

# WHY A FIDUCIARY DUTY SHIFT TO CREDITORS OF INSOLVENT BUSINESS ENTITIES IS INCORRECT AS A MATTER OF THEORY AND PRACTICE

J. William Callison\*

It is a mantra that directors owe fiduciary duties of care and loyalty to the corporation and its shareholders. The duty of care requires directors to exercise appropriate diligence in making decisions and taking other actions and in monitoring corporate management.<sup>1</sup> The duty of loyalty generally requires the director, in his or her capacity as a corporate agent, to subordinate his or her interests to those of the corporation. It is the loyalty duty that requires directors to refrain from using corporate assets for personal gain, usurping corporate opportunities, competing with the corporation, dealing with the corporation as or on behalf of a party having an adverse interest to the corporation, and other similar acts.

Both shareholders and creditors supply capital to the corporation. Creditors have fixed claims against the corporation entitling them to receive repayment of their principal, with interest, at specified time. Shareholders have the right to participate in firm profits through dividends, as they may be declared by the directors, and to share in residual assets (i.e., assets remaining after creditor payment) upon dissolution. Although non-corporate business organizations, such as partnerships, limited partnerships and limited liability companies, may not have the same role-denominations, similar concepts apply and such firms have equity holders, entitled to distributions and to share in residual assets, and may have creditors, entitled to fixed payments of principal and interest. Since equityholders and creditors have different rights, they often have different interests. For example, shareholders may prefer larger dividend payments and riskier investments to maximize the value of their residual interest,

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\* Partner, Faegre & Benson LLP, Denver, Colorado. I thank Dean Allan W. Vestal and the faculty of the University of Kentucky College of Law for their valuable input while I was a visiting professor of law at the school. I also thank Kathy Schaeffer for her research assistance. An earlier draft of this article was presented at the Second Annual Symposium on Delaware Business Entity Law -- Fiduciary Duties to Creditors: Evolution or Revolution, and I thank Professor Anne Conaway for organizing that symposium. Finally, I thank the University of Maryland School of Law and Professor Richard Booth for organizing the conference on Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies, at which a later version of this article was presented.

<sup>1</sup> See, e.g., Committee on Corporate Laws, American Bar Association, *Corporate Directors Guidebook* (3d ed. 2001), reprinted in 56 BUS. LAW. 1571, 1582 (2001).

while creditors may prefer that the corporation refrain from current distributions and from transactions that place assets at risk.

The probability and magnitude of the interest conflict between equityholders and creditors increase in the case of unsuccessful firms in which financial condition deteriorates and the debt-equity ratio increases. Among the conflicts besetting the unsuccessful firm are the level of risk that should be taken with respect to the firm's ongoing business, the amount of investment that should be made in new firm activities and, ultimately, the question of whether to maintain the firm as a going concern or to cease business altogether and liquidate the firm's assets.<sup>2</sup> Since shareholders do not have personal liability for obligations that cannot be met by the firm, their downside risk is minimal and they may adopt a gamblers' mentality and seek high risk/high reward uses of firm assets in new activities that may provide some level of equity in the future.<sup>3</sup> In addition, shareholders generally will seek to avoid liquidation. On the other hand, some creditors (but possibly not all creditors) may prefer that the firm take a risk-averse approach since they will obtain little benefit if the ventures succeed and may suffer further loss in asset value if they fail. In addition, they may desire that the firm liquidate and pay its assets to them forthwith.

Because creditors of insolvent firms may view themselves as the only persons with valid interests in the firm's remaining current assets, it is understandable that they might argue that it is inappropriate for directors to allow

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<sup>2</sup> The question whether fiduciary obligations should be extended to creditors can be viewed as an agency question in which management issues arguably cannot be solved satisfactorily by the firm's directors and officers, at least as long as they consider only the shareholders' interests. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983). The interests of persons involved with the firm may differ such that issue resolution may benefit persons who are empowered to select the board of directors (i.e., the shareholders) to the detriment of those who are not so empowered (i.e., the creditors). Numerous scholars have noted the moral hazard problem inherent in this setting. See Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (1932); Fama & Jensen, *supra*; Jensen & Meckling, *supra* at 308. Recent scholarship has focused on the question of how exclusively corporations and other business organizations should be managed to maximize the equity owners' wealth. See Margaret A. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1988) (reprinted, with commentary from other authors, in *Symposium: Team Production in Business Organizations*, 24 J. CORP. L. 743, 751 (1999)).

<sup>3</sup> This would also be the case for other limited liability firms, such as limited liability partnerships (LLPs), limited liability limited partnerships (LLLPs) and limited liability companies (LLCs). In the case of "regular" general partnerships and limited partnerships the agency problem is limited since at least one general partner has personal liability for the firm's debts and obligations.

the firm to gamble with those assets. However, creditors may also be so risk averse that they are unwilling to allow the firm to make reasonable investments that would increase the expected value of the firm and return it to solvency. In such case, creditors would bear the entire cost of a losing investment while their economic upside is limited to the amount owed them. As policymakers, corporate directors make decisions affecting both shareholder and creditor interests. Not surprisingly, directors can become whipsawed between these conflicting interests, and questions of whether directors owe duties to shareholders or to creditors, as well as questions of who can enforce the directors' duties, become paramount in the case of financially troubled organizations.

It has also become commonplace to state that when a corporation is in financial distress, typically based on a determination that it is insolvent or perhaps in the "zone of insolvency," the duties of care and loyalty that normally run from directors to the corporation for the benefit of its shareholders<sup>4</sup> shift to

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<sup>4</sup> See *Katz v. Oak Industries, Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986). There, the court held:

This case does not involve the measurement of corporate or directorial conduct against that high standard of fidelity required of fiduciaries when they act with respect to the interests of the beneficiaries of their trust. Under our law--and the law generally--the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature. Arrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.

Thus, the first aspect of the pending Exchange Offers about which plaintiff complains--that "the purpose and effect of the Exchange Offers is to benefit Oak's common stockholders at the expense of the Holders of its debt"--does not itself appear to allege a cognizable legal wrong. It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders; that they may sometimes do so "at the expense" of others (even assuming that a transaction which one may refuse to enter into can meaningfully be said to be at his expense) does not for that reason constitute a breach of duty. It seems likely that corporate restructurings designed to maximize shareholder values may in some instances have the effect of requiring bondholders to bear greater risk of loss and thus in effect transfer economic value from bondholders to stockholders. But if courts are to provide protection against such enhanced risk, they will require either legislative direction to do so or the negotiation of

the corporation's creditors.<sup>5</sup> This conclusion is founded in the Delaware Chancery Court's *Credit Lyonnais v. Pathe Communications* case,<sup>6</sup> continues through its decision in *Geyer v. Ingersoll Publications*,<sup>7</sup> and finds its most recent expression in the *Production Resources* decision.<sup>8</sup> Courts in other states have followed Delaware's lead, and have held that directors of insolvent firms owe fiduciary duties to creditors. One of the less well-reasoned cases, decided by the Colorado Court of Appeals, has generated an effort to reverse the trend through legislation intended to eliminate fiduciary duties to firm creditors. These developments will be discussed in this article. *Credit Lyonnais* and its offspring also have generated considerable academic attention, much of it focused on the question of when the fiduciary obligation shifts to creditors, rather than whether fiduciary obligations should shift to creditors at all.<sup>9</sup> In this article I consider the "whether" question, and conclude that there should not be a "creditor shift" even when a corporation or other business entity is insolvent.

