Much Ado About Little?
Directors' Fiduciary Duties in the Vicinity of Insolvency

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Abstract**:** Where the contract between a corporation and one of its creditors is silent on some question, should the law invoke fiduciary duties or other extra-contractual rights as a gap filler? In general, the law has declined to do so. There is some precedent, however, for the proposition that directors of a corporation owe fiduciary duties to bondholders and other creditors once the firm is in the vicinity of insolvency.

Courts embracing the zone of insolvency doctrine have characterized the duties of directors as running to the corporate entity rather than any individual constituency. This approach is incoherent in practice and unsupportable in theory. Courts should focus on whether the board has an obligation to give sole concern to the interests of a specific constituency of the corporation. The leading argument for imposing a duty on the board running to creditors when the corporation is in the vicinity of insolvency is the claim that shareholders will gamble with the creditor' money. This Article demonstrates that this argument is unpersuasive. It is director and manager opportunism, rather than strategic behavior by shareholders that is the real concern. Because bondholders and other creditors are better able to protect themselves against that risk than are creditors, there is no justification for imposing such a duty.

This article also argues that the zone debate is much ado about very little. The only cases in which the zone of insolvency debate matters are those to which the business judgment rule does not apply, shareholder and creditor interests conflict, and a recovery could go to directly to those who have standing to sue. In those cases, as this Article explains, there is a strong policy argument that creditors should be limited to whatever rights the contract provides or might be inferred from the implied covenant of good faith.

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I. Introduction

The two most basic questions of corporate governance are: (1) Who decides? In other words, what organ within the corporation ultimately is in control? (2) Whose interests prevail? When the ultimate decision maker is presented with a zero sum game, in which it must prefer the interests of one constituency over those of all others, which constituency prevails?

The latter question animates the corporate social responsibility debate. At one end of the spectrum are those who contend corporations should be run so as to maximize shareholder wealth. At the other end are stakeholderists, who argue that directors and managers should consider the interests of all corporate constituencies in making corporate decisions.[1]

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[1] As applied to corporation law and policy, the term "stakeholders" reportedly originated in a 1963 Stanford Research Institute memorandum as a descriptive term for "those groups without whose support the organization would cease to exist." R. Edward Freeman & David L. Reed, *Stockholders and Stakeholders: A New Perspective on Corporate Governance*, 25 CAL. MGMT. REV. 88, 89 (1983).

In this article, I take up a subset of that larger debate; namely, the fiduciary duties, if any, owed by directors to creditors of a corporation that is in the "vicinity of insolvency."[2] In the dominant contractarian theory of the corporation,[3] corporate law is understood as providing a standard form contract for the parties.[4] In other words, where the actual contracts reflected in the corporation's organic documents are silent, the law fills in the gaps. In particular, the fiduciary duties of care and loyalty owed to shareholders can be understood as gap-fillers that complete the contract between the corporation and its equity investors.[5]

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[2] *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 WL 277613 at *34 (Del. Ch. 1991) ("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, but owes its duty to the corporate enterprise.").

[3] The nexus of contracts model treats the corporation as a nexus of contracts among the various factors of production. *See, e.g.*, HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 18 (1996) (describing the firm as "a nexus of contracts," by which he means that the "firm is in essence the common signatory of a group of contracts" among various factors of production). Contractarians thus conceptualize the firm not as an entity, but as an aggregate of various inputs acting together to produce goods or services. Employees provide labor. Creditors provide debt capital. Shareholders initially provide equity capital and subsequently bear the risk of losses and monitor the performance of management. Management monitors the performance of employees and coordinates the activities of all the firm's inputs. The board supervises management and sets overall policy. *See generally* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 318-28 (1993); *see also* William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993) (former Delaware Chancellor opining that the nexus of contracts model of the firm is now the "dominant legal academic view").

[4] *See* Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1781 (2001) ("Contractarian commentators … argue that corporate law is best understood as a kind of standard form contract for governing relationships among officers, directors, and shareholders."). Providing a standard form contract, of course, is not the sole function of corporation law. Law also provides institutional features that could not be effected by internal contracts. *See, e.g.*, Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 406-23 (2000) (arguing that parties could not effect affirmative asset partitioning by contract). The firm thus has both contractual and institutional attributes.

