

## RETHINKING A CORPORATION'S OBLIGATIONS TO CREDITORS\*

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*No single body of law presently governs a corporation's obligations to creditors. However, disparate laws, starting from different perspectives, contribute to a patchwork of obligations that is poorly understood. Consequently, corporate directors have little guidance when balancing creditor and shareholder rights under corporate restructurings, securitizations, and leveraged transactions.*

*Commentators who have grappled with this issue focus almost exclusively on the fiduciary duty of a corporation's board of directors to shareholders. Some argue that only shareholders should be entitled to the duty; others argue that the duty should be extended to creditors under various circumstances. This Article maintains that both approaches are incomplete because they assume that the standard of duty, if one exists, is fiduciary and also because both fail to take into account other, more fundamental, sources of the corporate obligation to creditors.*

*This Article instead argues that the analysis of whether a corporation owes an obligation to creditors must start with the question of whether a debtor generally has an obligation to creditors. Only by answering that question can one analyze how the debtor's being a corporation should affect that obligation.*

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*The Article uses this two-step approach to reflect on the appropriate boundaries of the corporate obligation to creditors, particularly where the interests of shareholders and creditors conflict. It shows that a debtor—corporate or not—owes a limited obligation of good faith to creditors that addresses many of the evils that commentators advocating a broad fiduciary duty to creditors have identified.*

*The Article then explores how that obligation is affected when the debtor is a corporation. In that context, it analyzes the “vicinity of insolvency” test proposed by Chancellor Allen in the Credit Lyonnais case, and suggests an alternative approach that sets a brighter line to determine when directors should have loyalty to both creditors and shareholders but gives more leeway and discretion to directors when that dual loyalty arises.*

*Finally, the Article proposes a theory that unifies these commercial law and corporate governance approaches while balancing a corporation’s ability to take legitimate business risks with the reasonable expectations of creditors that their rights will not be impaired.*

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#### INTRODUCTION

The question of a corporation’s obligation to creditors has become an urgent one in the business community as more and more

corporations are restructuring in ways that benefit shareholders but potentially prejudice creditors.

Traditionally viewed, a corporation's obligation, or at least that of its directors, is solely to its shareholders. However, as corporations restructure in ways that maximize shareholder return, conflicts often arise between shareholder and creditor expectations. Marriott Corporation awakened the business community when, several years ago, it split in two by transferring its best assets to a newly created Marriott affiliate. Although the intention was to increase shareholder return, Marriott's bondholders sued. Since then, a succession of corporations, including RJR Nabisco and AT&T, have considered or implemented similar strategies.

This tension between shareholders and creditors can be found at the heart of a wide range of corporate and financial transactions. In leveraged finance transactions, the increase in a corporation's debt burden often works to the detriment of existing creditors but to the benefit of shareholders and, sometimes, management. In a leveraged buyout, for example, a corporation borrows money and uses the proceeds to purchase its own outstanding shares, typically consolidating stock ownership in the hands of a small group of managers. The value and likelihood of repayment of the corporation's existing debt, however, is thereby impaired because of the corporation's greatly increased leverage (ratio of debt to equity).<sup>1</sup>

The same conflict can arise in structured finance and asset securitization transactions, where a corporation raises financing on favorable terms by selling financial assets to a newly created subsidiary. Investors extend financing to this subsidiary believing that it is "bankruptcy remote," meaning it will not be affected by the parent corporation's subsequent bankruptcy.<sup>2</sup> However, if a corporation's obligation is only to shareholders and not to creditors, then the directors may well be obligated to vote to put the solvent subsidiary of a bankrupt parent into bankruptcy in order to induce the investors to promptly settle their claims at a discount<sup>3</sup> and thereby maximize value to the parent-shareholder.<sup>4</sup>

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<sup>1</sup> See, e.g., *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989).

<sup>2</sup> See Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 *STAN. J.L. BUS. & FIN.* 133, 135 (1994).

<sup>3</sup> See, e.g., *In re Days Inn of Am., Inc.*, 161 B.R. 11 (Bankr. D. Del. 1993) (where investors of a bankrupt but solvent subsidiary settled their claims at a 5% discount in order to receive prompt payment).

<sup>4</sup> There are no statutory restrictions on a company's decision to file a voluntary bankruptcy petition. 11 U.S.C. § 301 (1994). A pre-bankruptcy waiver by the parent-shareholder of the right to place its subsidiary into voluntary bankruptcy, or a restriction of the same in the subsidiary's organizational documents or by covenant, could be void under

More generally, tension between the interests of shareholders and creditors is inherent in every decision that increases a corporation's risk in order to make it more profitable. The celebrated case of *Credit Lyonnais v. Pathe Communications*<sup>5</sup> recently addressed this tension. However, many believe that its application raises as many questions as it attempts to answer.<sup>6</sup>

Until now, commentators analyzing a corporation's obligation to creditors have focused almost exclusively on the fiduciary duty of the board of directors. Some argue that only shareholders should be entitled to the duty; others argue that the duty should be extended to creditors under various circumstances. This Article maintains that both approaches are incomplete because they fail to take into account other, more basic, sources of a debtor's obligation to creditors.

Rather than focusing on the fiduciary duty of a board of directors, the inquiry must start with the more fundamental question of whether a non-corporate debtor has an obligation to creditors. Only after answering that question can one analyze how that obligation is affected when the debtor is a corporation. Using this two-step approach, this Article analyzes the debtor-creditor relationship under both commercial finance and corporate governance principles,<sup>7</sup> and concludes there is no appropriate basis, absent insolvency, to impose traditional fiduciary standards on what is essentially an arm's-length commercial relationship.<sup>8</sup>

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federal bankruptcy law. See STEVEN L. SCHWARCZ, *STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* 17 n.26 (2d ed. 1993).

<sup>5</sup> *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. Civ. A. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). See *infra* part II.B.

<sup>6</sup> See, e.g., Stephen R. McDonnell, *Geyer v. Ingersoll Publications Co.: Insolvency Shifts Directors' Burden From Shareholders to Creditors*, 19 DEL. J. CORP. 177, 177, 210 (1994) (stating that the language in *Credit Lyonnais* created ambiguities that, after *Geyer*, left a "myriad of questions" unanswered). See Rima F. Hartman, Note, *Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?*, 50 WASH. & LEE L. REV. 1761, 1766 (1993) (*Credit Lyonnais* leaves "crucial questions unanswered").

<sup>7</sup> Using this two-step approach, this Article will show that a non-corporate debtor has only limited obligations to creditors, arising under contract, fraudulent conveyance, and commercial law. However, directors of an insolvent corporate debtor, or of a corporate debtor whose action has a reasonable expectation of resulting in insolvency, have a dual loyalty to creditors as well as shareholders arising from the fact that creditors of an insolvent corporation replace shareholders as the residual claimants, at least until the corporation regains solvency. In balancing their dual loyalty, directors would have latitude in weighing benefit to shareholders with harm to creditors, and would be protected by the business judgment rule if they act in good faith.

<sup>8</sup> See *infra* part I.D. This Article focuses on a corporation's obligations to creditors. It does not examine obligations to other members of the corporate community, such as employees.

## I. SOURCES OF LAW

No single body of law presently governs a debtor's obligation to creditors. Disparate areas of law, discussed below, start from different perspectives in contributing to such an obligation. However, little thought has been given in the past to how these sources interrelate. The goal of this Article is to integrate these sources of law (done in this part) and then to apply them to corporate debtors (done in parts II and III).<sup>9</sup>

## A. Contractual

The primary source of a debtor's obligation to creditors is contract law.<sup>10</sup> The loan agreement or other contract governing the particular relationship between the debtor and a creditor<sup>11</sup> typically will contain covenants restricting the debtor's actions in an attempt to ensure that it remains creditworthy.<sup>12</sup>

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<sup>9</sup> The extent to which law should regulate the relationship between a debtor and its creditors is actually part of the larger question of when, and how, the law should regulate fairness in any private relationship. See generally Steven L. Schwarcz, *Observations on the Regulation of Fairness in Private Relationships* (forthcoming 1996-97) (on file with author). This Article observes that although all of the forms of regulating fairness in private relationships appear to be part of a continuum, there is no overall or systematic approach to regulation under existing law. For example, nuisance law in tort developed to regulate fairness based on actions, fiduciary obligation developed to regulate fairness based on the nature of relationships, and good faith in commercial law developed to regulate fairness among participants in markets. The problem is that each form of regulation has different standards as to when regulation applies and different remedies when it does.

<sup>10</sup> [T]he rights of the holders of the debt securities are largely a matter of contract.

There is no governing body of statutory or common law that protects the holder of unsecured debt securities against harmful acts by the debtor except in the most extreme situations. Short of bankruptcy, the debt securityholder can do nothing to protect himself against actions of the borrower which jeopardize its ability to pay the debt unless he takes a mortgage or other collateral or establishes his rights through contractual provisions set forth in the debt agreement or indenture.

AMERICAN BAR FOUNDATION CORPORATE DEBT FINANCING PROJECT, COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS 2 (1971). Accord *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1049 (2d Cir. 1982), cert. denied 1035 S. Ct. 1253 (1983); *Mann v. Oppenheimer & Co.*, 517 A.2d 1056, 1061 (Del. 1986) ("The rights of debenture holders are controlled by the terms of the indenture under which the securities are issued.").

<sup>11</sup> Loan agreements are sometimes called "indentures" where the lenders are investors in the public capital markets. The promissory notes issued to evidence the loans in these situations are called "debentures" or "bonds."

<sup>12</sup> These covenants include restrictions on liens ("negative pledge" causes), asset sales, debt incurrence and leverage, and change of control. Covenants enable creditors to monitor the debtor and thereby limit the risk of its misbehavior, which in turn decreases the amount of compensation that creditors will demand. See Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 135-36 (1989).

Covenants in private contracts, much less public debt indentures, cannot cover all future situations.<sup>13</sup> Also, not all creditors have the benefit of covenants. Trade creditors, for example, usually ship goods or provide services to a debtor on "open account" terms, without signing a formal contract containing covenants.<sup>14</sup> Also, involuntary creditors, such as tort creditors, have no contract with the debtor, and become creditors as a result of suffering damages from the debtor's actions.<sup>15</sup> It is clear, however, that the *contract itself* does not create fiduciary obligations between the debtor and its creditors: "Parties to a contract are not each others' fiduciaries; they are not bound to treat [each other] with the same consideration reserved for their families."<sup>16</sup>

Some courts have at least raised the issue of whether implied covenants should be inferred.<sup>17</sup> One must distinguish, however, between interpreting the scope and meaning of a contract term, a matter for contract law, and resolving an issue between parties to a contract that simply is not governed by the contract terms. This Article proposes that the commercial law obligation of good faith, discussed in part I.D, governs the fairness of private commercial relationships in the absence of contractual terms.<sup>18</sup>

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<sup>13</sup> See Lawrence Lessig, *The Limits of Lieber*, 16 CARDOZO L. REV. 2249, 2256-58 (1995) ("[E]very text must be imperfect . . . [A]ny text will be carried into contexts unanticipated."). Compare William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 719 (arguing that, at least with respect to convertible bonds, "[b]ondholder protective contract interpretation could never protect all bondholder expectations").

<sup>14</sup> Transactions in goods, however, are governed by Article 2 of the Uniform Commercial Code.

<sup>15</sup> See Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067, 1094 (1989).

<sup>16</sup> *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990); accord *Katz v. Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986) ("The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to bondholders."). But cf. Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1168 n.11 (1990) (arguing that fiduciary rights should be extended to public bondholders, although admitting that "scholars supporting expanded bondholder rights do not have a great deal of law supporting them"). Compare discussion *infra* part I.D. (arguing that public bondholders should not have fiduciary rights).

<sup>17</sup> See e.g., *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989).

<sup>18</sup> See Steven L. Schwarcz, *A Fundamental Inquiry into the Statutory Rulemaking Process of Private Legislatures*, 29 GA. L. REV. 909, 938 (1995); see also *infra* part I.D. Cf. *Metropolitan Life*, 716 F. Supp. at 1516-17; *Katz*, 508 A.2d at 880. But see RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

### B. *Creditors' Rights Laws*

Although creditors have various statutory rights against debtors,<sup>19</sup> the laws intended to protect creditors against debtor actions are very limited. The most significant is fraudulent conveyance law, which allows a debtor's trustee in bankruptcy to avoid certain asset transfers or obligations incurred "with actual intent to hinder, delay or defraud" creditors.<sup>20</sup> Where the debtor receives less than reasonably equivalent value in exchange for the assets transferred or obligations incurred, fraudulent conveyance law applies even absent actual intent to hinder, delay, or defraud if the debtor was, or became, "insolvent"<sup>21</sup> after giving effect to the transfer or obligation.<sup>22</sup>

Whenever one thinks of fraudulent conveyance law, one also thinks of preference law,<sup>23</sup> which allows a debtor's trustee in bankruptcy to avoid certain asset transfers made to repay or secure creditors within 90 days of an insolvent debtor's bankruptcy filing.<sup>24</sup> However, preference law reflects a policy of equality of distribution, and primarily protects creditors from each other. The debtor is no more than a stakeholder. Preference law would have little application to the types of corporate transactions discussed in this Article.

Another provision of law intended to protect creditors against debtor actions is the "best interests" test under the Bankruptcy Code,<sup>25</sup> which ensures that a debtor reorganizing in bankruptcy cannot force a creditor to accept a plan of reorganization without the creditor receiving at least what it would have received in the debtor's liquidation. Bankruptcy law sets out a formal priority scheme in liquidation, wherein creditors' claims are paid in full prior to shareholders receiving anything because of their equity in-

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<sup>19</sup> Article 9, Part 5, of the Uniform Commercial Code, for example, sets forth a creditor's foreclosure remedies; *see also infra* note 29.

<sup>20</sup> 11 U.S.C. § 548(a)(1) (1994). State fraudulent transfer law has parallel provisions, and applies whether or not the debtor is in bankruptcy. *See* U.F.T.A. §§ 1-13, 7A U.L.A. 639-67 (1985). *See generally* Steven L. Schwarcz, *The Impact of Fraudulent Conveyance Law on Future Advances Supported by Upstream Guaranties and Security Interests*, 9 CARDOZO L. REV. 729 (1987).