The article proceeds as follows: first, it considers the seminal Delaware cases concerning fiduciary duties to creditors in insolvency situations; second, it reviews developments in another state, Colorado, in which a court has taken an extreme view concerning fiduciary duties to creditors; third, it considers theoretical reasons why fiduciary duties should not be owed to creditors; and, finally, it sets forth several practical reasons why duties should not be owed to creditors and shows the nuisance created when courts cause a shift in fiduciary duties from shareholders, where they belong, to creditors, where they do not. It concludes that this particular form of judicial activism is not well founded and that it should be reversed.

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indenture provisions designed to afford such protection. (citations and footnote omitted).

<sup>5</sup> See, e.g., Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45, 63 (1998) (stating that "[t]he majority rule, and the law in Delaware, is that, upon insolvency, a board's duties are owed to the creditors of the enterprise.").

<sup>6</sup> *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation*, 1991 WL 277613 (Del. Ch. 1991).

<sup>7</sup> *Geyer v. Ingersoll Publications Company*, 621 A.2d 784 (Del. Ch. 1992).

<sup>8</sup> *Production Resources Group, Inc. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004).

<sup>9</sup> See, e.g., Ramesh K.S. Rao, et al., *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially Distressed Firm*, 22 J. CORP. L. 53 (1996) (focusing on the timing problem). Other commentators have considered the question of whether fiduciary duties should arise. See, e.g., Anne E. Conaway, *Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors*, 20 DEL. J. CORP. L. 1 (1995); Jonathan E. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189 (2003).

I. *The Delaware Chancery Cases*

A. *Credit Lyonnais v. Pathe Communications*. In *Credit Lyonnais*, then-Chancellor William Allen rejected a controlling shareholder's claim that corporate directors, all of whom were members of an executive committee appointed by the corporation's creditors pursuant to a loan agreement, disregarded his interests by failing to facilitate sales transactions that he sought in order to help him regain control of the corporation.<sup>10</sup> The court concluded that,

*At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers [i.e., the shareholders], but owes its duty to the corporate enterprise. The Ladd Management [group] was not disloyal in not immediately facilitating whatever asset sales were in the financial best interest of the controlling shareholder. In managing the business affairs of MGM, Mr. Ladd and those he appointed owed their supervening loyalty to MGM, the corporate entity. It was not disloyal for them to consider the corporation's interest in the [transaction]. . . . [T]he MGM board or its executive committee had an obligation to the community of interests that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long term wealth creating capacity.<sup>11</sup>*

Although some have interpreted this statement as implying that directors in insolvency cases owe fiduciary duties to creditors, a narrower construction of the *Credit Lyonnais* holding is that shareholders may not be able to succeed in asserting that directors of corporations acting "in the vicinity of insolvency" did not consider only shareholder interests in reaching their decisions. The court did not address directors' obligations to creditors in the case of insolvent corporations, and they are presumably at least as stringent as those with respect to corporations that are in the "zone."

The theory underlying the *Credit Lyonnais* holding is not entirely clear, but it appears to be grounded in economic efficiency considerations. In a famous footnote, Chancellor Allen suggested that a board of directors, faced with a decision on whether to accept a settlement offer in a case on appeal against a solvent debtor, could take one of three courses: (1) a very risky course, with a low success probability, that would produce the greatest return and leave significant shareholder equity, (2) a moderately risky course that would provide a higher probability of success but a lower return, such that creditors would be paid in full but shareholders would have less equity; and (3) a least risky course that would pay creditors in full but would leave no shareholder equity. Chancellor Allen postulated that the most efficient approach with the most likely overall

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<sup>10</sup> *Credit Lyonnais*, *supra* note 5 at \*33.

<sup>11</sup> *Id.* at \*34.

benefit for the corporation would be the moderately risky approach, but that a shareholder primacy approach would cause directors to choose the riskiest course while a creditor primacy approach would cause directors to choose the most risk-averse course.<sup>12</sup> Chancellor Allen wrote:

The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors. . . . While in fact the stockholders' preference would reflect their appetite for risk, it is possible (and with diversified shareholders likely) that shareholders would prefer rejection of both settlement offers.

But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than \$15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to the shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.<sup>13</sup>

Simply put, *Credit Lyonnais* empowers directors of corporations that are in the “zone of insolvency” to strike a balance in an attempt to reach a fair and efficient result, without fear of a fiduciary breach to shareholders whose interests, considered alone, would force excessively risky “bet the ranch, go for broke” decisions. Although the case did not involve creditor claims, it also appears to empower directors of corporations in the zone of insolvency to make decisions without fear of a fiduciary breach to those creditors whose interests, considered alone, would force an excessively cautious “stay the course, preserve existing assets at all costs” approach. However, *Credit Lyonnais* leaves unanswered the question of who, which “group interested in the corporation,” can enforce the fiduciary duties that are owed to the corporate enterprise in zone of insolvency settings. It also leaves unanswered the question of duties in corporations that have descended into actual insolvency.

B. *Geyer v. Ingersoll Publications Company*. In *Geyer*, the Chancery Court took the next step down the “creditor shift” path, at least with respect to insolvent corporations (as opposed to corporations in the “zone of

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<sup>12</sup> *Id.* at \*34, fn 55.

<sup>13</sup> *Id.*

insolvency”). With respect to a creditor’s claim that a director breached his fiduciary duties, the court held:

[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent “special circumstances . . . e.g., fraud, insolvency, or a violation of statute. . . .” *Furthermore, neither party seriously disputes that when the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors.* Therefore, the issue the parties present to me is *when* do directors’ fiduciary duties to creditors arise via insolvency. That is, I must decide whether insolvency arises so as to create a fiduciary duty to creditors when insolvency exists in fact or when a party institutes statutory proceedings (e.g., bankruptcy proceedings).<sup>14</sup>

The court ruled that insolvency in fact, rather than insolvency due to a statutory filing, causes fiduciary duties to shift to creditors<sup>15</sup> but, in accepting that the parties did not dispute that a shift occurs, did not state any basis for its holding that the shift occurs.

C. *Production Resources Group*. The recent *Production Resources Group* case substantially expands on *Credit Lyonnais*. There, an insolvent corporation’s judgment creditor alleged that the corporation’s board of directors and a non-director officer committed various fiduciary breaches. The creditor argued that, because the corporation was insolvent, (a) it could bring a fiduciary claim in its capacity as creditor and (b) it could do so directly rather than in derivative fashion and without overcoming exculpatory charter provisions protecting directors from claims that they breached their care duty.<sup>16</sup>

The court first noted that creditors typically may not allege fiduciary claims against corporate directors because creditors are presumed capable of protecting themselves by contract and because fraudulent conveyance law and bankruptcy law protects them.<sup>17</sup> Thus, the court stated that corporate law expects that the directors of a solvent corporation will cause the firm to undertake

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<sup>14</sup> 621 A.2d 784, 787. At least one court has viewed *Geyer* as standing for the proposition that, upon insolvency, director duties shift from shareholders to creditors exclusively. In re Toy King Distributors, Inc., 256 B.R. 1, 166 (Bankr. M.D. Fla. 2000).

<sup>15</sup> *Id.* at 787-88.

<sup>16</sup> 863 A. 2d 772, 775.

<sup>17</sup> *Id.* at 787. See Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063 (2001). Some commentators have argued that directors should be fiduciaries of other corporate constituents, such as bondholders and employees. See, e.g., Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165 (1990) (bondholders); Marleen A. O’Connor, *Restructuring the Corporation’s Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991) (employees). These arguments have gained little traction and are beyond the scope of this article.

economic activities to maximize the benefit to the stockholders, who are the firm's residual risk bearers.<sup>18</sup> Nothing new here.