[5] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 92 (1991). *Cf.* Jonathan R. Macey & Geoffrey P. Miller, *Good*

The shareholder-corporation contract, however, is not the only one that is incomplete. As with any relational contract, bond indentures and other long-term debt agreements also inevitably prove incomplete. In a world characterized by uncertainty, complexity, and bounded rationality, it cannot be otherwise.[6] Where the bond indenture is silent, should the law invoke fiduciary duties or other extra-contractual rights as gap fillers? As we shall see, the law has declined to do so.[7] As we shall also see, however, there is some precedent for the proposition that directors of a corporation do owe fiduciary duties to bondholders and other creditors once the firm is in the vicinity of insolvency.

Part II of this Article reviews the relevant legal rules. It begins with a review of the precedents establishing the basic rule that directors have a fiduciary duty to maximize shareholder wealth. It then turns to the precedents on fiduciary duties, if any, owed to creditors.

Part III addresses the policy arguments. It begins by criticizing the framing given the issue by Delaware courts. Those courts have characterized the duties of directors as running to the corporate entity rather than any individual constituency. This approach is incoherent in practice and unsupportable in theory. Instead, courts should focus on whether the board has an obligation to give sole concern to the interests of a specific constituency of the corporation. Part III then reviews the leading argument in favor of imposing fiduciary duties to creditors when the corporation is in the vicinity of insolvency; namely, the notion that shareholders will gamble with the creditor' money. I conclude that this argument is unpersuasive. It is director and manager opportunism, rather than strategic behavior by shareholders, which is the real concern. Part III concludes by arguing that bondholders and other creditors are better able to protect themselves against that risk than are creditors.

Finally, Part IV asks whether any of this matters very much. Even if the fiduciary duties owed by directors shift in the vicinity of insolvency from shareholders to creditors (or run to both in that setting), the vast majority of board of directors decisions should continue to be insulated from judicial review by the business judgment rule. Because I argue that the rule should apply even to

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Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory, 42 STAN. L. REV. 1059, 1068-69 (1990) (arguing that "courts should treat an allegation of a breach of a fiduciary duty as they would treat any other alleged breach of contract").

[6] *See* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES 23 (1975) (arguing that, under conditions of uncertainty and complexity, it becomes "very costly, perhaps impossible, to describe the complete decision tree").

[7] *See infra* Part II.B.

decisions in which the board makes trade offs between the interests of shareholders and creditors (or declines to make such trade offs), the debate arguably ends up being much ado about nothing (or, at least, about very little).

II. The Law

Corporate law does not mandate corporate social responsibility. To the contrary, the real question is whether the law even permits corporate social responsibility. Put another way, to what extent do the fiduciary duties of corporate directors permit them to consider the interests of creditors and other nonshareholder constituencies when making corporate decisions? After establishing that the law allows directors to do so only to the extent such consideration redounds to the best interests of the shareholders, this Part examines the legal rules governing fiduciary duties to creditors, with particular attention to the duties of directors of a corporation that is in the vicinity of insolvency.

A. The Shareholder Wealth Maximization Norm

Despite the obvious centrality of this problem to the operation of business corporations, there are surprisingly few authoritative precedents on point. Nevertheless, the law is reasonably well settled.

The law's basic position on corporate social responsibility was famously articulated in *Dodge v. Ford Motor Co.*[8] In 1916, Henry Ford owned 58% of the stock of Ford Motor Co.[9] The Dodge brothers owned 10%, with five other individuals owning the remaining shares.[10] Beginning in 1908, Ford Motor paid a regular annual dividend of $1.2 million.[11] Between 1911 and 1915 Ford Motor also regularly paid huge "special dividends," totaling over $40 million.[12] In 1916, Henry Ford announced that the company would stop paying special dividends.[13] Instead, the firm's financial resources would be devoted to expanding its business.[14] Ford also continued the company's policy of lowering prices, while improving quality.[15] The Dodge brothers sued, asking the court to order Ford

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[8] 170 N.W. 668 (Mich. 1919).

[9] *See id.* at 669-70 (summarizing holdings of the parties).