<sup>21</sup> Insolvency is not limited to balance sheet insolvency but includes constructive insolvency, including the debtor's not being able to pay its debts as they come due. *See infra* text accompanying note 113; 11 U.S.C. § 548(a)(2)(B) (1994).

<sup>22</sup> 11 U.S.C. § 548(a)(2) (1994). Fraudulent conveyance law therefore limits a corporate debtor from transferring assets to an affiliate in a corporate split, or from engaging in a leveraged transaction, that renders the corporation insolvent or unable to pay its debts.

<sup>23</sup> 11 U.S.C. § 547 (1994).

<sup>24</sup> *Id.*

<sup>25</sup> 11 U.S.C. § 1129(a)(7) (1994).

terests.<sup>26</sup> Accordingly, shareholders of an insolvent corporation in bankruptcy liquidation are not technically entitled to any value.<sup>27</sup>

The best interests test only applies in a debtor's bankruptcy, and therefore would not directly influence any of the corporate transactions discussed in this Article. Nonetheless, because it effectively disenfranchises shareholders of an insolvent corporation, it reinforces the obligation<sup>28</sup> that an insolvent corporation has to creditors.<sup>29</sup>

### C. *Fiduciary Obligation*

Some have argued that debtors owe a fiduciary duty to public bondholders, if not all creditors.<sup>30</sup> They are concerned that, absent such a duty, bondholders will be owed no duty at all. One commentator has stated that, "[g]iven, then, that courts have not recog-

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<sup>26</sup> 11 U.S.C. § 726(a) (1994).

<sup>27</sup> The "cram down" provisions of 11 U.S.C. § 1129(b)(2)(B) (1994) also prevent shareholders from receiving any property distribution because of their shares until creditors are paid in full. The Chapter 11 reorganization negotiating process, however, gives shareholders the practical ability to demand some value as an incentive to agree to a plan of reorganization and thereby avoid the need for a cram down. See Steven L. Schwarcz, *Basics of Business Reorganization in Bankruptcy*, 68 J. COM. BANK LENDING 36 (1985).

<sup>28</sup> See *infra* part II.A.

<sup>29</sup> Other laws protect creditors, but their impact is marginal to this Article. For example, section 553 of the Bankruptcy Code, 11 U.S.C. § 553, allows recovery of certain setoffs made within 90 days of an insolvent debtor's bankruptcy. Section 544, 11 U.S.C. § 544, allows the trustee in bankruptcy to avoid transfers and obligations that could be avoided by lien creditors and bona fide purchasers under state law. Section 552, 11 U.S.C. § 552, allows the trustee in bankruptcy to avoid certain pre-bankruptcy liens on assets newly arising in bankruptcy. These laws are all intended to enhance the debtor's estate in bankruptcy to protect creditors generally and to increase the debtor's ability to reorganize, but it is doubtful that they address actions that would create a conflict between shareholder and creditor interests. Laws that protect secured creditors are not relevant to this Article because secured creditors have contracted for an interest (a security—not an ownership—interest, but nonetheless an interest that in foreclosure may become ownership), in particular corporate assets. Further, these laws protect the property rights associated with that interest. See 11 U.S.C. § 1111(b); U.C.C. §§ 9-207, 9-306; U.C.C. §§ 9-501 to -507 (Secured Transactions—Default).

A legislature, of course, could choose to enact new laws to protect creditors against debtor actions. By way of comparison, and although this Article would not recommend such a statute without careful scrutiny and study of policy considerations, section 247 of the Ontario Business Corporations Act permits a creditor to assert a claim against a corporate-debtor whose action is oppressive or unfairly prejudicial to, or unfairly disregards, the creditor's interests. Ontario Business Corporations Act, R.S.O. ch. B.16, § 248 (1990) (Can.). See also *Palmer v. Carling O'Keefe Breweries of Can. Ltd.*, 67 O.R.2d 161 (Can. Div. Ct. 1989), where the court applied this statute to reach a result opposite to that reached in *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989) (discussed *infra* note 71).

<sup>30</sup> See, e.g., Mitchell, *supra* note 16. Professor Mitchell's analysis is "limited to publicly issued debt instruments of corporations with widely held stock." *Id.* at 1166 n.3.



nized a duty of care to bondholders, one must ask whether the status quo is justified."<sup>31</sup> That, however, mischaracterizes the status quo. It will be shown that commercial law already creates a limited good faith duty on the part of a debtor—corporate or not—to creditors,<sup>32</sup> obviating much of the urgency to impose a traditional fiduciary duty where none exists or should exist.<sup>33</sup>

Even if an urgency did exist, a fiduciary duty must arise from a fiduciary relationship, meaning that “one man trusts in or relies upon another”<sup>34</sup> and that reliance is accepted by the other.<sup>35</sup> Typical examples of fiduciary relationships are attorney and client, principal and agent, executor and heir, and landlord and tenant.<sup>36</sup> In a fiduciary relationship, good faith and fair dealing, rather than legal obligation, form the basis of the transaction.<sup>37</sup>

A debtor-creditor relationship, however, is not one of trust or reliance.<sup>38</sup> It is adversarial, as opposed to fiduciary. If I lend you money and you are obligated to repay it, no one would suggest that you are my fiduciary.<sup>39</sup> By the same token, creditors are under no

<sup>31</sup> *Id.* at 1209.

<sup>32</sup> See *infra* part I.D.

<sup>33</sup> See *infra* part III.D. The American Law Institute’s manual on corporate governance does not “take a position on the duty of directors or senior executives to creditors of the corporation. These matters are left to the law of creditors’ rights and bankruptcy and to the protection offered under the law of contracts.” 1 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.04, at 257 (1994).

<sup>34</sup> *State ex rel. Harris v. Gautier*, 147 So. 240, 242 (Fla. 1933); *Peckham v. Johnson*, 98 S.W.2d 408, 416 (Tex. Civ. App. 1936), *aff’d*, 120 S.W.2d 786 (Tex. 1938).

<sup>35</sup> *Reynolds v. Wangelin*, 53 N.E.2d 720, 724 (Ill. App. Ct. 1944); 36A C.J.S. *Fiduciary* (1961). These are not, however, precise definitions. “[B]ecause the circumstances which may create a fiduciary relationship are so varied, it is extremely difficult, if not impossible, to formulate a comprehensive definition . . . that would fully and adequately embrace all cases.” *Steevest, Inc. v. Scansteel Serv. Ctr., Inc.*, 807 S.W.2d 476, 485 (Ky. 1991). A relationship of trust or confidence appears essential. See Cecil J. Hunt, II, *The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship*, 29 WAKE FOREST L. REV. 719 (1994). An inequality in the relationship, “giving to one advantages over the other,” also may be required. *Yuster v. Keefe*, 90 N.E. 920, 922 (Ind. App. 1910).

<sup>36</sup> See *National Bank v. Insurance Co.*, 104 U.S. 54 (1881); *Robins v. Hope*, 57 Cal. 497 (1881); *Thomas v. Whitney*, 57 N.E. 808 (Ill. 1900).

<sup>37</sup> *State ex rel. Shriver v. Ellis*, 75 N.E.2d 704, 710 (Ohio Ct. App. 1946); 36A C.J.S. *Fiduciary* (1961).

<sup>38</sup> A debtor-creditor relationship is qualitatively different from the traditional examples of fiduciary relationships. Even in a landlord-tenant relationship, which is perhaps the closest fiduciary analogy, the landlord entrusts real property (by analogy, money) to a tenant (debtor) pursuant to a lease (loan agreement). The tenant is in possession of, and must care for and eventually return, the actual property leased. However, in the case of a loan, the money loaned becomes solely the debtor’s property, and can be used by the debtor without restriction. There is no entrusting of property rights.

<sup>39</sup> *Cf. Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990) (holding that loan contracts do not create fiduciary relationships); *Bratton*,

fiduciary obligation to their debtors.<sup>40</sup> This Article will also show that, notwithstanding Professor Mitchell's arguments,<sup>41</sup> even the relationship between public bondholders and debtors is not fiduciary.<sup>42</sup>

Although debtor-creditor relationships are not fiduciary, commercial law imposes a limited duty of good faith on lending relationships.<sup>43</sup> This limited duty creates obligations between a debtor and creditor that go beyond a purely legal relationship but, as will be shown,<sup>44</sup> do not offend the expectations of, or create uncertainties for, the parties. This is important because imposing a fiduciary standard on corporate debtors could impair the corporation's ability to take risks in its business. Risk taking is essential to business transactions and should not be limited without compelling reasons.

#### D. Commercial Law Obligation of Good Faith

Commercial transactions have an implied obligation of good faith, originating from the Uniform Commercial Code (UCC) and

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*supra* note 13, at 731 ("no fiduciary duties directly arise between [a debtor] and its creditors because no agency or trust relationship exists between them").

<sup>40</sup> See, e.g., *In re Ludwig Honold Mfg. Co.*, 46 B.R. 125, 128 (Bankr. E.D. Pa. 1985); *In re Teltronic Servs., Inc.*, 29 B.R. 139, 169 (Bankr. E.D.N.Y. 1983), *aff'd*, 762 F.2d 185 (2d Cir. 1985). *But see* *Barrett v. Bank of Am., N.T. and S.A.*, 224 Cal. Rptr. 76, 80-81 (Ct. App. 1986) (fiduciary relationship arose which included a duty of the lender to disclose certain facts to the borrower); *Barnett Bank of W. Fla. v. Hooper*, 498 So. 2d 923, 925 (Fla. 1986).

[W]here a bank becomes involved in a transaction with a customer with whom it has established a relationship of trust and confidence, and it is a transaction from which the bank is likely to benefit at the customer's expense, the bank may be found to have assumed a duty to disclose facts material to the transaction.

*Id.*

<sup>41</sup> See generally Mitchell, *supra* note 16.

<sup>42</sup> See *infra* part I.D.2.

<sup>43</sup> See discussion of the commercial law obligation of good faith, *infra* part I.D. For a more complete explanation of the commercial law obligation of good faith, see Schwarcz, *supra* note 18, and Schwarcz, *supra* note 9.

<sup>44</sup> See *infra* part I.D. For example, a debtor-creditor relationship, such as between a business and a single institutional lender, may be characterized by an ongoing course of dealing. Although the relationship is not fiduciary, it may lack adversarial character. The commercial law duty of good faith would recognize mutual understandings arising from such particular courses of dealing. See *infra* text accompanying notes 50-51.

common law principles of fairness.<sup>45</sup> This obligation, in a debtor-creditor relationship,<sup>46</sup> has been described as follows:

*Fairness* helps to preserve expectations by ensuring that parties are governed by neutral rules. In more limited circumstances, *fairness* also can mean [A] that the law should protect weaker parties, such as those with less bargaining power; [B] that opportunistic behavior should be prevented in circumstances that could not have been contemplated in advance; and [C] that implicit rules of conduct should be recognized if they arise from widespread courses of dealing in an industry or from particular courses of dealing between specific parties.<sup>47</sup>

Therefore, even though only secured debtor-creditor relationships are technically covered by the UCC, the commercial law obligation of good faith is part of any debtor-creditor relationship, whether secured or unsecured.<sup>48</sup>

How would the commercial law obligation of good faith apply to a debtor-creditor relationship? Neutral rules means that the law should not favor either party. This is presently true absent a debtor's bankruptcy. Under federal bankruptcy law, the automatic

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<sup>45</sup> See U.C.C. § 1-203 (1994); Schwarcz, *supra* note 18, at 933-39; see also *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990); *Neuman v. Pike*, 591 F.2d 191, 195 (2d Cir. 1979); *Katz v. Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986).

<sup>46</sup> The commercial law obligation of good faith in the context of a sale of goods includes a broader concept of "fair dealing." The author believes that a broader standard is inappropriate in a debtor-creditor relationship. The fair dealing relationship originated under Article 2 of the UCC in transactions among "merchants," consisting of a specialized community engaged in a high volume of undifferentiated transactions in goods without sophisticated contracts and in an atmosphere of trust. See Schwarcz, *supra* note 18, at 959 n.181. Debtor-creditor relationships do not generally involve an atmosphere of trust. This should not be confused with the corporate governance concept of fairness, which addresses matters such as disclosure, pricing, and director disinterestedness. See 1 AMERICAN LAW INSTITUTE, *supra* note 33, §§ 5.01-.16; see also HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS* § 238, at 102 (3d ed. 1983).

<sup>47</sup> Schwarcz, *supra* note 18, at 913 n.7 (citations omitted). This formulation may be slightly different from the usual concept of a hypothetical bargain. At least in a debtor-creditor context, good faith would not, in and of itself, appear to permit a court to recognize an implied term solely by asking what the parties would have agreed to had they thought about the matter; a further inquiry must be made whether one of the parties is weaker or whether the matter either could not have been contemplated in advance or reflects an implicit rule of conduct that arises from a widespread industry course of dealing or from a particular course of dealing between parties. See *id.* at 933-39. In this context, compare *Neuman*, 591 F.2d at 195 (emphasis added), which suggested that implied terms should be limited to what the parties would *surely* have agreed to had the matter come to their attention: "[a] promise . . . should be implied only if the court may *rightfully assume* that the parties would have included it in their written agreement had their attention been called to it."

<sup>48</sup> See *supra* part I.C. Indeed, lender liability law itself may implicitly derive from this good faith obligation, although lender liability, based on a creditor's obligation to the debtor, is the reciprocal of the debtor's obligation to creditors discussed in this Article.

stay and other rules favor debtor rehabilitation over creditor rights.<sup>49</sup> However, those are policy choices in bankruptcy, and therefore beyond the scope of this Article.