The court then correctly noted that *Credit Lyonnais* does not create a new body of creditor's rights law in "zone of insolvency" situations, but instead provides a shield protecting directors from shareholders' claims that the directors have a fiduciary obligation to undertake riskier activities for the shareholders' potential benefit as long as the company does not breach any legal obligations to creditors.<sup>19</sup> Although the court recognized that some commentators and courts have read *Credit Lyonnais* expansively to permit creditors of a firm that is in the "zone of insolvency" to challenge directors' business judgments as a breach of fiduciary duties owed to creditors,<sup>20</sup> the court concluded that the facts of *Production Resources* did not require it to "explore the metaphysical boundaries of the zone of insolvency."<sup>21</sup> In *Production Resources*, the court held that the creditor adequately pled that the corporation was insolvent in fact.<sup>22</sup> Notwithstanding his recognition that his "zone of insolvency" language is dictum, Vice-Chancellor Strine then strayed from *Credit Lyonnais* and stated that "I doubt the wisdom of a judicial endeavor to second-guess good-faith director

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<sup>18</sup> 863 A.2d at 787.

<sup>19</sup> *Id.* at 788.

<sup>20</sup> *Id.* at 789. The court refers to such a construction of *Credit Lyonnais* as "somewhat odd." *Id.* at 787-88.

<sup>21</sup> *Id.* at 789-90. The court notes that if creditors have standing to bring derivative claims in the "zone of insolvency," they will share that standing with stockholders and that this leads to possible derivative litigation by two sets of plaintiffs with starkly different conceptions of what is best for the firm. Further, the court states that it is often difficult to determine insolvency and that defining the "zone of insolvency" would be even more difficult. Plaintiffs' lawyers would press for an expansive view and since pleadings (e.g., motions to dismiss and motions for summary judgment) are approached in a plaintiff-friendly manner, creditors would be able to obtain discovery (and presumably settlement leverage) even in situations where the corporation is ultimately determined to be solvent and not even in the "zone." *Id.* at 790, n.56.

<sup>22</sup> *Id.* at 783. The court defined insolvency as either (1) a deficiency of assets below liabilities *with no reasonable prospect that the business can be successfully continued in the face thereof*, or (2) an inability to meet maturing obligations that fell due in the ordinary course of business. *Id.* at 782 (emphasis added). *Geyer* did not define insolvency so narrowly: "An entity is insolvent when it is unable to pay its debts that become due in the ordinary course of business. That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held . . . [T]here may be other definitions of insolvency that are slightly different. . . ." *Geyer, supra* note 7 at 670. *Production Resources* adds a gloss to the balance sheet insolvency test indicating that courts may need to consider whether there is a reasonable prospect that the business can successfully continue in the face of insolvency. This begs the question of the extent to which *Production Resources* establishes rules for insolvent corporations that have a reasonable prospect of successful continuation.



conduct in the so-called zone.”<sup>23</sup> It will be interesting to see whether Vice Chancellor Strine’s conservative approach holds the day in future “zone of insolvency” cases.

After its lengthy “zone of insolvency” dictum, the court reached its actual holding in the case:

*When a firm has reached the point of insolvency, it is settled that under Delaware law, the firm’s directors are said to owe fiduciary duties to the company’s creditors. This is an uncontroversial proposition and does not completely turn on its head the equitable obligations of the directors to the firm itself. The directors continue to have the task of attempting to maximize the economic value of the firm . That much of their job does not change. But the fact of insolvency does necessarily affect the constituency on whose behalf the directors are pursuing that end. By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders – that of residual risk-bearers. Where the assets of the company are insufficient to pay its debts, and the remaining equity is underwater, whatever remains of the company’s assets will be used to pay creditors, usually either by seniority of debt or on a pro rata basis among debtors [sic] of equal priority.*

In insolvency, creditors, as residual claimants to a definitionally-inadequate pool of assets become exposed to substantial risk as the entity goes forward; poor decisions by management may erode the value of the remaining assets, leaving the corporation with even less capital to satisfy its debts in ultimate dissolution. The elimination of the stockholders’ interest in the firm and the increased risk to shareholders is said to justify imposing fiduciary obligations towards the company’s creditors on directors.<sup>24</sup>

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<sup>23</sup> *Production Resources*, *supra* note 8 at 790, n.57. The court noted that real world situations are not akin to directors putting cash into slot machines, but involve different choices between the pursuit of plausible, but risky, business strategies that might generate shareholder equity and less risky strategies that guaranty that there will be no return for shareholders but only preservation of value for creditors. Further, different classes of creditors have disparate interests, with some creditors being akin to shareholders and preferring risky strategies.

One suspects from the tone of *Production Resources* that Vice-Chancellor Strine was uncomfortable with the “creditor shift” concept, but was bound to honor precedent and sought to limit the effect of that precedent.

<sup>24</sup> *Id.* at 790-91. I note here that Vice-Chancellor Strine’s “are said to” language seems equivocal, and leaves one to wonder what he would have ruled without *Geyer*’s precedent. *See* U.S. Bank National Association v. U.S. Timberlands Klamath Falls, L.L.C., 864 A.2d 930, 947 (Del. Ch. 2004) (defendant admitted that fiduciary duties extend to creditor interests when firm is insolvent, but contested insolvency).

Notwithstanding its conclusion that directors of insolvent corporations “owe fiduciary duties to the company’s creditors,” the court held that this does not change the nature of the harm in a fiduciary breach claim.<sup>25</sup> Even with respect to insolvent corporations, fiduciary breaches continue to be harmful to the entity and are derivative in nature.<sup>26</sup> Therefore, the court held that directors may

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<sup>25</sup> *Id.* at 792. The court also followed *Asmussen v. Quaker City Corp.*, 156 A. 180 (Del. Ch. 1931), and stated that the mere fact that directors of an insolvent firm favor certain creditors over others of similar priority does not constitute a breach of fiduciary duty, absent self-dealing. *Id.* at 791-92. This leaves hanging the question of whether creditors can claim fiduciary breaches when directors act in a manner that favors creditors over others of a lower priority. Such claims might not be derivative in nature.

<sup>26</sup> *Id.* The court stated:

More to the current point, the transformation of a creditor into a residual owner does not change the nature of the harm in a typical claim for breach of fiduciary duty by corporate directors. Two examples will illustrate this. Assume that a corporation, say an airline, is already insolvent but that it has ongoing operations. A well-pled claim is made by one of the company's many creditors that the directors have engaged in self-dealing. Is this claim a direct claim belonging to the corporation's creditors as a class, or the specific complaining creditor, such that any monetary recovery would go directly to them, or it? I would think that it is not. Instead, because of the firm's insolvency, creditors would have standing to assert that the self-dealing directors had breached their fiduciary duties by improperly harming the economic value of the firm, to the detriment of the creditors who had legitimate claims on its assets. No particular creditor would have the right to the recovery; rather, all creditors would benefit when the firm was made whole and the firm's value was increased, enabling it to satisfy more creditor claims in order of their legal claim on the firm's assets. In other words, even in the case of an insolvent firm, poor decisions by directors that lead to a loss of corporate assets and are alleged to be a breaches of equitable fiduciary duties remain harms to the corporate entity itself. Thus, regardless of whether they are brought by creditors when a company is insolvent, these claims remain derivative, with either shareholders or creditors suing to recover for a harm done to the corporation as an economic entity and any recovery logically flows to the corporation and benefits the derivative plaintiffs indirectly to the extent of their claim on the firm's assets. The reason for this bears repeating--the fact of insolvency does not change the primary object of the director's duties, which is the firm itself. The firm's insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value and logically gives them standing to pursue these claims to rectify that injury. Put simply, when a director of an insolvent corporation, through a breach of fiduciary duty, injures the firm itself, the claim against the director is still one belonging to the corporation.

