatever, some conflict-of-interest transaction, promotes some constituency, either the shareholders or the creditors. And we have chosen one constituency that approves it, and so now the burden is on the challenging party to prove the impropriety of the transaction." It seems to me inappropriate to allow corporations, insiders, to cherry-pick which constituency they can have approve, because insiders will be able to find one constituency at the time in question that they could essentially bribe by saying to one possible constituency, "Okay, we will make a good deal for you. Approve it, and we will bail out money to ourselves at the same time."

That is, there needs to be one constituency that is selected in advance. My gut instinct at the moment is that that constituency ought to be the stockholders because it is simply going to be easier where we have voting mechanisms already for stockholders to vote. I am not quite sure at the moment whether I would propose that this ought to be a mandatory default, i.e., one that the corporation cannot opt out of.

My last point, which I think is the one that actually got most of the uproar in the e-mail communication before this conference, involves the disclosure obligations under *Brincat*. Fraud requires an intention to induce reliance.⁶¹ Unanticipated creditor reliance may become increasingly frequent in the context of distress; i.e., if insiders lie to creditors, those lies may increasingly be more likely to result in creditors not exercising remedies. If, on the other hand, the corporation is not in distress, creditors are much less likely to have potential to exercise remedies.

60. DEL. CODE ANN. tit. 8, § 144 (Supp. 1999).

61. See W. PAGE KEETON, DAN B. DOBBS, ROBERT E. KEETON & DAVID G. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS 88, 728 (5th ed. 1984).

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Allowing affirmative misstatements that cause damage is not desirable, in my view. Consider the failure by parties to provide by contract the rules governing disclosure if a corporation becomes distressed. That is, consider whether in a contract a debtor states, with the consent of a creditor, that, “When we are in distress, we can—we are going to be free to lie to you,” or “We are not going to be free to lie to you.” Whether parties contract as to that matter or not does not strike me as being dispositive of whether the law’s supplying an outcome saying you cannot lie to creditors in distress is inefficient. The reason is that I went on CORI’s (Contracting and Organizations Research Institute’s) website,⁶² and within the approximately 800 asset-purchase agreements on the site looked for any contract that used the word “lie” in this context. Do parties bargain about lying? Not one of them included that word in that context.

Parties do not explicitly bargain about lying. That is what the asset-purchase agreements say. That was actually my experience as well during the time I was a practicing lawyer. I cannot recall anybody saying, “I want the ability to lie to your client.” People do not bargain about it because it impedes the formation of trust necessary to enter into a voluntary contractual relationship. Parties do not bargain about it. We can, through the careful selection of legal rules, provide an outcome that the parties’ express bargains do not address and that might nevertheless be efficient.

So, my proposal would be to allow a cause of action for misstatement as a breach of fiduciary duty if a corporation is in distress, even if the defendant, the person who makes the misstatement, is unaware of a transaction in reliance. That would just eliminate the requirement of proof of the first element of fraud, which requires intention to do so (induce reliance).

I believe my time is up, if not more than up. I apologize.

LISA FAIRFAX: No problem. Thank you. Now we are going to have Larry and Bob commentate.

LAWRENCE HAMERMESH: I am going to direct my comments mostly to Jonathan. The doctrine is incoherent, as you say, and I think there is good reason for it. I think you put your finger on it. When we talk about *Credit Lyonnais* duties, we talk about this concept arising from the *Credit Lyonnais* case, yet, as you say, that case had absolutely nothing to do with this whole concept. Although the case was tried over months and months of intensive litigation, the sole basic issue was whether a corporate-governance agreement was violated. There was lurking behind that issue the sense that Parretti, as the sole stockholder, was somehow being mistreated by the directors whom the bank had installed, and that it was wrong for them as directors to do things that interfered with Parretti’s rights as a stockholder.⁶³ But

62. Contracting and Organizations Research Institute, <http://cori.missouri.edu/> (last visited on Feb. 2, 2007).

63. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, 1991 WL 277613 (Del. Ch. 1991).

those rights had been thoroughly refined and cast in the form of the corporate-governance agreement. So when Chancellor Allen put his famous footnote 55 into that opinion, I guess I read it, but I did not pay much attention to it because for me, as someone who was involved in the case, that really was not what the case was about. And yet we have this industry that sprung up after that on the strength of footnote 55, and not just academic articles, but judicial opinions, as if there was some real thing here, some real fiduciary duty.