Holding aside for the moment the question of whether the debtor or the creditor is the weaker party, the commercial law obligation of good faith also means that opportunistic behavior should be prevented in circumstances that could not have been contemplated in advance, and that implicit rules of conduct should be recognized if they arise from widespread courses of dealing in an industry or from particular courses of dealing between specific parties.<sup>50</sup> These aspects of good faith "do not impair the [relative] expectations of the parties. In the former case, the parties could not have expected the circumstances to occur and, therefore, could not have formed expectations regarding it. In the latter case, the court merely recognized the parties' mutual understanding."<sup>51</sup>

Because commentators advocating a traditional fiduciary relationship generally try to balance the "reasonable expectations" of bondholders with the "legitimate business" needs of the debtor, the commercial law obligation of good faith already may achieve that balance without needing to impose fiduciary standards.<sup>52</sup>

That leaves the question of how, if at all, the commercial law obligation of good faith protects weaker creditors.<sup>53</sup> Starting with a typical debtor-creditor relationship, most jurisprudence assumes that the debtor, not the creditor, is the weaker party. Witness usury and consumer lending laws which originated in the context where individuals were debtors. In a corporate debtor context, however, the debtor may have significantly greater sophistication, if not bargaining power, than a creditor. A case by case analysis is therefore warranted.

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<sup>49</sup> See, e.g., 11 U.S.C. § 362 (1994).

<sup>50</sup> Schwarcz, *supra* note 18, at 933-39.

<sup>51</sup> *Id.* at 937-38; see also *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989).

<sup>52</sup> Some commentators would go even further, however, and impose "community values of fairness and decency." Mitchell, *supra* note 16, at 1225. The commercial law obligation of good faith preserves expectations, but in an objective context. See *supra* text accompanying notes 45-51.

<sup>53</sup> This aspect of good faith is conceptually related to the focus on inequality in fiduciary law, but without the element of trust or confidence. Nonetheless, it is part of the continuum by which the law regulates fairness in private relationships. See Schwarcz, *supra* note 9.

### 1. *Banks and Other Institutional Creditors*

The most obvious corporate debtor-creditor relationship arises out of bank financing. Typically, a bank, or sometimes a finance or insurance company,<sup>54</sup> agrees to make loans to a corporate debtor to fund its working capital or other business needs. These private lending relationships between financial institutions and corporations involve sophisticated parties on both sides, and therefore neither can be presumed to be a weaker party.

There remain, however, several classes of creditors that do merit further inquiry as to whether they are "weaker" parties: public bondholders, trade creditors, and tort and other involuntary creditors.

### 2. *Public Bondholders*

Public bondholders are investors that lend money by investing in long-term debt obligations (often called "bonds" or "debentures") issued by a corporation or other institutional debtor. There are three significant distinctions between public bondholders and the prior category of private institutional creditors. First, the public bondholders themselves rarely negotiate the covenants or other contractual terms of their loan agreement; this is typically done by investment bankers or similar persons who underwrite<sup>55</sup> the corporation's debt. The underwriter negotiates covenants that it believes will be necessary to sell the debt to investors.<sup>56</sup>

Some have argued that a corporation's board of directors should have a *fiduciary* obligation to public bondholders because the bondholders do not negotiate their own contract.<sup>57</sup> That, however, goes too far.<sup>58</sup> A fiduciary obligation only arises from a fidu-

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<sup>54</sup> A finance company is a financial institution that makes loans to companies in the ordinary course of its business but is not regulated as a bank or insurance company. Examples include General Electric Capital Corporation, CIT Corporation, Heller Financial Corporation, and Household Finance Corporation.

<sup>55</sup> Underwriting means either buying the debt for resale or agreeing, usually on a "best efforts" basis, to sell the debt to investors even though the underwriter itself does not necessarily buy it.

<sup>56</sup> See *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1509 (S.D.N.Y. 1989) ("Since the underwriters must sell or place the bonds, they necessarily negotiate in part with the interests of the buyers in mind."); Mitchell, *supra* note 16, at 1178-79.

<sup>57</sup> See, e.g., Mitchell, *supra* note 16, at 1178-79.

<sup>58</sup> Mitchell indeed goes much too far. He advocates that the remedy for violating his suggested fiduciary duty "would be to declare an immediate default on the bonds, by permitting the bondholders to demand repayment of principal and accrued interest, thus preserving for them the basic underlying right which distinguishes bondholders from stockholders." *Id.* at 1226. He believes that directors will weigh "the cost of a potential acceleration of the bonds" with "the benefits [to shareholders] to be derived from under-

ciary relationship, and this Article already has shown that a debtor-creditor relationship does not create a traditional fiduciary relationship.<sup>59</sup> Bondholders have no basis to trust or rely upon the corporate debtor, and the corporate debtor does not accept the bondholders' confidence. Rather, the underwriters negotiate the covenants in anticipation of selling the bonds to investors.<sup>60</sup> Bondholders are protected by the federal securities law disclosure requirements, which mandate prospectuses that accurately disclose all material risks.<sup>61</sup> The disclosure levels the playing field of information disparity.<sup>62</sup> If the covenants and other protections are insufficient, investors will not buy the bonds.<sup>63</sup> Nonetheless, in the

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taking the [proposed] transaction." *Id.* That, however, is extremely unlikely. Acceleration will cross-default to, and thereby allow acceleration of, all of the corporation's other debt, creating a liquidity crisis and most likely forcing the corporation into bankruptcy.

<sup>59</sup> Cf. the discussion in *supra* part I.C setting forth elements of a fiduciary relation.

<sup>60</sup> If a traditional fiduciary relation exists at all, it would appear to be more logically based on the relationship between the bondholders and the underwriters who negotiate the bond covenants, effectively on their own behalf. That, however, is an issue beyond the scope of this Article. See Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. REV. 931, 981 (1993):

Our findings are inconsistent with those commentators who claim that bondholders cannot obtain effective contractual protection. These commentators argue that, because bondholders do not negotiate the contractual terms of a bond, they need extra-contractual protection. We find, however, that bondholders did obtain substantial contractual protection in the wake of the RJR buyout.

<sup>61</sup> Sections 7 and 10 of the Securities Act of 1933 impose standards of disclosure and require the filing of a registration statement with the Securities and Exchange Commission in connection with any public offering of nonexempt securities. 15 U.S.C. §§ 77g, 77j (1994). The Securities Exchange Act of 1934 also imposes liability on the corporation for certain types of fraudulent statements or omissions. 15 U.S.C. §§ 78a-78j (1994).

<sup>62</sup> In the case of the sale of public bonds, the risks are disclosed. Compare this to the law that is developing to regulate the sale of derivatives. Buyers who are injured argue that sellers have not adequately disclosed the risks. In *Bankers Trust Int'l Plc v. PT Dharmala Sakti Sejahtera*, 1994 Folio Nos. 2168 and 1396 English High Ct. of Justice, Commercial Ct., Dec. 1, 1995, the court held that Bankers Trust did not violate a fiduciary duty under English law when it sold derivatives to the Indonesian financial services firm. Dharmala argued that Bankers had a duty of care to disclose "the risks and potential financial consequences to [Dharmala] of accepting them." Dominic Bencivenga, *Blueprint for Dealers: U.K. Derivatives Ruling Guide for U.S. Litigation*, N.Y. L.J., Dec. 14, 1995, at 5 (alteration in original). The court, influenced at least in part by contractual disclaimers that Dharmala could "judge the suitability of any advice given," *id.*, and that Bankers Trust was "not obligated to warn [Dharmala]," *id.* (alteration in original), of the risks involved, ruled that Dharmala "was basically making its own assessment of the suitability and risks of the transaction." *Id.*

<sup>63</sup> See, e.g., *Kessler v. General Cable Corp.*, 155 Cal. Rptr. 94, 103 (Ct. App. 1979) (no fiduciary rights existed as to bondholders because investors would shop in market offering debentures); see also *infra* text accompanying note 65 (arguing that bondholders expect risks and bargain for higher rates in return or choose to invest in other securities). *But cf.* Mitchell, *supra* note 16, at 1221 ("[G]iven my view of legal principles as expressing higher

author's experience, covenants in public bond loan agreements (usually called "indentures") are weaker than in a privately negotiated loan agreement.<sup>64</sup> That, however, is insufficient to impose a higher commercial law obligation of good faith, much less a fiduciary duty, on the corporate debtor; weaker covenants are compensated for by higher interest rates.<sup>65</sup>

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social goals . . . I reject the use of market forces, even if remedially effective, as an adequate means of addressing bondholders' problems."). Mitchell argues that protections afforded public bondholders by contract interpretation, even if providing some remediation, would be inadequate given his view that a fiduciary relationship exists. The author disagrees with Mitchell on this point.

<sup>64</sup> Although public bond indenture covenants are thought to be weaker because underwriters do not vigorously represent the bondholders' interests, the more likely reason they are weaker is that in public transactions the debtor cannot practically go back to the investors, who may be widely dispersed and whose identities may be hard to determine, for consents to amend or waive covenants. There is a premium that is paid for the covenants being more flexible. The debtor pays this premium in the interest rate on the bonds. Nonetheless, the rate sometimes may end up being lower than on private debt because investors are desirous of investing in public bonds, which are freely tradable. See Schwarcz, *supra* note 2, at 148.

<sup>65</sup> See, e.g., Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 Nw. U. L. REV. 565, 621 (1995) ("Though the direct evidence on pricing [of publicly issued bonds] is sparse, there do not appear to be substantial imperfections in the pricing of legal terms: the bulk of the relevant studies shows that legal terms are priced and that the market for newly issued bonds works well."). "While a valid argument can be made that a fiduciary duty to bondholders is desirable, there are also strong arguments that such a duty is not desirable. Thus, the case for fiduciary duties falls short of what would be required to justify their imposition as a *mandatory* term." *Id.* at 622. An article in *Business Week*, describing the uproar in the public bond markets from Marriott's corporate split and the resulting fall in bond value, is instructive:

No more Marriotts. That's the battle cry of disgruntled bondholders after the lodging company skewered them last fall with a proposal to split itself into a highly profitable hotel operator and a so-so hotel-property owner. . . . Marriott's stock price has surged 35%, while its bonds have dropped 30%.

[Institutional investors in public debt] are calling for tighter covenants in bond contracts to thwart recurrences. . . .

Not likely. Bondholders can—and will—fuss all they like. But the reality is, their options are limited: Higher returns or better protection. Most investors will continue to go for the gold. . . .

You can look it up. Four years ago, in the wake of the RJR Nabisco Inc. takeover, bondholders were shocked when the company's vast new debt drove its bonds into junk status, wiping out millions of dollars' worth of value. The bond buyers' response in 1989 was to insist on "event-risk" language for investment-grade debt issues: Covenants requiring companies to redeem bonds at face value if they get hit with a lower credit rating.

These hard-line covenants, also known as "poison puts," faded fast, though: The number of issues so protected, 40 in 1989, dropped to 6 last year. . . .

[Loose-covenant bonds may be] more attractive. Their greater risk means they pay higher yields—up to .06 points more than downgrade-protected debt instruments. . . .

And bond investors, compensated with richer yields, will have short memories. Caveat emptor.

The second distinction between public and private debt is that public debt is freely traded in the capital markets and, therefore, less likely to be held to maturity. To facilitate trading, bonds are typically rated by one or more nationally recognized securities rating agencies, such as Standard & Poor's and Moody's, when they are originally issued.<sup>66</sup> The market trading value of the bonds is therefore a function not only of the interest rate on the bonds but also of their rating. If a debtor's financial condition deteriorates, the rating on its bonds may be lowered, or "downgraded." A ratings downgrade will lower the market trading value of the bonds. However, the risk of a downgrade is disclosed in prospectuses pursuant to which bonds are publicly issued,<sup>67</sup> and bondholders cannot argue that they were unaware of the risk.

Is there, nonetheless, an obligation on the part of a debtor not to injure bondholders by acting in a way that would cause a ratings downgrade? Under the commercial law obligation of good faith, no such duty would exist unless the debtor's action constituted "opportunistic behavior . . . that could not have been contemplated in advance"<sup>68</sup> or that violated "widespread courses of dealing in [the debtor's] industry or . . . particular courses of dealing between"<sup>69</sup> the debtor and its creditors.<sup>70</sup> Whether a debtor's action would fall within one of these categories is a question of fact.<sup>71</sup>

The third distinction between public and private debt is that investors in public debt are often assumed to be the proverbial

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Larry Light, *Bondholder Beware: Value Subject to Change Without Notice*, BUS. WK., Mar. 29, 1993, at 34.

If investors want greater security, they can choose to invest in government securities. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 1989 COLUM. L. REV. 1416, 1430 (arguing that all corporate governance terms are priced adequately and accurately in the market, notwithstanding any lack of widespread knowledge, whether or not negotiated).

<sup>66</sup> The highest rating is AAA. Ratings as low as BBB are referred to as "investment grade," with ratings below that regarded as speculative.

<sup>67</sup> Disclosure of this risk is required under section 5 of the Securities Act of 1933, which mandates disclosure of all material risks. 15 U.S.C. § 77e (1994).

<sup>68</sup> Schwarcz, *supra* note 18, at 913 n.7.

<sup>69</sup> *Id.*

<sup>70</sup> See *id.*

<sup>71</sup> See *infra* part III for an application of this standard to representative corporate transactions such as corporate splits, securitizations, and leveraged transactions. The one court that has considered whether a debtor is obligated to public bondholders not to cause a ratings downgrade held it is not so obligated. In *Metropolitan Life*, the court ruled on the facts before it that insurance company investors in RJR Nabisco's public debt had no claim against the company resulting from its leveraged buyout that downgraded the public debt from investment grade to speculative ratings. *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1521-22 (S.D.N.Y. 1989).



“widows and orphans.”<sup>72</sup> In reality, however, public debt investors are often the same financial institutions that invest in private debt.<sup>73</sup> In addition, the face amount of a bond is rarely less than \$5,000, suggesting that even individual investors are somewhat sophisticated. The author is therefore reluctant to suggest that investors in public bonds should be categorically assumed to be “weaker” than the corporate debtor.