*See also* *In re Adelphia Communications Corp.*, 323 B.R. 345, 386-87 (Bankr. S.D. N.Y. 2005)

assert the same defenses as they could assert in a shareholder derivative action, and that exculpatory charter provisions continue to insulate the directors from duty of care claims pursuant to §102(b)(7).<sup>27</sup> *Production Resources*, therefore, can be viewed narrowly as a standing case, in which creditors of insolvent corporations are provided standing to pursue in derivative fashion the corporation's claims that fiduciary breaches diminished the firm's value.<sup>28</sup> On the other hand, the *Production Resources* holding is capable of a broader reading in which directors must undertake actions that are best for the creditors, but not necessarily for other stakeholders or the firm "as a legal and economic entity," in *Credit Lyonnais*' words.

Unlike Chancellor Allen in *Credit Lyonnais*, Vice Chancellor Strine did not provide a theoretical underpinning for his conclusion that "when the firm has reached the point of insolvency,... directors are said to owe fiduciary duties to the firm's creditors." Instead, Vice Chancellor Strine appears to have adopted a simple "if/then" analysis – if insolvent, then duties shift to creditors. This approach does not provide enlightenment concerning why duties arise, and therefore is not helpful in determining how the Delaware Chancery Court is likely to approach cases which do not come within *Production Resources*' factual setting, including "zone of insolvency" situations and even situations when the entity is balance sheet insolvent but where there is a "reasonable prospect that the business can be successfully continued in the face thereof."<sup>29</sup> *Production Resources* also does not provide guidance on the nature of the duty to creditors and the firm.

D. *The Underlying Basis for Creditor Shifts.* To the extent articulated in *Credit Lyonnais* and *Production Resources*, the theory for a "creditor shift" in fiduciary duty enforcement for insolvent corporations appears to be the following: (a) shareholders generally are residual claimants; (b) since they are residual claimants, shareholders generally are the only persons able to enforce corporate fiduciary duties; (c) in insolvency situations, creditors become

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<sup>27</sup> *Id.* at 793-95. See also *Pereira v. Farace*, \_\_\_ F.3d \_\_\_, 2005 WL 1532318 at \*11 (2d Cir. 2005) (bankruptcy trustee's breach claims subject to exculpatory clause defense); *Continuing Creditors' Committee of Star Telecommunications, Inc. v. Edgecomb*, 2004 WL 2980736 at \*11-12 (D. Del. 2004) (same).

<sup>28</sup> *Id.* ([B]ecause of the firm's insolvency, creditors would have standing. . . .")

<sup>29</sup> Interestingly, this definition of insolvency may turn full circle to the original "creditor shift" cases, founded in trust fund theory, in which the duty to creditors arose upon corporate liquidation. See, e.g., *Wood v. Dummer*, 30 F.Cas. 435 (C.C.D. Me. 1824) (creditor duties arise upon corporate liquidation); *Hollins v. Brierfield Coal & Iron Co.*, 150 U.S. 371 (1893). It begs the question of what occurs in other cases in which the corporation is insolvent but not liquidating or considered by the court to be on the brink of liquidation. Perhaps, as it retreated from "zone of insolvency" analysis, the Delaware courts will limit the creditor shift to liquidation cases. The court did not tip its hat to this ironical conclusion, however.

the residual claimants; (d) therefore, creditors are able to enforce corporate fiduciary duties in insolvency cases.<sup>30</sup> Thus, the “creditor shift” appears to be based on payment priority rather than some other underlying theory of fiduciary duty. When there is no equity value, creditors receive the benefit (and bear the cost) of management decisions prior to the shareholders and, therefore, fiduciary obligations shift to the creditors. Because increases in firm value go to creditors until the firm is solvent, the creditors and not the shareholders have certain rights traditionally associated with ownership.<sup>31</sup> Although Delaware courts have included fiduciary duties among these rights, the deemed ownership shift based on priority is imperfect. For example, shareholders continue to elect directors – thereby setting up the dilemma for the directors since they have a loyalty to shareholders based on corporate structure.<sup>32</sup>

E. *Going to the Extreme – Colorado’s Experience With the Creditor Shift.* Although *Production Resources* was appropriately judicious in cabining the effect of the creditor shift, there can be no assurance that courts in other states will not seize on broader concepts raised in the Delaware cases (along with broad fiduciary duty language contained in the Delaware cases) and give creditors of insolvent entities a much larger field in which to operate. Certainly, that has been the effect in Colorado, at least as of this writing. In *Anstine v. Alexander*, a bankruptcy trustee sued the president of a corporation and the president’s legal counsel, alleging that the president breached his fiduciary duties by warehousing home warranty premiums tendered to the corporation, after the policies purchased by the corporation to secure such warranties were found to be fraudulent, and then transferring the escrowed premiums offshore to obtain replacement insurance.<sup>33</sup> The president’s legal counsel was sued, and

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<sup>30</sup> See Official Committee of Unsecured Creditors of Hechinger Investment Co. of Delaware, Inc. v. Fleet Retail Financial Group, 274 B.R. 71, 89 (D. Del. 2002) (“[W]hen a corporation enters the zone of insolvency, the creditors – and not just the shareholders – are residual risk bearers whose recovery is dependent upon the business decisions of the directors.” Fundamentally, the court noted, the directors of such a firm are “playing with the creditors’ money.”).

<sup>31</sup> See Steven L. Schwarcz, *Rethinking a Corporation’s Obligations to Creditors*, 17 CARDOZO L. REV. 647, 665-68 (1996).

<sup>32</sup> If there is a creditor shift with respect to fiduciary duties, perhaps there also should be a creditor shift with respect to director selection.

<sup>33</sup> *Anstine v. Alexander*, 2005 WL 913503 (Colo. App. 2005). It seems that the president’s actions may have been for the corporation’s best interests, or at least protected under the business judgment rule, but the court’s decision contains no discussion of this aspect of the case. *Anstine* can be compared unfavorably with the Supreme Court of Canada’s *People’s Department* decision, in which the Court held:

As for the fiduciary duty, the directors and officers must act with integrity and in good faith in the best interest of the corporation.... The interest of the corporation should not be confused with that of the

found liable in a jury trial, for aiding and abetting the president's breach of fiduciary duties by advising the president to warehouse the premiums and assisting the president to use those premiums to purchase unacceptable offshore policies. The Colorado Court of Appeals first addressed the question of whether the corporation's bankruptcy trustee had standing to pursue the aiding and abetting fiduciary breach claim. In a truncated opinion, and without citing to substantial authority, the court held,

We agree with the trial court and conclude that [Trustee has] standing as a fictitious judgment lien creditor. Here, any hypothetical judgment lien creditor would have standing to sue the attorneys for malpractice causing injury to BHW *and to sue BHW's president for breach of his fiduciary duty to BHW and, if BHW was insolvent, for breach of his fiduciary duty to BHW's creditors*....Such a lien creditor would also have a cause of action against anyone who aided and abetted that breach of fiduciary duty.<sup>34</sup>

The court then cemented its conclusion that creditors of insolvent corporations have direct, rather than derivative, fiduciary claims against officers and directors by stating that defenses that the president might assert against the corporation could not be asserted in the context of a creditor claim.<sup>35</sup> Thus, at least in Colorado, creditors of insolvent corporations can bring direct actions against corporate officers and directors and defenses that could otherwise be asserted in derivative cases are rendered useless.