In any event, one struggles for explanations for what the Delaware courts are doing and saying about this. And yet it is interesting to see just how little occasion the Delaware state courts have had to talk about the duty, for the reason that Russ pointed out—namely, that the cases interpreting and applying the supposed duty arise in bankruptcy.

So I am not impressed with the Ed Rock “Saints and Sinners” argument⁶⁴ as an explanation as to why the opinions in this line of cases come out the way they do. If that were the explanation, I would expect to see a whole lot more factual development, whereas in these opinions, like *Production Resources*, the defendants—the bad guys, if you will—are a caricature. There is not a lot of depth with factual explanation.

I am impressed, on the other hand, and I do agree with you, that there is some validity to the point about turf protection. The *Production Resources* opinion is about thirty pages long, I think, in the West Publishing version of it, but less than four pages of it is the facts. Lots of it is law, with lots of dictum, as Russ pointed out. Why? I think the reason is that Vice Chancellor Strine probably feels the same motivations I feel in seeing what other people have done with Chancellor Allen’s footnote 55. And he saw this one case as a chance—perhaps a rare chance—for the Delaware courts to say “Time out. This is getting out of hand. Let us trim this all back.” And he is in part responding to the fact that concerns me, namely that the law that has emerged here suggesting there are director duties to creditors under Delaware corporate law is being made by the bankruptcy courts rather than the Delaware state courts. And this *Production Resources* case was one of the rare chances Vice Chancellor Strine had to try to pull it back and say, “Hey, you guys are taking this way out of proportion. I am going to try to explain how to bring it back under control. I am going to reduce your role under section 102(b)(7) in an attempt to limit these claims.”

The one thing that I want to add, which will have to be left to the later panels, is that if 102(b)(7) is brought back into the picture, what is going to be the role not for director’s duties to creditors, but for the duties of managers of LLC’s to creditors, when LLC agreements can operate much more actively in defining or eliminating fiduciary duty altogether? That to me is a very interesting topic.

64. See Rock, *supra* note 48.

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ROBERT LAWLESS: I think the papers combine two separate ideas. First, there is this doctrinal idea that there are gaps in the law. To me, the duty of creditors completely overlaps with existing doctrines. I know some of the later papers are going to make some bigger points about this overlap, but I wanted to talk specifically about fraudulent-transfer law because I think it overlaps most with the duties of creditors. When scholars or courts are talking about the duties of creditors, it is often just a footnote or other rhetoric cloning the fraudulent-transfer case law. In other cases, the issue is really just a simple fraud, and the victim just happens to be a creditor of the perpetrator.

Yes, in some cases, there are some problems with fraud or fraudulent-transfer doctrines. For example, some cases (erroneously) hold that there is no aiding-and-abetting liability for fraudulent transfers. There can also be questions of derivative standing. Once they get to bankruptcy court, can creditors sue, or does the power to sue reside exclusively in the trustee in bankruptcy? The court decisions on issues such as these are what has come to be called a duty of creditors. A lot of what we heard from Russell and Royce is filling in gaps in fraudulent-transfer doctrine.

The whole duty-to-creditors debate reminds me of a story that is attributed to Abraham Lincoln. The story never actually happened, but it makes my point, which means I can use it. At the Lincoln-Douglas debates, Lincoln is being heckled by someone making a small semantic point. "So," Lincoln asks the heckler, "how many legs would a horse have if you called its tail a leg?" "Five," the heckler responds. "Wrong," Lincoln is supposed to have stated, "calling a tail a leg does not make it one." I think that story illustrates the same point as what is happening here. Saying that a fraudulent-transfer case, a simple fraud case, or just a derivative-standing issue involves a duty to creditors does not make it so. It is still a fraudulent-transfer issue, a standing issue, what have you. If instead of using the rhetoric of a duty to creditors, we talk about problems with fraudulent-transfer law or the law of fraud, we have more honest conversations about the doctrine. For example, should we have reliance requirements for creditors?