### 3. *Trade Creditors*

Trade creditors constitute the next class of creditors that merits further inquiry. They are persons that sell goods or provide services to the corporation, which in turn promises to pay them at a later date.<sup>74</sup>

Trade creditors enter into consensual, as opposed to involuntary, private relationships with corporate debtors, whether or not those relationships are evidenced by formal contracts. It is not compelling to argue that they are “weaker” than the corporate debtors with which they deal, as many trade creditors are themselves major corporations, such as IBM (supplying computers), or Xerox (selling or leasing photocopiers), or U.S. Steel (selling steel to be used in manufacturing a product). Furthermore, trade creditors have various ways to protect themselves at the initial transaction stage, such as shortening payment terms<sup>75</sup> or requiring contemporaneous or even prior payment.<sup>76</sup> Trade creditors seeking additional protection can even demand purchase money security interests to secure repayment.<sup>77</sup>

### 4. *Tort and Other Involuntary Creditors*

The last class of creditors that merits further inquiry is that of tort and other involuntary creditors. Tort creditors, for example, are persons with claims against the corporation arising out of wrongs that the corporation, intentionally or negligently, may have caused. Tort claims do not arise out of a contractual or even consensual relationship, and the creditors have no opportunity to negotiate (nor are they direct beneficiaries of) covenants. They therefore may well be weaker parties in the commercial law sense.

<sup>72</sup> See Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbb (1994).

<sup>73</sup> See *Metropolitan Life*, 716 F. Supp. at 1504.

<sup>74</sup> See U.C.C. § 9-106 (1994).

<sup>75</sup> An example of this is shortening the time for payment from the standard 60, 90, or 120 days to 30 days or less.

<sup>76</sup> These terms are referred to as “cash on delivery” (COD) and “cash before delivery” (CBD).

<sup>77</sup> See U.C.C. § 9-107 (1994).

Nevertheless, the sole hope of tort creditors is that the corporation will be solvent to repay them. Tort claims have no trading market, and often are prohibited by law from being sold.<sup>78</sup> Tort creditors, therefore, are already protected under fraudulent conveyance law,<sup>79</sup> which limits a debtor from conveying assets or incurring obligations without obtaining a reasonably equivalent value in return if the debtor is, or would thereby be rendered, insolvent.<sup>80</sup> To impose a greater obligation on solvent corporate debtors would restrict the corporation without necessarily benefiting the tort creditors.<sup>81</sup>

In summary, creditors are not *per se* "weaker parties" whom the law should specially protect,<sup>82</sup> for purposes of the commercial law obligation of good faith. Each creditor should therefore be owed only a limited obligation of good faith by a debtor, to prevent opportunistic behavior that could not have been contemplated in advance and to abide by rules of conduct that arise from widespread courses of industry dealing or particular courses of dealing between the parties. This limited obligation, which arises under commercial law, should be the same for a corporate debtor as for a non-corporate debtor.<sup>83</sup>

A non-corporate debtor's obligation to creditors can be summarized as follows:

1. The debtor is bound according to its explicit contractual obligations, including covenants.
2. The debtor also has an implied commercial law obligation of good faith to creditors.<sup>84</sup> That obligation, however, is limited, and does not embrace a broad notion of "fair deal-

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<sup>78</sup> See, e.g., N.Y. GEN. OBLIG. LAW § 13-101 (McKinney 1989); Clarence E. Hagglund & Britton D. Weimer, *Assignability of Tort and Breach of Contract Claims*, 39 FED'N OF INS. & CORP. COUNS. Q. 303 (1989).

<sup>79</sup> See *supra* discussions in part I.B.

<sup>80</sup> Insolvency goes beyond balance sheet insolvency. Schwarcz, *supra* note 18, at 729 n.3.

<sup>81</sup> *But cf. infra* note 137, explaining that this is somewhat of an oversimplification because increased leverage can make a corporate debtor more vulnerable to business reverses.

<sup>82</sup> One example of such a weaker party would be a consumer.

<sup>83</sup> Another source of law for a corporation's obligations to creditors is fraud. Absent fraudulent conveyance law, discussed *supra* part I.B, these laws, arising under state common law and federal and state securities laws, are limited in their application to conflicts between shareholders and creditors. The obvious example would be a corporation's issuance of debt securities without adequate disclosure of contemplated actions that would benefit shareholders but might materially adversely affect the securityholders. Some of the bondholders in the Marriott split litigation made that argument. However, a corporation can satisfy this obligation by proper disclosure.

<sup>84</sup> See *supra* part I.D.

ing.”<sup>85</sup> Commercial law does not create a traditional fiduciary relationship.

3. Fraudulent conveyance laws further restrict a debtor's ability to transfer an asset or to incur an obligation either when insolvent or when the transfer or incurrence would make it insolvent or with intent to hinder, delay or defraud creditors.

## II. DERIVING A UNIFIED THEORY FROM THESE SOURCES OF LAW

A debtor's obligation to creditors arises from various sources of law. This part attempts to derive a unified theory of a corporate debtor's obligation to creditors by examining the obligation of a non-corporate debtor, and then analyzing whether the result changes when the debtor is a corporation.

### A. *Solvent and Insolvent Corporations*

So long as a corporation is solvent, a corporate debtor should have no different obligations than a non-corporate debtor.<sup>86</sup> In general, directors of a solvent corporation owe fiduciary obligations solely to shareholders.<sup>87</sup> The commercial law obligation of

<sup>85</sup> See *supra* part I.D; see also Schwarcz, *supra* note 18, at 934, 959-62.

<sup>86</sup> This is true subject to the discussions of “vicinity of insolvency” and “contingent insolvency.”

<sup>87</sup> See *Pepper v. Litton*, 308 U.S. 295, 306 (1939). Directors are obligated to consider the “best interests” of the corporation—interests that have traditionally been synonymous with its shareholders' interests. Directors are not prevented from considering other interests so long as the shareholders' interests are not disserved. A.A. Sommer, Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33, 47 (1991). Codification of the directors' obligation has occurred in so-called “constituency statutes.” However, “constituency statutes are a redundancy,” *id.*, because they echo the directors' common law obligation to consider the best interests of the corporation. “[T]he typical statute . . . will have little or no effect on decisions courts would reach, absent statute.” Charles Hansen, *Other Constituency Statutes: A Search For Perspective*, 46 BUS. LAW. 1355, 1375 (1991). Some states have specifically passed constituency statutes that expand the directors' consideration beyond the shareholders to a discretionary consideration of the interests of creditors, employees, suppliers, and customers, and some to even include the community, state, region, nation, and society. See, e.g., FLA. STAT. ANN. § 607.0830(3) (West 1993); GA. CODE ANN. § 14-2-202(b)(5) (1994); HAW. REV. STAT. § 415-35(b) (1992 Supp.); ILL. ANN. STAT. ch. 32, para. 8.85 (Smith-Hurd Supp. 1992); ME. REV. STAT. ANN. tit. 13A, § 716 (West 1981); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West 1992); MINN. STAT. ANN. § 302A.251 (West 1985); MISS. CODE ANN. § 79-4-8.30(d) (Supp. 1988); N.J. STAT. ANN. § 14A:6-1(2) (West 1969); N.M. STAT. ANN. § 53-11-35(D) (Michie Supp. 1993); OHIO REV. CODE ANN. § 1701.59(E) (Baldwin 1995); WIS. STAT. ANN. § 180.0827 (West 1995). These statutes were passed in the late 1980s when corporate raiding was rampant. “[C]onstituency statutes are intended to emphasize the primacy of the interest of the corporate entity over the short-term interests of arbitrageurs and others interested in quick takeover profits.” Craig C. Albert, *The Lawyer-Director: An Oxymoron?*, 9 GEO. J. LEGAL ETHICS 413, 429 (1996). Several states specifically limited the directors' consideration of other constituencies to those situations when an acquisi-

good faith already provides a limited good faith duty of the debtor to creditors, and there is nothing about shareholder ownership that would expand that duty.<sup>88</sup>

However, where a corporation is insolvent, the model of a non-corporate debtor is inadequate because corporate ownership and creditors' rights converge in insolvency. This subpart will show that creditors then take on rights traditionally associated with ownership, and therefore, in that context, corporate directors owe a fiduciary duty to creditors as well as shareholders.

An owner of an asset generally has burdens and benefits associated with the asset.<sup>89</sup> Ownership, however, is sometimes a continuum in which the benefits and burdens can shift.<sup>90</sup> Similarly, a shareholder's burdens and benefits blend with those of a creditor when the corporation becomes insolvent. To understand why, it is first necessary to analyze how rights differ between shareholders and creditors of a solvent corporation.

Shareholders and creditors of a solvent corporation have very different rights. A shareholder has the right to all of the corporation's "equity" value once creditors are paid. A shareholder has no right to interest, but does have an expectation of dividends if the

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tion proposal is under review. ARIZ. REV. STAT. ANN. § 10-2702 (1996); IDAHO CODE §§ 30-1602, -1702 (1995); IOWA CODE ANN. § 491.101B (West 1991); LA. REV. STAT. ANN. § 12:92 G (West 1994); MO. ANN. STAT. § 351.347 (Vernon 1991). The Connecticut legislature imposed a mandatory obligation (as opposed to the discretionary obligation codified by the other states) on directors of public corporations to consider both long- and short-term interests of the shareholders as well as the employees, customers, creditors, suppliers, the community, and society, only when selling corporate assets, but even this statute has been repealed, effective January 1, 1997. 1994 CONN. LEGIS. SERV. P.A. 186 (S.H.B. 5712) (West); CONN. GEN. STAT. ANN. § 33-313 (West 1987). Only three states, Indiana, Iowa, and Pennsylvania, have granted non-shareholder constituencies the potential of equal weight with shareholders by stating that the "directors shall not be required . . . to regard any corporate interest . . . as a dominant or controlling interest or factor." 15 PA. CONS. STAT. ANN. § 515 (1995); see IND. CODE ANN. § 23-1-35-1(f) (Burns 1995); IOWA CODE ANN. § 491.101B (West 1991) (application limited to control share acquisition proposals and business combinations). Therefore, the impact of constituency statutes is doubtful. Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1511-12 n.87 (1993).

<sup>88</sup> Cf. Bratton, *supra* note 13, at 734 ("No change in financial fundamentals has altered the interests of stockholders and creditors of solvent corporations so as to change the relative weights of the interests thus balanced.").

<sup>89</sup> See generally Steven L. Schwarcz, *The Parts are Greater Than the Whole: How Securitization of Divisible Interests can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies*, 1993 COLUM. BUS. L. REV. 139; cf. Peter V. Pantaleo et al., *Rethinking the Sale of Financial Assets*, BUS. LAW. (forthcoming 1996) (on file with author).

<sup>90</sup> See *supra* note 89. Cf. U.C.C. §§ 2-401, 9-202 (1994). At least in commercial law, rights no longer depend on property law concepts of ownership.

corporation is profitable as well as a right to elect directors. A creditor, on the other hand, has a right to repayment that is senior to that of shareholders, and also a right to be paid interest, but no right to an upside.<sup>91</sup>

Insolvency, however, makes shareholder rights more like those of a creditor, and creditor rights more like traditional ownership. Shareholders of an insolvent corporation have no expectation of either dividends<sup>92</sup> or equity.<sup>93</sup> Other than the right to elect directors,<sup>94</sup> shareholders of an insolvent corporation are in no different position than if they were subordinated creditors where senior debt exceeded assets.<sup>95</sup>

Creditors of an insolvent corporation, however, not only have a senior right to repayment but they also now have the right, traditionally associated with ownership, to the "upside" in value of the corporate debtor's assets, at least until the corporation regains solvency.<sup>96</sup> This right is similar to a shareholder's right to the equity of a solvent corporation: in economic terms, the creditors have now become the primary residual claimants. Another way of thinking about this is that, absent insolvency, creditors can protect their rights by enforcing payment terms in their contract, whereas shareholders must rely on directors. But in insolvency, the value of the contractual payment terms becomes doubtful unless directors can increase the corporation's value.<sup>97</sup> The fiduciary obligation that di-

<sup>91</sup> See U.C.C. §§ 9-502(2), 9-504(2) (1994). For a comparison of debt and equity in the context of a privately-held corporation, see Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 *STAN. L. REV.* 271, 274-75 n.8 (1986).

<sup>92</sup> N.Y. BUS. CORP. LAW § 510(a) (McKinney 1983); DEL. CODE ANN. tit. 8, § 170(a) (1991).

<sup>93</sup> Insolvency means there is no equity because liabilities exceed assets.

<sup>94</sup> This is not a meaningful distinction between shareholders and creditors if the directors have fiduciary obligations to both while in insolvency.

<sup>95</sup> By way of comparison, creditors of an insolvent individual are subject to historically protected rights of the individual to achieve a fresh start. Even her existing assets cannot be taken completely away. 11 U.S.C. § 1322 (1994). See 11 U.S.C. § 726 (liquidation priorities); § 1129(b)(2) (cram down). See Schwarcz, *supra* note 27.

<sup>96</sup> Creditors of an insolvent corporation are entitled to any increase in the corporation's value until assets are sufficient to pay liabilities. Thereafter, shareholders would be entitled to any additional increase in value. Accordingly, the more insolvent the corporation, the greater the creditors' (and the more remote the shareholders') right to an upside. This is why this Article later proposes that "the more insolvent the corporation is or would become, the more the fiduciary obligation shifts from shareholders to creditors, *in a continuum*." See *infra* part II.C.4 (emphasis added). Accord Lin, *supra* note 87, at 1491-92 (observing that creditors of an insolvent corporation acquire the status of residual claimants with limited upside potential).

<sup>97</sup> Cf. Bratton, *supra* note 13, at 733 (footnotes omitted):

[S]o long as the corporate debtor remains able to repay the debt, creditors' interests have not been impaired sufficiently to justify legal restraints on the corporation's self-interested actions. A different judgment is made regarding

rectors previously owed only to shareholders as owners of the corporation<sup>98</sup> therefore should, in the case of an insolvent corporation, also extend to creditors, whose rights have been transformed by insolvency into equity-type rights.<sup>99</sup> Indeed, that is what the courts, at least in Delaware and certain other states, have held.<sup>100</sup> Furthermore, although this Article does not rely on the trust fund doctrine,<sup>101</sup> courts applying that doctrine have similarly held that directors of an insolvent corporation have a fiduciary obligation to creditors.<sup>102</sup>

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insolvent corporate debtors. Because insolvency jeopardizes repayment, the balance of interests shifts to favor the creditors, giving rise to consumer protection in law.

<sup>98</sup> See *supra* part I.C and text accompanying note 85.