*Anstine v. Alexander* has provoked an equal and opposite reaction from the Colorado corporate bar, and legislation has been drafted to move creditor claims back inside the derivative box. The current version of the proposed Colorado legislation provides:

A director or officer of a corporation, in the performance of duties in that capacity, shall have neither any fiduciary or other duty to, nor any liability to, any creditor or other person other than the corporation

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shareholders, the creditors or any other stakeholder. The directors' fiduciary duty remains the same, even if the corporation is in the vicinity of insolvency. In assessing the actions of the directors, any honest and good faith attempt to redress the corporation's problem situation will, if successful, retain value for the shareholders while improving the creditors' position. Should the attempt fail, it would not qualify as a breach of the statutory fiduciary duty. There was no need to read the interest of the creditors into the fiduciary duty. Creditors and stakeholders and their interests are protected in several ways...[and they] have viable remedies at their disposal.

*People's Department Stores, Ltd.*, 2004 SCC 68 (2004).

<sup>34</sup> *Id.* at \*3 (emphasis added).

<sup>35</sup> *Id.*

except as may otherwise be expressly provided by statute. Nothing in this section shall affect any duty or liability of an officer or director to any shareholder of the corporation.

If passed, the Colorado legislature will undo the effects of *Anstine*, and will clarify that directors owe no fiduciary duty to corporate creditors. Instead, such creditors will need to proceed against directors who breach their fiduciary duties by other means, such as through a derivative action or by foreclosure on the corporation's right of action against its directors with subsequent litigation of the corporation's claim, and directors would retain such defenses as they might have against claims brought by the corporation.

## *II. Theoretical and Practical Arguments Against the Creditor Shift*

The “F” word – fiduciary -- is not a throw-away<sup>36</sup> and, since there can be major ramifications when the term is introduced, courts should be very careful to use the term only when it is appropriate. Simply put, if a person in a particular relationship with another is subject to a fiduciary relationship, that person must be loyal to the interests of the other person. As noted by Deborah DeMott:

In general terms, the law governing fiduciary obligation addresses two questions: First, in what circumstances does fiduciary obligation apply? Second, what does the obligation require a person to do? If a person in a particular relationship with another is subject to a fiduciary obligation, that person (the fiduciary) must be loyal to the interests of the other person (the beneficiary). The fiduciary's duties go beyond mere fairness and honesty; they oblige him to act to further the beneficiary's best interests. The fiduciary must avoid acts that put his interests in conflict with the beneficiary's. For example, if the fiduciary contracts with the beneficiary, the contract is voidable by the beneficiary unless the fiduciary has disclosed his interests adequately under the circumstances. If the fiduciary benefits through acts inconsistent with his obligation of fidelity, the beneficiary can recover any benefit realized by the fiduciary unless he consents to the fiduciary's retention of it. In transactions between the fiduciary and the beneficiary, therefore, the fiduciary must be candid and must evince utmost good faith.

To be sure, the ramifications of these basic principles are complex, as may be the determination whether, in a particular relationship, a fiduciary obligation exists in the first place. Only

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<sup>36</sup> Instead, the “F” word is a “fighting” word.

confusion will result if a court grounds its approach in a mistaken conception of fiduciary obligation.<sup>37</sup>

There are several theoretical and practical arguments against recognizing that creditors of insolvent firms have fiduciary claims against directors, officers and managers of such firms. On the theoretical side, the creditor shift is not supported by classical theories of fiduciary duty. On the practical side, the creditor shift creates unacceptable uncertainty, ambiguity and unfairness. Therefore, this article encourages retreat from using the fiduciary term to describe relationships with creditors of insolvent entities.

A. *The Creditor Shift is Not Supported by Classical Theories of Fiduciary Duty.*

Two leading academic approaches to fiduciary duty have emerged – contractarian and fiduciarian<sup>38</sup> – and the creditor shift is supported by neither. In each case, there is recognition that the internal structure of business entities creates relationships of power and dependency, and that the law has attempted to provide a principled set of regulations to ensure that those with power are

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<sup>37</sup>Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 882 (1988) (citations omitted).

<sup>38</sup> I use the term “fiduciarian” rather than the alternative “anti-contractarian” term because I believe it is less conclusory and does not imply that the concepts reposed by fiduciarians arose in negative response to the “bundle of contracts” theory of the firm. J. William Callison, *Blind Men and Elephants: Fiduciary Duties Under the Revised Uniform Partnership Act, Uniform Limited Liability Company Act, and Beyond*, 1 J. SM. & EMERG. BUS. L. 109 at 117, n.53. See John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989) (drawing similar distinction between those that view American corporate law as primarily composed of mandatory rules that the shareholders cannot modify and those that view corporate law as composed of waivable default rules, and arguing for an information-revealing approach of “coercive” default rules). Coffee also notes the major dispute separating contractarians and fiduciarians:

Put simply, fiduciary law is deeply intertwined with notions of morality and the desire to preserve a traditional form of relationship. One side believes deeply in the moral tradition of the fiduciary relationship, while the other is equally convinced of the justice of its libertarian position that the parties should be the sovereign masters of their own relationship.

What is there then in traditional fiduciary law from which rational parties may wish to deviate? The traditional fiduciary ethic insists that the fiduciary act selflessly. At bottom, the anticontractarians believe not only that the beneficiaries desire such a relationship, but that a public morality requires its preservation. Two visions of society here collide: the individualistic, wealth-maximizing view of the economist and the communitarian ethic of the moralist.

*Id.* at 1658.

accountable to those who are dependent on its appropriate exercise.<sup>39</sup> The question becomes the foundation of (and limitations on) the power and dependency relationship. Theoretical discussions of fiduciary duty recurrently focus on the question of whether restrictions on managerial behavior are, or should be, derived from moral notions or, alternatively, from simple contract. Specifically, the question is whether fiduciary relationships have meaning beyond the parties' contract or whether the conditions generating the fiduciary relationship impose restrictions on the parties that classic contract doctrine would not require or permit.

Contractarians argue that fiduciary duties should be confined to relationships that involve the contractual delegation of broad and open-ended (i.e. not subject to limitations and constraints such as active monitoring or approval power) power over one's property.<sup>40</sup> Thus, the existence of fiduciary duties depends on the structure of the parties' relationship, as expressed by their actual or implied contract, and not on exogenous vulnerabilities or other sources.<sup>41</sup> Contractarians further argue that fiduciary duties constitute a response to the impossibility of writing contracts that completely specify the parties' obligations.<sup>42</sup> Thus, contractarians conclude that the "fiduciary" relationship is a contractual gap-filler, characterized by high costs of specification and monitoring, in which the courts prescribe the actions the parties, who are presumed to be rational and wealth-maximizing persons, would have preferred if bargaining were cheap and promises fully enforced.<sup>43</sup>

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<sup>39</sup> See Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1675 (1990).

<sup>40</sup> See Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 211 (2005) (arguing that "default fiduciary duties should be confined to relationships that involve the contractual delegation of broad power over one's property. Broad delegation means management power that is not subject to limitations or constraints such as the purported owner's active monitoring or approval power, or a debtor's duty to repay, and pay interest on, a loan. Fiduciary duties are appropriate for relationships like those between directors and shareholders in public corporations. They do not fit relationships among parties who expect to be active, as in the typical general partnership. Moreover, the existence of default fiduciary duties depends solely on the structure of the parties' relationship--that is, on the terms of their express or implied contract--and not on any vulnerability arising other than from this structure.") See D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399 (2002).

<sup>41</sup> See Frank H. Easterbrook and Daniel R. Fishel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425, 427 (1993) ("Fiduciary duties are not special duties; they have no moral footing; they are the same sort of obligations, derived and enforced in the same way, as other contractual obligations. Actual contracts always prevail over implied ones. Obligations implied to maximize value in high-transaction-costs cases may have some things in common, but differences in the underlying transactions will call for different 'fiduciary' obligations, just as actual contracts differ across markets.").