I want to move to the other point. There is a theoretical justification for the duty to creditors that was touched on a little bit by Jonathan. This theoretical justification is the standard overinvestment story that firms near insolvency or in insolvency overinvest. That is, insolvent firms make investments that—because of their different discount rates—creditors do not want but shareholders do.

If we buy the overinvestment story, then, Jonathan, I think your "Saints and Sinners" argument is an interesting point. I am not sure I think that argument describes what is actually happening, however, and I share some of Larry's concerns about whether that argument is descriptively accurate. To me there is an empirical question here that has not been touched on at all, and that is whether firms near insolvency do, in fact, overinvest. And I think one can do an empirical study on that.

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Let me just, quickly, talk about evidence that we do have that suggests there perhaps is not an overinvestment problem near insolvency. Think back to some of the mass tort bankruptcies, *Johns-Manville*,⁶⁵ for example. The shareholders there complained bitterly that the directors were favoring creditor interests over the shareholders, that Mansville had been pushed into the bankruptcy to try to deal with the creditor problems. Similar dynamics occurred in other bankruptcies. *Piper Aircraft*⁶⁶ comes to mind. There are also the LoPucki and Whitford⁶⁷ articles that empirically examine the corporate governance in publicly traded company bankruptcies. They found very mixed results on whether management preferred shareholder interests over creditor interests at the time of insolvency. In fact, they found that in most cases management was clearly aligned with creditors at the time of the insolvency. One might respond that the LoPucki and Whitford studies only included companies that were already in Chapter 11. But I think these studies give us some evidence that, perhaps, this overinvestment story is overblown in the real world.

Looking to more contemporary examples in the world today with insolvent companies, we see more asset sales occurring more frequently.⁶⁸ These sales suggest more liquidations, suggesting that perhaps insolvent companies are more likely now favoring creditor interests than debtor interests.

LARRY RIBSTEIN: As to Russell's point, he said *Production Resources* held that fiduciary duties were owed to creditors. I think we need to get a distinction. The question to ask there is: Would the case have come out any differently without that reasoning? I do not think so because all the Vice Chancellor has done is talk about a general duty to the corporation.

With respect to Jonathan's point about the request function of law, I guess I agree mostly with what he said except to clarify the dicta only. My only question would be: What exactly are they expressing? Because, you know, as I say in my paper, we are talking about the business judgment rule here, and this is where the cases really, all of them allow.

I also wanted to talk for a second about Larry Hamermesh's question about what Vice Chancellor Strine's reference to 102(b)(7) would mean for the complete act in Delaware for LLCs and partnerships. One answer is that it will give people an opportunity to contract around any fiduciary duties to creditors, effectively contract around any fiduciary duties to creditors if the court found them to exist, which I do not think they do. We will talk about that later today, by choosing the LLC tort. In

65. *Manville Corp. v. Equity Sec. Holders Comm.* (In re Johns-Manville Corp.), 801 F.2d 60 (2d Cir. 1986).

66. *In re Piper Aircraft Corp.*, 244 F.3d 1289 (11th Cir. 2001).

67. Lynn M. Lopucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597 (1993); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993).

68. Douglas G. Baird & Robert K. Rasmussen, *Bankruptcy at Twilight*, 56 STAN. L. REV. 673, 675-86 (2003) (cataloguing rise in asset sales during bankruptcy proceedings).

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other words, if the courts did apply these duties, given that they would be costly for reasons among which Royce has talked about, it might be enough of a loss to have a classic forum. I do not know.

I had a question about whether he was talking about the holding or the dicta, a question for Jonathan about what these things are expressing, and a question for Larry about the application to LLCs with the 102(b)(7) reasoning and *Production Resources*. Would this not effectively make LLCs an essential opt-out device for fiduciary duties to creditors if the courts held them to exist?