<sup>99</sup> *Accord* *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784 (Del. Ch. 1992). *Cf.* *Norwood P. Beveridge, Jr., Does a Corporation's Board of Directors Owe a Fiduciary Duty to its Creditors?*, 25 ST. MARY'S L.J. 589, 593-95, 621 (1994) (citations omitted) (arguing that the "trust fund" doctrine—a doctrine "often . . . repudiated as a fiction unsound in principle and vexing in business practice," to the effect that corporate directors as agents of the corporation may be held liable "when they have participated in tortious acts of the corporation"—"does not support an implied fiduciary duty by corporate directors that runs directly to the creditors of a solvent or nearly insolvent corporation"). Because this Article does not rely on the trust fund doctrine, *Beveridge's* argument is not relevant to its conclusions.

<sup>100</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986); *Geyer*, 621 A.2d at 784 (holding that, under Delaware case law and the ordinary meaning of the word "insolvent," insolvency in fact is sufficient to invoke the insolvency exception which confers fiduciary duties on directors in respect to creditors); see also 1 JAMES D. COX ET AL., *CORPORATIONS* § 10.18 (1995) ("There is a developing body of law that suggests directors do owe a fiduciary duty to creditors when the corporation is insolvent or is approaching insolvency."); *Lin, supra* note 87, at 1512 ("There is, however, an important yet ill-defined exception to the legal primacy of shareholder interests. Several courts have held that once the corporation becomes insolvent, directors owe a fiduciary duty to creditors." (citing *In re STN Enters.*, 779 F.2d 901, 904 (2d Cir. 1985) (interpreting Vermont law); *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981) (interpreting New York law) (superseded by state statute); *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F.2d 973, 977 (4th Cir. 1982) (interpreting South Carolina law); *Brown v. Presbyterian Ministers Fund*, 484 F.2d 998, 1005 (3d Cir. 1973) (interpreting Pennsylvania law) (superseded by state statute); *Automatic Canteen Co. of Am. v. Wharton*, 358 F.2d 587, 590 (2d Cir. 1966) (interpreting Indiana law); *In re Xonics, Inc.*, 99 Bankr. 870, 872 (Bankr. N.D. Ill. 1989); *In re Holly Hill Medical Ctr., Inc.*, 53 Bankr. 412, 413-14 (Bankr. M.D. Fla. 1985); *In re IMI, Inc.*, 17 Bankr. 784, 786-87 (Bankr. E.D. Wis. 1982); *In re Roberts, Inc.*, 15 Bankr. 584, 586 (Bankr. D. R.I. 1981); *A.R. Teeters & Assoc., Inc. v. Eastman Kodak Co.*, 836 P.2d 1034, 1043 (Ariz. 1992); *Francis v. United Jersey Bank*, 432 A.2d 814, 824 (N.J. 1981); *Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974), *aff'd in part and rev'd in part on other grounds*, 347 A.2d 133 (Del. 1975); *Snyder Elec. Co. v. Fleming*, 305 N.W.2d 863, 869 (Minn. 1981); *Rosebud Corp. v. Boggio*, 561 P.2d 367, 372 (Colo. Ct. App. 1977); *Hixson v. Pride of Texas Distrib. Co., Inc.*, 683 S.W.2d 173, 176 (Tex. Ct. App. 1985)).

<sup>101</sup> See *supra* note 99.

<sup>102</sup> *HENN & ALEXANDER, supra* note 46, at 626; *cf.* *Lin, supra* note 87, at 1513 n.92: The courts have reasoned that, upon insolvency, the directors become "trustees" for the creditors and hold corporate assets as a "trust fund" for the benefit

### B. *Contingent Insolvency*

The foregoing analysis showed that directors of an insolvent corporation have a fiduciary obligation to creditors as well as to shareholders. The concept of insolvency, however, recently has been extended by at least one noted judge to corporations that are not technically insolvent but merely in the "vicinity of insolvency." The rationale is that shareholders of corporations near insolvency have nothing to lose and everything to gain by the corporation's engaging in risky ventures that might dramatically increase equity even if those ventures have a negative expected value.<sup>103</sup>

In the case of *Credit Lyonnais v. Pathe Communications*,<sup>104</sup> Chancellor William Allen, one of the nation's most respected judges on corporation law, ruled that directors of a Delaware corporation that is in the vicinity of insolvency have an obligation to creditors as well as shareholders. This Article will suggest a narrowing of Chancellor Allen's approach. It is first necessary, however, to understand *Credit Lyonnais*.

Pathe Communications Corp. (the "Parent Shareholder") owned almost all of the stock of MGM-Pathe Communications Co. (the "Subsidiary"). Credit Lyonnais Bank Nederland had made loans both to the Parent Shareholder and to the Subsidiary in connection with a leveraged buyout of the predecessor of the Subsidiary by Giancarlo Piretti and others.

of these investors. *See Sea Pines Co.*, 692 F.2d at 976-77; *Clarkson Co. Ltd.*, 660 F.2d at 512; *Automatic Canteen Co. [of Am.]*, 358 F.2d at 590; *New York Credit Men's Adjustment Bureau [v. Weiss]*, 110 N.E.2d [397,] 398 [(1953)]. Therefore, the directors of an insolvent corporation "occupy a fiduciary position towards the creditors, just as they do toward the corporation when it is solvent." *Automatic Canteen Co. [of Am.]*, 358 F.2d at 590.

*See also Jackson v. Ludeling*, 88 U.S. 616, 624 (1874) ("[T]hey had the custody and charge of . . . the corporation. And they held it in a very legitimate sense as trustees. Certainly they were the trustees of the stockholders, and also, to a considerable degree, of the bondholders, owners of the mortgage."). *Accord Bovay v. H.M. Byllesby & Co.*, 38 A.2d 808, 813 (Del. 1944) ("The fact which creates the trust is the insolvency, and when that fact is established, the trust arises, and the legality of the acts thereafter performed will be decided by very different principles than in the case of solvency."). *See also N.Y. Credit Men's Adjustment Bureau, Inc. v. Weiss*, 110 N.E.2d 397, 399 (1953): "[A] trust arises, whether or not equitable proceedings have been commenced, immediately upon insolvency of the corporation." McDonnell, *supra* note 6, at 192 (quoting Gregory Varallo & Jessee A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 *BUS. LAW.* 239, 247 (1992)). *See id.* at 186-87 (discussing the trust fund doctrine since its promulgation by Justice Story in *Wood v. Drummer*, 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944)).

<sup>103</sup> This dilemma would not arise for a non-corporate debtor because insolvency does not artificially cut off ownership value; corporate shareholders, in contrast, only can look to the value of the corporation's equity.

<sup>104</sup> *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. Civ. A. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

Unfortunately, only months after the leveraged buyout was consummated, trade creditors forced the Subsidiary into an involuntary bankruptcy case, although the Subsidiary had emerged from bankruptcy at the time of the action in controversy. By reason of defaults by the Parent Shareholder on its loans from Credit Lyonnais, which were secured by stock of the Subsidiary, Credit Lyonnais took over voting control of the Subsidiary's stock. Also, pursuant to a corporate governance agreement entered into by the parties and a related interim court order, the powers of the board of directors of the Subsidiary were exercised on a day-to-day basis by an executive committee consisting of directors who were not nominees of the Parent Shareholder.

The controversy arose when the executive committee voted against selling the Subsidiary's interest in a foreign movie distribution consortium. Giancarlo Paretti, on behalf of the Parent Shareholder, claimed that the executive committee's decision breached a fiduciary duty of the directors to the Parent Shareholder because the sale was supported by, and arguably would have benefited, the Parent Shareholder. The court ruled that the executive committee's decision was valid. Pointing out that the Subsidiary only recently emerged from bankruptcy and the directors still "labored in the shadow of that prospect,"<sup>105</sup> Chancellor Allen stated that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue [sic] risk bearers [i.e. the shareholders], but owes its duty to the corporate enterprise [including creditors]."<sup>106</sup> Chancellor Allen, in his widely cited footnote number 55, went on to attempt to clarify and quantify this duty.

Citing a hypothetical corporation whose sole asset is a judgment for \$51 million that is being appealed, and whose sole liability is \$12 million owed to bondholders, the judge considered a range of probable outcomes, including settlement of the lawsuit and continued litigation. In considering these outcomes, he noted that the value of the corporation, measured by the expected value of the judgment on appeal and discounted for the possibility that the judgment might be modified or reversed, was \$15.55 million. The

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<sup>105</sup> *Id.* at \*34.

<sup>106</sup> *Id.* Although Chancellor Allen's phrase "corporate enterprise" is broad, "context as well as prior usage suggest that the court intended the phrase to include only holders of debt and equity rather than more removed constituencies such as labor, environmental advocates, or the corporation's local community." Vladimir Jelisavcic, Comment, *A Safe Harbor to Define the Limits of Directors' Fiduciary Duty to Creditors in the "Vicinity of Insolvency"*: *Credit Lyonnais v. Pathe*, 18 J. CORP. L. 145, 152 (1992) (footnotes omitted).



judge concluded that the directors of the corporation owed a duty to the "community of interests that the corporation represents"<sup>107</sup> to accept the best settlement offer that would equal or exceed \$15.55 million (the enterprise value), and to reject any settlement offer below that amount. The heart of Chancellor Allen's argument was that a shareholder may well want to hold out for a higher settlement amount because a \$15.55 million settlement would pay only \$3.55 million (\$15.55 million minus \$12 million) to shareholders, whereas continued litigation might result in a much larger recovery for shareholders.

The *Credit Lyonnais* case raises three questions: (1) is the extension of a fiduciary duty to creditors justified absent actual insolvency; (2) if so, what does "vicinity of insolvency" mean; and (3) how would the case be applied beyond the pristine example given by Chancellor Allen? One would begin to answer the first question by observing that an insolvent debtor that is not a corporation owes no fiduciary<sup>108</sup> obligation to creditors. Therefore, the analysis shifts to examining how the result changes when the debtor is a corporation.

Shareholders of a solvent corporation, even one that is highly leveraged or has minimal net worth, still expect dividends and an equity upside, and creditors still expect payment of principal and interest but no upside. Shareholder and creditor rights merge to create a fiduciary obligation<sup>109</sup> to creditors only where the corporation becomes insolvent. This Article therefore proposes that a corporation has a fiduciary obligation to creditors only where it is actually insolvent or where its action would cause insolvency,<sup>110</sup> thereby causing shareholder and creditor rights to merge.

This analysis also answers the second question: What does "vicinity of insolvency" mean? It is not—or at least should not be—a vague conception of high leverage or minimal net worth. Directors who are expected to labor under a dual loyalty must be able to determine when that loyalty arises. Because a solvent corporation has a fiduciary duty to creditors only where its action would cause

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<sup>107</sup> *Credit Lyonnais*, 1991 WL 277613, at \*34 n.55.

<sup>108</sup> Creditors of an insolvent debtor may, however, have certain rights under fraudulent conveyance law. See *supra* part I.B. Those rights, however, exist to avoid transfers of assets and incurrences of debt, and do not arise out of a fiduciary relationship.

<sup>109</sup> See *infra* part II.C.

<sup>110</sup> Compare fraudulent conveyance law, discussed *supra* part I.B, which can be used to avoid certain asset transfers or obligations incurred by a debtor that is or would thereby become insolvent. Fraudulent conveyance law, however, does not create a fiduciary obligation to creditors.

insolvency,<sup>111</sup> the term vicinity of insolvency should, therefore, only mean those circumstances. It is not the corporation's closeness to insolvency that is relevant, but rather whether, under the circumstances, a corporation's contemplated action would cause<sup>112</sup> insolvency, meaning that insolvency is one of the reasonably expected outcomes.<sup>113</sup> Perhaps a better term for vicinity of insolvency therefore should be "contingent insolvency."<sup>114</sup>

The third question raised by *Credit Lyonnais* is how it would be applied beyond the pristine example given by Chancellor Allen. To apply Allen's test, directors would have to determine whether or not the proposed action would have a negative expected value to the enterprise. That, however, may be difficult to determine for an operating company. Also, to the extent that determination requires valuation, it would be costly. Furthermore, the results can vary dramatically, depending on the assumptions used, creating potential liability for directors.<sup>115</sup>

This Article, therefore, questions valuation or any other approach that tries to substitute formulas for basic business judgment. Rather, because contingent insolvency is significant only because it means that insolvency is a reasonable expectation, the

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<sup>111</sup> See *supra* part II.A.

<sup>112</sup> The standard of "would cause" is a judgment call, but the author suggests it should only include circumstances where insolvency is one of the reasonably expected outcomes. The business judgment rule would protect directors who, in good faith, determine that insolvency is not a reasonably expected outcome, even if insolvency actually results. See *infra* text accompanying notes 115-19.

<sup>113</sup> By insolvency, the author means that the corporation's liabilities exceed its assets. See *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 789 (Del. Ch. 1992) (holding that insolvency for purposes of the fiduciary duty to creditors occurs where the corporation "has liabilities in excess of a reasonable market value of assets held," thereby jeopardizing payment of debt). Compare Stephen H. Case, *Rights of Creditors to Sue Corporate Directors for Breach of Fiduciary Duty in America*, in ALI-ABA COURSE OF STUDY, FUNDAMENTALS OF CHAPTER 11 BUSINESS REORGANIZATIONS 311 (1994) (arguing that insolvency should be defined by a bankruptcy law standard) with Jelisavcic, *supra* note 106 (arguing in favor of Altman's "Z-score" model).

<sup>114</sup> A concept of "vicinity of insolvency" is *not* necessary to avoid the apparent discontinuity caused by extending fiduciary rights to creditors of an insolvent, but not a solvent, corporation. It is not as if a \$1 increase in a corporation's liabilities, making a borderline solvent corporation become insolvent, radically changes director obligations. This Article only proposes that directors of insolvent corporations have fiduciary obligations to creditors as well as to shareholders. The greater the insolvency, the more those obligations would shift from shareholders to creditors, in a continuum. See *infra* part III.D.

<sup>115</sup> Compare this with the valuation requirement under the cram down test used in confirming a bankruptcy plan of reorganization. 11 U.S.C. § 1129(b)(2) (1994). Parties often compromise their claims in order to reach a consensual plan and thereby avoid the time, expense, and possible litigation that valuation entails. See Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441 (1984); Peter V. Pantaleo, *Reorganization Value*, 51 BUS. LAW. 419 (1996).

duty of directors faced with a corporation's contingent insolvency should be similar to the duty of directors of an insolvent corporation.