<sup>42</sup> *Id.* at 426.

<sup>43</sup> *Id.* at 427.



The contractarian conception of fiduciary duty works in the interstices of power, specifically the power to contract and to meaningfully negotiate and document the pertinent terms of the contract. When parties have bargaining power together with an ability to express their rights and obligations there would be no fiduciary duty. The contractarian approach directly implicates concepts of fiduciary duty to creditors, at least to voluntary creditors. As noted by Frank Easterbrook and Daniel Fischel, creditors are able to contract at low cost, and fiduciary duties should not run to them.<sup>44</sup> The most significant class of creditors, lenders, are able to protect themselves through the exercise of bargaining power and the negotiation of security interests in firm assets.<sup>45</sup> Lenders also are protected by the firm's duty to perform its contracts in good faith. Further, in the contractarian view, imposition of fiduciary duties comes with cost. In the case of director duties to creditors, the cost to the corporation and its shareholders include the costs of obtaining skilled directors at the time when it most needs them – either the corporation would not be able to obtain directors willing to bear the personal risk, which is magnified by the lack of clear definition of duties, or the firm will need to pay more to directors or bear increased insurance costs.

Fiduciarian legal scholars consider fiduciary duties through a different lens. Professor Melvin Eisenberg succinctly states the fiduciarian approach:

All law builds on moral, policy, and experiential propositions. The moral proposition that underlies the law of negligence is that if a person assumes a role whose performance involves the risk of injury to others, he is under a moral duty to perform that role carefully.... A moral obligation to exercise care in the performance of one's role is also imposed on corporate officers and directors.<sup>46</sup>

As noted by another leading fiduciarian, contractarians begin with the assumption that the state imposes only thinly textured restrictions on the

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<sup>44</sup> Specifically, Easterbrook and Fishel note that, “Managers owe fiduciary duties to equity investors, but not debt investors or employees, because these claimants can contract at low cost, while the costs of specification are prohibitively high for the residual claimants. *Id.* at 437. In *Are Partners Fiduciaries?*, *supra* note 40 at 226, Larry Ribstein refrains from addressing the insolvency question in detail and notes that “The appropriate way to protect the creditors is through a ‘good faith’ duty that enforces the creditors’ expectations by flexibly interpreting the specific terms of the debt agreement....Fiduciary-like duties to creditors are appropriate, at most, only when the firm nears insolvency, where the creditors may be, in effect, residual claimants.” [*Discuss Larry’s position (and others’) in papers for this Symposium*].

<sup>45</sup> For example, creditors who fear insolvency may seek a higher interest rate, and may seek to influence firm management through proxy rights and board representation. Their bargaining power may be superior to the firm's.

<sup>46</sup> Melvin A. Eisenberg, *The Duty of Care of Corporate Officers and Directors*, 51 U. PITT. L. REV. 945, 945-48 (1990). See DeMott, *supra* note 37.

contracting parties' behavior vis-à-vis one another before and in performance of their contract, while fiduciarians begin by contemplating the thick state-imposed restrictions that substantially hamper the parties' freedom to act (contractually or otherwise) or to alter their obligations to their beneficiaries.<sup>47</sup> Fiduciarians accept that values other than wealth-maximization, including trust values, are served by the visions of human relationships underlying fiduciary concepts and that the fiduciary relationship serves functions not addressed by mere contract.<sup>48</sup>

Notwithstanding their view that fiduciary duties arise independently from contract, some fiduciarians recognize that parties some parties can change the scope of fiduciary duties by contract, at least to some extent.<sup>49</sup> Concepts of volition and cognition assist in determining the modifiability of fiduciary duties, and contracts can vary duties among those that have these powers.<sup>50</sup> Thus, the

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<sup>47</sup> Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 598 (1997). Brudney notes:

To characterize the state-imposed limits as 'default' rules or 'background' rules suggests that the parties are free to ignore, or decline to be bound by, restrictions that society imposes to protect individuals, whether paternalistically, or to avoid externalities, or otherwise. The suggestion is that parties are as free to 'contract' with one another as they would be in a pre-state world with no socially imposed restrictions. That basic structural assumption is problematic. Some of those background rules are not permitted to be circumvented by the parties; others are. Even in the latter case, the existence of state-imposed background rules limits the parties' power to 'contract around' them (in whole or in part) or to treat their arrangements as if the rules did not exist."

*Id.* at 597-98. See also Melvin A. Eisenberg, *The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 824 (1999) ("Unfortunately, it has proved easy to confuse the positive proposition that the corporation is a nexus of reciprocal arrangements with the normative position that the persons who constitute a corporation should be free to make whatever reciprocal arrangements they choose, without the constraints of mandatory legal rules.... To reason from the nexus-of-contracts conception to a rejection of mandatory legal rules is to mistakenly reason from is to ought."").

<sup>48</sup> *Id.* at 604. See Margaret M. Blair & Lynn A. Stout, *Trust, Trust-worthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001).

<sup>49</sup> See Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1471 (1989) ("The core fiduciary rules which govern the close corporation are mandatory, but private rules that do not present the dangers of systematic unforeseeability and exploitation...normally will be given effect."); Brudney, *supra* note 47 at 605.

<sup>50</sup> *Id.* at 612. See also Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1405 (1985) (arguing that demonstrating the degree of cognition and volition by parties that is adequate to support the concept of contract with the implied consequences of party autonomy requires solution of complex and intractable problems).

common public stockholder is in need of robust and less modifiable fiduciary obligations since he or she is relatively unable to specify the opportunistic behavior against which protection is required or, due to a lack of information, to monitor decisions made pursuant to contractual restrictions or to enforce compliancy with contractual terms.<sup>51</sup> On the other hand, it is strongly arguable that, in the fiduciarian construct, duties should not run to corporate creditors.<sup>52</sup> First, creditors frequently have both sufficient knowledge and power to structure their relationship with the corporation and in connection with its management. Thus, loan agreements can include debt acceleration provisions allowing lenders to obtain the corporation's assets in the event of insecurity, lenient receivership provisions, provisions allowing creditors to appoint corporate directors, and the like.<sup>53</sup> Even in the case of creditors that lack power and information, Brudney concludes that management represents the shareholders' interests in conducting corporate affairs, and that corporate managers should not owe fiduciary duties to creditors since that would establish an intractable conflict.<sup>54</sup> Therefore, in the

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<sup>51</sup> *Id.* Brudney also notes that public stockholders also do not have the capacity of commercial contracting parties to specify limits, monitor management, select officers or terminate them.

<sup>52</sup> *Id.* at 611, n.41 (noting that there is room to argue about the allocation of entitlement among various "stockholders" and that there are several economic reasons to empower common stockholders to vote for directors, both because they take residual risks and because of their inability to adequately specify or monitor threats to their residual interest, and concluding that these reasons and the accompanying corporate structure imply that management's fiduciary obligations should run to stockholders rather than other participants in the corporate enterprise.")

<sup>53</sup> In addition, creditors can ameliorate their risks by charging higher interest rates, lending on a short-term basis, taking appropriate collateral, and obtain appropriate negative covenants preventing the firm from taking actions that are perceived as risky or paying out assets to shareholders as dividends. Although the risks of debtor opportunism may not be fully anticipable at the time the loan is made, shareholders are more at risk from opportunism than are creditors since many things that can reduce the firm's value will not reduce the value of its debt. Some creditors, such as trade creditors, lend on a relatively short-term basis and do not need fiduciary protections; in the event of trouble, they can stop doing business with the firm or establish cash on delivery or other payment terms.