LAWRENCE HAMERMESH: I think the answer is yes. That is exactly why I called on you before. I am not suggesting that people are going to be converting their entities, public companies, into public LLCs in order to avoid a creditor claim. But it raises one of the questions pointed out in Royce's paper. If there is a situation in which you are in a zone of insolvency, whatever that is, and there is some question of possible claims of creditors at stake and you are dealing with an LLC, who at that point is going to create the fiduciary rule governing a fiduciary duty to creditors? Is it going to be the members? Presumably at that point they are antagonistic to the creditors. And, if so, what sense does any of this make?

LARRY RIBSTEIN: What sense does what make?

LAWRENCE HAMERMESH: What sense does the underlying duty make to begin with, if it all can be . . .

LARRY RIBSTEIN: If you loaned money to an LLC, that has this in the operating agreement, do you not in effect sign on to that provision in the operating agreement?

LAWRENCE HAMERMESH: If it is already there, yes. But you are not the—you have to anticipate the possibility of amendment if that provision is not there already.

LARRY RIBSTEIN: Well, could you assert that if and go back—you are right.

JONATHAN LIPSON: We do not know exactly what they are expressing, perhaps because they do not yet know what they are trying to say. It may be what Ed Rock says the Delaware courts were expressing in the MBO context, meaning a fairly traditional story about care, good faith, and so on.

LARRY RIBSTEIN: I am asking you whether you had any ideas about it.

JONATHAN LIPSON: I think they may be wrestling with priority. I also think that they are trying to assert their stake in the discussion because they should legitimately be concerned that bankruptcy courts will start to make Delaware law that they do not agree with. I did a quick survey of cases and interestingly I think that the supposition amongst the Delaware folks is that these bankruptcy courts are going to side with creditors and stick it to directors. In fact, it does not look like that is what is happening at all. In fact, it looks like the Delaware courts are more solicitous of directors than is, for example, the Southern District of New York. This is not what people would necessarily have anticipated.

LAWRENCE HAMERMESH: Solicitous of creditors.

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JONATHAN LIPSON: The Delaware court may be more solicitous of creditors. Just a quick side bar, we haven't done any empirical analysis, but it would not surprise me at all if that turned out to be the case.

LARRY RIBSTEIN: If you know why, if you do not know whether you are expressing it, then how can you then express a theory of what it says?

JONATHAN LIPSON: I think there are several things that they might be expressing . . .

LARRY RIBSTEIN: If they are not clearly saying anything, then how can you have an expressive theory on what they are saying?

JONATHAN LIPSON: Why would you have to have one?

LARRY RIBSTEIN: Well, it seems like you want them to be expressing something in order to use that as motivation for the language.

RUSSELL SILBERGLIED: But they all might be expressing something different from each other. Each judge is having his own expressive view different from every other judge's expressive view.

JONATHAN LIPSON: That's a fair question. I think I am saying something slightly different than Ed Rock. As I said, there may well be strengths and weaknesses with his *Sanits and Sinners* analysis. My only point is that you have got all of this dicta out there that people spent a lot of time developing for some reason. I think they are trying to express some views on the relationship between directors and creditors when a firm is distressed. I am not sure that they know yet what that should be. As I said, they may be saying something about priority; they may be saying something about investment and risk when a firm is distressed. I don't think we know for sure, yet. That's part of what I want to figure out.

LARRY RIBSTEIN: But Ed Rock had a pretty clear view of what they were expressing. It is important to his expressive theory. That is why I am thinking if you have an expressive theory, something that necessarily goes with that, it is a clear view of what they are expressing.

LISA FAIRFAX: Let us get one more question.

RUSSELL SILBERGLIED: Can I respond to his question, please. First of all, I happen to agree with both of you and Larry on the LLC point, but the question to me is whether it is dicta or whether it is holding. I read the sentence right before head note 7, to change it from where he stops talking about dicta or starts talking about holding. That sentence reads, "[f]ortunately, this case does not require me to explore the metaphysical boundaries of the zone of insolvency. Instead, it requires me to apply a more well-settled line of authority, albeit it a line of authority that is perhaps less well understood."⁶⁹

The next sentence is the one I read to you before: "When a firm has reached the point of insolvency, it is settled that under Delaware law, the firm's directors are

69. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 790 (Del. Ch. 2004).