It already has been shown that directors of an insolvent corporation have a fiduciary duty to creditors as well as shareholders.<sup>116</sup> Current law, however, does not provide any hard and fast rules upon which a director may rely in discharging this duty. Managing a corporation requires making judgment calls, and directors are protected from being second-guessed by the business judgment rule.<sup>117</sup> Although a complete discussion of dual loyalty is beyond the scope of this Article, the focus should be on the balance between protecting creditors and not discouraging a corporation's ability to innovate and take appropriate business risks.<sup>118</sup> A leading practitioner has summarized the issues as follows:

What about the duty of undivided loyalty? Does the conflict of interest between the shareholders and the creditors [of an insolvent corporation] present the director with inescapable exposure to personal liability? The answer is clearly "No". [sic] Several protective mechanisms can be put to work, in both the easier cases involving this problem and the more complex.<sup>119</sup>

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<sup>116</sup> See *supra* part II.A.

<sup>117</sup> See *supra* note 112. "If [the presence of a business decision, disinterestedness and independence, due care, good faith, and the absence of an abuse of discretion] are present—and they are presumed to be present—and the case does not involve fraud, illegality, ultra vires conduct or waste, then the court will not second guess the merits of the decision." DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE* 3 (4th ed. 1993). The rule has been stated as follows: "A board of directors enjoys a presumption of sound business judgment, and its decision will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment." *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971); see also *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985); *Aronsohn v. Lewis*, 473 A.2d 805 (Del. 1984).

<sup>118</sup> This balancing would help to resolve the dilemma of creditors and shareholders of an insolvent corporation, each seeking to seize assets to the detriment of the other. "Shareholders' and creditors' races to the [insolvent] firm's assets are detrimental to each others' interests. Both groups may accelerate the eventual demise of the corporation, not because of the corporation's declining financial health, but because of their opportunistic behavior." Lin, *supra* note 87, at 1494.

<sup>119</sup> Case, *supra* note 113, at 331. Case argues that, although there are no reported judicial precedents regarding this situation in the context of the director of [an] insolvent corporation . . . many precedents exist in the field of personal trusts, where it is well settled that the fiduciary faced with conflict of beneficiaries is protected from liability if he or she remains impartial and fairly resolves the dispute without abuse of discretion.

*Id.* Case also suggests that director conflicts between common and preferred shareholders may be a precedent for resolving conflicts between shareholders and creditors. The rationale for this is that claims of preferred shareholders have priority over common shareholders, just as claims of creditors have priority over shareholders generally. *Id.* at 326-27. Even if some directors, by reason of holding a material personal financial stake in the

To illustrate the difference between Chancellor Allen's enterprise value test and the balancing approach proposed in this Article, consider a "double-or-nothing gamble" by a corporation with assets of \$100, debt of \$90, and equity of \$10.<sup>120</sup> The corporation takes a risk that gives it a fifty percent chance of doubling its assets to \$200 and a fifty percent chance of losing all its assets. This gamble would appear to be acceptable under Chancellor Allen's test<sup>121</sup> because it does not change the corporation's value *ex ante*. The problem, however, is that it cuts the debt's value in half because the debt doesn't share in the upside, and creditors have a fifty percent chance of losing everything.

Even if one varies the numbers in the double-or-nothing gamble to make them more realistic, the problem remains. For example, a corporation considers taking an action that, if successful, will increase its enterprise value by fifty percent but, if unsuccessful, will reduce it by forty percent, causing insolvency. Assume equal chances of success and failure. *Ex ante*, this business gamble increases enterprise value, yet it exposes creditors to significant risk solely for the benefit of shareholders. Enterprise value by itself is, therefore, an inadequate test. It works only if directors can settle on a fixed amount, like the fixed settlement in Chancellor Allen's example. It does not work in the real world where directors decide on a course of action that itself may have inherent risk that creditors bear entirely.

Now analyze these gambles under the balancing approach suggested by this Article. Both gambles create a reasonable expectation of insolvency. The corporation's directors, therefore, would have a dual fiduciary obligation to creditors and shareholders, and would be obligated to act in good faith to try to balance the rights of those parties. Under that balancing, the double-or-nothing gamble would appear to go too far in favoring shareholders over creditors, and directors would presumably decide against it.

The second gamble, however, appears more difficult to analyze under the balancing test. If the balance were determined by a

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corporation's stock or debt (*see Cede & Co.*, 634 A.2d at 363-64), are personally conflicted and therefore cannot rely on the business judgment rule, Case proposes, and the author agrees, that a committee of disinterested directors could rely on the business judgment rule in approving the board's decision. Case, *supra* note 113, at 328.

<sup>120</sup> The "double-or-nothing gamble" was suggested by Professor Ronald Gilson of Columbia Law School.

<sup>121</sup> Of course, the gamble as stated is so blatant that it may violate the "smell test." The author also observes, in Chancellor Allen's favor, that footnote 55 in the *Credit Lyonnais* case may have implicitly assumed that creditors under any settlement would be paid in full.

simple arithmetic comparison of benefit to shareholders with harm to creditors, it would favor the shareholders. Yet that still allows creditors to be exposed to significant risk solely for the benefit of shareholders. The fallacy, of course, is that balancing benefit to shareholders with harm to creditors is like balancing “apples and oranges”—they are not comparable commodities.

There are at least two possible solutions. The first is to modify the balancing test to require more, such as a determination whether the gamble itself has a valid business purpose. Although this approach might eliminate gambles that are purely speculative, it would not resolve the underlying dilemma. One could additionally require that if there were a valid business purpose, the directors still would have to consider less harmful ways to accomplish the business objective. That inquiry, however, appears too open-ended and procedurally burdensome as a basis for directors to make decisions.<sup>122</sup>

A second possible solution, and the one adopted by this Article, is to more directly address the non-comparable nature of the commodities being balanced. In applying the balancing test, directors should have latitude to make their own good faith weighing of benefit and harm, recognizing that harm to creditors may well be more significant than benefit to shareholders.<sup>123</sup>

Some guidance can be gained by comparing the somewhat analogous dilemma that arises under “substantive consolidation” law in bankruptcy. Although the analogy is imprecise, it provides a

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<sup>122</sup> Cf. Mitchell, *supra* note 16, at 1210-28. In the context of arguing that a corporation has fiduciary obligations to public bondholders—a position this article does not adopt—Mitchell proposes a

test [that] would proceed through several stages of inquiry [in applying those obligations]. The first question, as to which the bondholders bear the burden of proof, is whether actions taken by the corporation are inconsistent with their reasonable expectations. Assuming that they sustain this burden, the next inquiry, as to which the burden of proof would be on the directors, would be whether the directors had a legitimate business purpose in causing the corporation to act as it did. If the directors demonstrate a legitimate business purpose, the bondholders would have the opportunity to demonstrate that other reasonable means of accomplishing that purpose were available to the board that would have been less harmful to the bondholders.

*Id.* at 1224. Although this test is thoughtful, it appears more suited as a litigation inquiry than as guidance by which directors can make decisions.

<sup>123</sup> Creditors have legally enforceable claims for payments. Shareholders have only expectations. The law generally favors existing rights over potential rights. By way of comparison, the Fifth Amendment “takings” jurisprudence does not recognize speculative property interests. See *Lucas v. South Carolina Coastal Council*, 112 S. Ct. 2886, 2894-95 nn.7-8 (1992); *Yee v. City of Escondido*, 112 S. Ct. 1522 (1992); *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1011 (1984); cf. *El Paso v. Simmons*, 379 U.S. 497 (1965) (denying land speculators the right to windfalls from state contracts).

useful perspective for gaining insight into the tension between balancing benefit to a corporate enterprise with harm to its creditors.<sup>124</sup> Substantive consolidation is an equitable remedy in bankruptcy law that

involves the pooling of the assets and liabilities of two or more related entities; the liabilities of the entities involved are then satisfied from the common pool of assets created by consolidation. . . .

Because the entities to be consolidated are likely to have different debt-to-asset ratios, consolidation "almost invariably redistributes wealth among the creditors of the various entities."<sup>125</sup>

Substantive consolidation applies a balancing test that also grapples with the dilemma of comparing apples and oranges: whether the "consolidation yields benefits offsetting the harm it inflicts on objecting parties."<sup>126</sup> To resolve this dilemma, "the court may order consolidation only if it determines that the demonstrated benefits of consolidation 'heavily' outweigh the harm."<sup>127</sup>

This Article does not necessarily propose that substantive consolidation's "heavily outweigh" test is the appropriate standard for corporate directors to use in balancing benefit to shareholders with harm to creditors. However, that test suggests that where non-

<sup>124</sup> Although an analogy cannot substitute for analysis, it nonetheless can provide "a point of view from which to look and compare, a starting-point for genuine investigation." ISAIAH BERLIN, *THE HEDGEHOG AND THE FOX: AN ESSAY ON TOLSTOY'S VIEW OF HISTORY* 4 (Elephant Paperback 1993) (1953). Cf. RICHARD A. POSNER, *OVERCOMING LAW* (1995). "[Although] analogy gets us only to the threshold of analysis," *id.* at 521, "[m]etaphor plays a useful cognitive role in jolting a person out of his existing frame of reference by getting him to look at something in a fresh, and perhaps more illuminating, way," *id.* at 523; see also Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 *DUKE L.J.* 879, 890 ("Metaphor, when effectively used, is a powerful rhetorical device because it engages the reader's attention and imagination in ways that more literal uses of language do not.")

<sup>125</sup> *Eastgroup Properties v. Southern Motel Assoc., Ltd.*, 935 F.2d 245, 248 (11th Cir. 1991) (citation omitted); see also Steven L. Schwarcz & Alan E. Rothman, *Civil Forfeiture: A Higher Form of Commercial Law?*, 62 *FORD. L. REV.* 287, 309-13 (1993) (discussing how insolvency resulting from substantive consolidation can harm creditors).

<sup>126</sup> *In re Auto-Train Corp., Inc.*, 810 F.2d 270, 276 (D.C. Cir. 1987). Accord *Eastgroup Properties*, 935 F.2d at 249. Its non-comparable commodities include the benefit to creditors of an insolvent company seeking consolidation, *id.* at 251, and the benefit of "avoid[ing] the expense or difficulty of sorting out the debtor's records to determine the separate assets and liabilities of each affiliated entity," *Auto-Train Corp., Inc.*, 810 F.2d at 276, as compared to "the harm it inflicts on objecting creditors," *id.*

<sup>127</sup> *Auto-Train Corp., Inc.*, 810 F.2d at 276. Accord *Eastgroup Properties*, 935 F.2d at 249. Compare these cases with the more stringent test of *In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515 (2d Cir. 1988) (denying consolidation where one creditor would suffer unfairly).

comparable commodities of benefit and harm to different parties are being weighed, the benefit may have to considerably outweigh the harm, or at least provide a compelling case, to be justified. This Article opens a dialogue on what the appropriate standard should be.<sup>128</sup>

How, then, would the balancing test apply to the second gamble—the action that, if successful, would increase enterprise value by fifty percent but, if unsuccessful, would reduce it by forty percent, causing insolvency, with equal chances of success and failure.<sup>129</sup> In considering this gamble, directors may well conclude that the benefit to shareholders does not sufficiently outweigh the risk to creditors. The actual determination will depend on the particular facts<sup>130</sup> as well as the standard ultimately adopted for the balancing. The point, however, is that, unlike Chancellor Allen's enterprise value test under which this gamble would be acceptable, it is by no means obvious that the gamble is compelling, and therefore acceptable, under the balancing test.

This Article, therefore, suggests an approach to the vicinity of insolvency conundrum that sets a brighter line than Chancellor Allen's approach to determine when directors have loyalty to creditors as well as shareholders, but gives more leeway and discretion to directors when that dual loyalty arises. Part III shows that this approach can be applied without limiting a corporation's ability to take normal business risks.

### C. *Unified Theory*

The following unified theory of a corporation's obligations to creditors therefore derives from part II:

1. A corporate debtor is bound according to its explicit contractual obligations, including covenants.
2. A corporate debtor also has a commercial law obligation of good faith to not act opportunistically in circumstances that could not have been contemplated in advance, and to abide by implicit rules of conduct that arise from widespread courses of dealing in its industry or from particular courses of dealing between the corporation and its creditors.

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<sup>128</sup> Other possible standards might be that benefits "manifestly" or "demonstrably" outweigh the harm, or merely that the balance presents a compelling case.

<sup>129</sup> See *supra* text accompanying note 121.

<sup>130</sup> For example, if there is only a single class of debt, the terms of the debt might indicate how much risk the creditors intended to assume. Holders of junk bonds bearing high interest rates would have bargained for a high level of risk. In practice, however, it may be difficult to assess creditor risk because most corporations have multiple classes of debt with different rates and terms, as well as trade and involuntary debt.

3. Fraudulent conveyance laws further restrict a debtor's ability to transfer an asset or to incur an obligation when insolvent, or if the transfer or incurrence would make it insolvent, or if the transfer is made with intent to hinder, delay, or defraud its creditors.

4. Directors of an insolvent corporation, or of a corporation whose actions have a reasonable expectation of resulting in insolvency, have a fiduciary obligation to creditors as well as shareholders. Directors then must scrutinize actions that increase shareholder return by impairing creditor claims. The more insolvent the corporation is or would become, the more the fiduciary obligation shifts from shareholders to creditors, in a continuum. In balancing this fiduciary obligation, directors should have latitude to make their own good faith balancing of benefit and harm, recognizing that harm to creditors may well be more significant than benefit to shareholders; and therefore the benefit might have to considerably outweigh the harm, or at least provide a compelling case, to be justified. Nonetheless, directors would not need to assess intrinsic fairness. Further, the business judgment rule would protect directors from being second-guessed if they consider their dual fiduciary obligation in good faith.

The application of this unified theory to actual corporate transactions is discussed in part III of this Article.

### III. APPLICATIONS

In this section, the unified theory will be applied to representative corporate transactions that enhance shareholder value but thereby increase the riskiness of the corporation's debt.