<sup>54</sup> Brudney writes:

If there is little basis for imposing on common stockholders fiduciary loyalty obligations to seniors [senior debt holders] in dealing with the enterprise's distribution or investment policy or capital structure, there is little more basis for imposing such obligations on management. If the matter is viewed structurally, and management is seen as the agent (albeit indirect) of the common stockholders vis-a-vis seniors, management should not owe to senior security holders fiduciary obligations that preclude it from favoring common stockholders any more than does its principal. Similarly, if management is seen as the agent of "the corporation," that status imposes restraints on management's self-aggrandizing or careless behavior. But the case

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remains to be made as to why in managing corporate affairs managers incur fiduciary obligations to the seniors, or indeed any different obligations than the common stock does in choosing management or otherwise directing corporate affairs.

The conflict of interest between debt and equity over investment or distribution policy or capital structure implicates the economic question of whether the goal of the corporate decision-maker should be to maximize stockholders' value rather than enterprise (and possibly creditors') value if its decision affects those values differently. *Traditional fiduciary stricture suggests that the proper decision for management to take is to favor commons' interest, at least until the enterprise is insolvent or reaches "the vicinity of insolvency." At that time, or possibly earlier, it may be necessary and appropriate for the corporate decision-making body (the board and management) to reconcile the interests of the competing claims of stockholders and creditors (and other stakeholders) in maximizing the enterprise's value. If so, that body should by law (1) be so instructed, and furnished with appropriate criteria for decision, and (2) be constituted of appropriately weighted representatives of each class of claimants.* The costs of thus requiring a regime of bargaining at the board room table may well be considerably less than the costs of making the same persons arbiters for conflicting interests with accountability to none. *So long as the board is constructed only of representatives of common stock, that constituency has a claim on its institutional loyalty as fiduciary that is logically prior to any comparable claim by seniors.*

If the fiduciary role is viewed as constraining managerial slack or diversion of assets to itself, as distinguished from managerial favoring of the interests of commons over those of seniors, a somewhat different problem is presented. To the extent that such managerial conduct renders the corporation unable to meet its contractual obligations to seniors (e.g., to pay interest or dividends or principal), seniors are entitled to relief from actual default in meeting those obligations. In that process, they may be entitled to assert that management violated its fiduciary obligations to the common stockholders (who in that context are equivalent to "the corporation") and, because recovery for that violation is an asset of "the corporation" which should cushion, if not be allocated to, the seniors, they should be entitled to pursue it. But seniors have no claim to receive any of those recovered assets until their contractual entitlement matures. The fact that managerial behavior so depletes corporate assets as to cause a decline in the prices of senior securities prior to their maturity gives seniors no more claim to force corporate action against management than they would have against common stockholders for directing comparably effective behavior. *To allow seniors to enforce such claims when prices drop, but there has been no violation of the contractual obligations of the corporation or of the common stockholders to them, would interfere with common stockholders' control of the enterprise in violation of the essential premises of the arrangements between them --whether the issue arises*

fiduciarians view, creditors are left with contractual, rather than fiduciary, protections.

B. *The Creditor Shift Creates Unacceptable Ambiguity and Uncertainty.*

In addition to the theoretical concerns enunciated above, shifting fiduciary duties to creditors creates undue confusion and uncertainty, and the possibility for unfairness in application.

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*with respect to investment policy, asset management or corporate structure.*

It should also be noted that intractable problems arise if management is regarded as having, from whatever source, fiduciary obligations to both common stockholders and seniors. Although the exclusive benefit principle precludes management from diverting any corporate assets or values from the beneficiary to itself, it implicates a broader premise: *management receives its power and concomitant fiduciary obligation of loyalty for the benefit of the common stock.* But that premise cannot be invoked in deciding how management can or should meet the competing claims of seniors and juniors if the premise is transmuted into a fiduciary obligation to both of them. The same is true for the principle of equality if the competing claims are to unequal return (in amount and in priority). In the absence of relevant contract terms or other instructions, management is left without boundaries set by the parties or the state, and without the support of any signal from the fiduciary notion. The "fiduciary" in such circumstances sits at large, like a Kadi under a tree.

If in theory the fiduciary concept would offer little or nothing to guide management in allocating risks and shares between seniors and common stockholders, in practice it might well produce injury to both sets of putative beneficiaries. As has been pointed out powerfully in the literature, to give management a role that does not tie it to common stockholders but obligates it to be "fair" to conflicting claimants is to enable it to play its obligations to one group off against those to the others. Thus management becomes free to serve its own interests at the expense of all investors or other stockholders.

*Id.* at 644-48 (citations omitted and emphases added). *See also*, Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1837 n. 49 (1992) (noting that the conflict between stockholders' and bondholders' interests does not permit management to owe duties to both and that "more textured and particularized doctrine" should be used). *But see* Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1177-86 (1990) (arguing for fiduciary duties to corporate bondholders). From the fiduciarians' perspective, bondholders should be the easiest case for finding fiduciary duties since dispersed bondholders have relatively little power or knowledge.

a. *When does a shift occur?* Delaware case law contemplates that the creditor shift begins when a firm enters the “zone of insolvency” and continues, presumably with increasing impact, through the point when the firm is insolvent with no reasonable possibility of continuing as a going concern. This construct gives rise to large practical issues, fraught with director risk, of determining when the firm enters (and exits) the various stages of insolvency. The risk is compounded if there is an actual change in creditor rights when the firm enters the “zone,” as opposed to a *Credit Lyonnais*-like power of directors to consider broader constituencies.

In order to determine both insolvency and a descent into the “zone of insolvency”<sup>55</sup> it becomes necessary to keep a running tally of the firm’s asset value and of the amount of its liabilities.<sup>56</sup> Without a liquidation sale it is inherently difficult to determine the going-concern value of assets, particularly in the case of complex assets such as intellectual property and financial assets. Similarly, it is difficult at times to determine the existence and amount of the firm’s liabilities, including contingent and unknown liabilities.<sup>57</sup> This creates a dangerous situation for directors, who might err on the conservative side and find insolvency, thereby running risks that they favor creditors and thereby breach their duties to shareholders and operating the firm in an inefficient manner. Further, by adopting the perspective that directoral decisions in the “zone of insolvency” obtain increased protection from shareholder complaint, directors may seek to establish that the firm is in the “zone” and obtain greater protections. However, it is uncertain where the “zone” begins and ends.

b. *Which creditors should obtain the benefit of a creditor shift?* Creditors are not homogeneous. Some negotiate detailed contracts with the firm, some do not; some are fully secured with the firm’s assets, some have lesser or no security; some are voluntary creditors, some are involuntary creditors; some are protected by law, some are not; some can exit easily from their relationships with the firm, some cannot. With respect to voluntary, fully secured creditors that have detailed loan agreements, one can argue that the extension of fiduciary duties creates a windfall beyond the bargained-for terms. Even with respect to other voluntary creditors, one can argue that they priced their credit terms by reference to the fact that the firm may be unable to pay and that the firm’s

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<sup>55</sup> A recent decision as to what is meant by the “zone of insolvency” has held that in order not to be in the zone a corporation must have the “ability to obtain enough cash for its projected obligations and fund its business requirements for working capital and capital expenditures with a reasonable cushion to cover the variability of its business needs over time.” *Periera v. Cogan*, 294 B.R. 449 (S.D. N.Y. 2003). This seems standard to be very difficult to apply.

<sup>56</sup> Determining insolvency may also require a further determination of whether there is a reasonable prospect that the firm can be continued in the face of its financial difficulties.