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said to owe fiduciary duties to the company's creditors.⁷⁰ I read that as the holding of the case. Your point, I think it is a well-taken one, that the court could have decided it differently because it could have said there is no difference in result if I am just talking about the fiduciary duty owed to the company itself. But that is not what the court did. The court could have done that, but that is not what it did. So I view those two sentences I just read to you right now as the holding of the case. That is my point there.

ALAN SCHWARTZ: I have a question to Royce and maybe to the panel, but to Royce. It concerns your fifth point. Suppose I am a chair of an audit committee and my company conducts an audit. And I tell my CFO or controller to get a presentation for me to make to the banks and they tell me they will do the best they can, the numbers are materially off. Is it your point that, if I am chairing the audit committee I am going to have a fraudulent intention? Because if it is, I think you are going to have a whole lot of trouble finding people to chair audit committees.

And my other question to the panel, some people said well, they really weren't sure there was this duty that existed. It is my impression that lawyers are advising clients when their companies are in difficult circumstances that they had better take creditor interest in account, too. So it may be. My question is, is the law not enacted that we have such a duty? Those are my two questions.

RUSSELL SILBERGLIED: Let me start on that last point as a practitioner and one who practices in bankruptcy and often gives advice to companies that are on the edge and the answer to your question is yes. The advice given by me personally to the board of directors and by every other lawyer that I know is you'd better take into account the interest of the creditors. There are certainly instances where you can prefer stockholders and you get into the nuances that I talked about before, the business judgment rule, the requirement that you prefer creditors; however, you have to really think about self interest and all of these types of things.

But, absolutely, you talk about taking into account creditors' interests because, quite frankly, this discussion is fascinating academically, and the cases may come out differently in the future, but a director of a corporation that is facing this decision right now does not want to hear that somebody might interpret the cases differently. They want to know: what am I most likely going to get sued for, and by whom, if the transaction does not go as expected. And they also want to know, for example, as a non-lawyer they might not express it this way, is somebody going to file a frivolous suit against me that cannot get dismissed on a motion to dismiss.

And the answer to all of those questions is, if you are concerned about that, you must in today's day and age take into account the interest of creditors.

ROYCE BARONDES: As to whether there could be liability, the answer is yes. I think that particularly in connection with setting forth (providing creditors) periodic financial information, when a distressed corporation is doing that, they should

70. *Id.* at 790–91.

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expect that the creditors, when they receive this information, will use it for purposes of deciding the extent to which they will exercise remedies. And the people within the debtor corporation need to provide that information in an accurate way. If they provide accurate information, they do not have a problem.

Fraud still has a scienter element, however. So, not only would there need, in order for there to be fraud liability, for there have to been a false statement, but there also has to be recklessness as to its preparation.

I am not saying that element, recklessness as to its preparation, is missing (or omitted). But, rather, it seems to me relatively clear that if you are delivering, for example, unaudited quarterly information to creditors to show that the covenants had been complied with, that the creditors are going to rely on that in deciding whether to accelerate. Creditors may think, "I cannot accelerate because the financial statements have not triggered a covenant."

I would have thought that more of the issue (i.e., the focus of claims asserted in the future if this particular element, proof of an intention to induce reliance, were not required) would arise from those cases involving defendants certifying, "I have complied with the covenants (or not)." And in those circumstances, I would believe that you would expect creditors to rely on information that is being provided as being accurate for purposes of assessing whether or not they are to pursue various types of remedies.

ALAN SCHWARTZ: Let me make it just a little bit more precise. Under the doctrine, there are CFOs, the president, a bunch of people have been certified.

ROYCE BARONDES: Yes.

ALAN SCHWARTZ: And they certified to the best of their knowledge and belief and so on and so forth. Are you imposing a grave duty on the directors or would it be the same thing?

ROYCE BARONDES: This is actually lesser liability, because a fraud claim is not just reasonable knowledge, it actually requires reckless indifference to the truth.

LISA FAIRFAX: Thank you very much. What a lively panel. I apologize for going over, but I think that suggests the level of interest in the nuance associated with all of the issues that we are going to be discussing today. Thanks again.