#### A. *Corporate "Splits"*

In these transactions, a corporation whose business consists, for example, of profitable and unprofitable product lines restructures by transferring the assets associated with the profitable product line to a newly created affiliated corporation ("Newco"). Newco is owned by the same shareholders who own the original corporation ("Oldco"), now shorn of the assets transferred to Newco.<sup>131</sup> The goal of this restructuring, or "corporate split," is to create two corporations, with the original corporation, Oldco, holding the unprofitable product line, and the new corporation, Newco, holding the profitable product line, in anticipation that the com-

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<sup>131</sup> This is normally accomplished by a stock split or dividend in which shareholders of Oldco receive shares of Newco in an amount proportional to their holdings of Oldco stock.



bined stock price of these corporations will exceed the stock price of the original corporation. The stock market appears to recognize this price increase,<sup>132</sup> and therefore this Article assumes that it can exist.

Corporate splits benefit shareholders, but can prejudice creditors. The original corporation had assets of both product lines to offset its debt. Newco now has assets of the profitable product line but none of the debt. The debt remains with Oldco, which now only owns assets of the unprofitable product line. Should a corporation be permitted to engage in a corporate split to benefit its shareholders, even though it is detrimental to its creditors?

Assume there are no contractual covenants prohibiting the split. Also assume that the corporate split does not leave Oldco insolvent, and is not intended to hinder, delay, or defraud its creditors. If it did, the transfer of assets to Newco would be a fraudulent conveyance, and therefore voidable under both federal and state fraudulent transfer law.<sup>133</sup>

Even if Oldco is not left insolvent, certain of its creditors may be prejudiced by the reduction in market value of debt securities resulting from Oldco's diminished financial condition. However, only creditors who customarily trade their claims are likely to be so prejudiced, and these creditors are consensual and not involuntary.<sup>134</sup> Private lenders, such as banks and insurance companies, and investors in public bonds, choose to make their investments knowing the risks and benefits and accepting higher interest rates in return.<sup>135</sup> Non-consensual or involuntary creditors, such as tort creditors, do not trade their claims because there is no market for, or even custom of, trading involuntary claims. Indeed, it is often

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<sup>132</sup> See *Hungry Shareholders vs. Wary Managers*, N.Y. TIMES, Nov. 4, 1995, at 1 (Bus. Sec.). This price increase appears to reflect, from the standpoint of shareholders, a higher-valued allocation of risk with assets. However, the shareholders gain at least partly at the expense of creditors whose risk is increased, thereby creating the tension.

<sup>133</sup> 11 U.S.C. § 548 (1994); U.F.T.A. § 7(a)(1), 7A U.L.A. 660 (1985). As discussed *supra* in part I.B, fraudulent transfer law prevents a debtor's transfer of assets for less than reasonably equivalent value that leaves the debtor actually or constructively unable to pay its creditors. In a corporate split, one would not even need to get to the question of corporate duty during actual or contingent insolvency.

<sup>134</sup> In a debtor's bankruptcy, all of its claims can be traded. See Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990). But we are assuming that the corporate split does not result in insolvency, much less bankruptcy.

<sup>135</sup> Trade creditors are consensual and also know the risks. However, because their claims are not usually traded, they are not generally prejudiced.

illegal to trade such claims.<sup>136</sup> Therefore, the diminished financial condition of the corporate debtor does not necessarily prejudice involuntary creditors so long as the debtor remains solvent.<sup>137</sup> Furthermore, fraudulent conveyance law, as well as the dual fiduciary duty of directors in a contingent insolvency, limit corporate splits that render the debtor insolvent.

Consensual creditors that wish to restrict corporate splits can negotiate covenants, such as simple net worth tests or covenants prohibiting the corporation from transferring a substantial part of its assets. These covenants are common, in the author's experience, in bank and insurance company loan agreements. They are uncommon, however, in public bond indentures,<sup>138</sup> and trade creditors do not generally impose covenants.<sup>139</sup> The rationale for this distinction is simple. Banks and insurance companies (collectively, "institutional lenders") closely examine the credit of a corporate borrower before making a loan. They therefore require tight covenants to ensure that the borrower's financial condition does not deteriorate during the term of the loan, and also require remedies, such as the right to accelerate the debt, if the condition, as measured by the negotiated covenants, does deteriorate. The corporation, for its part, may be prepared to agree to restrictive covenants

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<sup>136</sup> In New York and many other states, it is often illegal to sell tort claims. *See, e.g.*, N.Y. GEN. OBLIG. LAW. § 13-101 (McKinney 1989) (restricting sale of personal injury tort claims).

<sup>137</sup> This is, of course, somewhat of a simplification. A creditor of a highly solvent corporation is generally more likely than a creditor of a less solvent corporation to be repaid on its debt at a future date. That is because the more highly solvent company can suffer more losses and still be able to pay its debts. Indeed, it is rating agency and investor recognition of this fact that leads to a downgrade in rating and a reduction in market value from a corporate split. Nonetheless, creditors holding debt that has no expectation of being traded do not suffer any loss if their debt is eventually repaid according to its terms. To limit corporate risk taking in order to assure a creditor's eventual likelihood of repayment, where the debtor is solvent and, therefore, presently capable of repaying its debts, would appear to be unwise.

<sup>138</sup> Public bond indentures almost never contain net worth covenants, and usually only include restrictions on the transfer of "all or substantially all" of the corporation's assets. However, in the author's experience, many of the riskier unrated "junk bonds" underwritten by Drexel Burnham Lambert contained net worth covenants that triggered a corporate buy-back instead of an event of default. Unrated bonds issued in today's "high yield" markets also contain protective covenants. That suggests that protective covenants indeed may be necessary to induce investors to buy bonds of riskier corporations, and in that case the market will find creative solutions.

<sup>139</sup> Trade creditors do not impose covenants because they have no ability to monitor the covenants. A trade creditor that is concerned about repayment will typically sell its goods on a purchase money secured basis or on a C.O.D. (cash on delivery) or C.B.D. (cash before delivery) basis. Involuntary creditors cannot impose covenants. This Article has already shown that trade and involuntary creditors are owed no special obligation by a corporation so long as it remains solvent. *See also supra* part I.D.

if it cannot obtain a better deal elsewhere. It expects, however, that the institutional lenders will consider waiving or amending the covenant, sometimes for an increase in the lending rate, if the corporation later makes such a request based on its business needs.<sup>140</sup>

This type of bargain is more difficult to make with public bondholders. Because the bonds can be freely traded, the identity of the actual bondholders is sometimes difficult to establish on a current basis. Even if bondholder identities could be determined, the possibility of widespread ownership of the bonds may, as a practical matter, make waivers and amendments harder to obtain.<sup>141</sup> Furthermore, a corporation soliciting waivers or amendments from public bondholders would have to comply with the federal securities law disclosure requirements,<sup>142</sup> which can be expensive and time consuming. Corporations therefore often prefer, and are willing to pay a higher rate of interest,<sup>143</sup> to issue public debt with covenants that give some protection to bondholders but still are flexible enough to allow the corporation to engage in any business activity that may become desirable in the future.

The experience of public bond covenants after the Marriott Split is particularly revealing. Investors in public bond issues became sensitized to the so-called "event risk" of a corporate split, and many indentures entered into shortly thereafter contained covenants restricting such splits.<sup>144</sup> Soon, however, investors preferred the higher rate offered by corporations in lieu of these covenants,<sup>145</sup> and, in the author's experience, these covenants are now rarely seen in public debt indentures.

Public bondholders would not, merely by reason of their status as public investors, obtain additional rights under the commercial law duty of good faith. This Article has argued that whether or not public bondholders have equal bargaining power with the corporate debtor—which they do not<sup>146</sup>—they are not so clearly weaker that commercial law should favor them.<sup>147</sup> Public bondholders can

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<sup>140</sup> It is ironic that this same scenario occurred in *Metropolitan Life*.

<sup>141</sup> Although bondholders can be widely distributed, large concentrations of bonds are sometimes held by institutional investors, thereby making waivers and amendments easier to obtain.

<sup>142</sup> See 15 U.S.C. §§ 77aaa-77bbbb (1994).

<sup>143</sup> See *supra* note 65.

<sup>144</sup> See *supra* note 65.

<sup>145</sup> See *supra* note 65.

<sup>146</sup> Nonetheless, a bondholder has a form of bargaining power in deciding whether or not to make the initial purchase of bonds. Anticipating that decision, investment bankers negotiate terms that are expected to be sufficient to entice investors to buy the bonds.

<sup>147</sup> See *supra* part I.D.

choose whether to invest. As the Marriott lesson showed, they weigh risk with rate of return in making their investment decisions.

The foregoing discussion assumed a market and investors who are aware of the possibility of a corporate split. Would the analysis change for the first corporate split, before which the market would not reasonably expect such an action? This is a harder question because it would require factual determinations under the commercial law duty of good faith. The inquiry would focus on whether the corporate split constituted opportunistic behavior that could not have been contemplated in advance, or whether it violated implicit rules of conduct arising from a widespread course of dealing in the industry. Consider this in the context of Marriott.

Because Marriott was the first corporate split, one might argue that its public bondholders could not have contemplated that action in advance when weighing risk with rate of return in making their investment decision. One also might argue that the widespread course of dealing of corporations issuing public debt in the capital market is to transfer assets to affiliated companies only for return consideration. A counter-argument, however, might be that the corporate split is not really a transfer to an independent third party but, effectively, a transfer to shareholders. Therefore, it is no different from a creditor's standpoint than an ordinary dividend of the assets to shareholders, an event that can be limited by a net worth covenant. Which of these arguments would have succeeded in the Marriott corporate split, or in other innovative corporate actions not yet contemplated, is a question of fact.<sup>148</sup> The essential point, however, is that the actions would be subject to scrutiny under the commercial law duty of good faith, without the need<sup>149</sup> to impose a traditional fiduciary standard.

### B. *Securitizations*

In a securitization, a company (the "originator") can obtain low cost, capital market financing by transferring its accounts receivable or other rights to payment ("receivables")

to a newly formed special purpose corporation, trust, or other legally separate entity [the "SPV"]. The transfer is intended to

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<sup>148</sup> This Article does not purport to assess how prevalent in the marketplace an action must be to change universal expectations, and whether it would make a difference if the Marriott corporate split had been enjoined so as to cast doubt on the future use of that technique.

<sup>149</sup> Absent insolvency or contingent insolvency; *see supra* parts II.A-B.

separate the receivables from risks associated with the originator. . . .

To raise funds to purchase these receivables, the SPV issues securities in the capital markets. The SPV, however, must be structured as "bankruptcy remote" to gain acceptance as an issuer of capital market securities.

To achieve bankruptcy remoteness, . . . an SPV that is owned or controlled by the originator is usually required to have one or more independent directors.<sup>150</sup>

The independent director requirement is intended to reduce the chance that the SPV would file a voluntary bankruptcy petition where the originator is bankrupt.<sup>151</sup> "Such an independent director theoretically would be less influenced by the originator and more likely to consider his or her fiduciary obligations when required to vote for or against the SPV's bankruptcy."<sup>152</sup> The dilemma, of course, is that if the SPV's directors have a fiduciary duty only to shareholders, then the directors, including the independent directors, may well be obligated to cause the SPV to file a voluntary bankruptcy petition in order to compromise the debt securities and thereby maximize value to the originator-shareholder.

The unified theory presented by this Article offers some help to resolve this dilemma. Although one could not contractually restrict the SPV from filing a voluntary bankruptcy petition,<sup>153</sup> and fraudulent conveyance law would not apply because filing for bankruptcy is neither an asset transfer nor incurrence of an obligation,<sup>154</sup> the obligations arising under commercial law and contingent insolvency provide some guidance.

Under the commercial law duty of good faith, the SPV would have an obligation to abide by implicit rules of conduct that arise from particular courses of dealing between the corporation and its creditors. In a securitization, the originator creates the SPV on the premise, and discloses to the SPV's creditors to induce them to buy the SPV's debt securities, that the SPV will be bankruptcy remote and that the originator will take no steps to cause the SPV to file for bankruptcy based on the originator's financial condition. Cred-

<sup>150</sup> Schwarcz, *supra* note 2, at 135-36.

<sup>151</sup> A debtor may file for voluntary bankruptcy generally at its discretion. 11 U.S.C. § 301 (1994). A corporate SPV "normally would make this decision by a vote of its board of directors." SCHWARCZ, *supra* note 4, at 16.

<sup>152</sup> SCHWARCZ, *supra* note 4, at 17.

<sup>153</sup> Such a restriction could be void. *See supra* note 4.

<sup>154</sup> Because federal fraudulent conveyance law arises under federal bankruptcy law, it would also be circular to use fraudulent conveyance law to prohibit a bankruptcy filing. Furthermore, state fraudulent conveyance law could not preempt a federal bankruptcy filing.

itors invest based on the explicit understanding of bankruptcy remoteness between the SPV and the originator. They therefore might argue that the commercial law duty of good faith requires the SPV to abide by this course of dealing, so long as doing so would not injure third parties. There is, nonetheless, an issue of first impression whether the bankruptcy policy against restricting voluntary petitions would limit the duty of good faith.<sup>155</sup>

The obligation arising from contingent insolvency may provide additional guidance. The SPV is a corporation whose proposed action, filing a voluntary bankruptcy petition, could cause insolvency.<sup>156</sup> Directors of the SPV therefore should consider creditors as well as shareholders when deciding whether the SPV should file for voluntary bankruptcy.<sup>157</sup> The SPV's bankruptcy would significantly impair its creditors by suspending their right to payment and possibly compromising their claims. On the other hand, the originator as shareholder would still have its bargained-for equity in a non-bankrupt SPV.<sup>158</sup> Because the benefit to shareholders does not appear to outweigh the harm to creditors, directors are likely to vote against a bankruptcy filing.<sup>159</sup>

The unified theory therefore helps to explain an SPV's bankruptcy remoteness in securitization transactions.