<sup>57</sup> There is also a question of the role of contingent and future liabilities in the insolvency analysis. See *Conaway*, *supra* note 9 at 13-50.

directors do not have duties to them beyond an obligation to treat them in good faith, and, therefore, that extension of fiduciary duties creates a windfall. Recognizing a fiduciary duty to ordinary trade creditors, who reach agreements based on oral understandings and past practices and generally do not bargain concerning contract terms, would place such creditors ahead of the firm's secured creditors, and the law should not do this.

Finally, the fact that creditors are not homogeneous means that they have different interests with respect to director decisions. The over-secured creditor may not care, since it will be paid from firm assets regardless of outcome; the marginally secured creditor may prefer conservative decisions that minimize the risk in asset liquidation value; the undersecured or unsecured creditor may be in the same position as a shareholder, and prefer risky management decisions since the reward provided by successful decisions may be the only way to recoup their investment in the firm. It is likely that the creditors that prefer riskier decisions had low volition and cognition levels relative to the creditors who entered contracts, and it is relatively likely that these creditors lack the resources or the desire to assert their interests through fiduciary duty claims. The result is that questions of fairness and efficiency remain despite the creditor shift. In addition, the foundation for the creditor shift appears to be the creditors' interests in residual assets, and there frequently will be questions of which creditor or group of creditors best represent the residual interest.

c. *What are the duties?* Delaware case law indicates that there is a "zone of insolvency" in which directors may consider the interests of constituencies other than shareholders and that directors have fiduciary duties to creditors when the firm is insolvent, at least as insolvency was defined in *Production Resources*. However, the Delaware case law is principally procedural and does not define the substance of these duties or the interests to be taken into account. Further, the Delaware cases seem to contemplate a solvency-insolvency scale in which a downward-spiraling firm enters the zone of insolvency and exits with liabilities in excess of assets and no reasonable possibility of recovery. It is likely that fiduciary duties shift along the scale, and even that an insolvent but improving firm may enter the "zone of insolvency" where directors are protected from creditor suit if they take shareholder interests into account in making decisions. The result is a multivariate analysis that, without clear definition by the courts or the legislature, is too difficult to comprehend or administer.<sup>58</sup>

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<sup>58</sup> See Brudney, *Contract and Fiduciary Duty* at 645-6 (recognizing possible creditor shift and arguing that the board of directors should by law be instructed as to its obligations and furnished with appropriate criteria for decisions, and should be constituted of appropriately weighted representatives of each class of claimants).

In addition, there is a question of whether corporate law concepts that protect directors against shareholder fiduciary claims, such as the business judgment rule, continue to apply when directors owe fiduciary duties to creditors. Although the Delaware Chancery Court has held that “there is room for application of the business judgment rule” in insolvency cases,<sup>59</sup> there is authority to the effect that directors of insolvent firms hold a fiduciary duty as trustees to protect assets for the creditors’ benefit.<sup>60</sup> If directors are or become akin to trustees, trust principles rather than corporate law principles might be applied in defining their duties.<sup>61</sup> Courts have been divided as to whether the business judgment rule, as opposed to “trust fund” standards, should apply to insolvent corporations.<sup>62</sup>

d. *What about closely held corporations, limited partnerships and limited liability companies?* In addition to publicly held companies in which fiduciary duties are generally incapable of contractual modification, the business organization universe is full of other forms, specifically closely-held corporations, limited partnerships, and limited liability companies, in which the emerging consensus is that fiduciary duties are capable of modification by agreement.<sup>63</sup> Delaware has been a leader in establishing this consensus, and in 2004 the Delaware legislature enacted amendments to the Revised Uniform Limited Partnership Act and the Limited Liability Company Act permitting partners and members to contractually restrict or eliminate most fiduciary duties as long as the implied contractual covenant of good faith and fair dealing is not eliminated.<sup>64</sup> Further, the Delaware statutes protect partners, members and managers that in good faith rely on the provisions of their partnership agreement or limited liability company agreement.<sup>65</sup> It is likely that similar rules will apply

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<sup>59</sup> *Angelo, Gordon & Co., L.P. v. Allied Riser Communications Corp.*, 805 A.2d 221, 229 (Del. Ch. 2002).

<sup>60</sup> *See Jewel Recovery LP v. Gordon*, 196 B.R. 348, 354 (N.D. Tex. 1996). *But see Xonics Inc.* 99 B.R. at 872 (holding that directors become trustees but applying business judgment rule standards).

<sup>61</sup> One is left wondering whether substantive duties might shift as the firm moves from the “zone,” through insolvency with a chance of continuation, to insolvency with no reasonable possibility of continuation. The latter situation is most like that of the “trust fund” cases.

<sup>62</sup> *Compare In re Ben Franklin Retail Stores, Inc.*, 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998) (business judgment rule applicable) *with In re Schultz*, 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997) (applying trust fund doctrines).

<sup>63</sup> *See RUPA §103(a)*, 6 Pt. I U.L.A. 73 (2001) (“Except as otherwise provided in subsection (b), relations among the partners and between the partners and the partnership are governed by the partnership agreement. To the extent the partnership agreement does not otherwise provide, this [Act] governs relations among the partners and between the partners and the partnership.”); **cite to ULPA 2001 and ULLCA equivalents.**

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to close corporations in which shareholders bargain concerning the precise fiduciary obligations owed by firm management.

It also is likely that the creditor shift will apply to closely-held corporations, limited partnerships and limited liability companies in which equity owners are protected from personal liability for managerial actions.<sup>66</sup> However, it is unclear how statutory amendments and judicial developments permitting the modification or even elimination of fiduciary duties will affect creditors' rights when the firm is insolvent or in the zone of insolvency. For example, if a limited liability company agreement eliminates the members' and managers' duty of loyalty or duty of care, are the creditors' rights to sue for breaches also eliminated? Since limited liability companies are creatures of contract governed by operating agreements which are freely amendable by the members, can an operating agreement be amended while the firm is in the zone of insolvency (or immediately before it enters the zone) to modify or eliminate fiduciary duties to the company and its members, and hence its creditors? How do statutory provisions addressing the effect of partnership agreements and operating agreements on "third parties" limit the ability of members to alter the managers' fiduciary obligations in a manner that affects creditors rights?<sup>67</sup> My suspicion is that some states, such as Delaware, will conclude that creditors rights will follow the owners' agreement and that other states, such as Colorado under the *Anstine* case, will give less leeway to the parties' agreement.

### III. CONCLUSION

The courts' recent move to create fiduciary duties to creditors in insolvency situations is flawed in principal and unworkable in practice, and should be reversed. This should not be grounds for despair among creditors, since they continue to enjoy legal protections traditionally provided to them pursuant to contract law and under traditional creditors' remedies laws. Creditors should negotiate for those protections that they deem fit for their particular relationship with the debtor, and should proceed to use bankruptcy, receivership and foreclosure protections in the event the debtor entity is unable to meet its obligations.

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<sup>66</sup> See *U.S. Bank, N.A. v. U.S. Timberlands Klamath Falls, LLC*, 864 A.2d 930 (Del. Ch. 2004) (denying motion to dismiss creditors' fiduciary duty claims against manager of allegedly insolvent limited liability company); *Bren v. Capital Realty Group Senior Housing, Inc.*, 2004 WL 370214 at \*4-6 (Del. Ch. 2004) (noteholder was owed fiduciary duty by general partner when limited partnership became insolvent);

<sup>67</sup> See Robert Keatinge, *The Partnership Agreement and Third Parties: ReRULPA Section 110(b)(13) v. RUPA Section 103(b)(10)*, 37 SUFF. U. L. REV. 873 (2004).