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<sup>155</sup> A complete analysis of the bankruptcy policy against restricting voluntary petitions is beyond the scope of this Article. The author notes, however, that bankruptcy courts have recognized bad faith as a basis to dismiss a voluntary bankruptcy petition. See *In re Campbell*, 124 B.R. 462, 464 (Bankr. W.D. Pa. 1991). Bad faith means that the debtor has no need for financial reorganization and has filed the petition solely to frustrate particular creditors. *In re Reiser Ford, Inc.*, 128 B.R. 234, 237-38 (Bankr. E.D. Mo. 1991); *In re Southern Cal. Sound Sys., Inc.*, 69 B.R. 893, 899-900 (Bankr. S.D. Cal. 1987). The author assumes that the SPV involved in the securitization is solvent and not in need of financial reorganization, and that the only reason for its filing bankruptcy would be to compromise the claims of its creditors for the benefit of the originator.

<sup>156</sup> See *supra* discussion of insolvency in notes 21 and 113. At least under Delaware corporation law, "insolvency means insolvency in fact rather than insolvency due to a statutory filing in defining [when] a fiduciary duty to creditors arises." *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992). Nonetheless, "insolvency in fact" includes a Delaware corporation being "unable to pay its debts as they fall due in the usual course of business." *Id.* at 789. This definition would arguably include a federal bankruptcy filing because the automatic stay suspends payment of any debts. 11 U.S.C. § 362 (1994).

<sup>157</sup> This would not appear to violate bankruptcy policy. Directors are not restricted from filing a voluntary petition, but are merely obligated to consider their fiduciary duty to creditors as well as shareholders in making their decision.

<sup>158</sup> This assumes that the SPV is realizing the value of its assets in the ordinary course of its business, and a filing is not needed to avoid an asset foreclosure or otherwise protect the SPV's equity.

<sup>159</sup> Although directors would also be protected by the business judgment rule if they decide in good faith to vote for bankruptcy.

C. *Leveraged Buyouts*

In a leveraged buyout (“LBO”), a management group takes control of a public corporation by causing the company to borrow money and to use the proceeds to buy back its own outstanding shares of stock.<sup>160</sup> Shareholders benefit because they are bought out at a premium. The corporation’s creditors, however, are prejudiced because the funds borrowed by the corporation to accomplish the LBO adds to the corporation’s overall debt burden without increasing its assets: “RJR Nabisco’s actions [engaging in an LBO] have drastically impaired the value of the bonds previously issued to plaintiffs by, in effect, misappropriating the value of those bonds to help finance the LBO and to distribute an enormous windfall to the company’s shareholders.”<sup>161</sup> Does an LBO violate a corporation’s obligations to its creditors assuming that contractual covenants are not breached?

In analyzing that question, we can assume that the LBO neither leaves the corporation insolvent nor is intended to hinder, delay, or defraud its creditors. This assumption is justified because LBO lenders, to limit the risk of fraudulent conveyance, customarily require opinions from independent valuation experts<sup>162</sup> demonstrating that the corporation will be “solvent.”<sup>163</sup>

As with corporate splits, only creditors who customarily trade their claims—meaning only consensual and not involuntary creditors<sup>164</sup>—are likely to be prejudiced by an LBO if the corporation remains solvent.<sup>165</sup> However, consensual creditors chose to make their investment knowing the risks and benefitting from higher interest rates in return.<sup>166</sup> They could have insisted on covenants that would prohibit an LBO—such as a net worth or leverage test. This Article has shown, however, that “most investors will continue to go for the gold.”<sup>167</sup> Furthermore, the experience of public bond

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<sup>160</sup> See David G. Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73 (1985). More recently, management groups are assisted in the LBO by financial sponsors such as Kohlberg Kravis Roberts & Co. (KKR).

<sup>161</sup> *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1506 (S.D.N.Y. 1989).

<sup>162</sup> One such expert is the firm of Houlihan Lokey Howard & Zukin Inc.

<sup>163</sup> This means that its assets will exceed its liabilities, it will be able to pay its debts as they mature, and it will have an adequate capital for its business after giving effect to the LBO.

<sup>164</sup> See *supra* text accompanying notes 134-37.

<sup>165</sup> As discussed in note 137, *supra*, this is somewhat of a simplification.

<sup>166</sup> See *supra* text accompanying note 135.

<sup>167</sup> See Light, *supra* note 65, at 34.

covenants after the Marriott Split<sup>168</sup> appears equally applicable to LBO bond covenants.<sup>169</sup>

The *Metropolitan Life v. RJR Nabisco* case is particularly telling. Metropolitan Life originally held bonds that benefitted from indenture covenants limiting an LBO.<sup>170</sup> It chose, however, to waive those covenants in return for better terms and an increased interest rate on the bonds.<sup>171</sup> Only in retrospect, when RJR Nabisco became the subject of an LBO, did Metropolitan Life complain about its choice.

The unified theory of this Article therefore would not restrict a corporation's decision to engage in an LBO.

#### D. *Risky Business Ventures*

Corporations, as businesses, must take risks in order to prosper. Sometimes these risks are significant, such as a corporation entering into a new and untested product line which, if successful, will be highly profitable but, if unsuccessful, could bankrupt the company. These types of ventures can be like the double or nothing gamble, discussed in part II.B, although they are usually not nearly as blatant.

Risky business ventures therefore raise hard policy choices: Should risk taking be encouraged where the success rate is low and the venture is financed by creditors? Ventures that are unlikely<sup>172</sup> to cause a solvent corporation to become insolvent raise no fiduciary obligation to creditors.<sup>173</sup> However, ventures that are likely, or reasonably expected, to cause insolvency, or that are engaged in by an insolvent corporation, raise the dual fiduciary obligation of directors discussed earlier.<sup>174</sup> Directors would then have to balance the benefit to shareholders with the harm to creditors, and would be protected by the business judgment rule if they act in good faith.

This Article has shown that the more insolvent the corporation is or would become, the more the fiduciary obligation shifts from shareholders to creditors, in a continuum. In the context of a risky business venture, this means that directors should give

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<sup>168</sup> See *supra* text accompanying note 144.

<sup>169</sup> See Kahan, *supra* note 65, at 621-22.

<sup>170</sup> *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1511 (S.D.N.Y. 1986).

<sup>171</sup> *Id.*

<sup>172</sup> Meaning that the venture is not reasonably expected to cause insolvency. See *supra* note 114.

<sup>173</sup> Assuming they are not prohibited by contractual covenant.

<sup>174</sup> See *supra* part II.B.



greater scrutiny, from the standpoint of creditors, to ventures that, if unsuccessful, would significantly impair repayment of the debt as opposed to those where the insolvency, if it occurred, would not significantly impair repayment.<sup>175</sup> The author does not, however, suggest that this shift can be quantified; directors should have latitude to make their own good faith weighing of shareholder benefit and creditor harm. For example, creditors should scrutinize ventures such as the double-or-nothing gamble which, if unsuccessful, would wipe out creditors. But ventures that, if unsuccessful, would make the corporation insolvent by only \$1 would merit little scrutiny.

This can be further illustrated by recalling the hypothetical described by Chancellor Allen in his footnote 55 to the *Credit Lyonnais* case. He posits a corporation whose sole asset is a judgment on appeal having a 25% chance of affirmance, a 5% chance of reversal, and a 70% chance of modification to a lesser amount. Either reversal or modification would leave the corporation insolvent. Because the 75% combined chance of reversal or modification makes insolvency a reasonable expectation, the corporation's directors would have a fiduciary obligation to creditors as well as shareholders.<sup>176</sup>

How, then, would a director fulfill his or her dual fiduciary obligation? Reversal of the judgment, under Chancellor Allen's hypothetical, would completely wipe out the corporation's \$12 million in bondholder claims. Modification would result in only a \$4 million recovery for payment of those claims, still creating a significant insolvency. Therefore, a director's duty to creditors should be at the high end of the continuum.

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<sup>175</sup> Directors should weigh the probability of the venture failing with the consequences of failure. For example, greater scrutiny should be given to a venture that has a 60% chance of failing than one that has a 40% chance if both have the same consequences of failure. However, little scrutiny needs to be given to a venture with a 60% chance of failing if the failure would have only minimal consequences to creditors.

<sup>176</sup> Because Chancellor Allen's hypothetical is pristine, only the fiduciary obligation of directors is called into play. No contractual obligation would arise because there are no apparent covenants restricting the corporation's conduct of the litigation. No fraudulent conveyance would occur because none of the actions taken in the litigation would constitute a transfer of property or the incurrence of an obligation. The commercial law obligation of good faith would not be breached because the corporation's creditors are not inherently weaker parties, *see supra* text accompanying notes 54-83, and the litigation constitutes neither opportunistic behavior that could not have been contemplated by the creditors in advance nor a violation of implicit rules of conduct that arise from widespread courses of industry dealing or from any apparent course of dealing between the corporation and its creditors.

That does not, however, mean that directors are constrained to settle the litigation at any price that avoids the risk of insolvency.<sup>177</sup> Rather, in determining the litigation strategy, directors simply must act in good faith to try to balance the relative interests of shareholders and creditors, recognizing that harm to creditors may well be more significant than benefit to shareholders. One therefore would expect the directors to attempt to settle the litigation at an amount that pays creditors but also achieves as high a recovery for shareholders as can be reasonably negotiated. If negotiations break down and the judgment is ultimately reversed or modified on appeal, directors would be protected by the business judgment rule if they acted in good faith.

It is also useful to consider variations on Chancellor Allen's hypothetical. For example, if modification would result in a \$13 million (as opposed to merely \$4 million) recovery, only the 5% chance of reversal would cause insolvency. Directors then may fairly conclude that insolvency is not a reasonable expectation. Their fiduciary obligation therefore would be solely to shareholders.<sup>178</sup>

On the other hand, if modification would result in an \$11.8 million recovery—more than the \$4 million in the original hypothetical but still not enough to pay the \$12 million of bondholder claims—there again would be a 75% chance of insolvency. Directors therefore would have a dual fiduciary obligation to creditors and shareholders. However, because the insolvency resulting from modification would be slight (resulting in only a \$200,000 loss on \$12 million of claims, or less than 2%), the directors' duty to creditors would be at the low end of the continuum. Benefit to shareholders may well outweigh the harm to creditors. Director loyalty

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<sup>177</sup> Nor does it mean, as Chancellor Allen suggested in his footnote 55, that directors must settle at any price that preserves the corporation's *ex ante* value. See *supra* text accompanying note 107.

<sup>178</sup> There is a minor discontinuity in this analysis that should be explained. The analysis assumes that a dual fiduciary obligation would only arise where there is a reasonable expectation of insolvency. See *supra* text accompanying note 113. Therefore, in the hypothetical above, no fiduciary obligation arises from only a 5% risk of insolvency, even though the insolvency, if it occurred (caused by reversal of the judgment), would be catastrophic to creditors. This approach recognizes that risk is present in any business transaction and that it is unrealistic to burden directors with dual loyalties for events that are not reasonably expected to occur.

Furthermore, actual transactions rarely yield precise probabilities like 5%. Directors therefore would make judgment calls on whether or not there is a reasonable expectation of insolvency, and again would be protected by the business judgment rule if they act in good faith even though insolvency later occurs.

would then be primarily to the shareholders to resist any settlement that is not favorable to them.

It is also important to view risky business ventures in a practical context. Creditors take risks when they invest in a company. The law cannot eliminate a business risk; it can only try to reach an appropriate balance between competing rights. Furthermore, most business ventures are not "bet the company" transactions. Usually, the corporation is risking losses to generate substantially greater profits if the venture is successful. Losses do not, however, make a corporation insolvent unless they exceed its equity, and most business ventures are not reasonably expected, even if unsuccessful, to have that dramatically negative an impact on the corporation.

There are, of course, industries where bet the company transactions are common. Small companies in fast moving markets, such as high technology, often risk insolvency whenever they bring out a new product whose cost is high in relation to the company's capital. This Article does not suggest that directors of these companies face threats of personal liability if they lose these bets. The directors may well conclude<sup>179</sup> that there is a compelling case for the product innovation, such as where failure to bring out the product would result in the certain death of the company, innovation of this type is customary in the company's industry, and creditors know the riskiness of their debtor.<sup>180</sup>

This Article, therefore, does not suggest that risky business ventures are inappropriate or violate corporate obligations to creditors. It only suggests that directors should scrutinize them from the standpoint of creditors as well as shareholders if the corporation is insolvent or if the venture would make it insolvent.

#### CONCLUSION

This Article has derived a unified theory of a corporate debtor's obligation to creditors by examining the obligation of a non-corporate debtor and then analyzing how the obligation is affected when the debtor is a corporation. It has shown that a non-corporate debtor not only has obligations under contract and fraudulent conveyance law but also has a limited commercial law obligation of good faith to creditors.

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<sup>179</sup> If the directors do so in good faith, they would be protected by the business judgment rule. See *supra* part II.C.4.

<sup>180</sup> Cf. *supra* note 135 and accompanying text. Involuntary creditors cannot always know the risks. Assuming such creditors exist, their interests would be taken into account as part of the overall balancing engaged in by the directors.

These obligations apply equally to corporate and non-corporate debtors. The commercial law obligation of good faith obviates the need to attempt to create a traditional fiduciary relationship between a solvent corporate debtor and its creditors, which not only would have little conceptual justification but also could impair a corporation's risk taking ability which is essential to success in business transactions.

This Article also has shown that directors of a corporation that is insolvent, or whose action would have a reasonable expectation of resulting in insolvency, have a fiduciary obligation to creditors as well as to shareholders. Directors then must scrutinize actions that increase shareholder return by impairing creditor claims. The more insolvent the corporation is or would become, the more the fiduciary obligation shifts from shareholders to creditors, in a continuum. In balancing this fiduciary obligation, directors should have latitude to make their own good faith weighing of benefit and harm, recognizing that harm to creditors may well be more significant than benefit to shareholders; and therefore the benefit may have to considerably outweigh the harm, or at least provide a compelling case, to be justified. Nonetheless, directors generally should be able to rely on the business judgment rule in balancing their dual obligations without needing to assess intrinsic fairness.

The unified theory proposed in this Article therefore balances a corporation's ability to take legitimate business risks with the reasonable expectations of creditors that their rights will not be impaired. The theory does not require implementing legislation or changes in case law. We need only to visualize the theory in the law that lies before us.