[10] *Id.*

[11] *Id.* at 670

[12] *Id.*

[13] *Id.* at 671.

[14] *Id.*

[15] *See id.* at 682-84 (discussing Henry Ford's plans for the corporation).

Motor to resume paying the special dividends and to enjoin the proposed expansion of the firm's operations.[16] At trial, Ford testified to his belief that the company made too much money and had an obligation to benefit the public and the firm's workers and customers.[17]

The plaintiff Dodge brothers contended an improper altruism[18] towards his workers and customers motivated Ford.[19] The court agreed, strongly rebuking Ford:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.[20]

Consequently, "it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others."[21]

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[16] *Id.* at 673.

[17] *See id*. at 682-84 (summarizing Henry Ford's testimony).

[18] The term altruism is used herein to describe any decision motivated by considerations other than shareholder wealth maximization. It thus includes, but also is much broader than, the special case of corporate philanthropy.

[19] *See Dodge*, 170 N.W. at 671-73 (summarizing Dodge brothers' allegations).

[20] *Id.* at 684.

[21] *Id.* For an interesting interpretation of *Dodge*, which argues that the shareholder wealth maximization norm originated as a means for resolving disputes among majority and minority shareholders in closely held corporations, see D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277 (1998). I am skeptical of Smith's interpretation. In the first instance, the court's own analysis in *Dodge* is not limited to close corporations. Smith places considerable emphasis on the sentence immediately preceding the court's statement of the shareholder wealth maximization norm. *See id*. at 319 (using italics for emphasis). In that sentence, the court draws a distinction between the duties Ford believed he and his fellow stockholders owed to the general public "and the duties which in law *he and his codirectors* owe to protesting, minority stockholders." *Dodge*, 170 N.W. at 684 (emphasis supplied). On its face, the duty to which the court refers is that of a director rather than the duties of a majority shareholder. (Concededly, both the specific passage in question and the opinion in general are sufficiently ambiguous to permit Smith's interpretation.) In the second instance, whatever *Dodge* originally meant, the evolutionary processes of the common law have led to *Dodge* being interpreted as establishing a basic rule for boards of directors; namely, that the board has

To be sure, a few cases posit that directors need not treat shareholder wealth maximization as their sole guiding star. *A. P. Smith Manufacturing Co. v. Barlow*,[22] the most frequently cited example, upheld a corporate charitable donation on the ground, inter alia, that "modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate."[23] Ultimately, however, the differences between *Barlow* and *Dodge* have little more than symbolic import. As the *Barlow* court recognized, shareholders' long-run interests are often served by decisions (such as charitable giving) that appear harmful in the short-run.[24] Because the court acknowledged that the challenged contribution thus could be justified on profit-maximizing grounds, its broader language on corporate social responsibility is arguably mere dictum. In any event, *Barlow* remains the minority view.[25]

Indeed, *Dodge*'s theory of shareholder wealth maximization has been widely accepted by courts over an extended period of time. Almost three quarters of a century after *Dodge*, for example, the Delaware Chancery Court similarly opined in *Katz v. Oak Industries*:[26] "It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders."[27] In

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a duty to maximize shareholder wealth. As Smith himself concedes, moreover, his interpretation departs from the "consensus" of most corporate law scholars. Smith, *supra*, at 283.

[22] 98 A.2d 581 (N.J. 1953).

[23] *Id.* at 586. *See also* Theodora Holding Corp. v. Henderson, 257 A.2d 398, 404 (Del. Ch. 1969) (opining that corporate social responsibility is a desirable goal).

[24] *Barlow,* 98 A.2d at 586. Despite its strong emphasis on the board's obligation to pursue shareholder interests, the *Dodge* court likewise recognized that, in many situations, ethical or humanitarian considerations are wholly consistent with long-term shareholder wealth maximization. Providing health care to employees costs money in the short-run, for example, but in the long-run healthy employees with high morale may be more productive. A board of directors thus may decide to incur such short-run costs in order to reap long-term gains without fear of liability: "The difference between an incidental humanitarian expenditure of corporate funds for the benefit of the employees, like the building of a hospital for their use and the employment of agencies for the betterment of their condition, and a general purpose and plan to benefit mankind at the expense of others, is obvious." Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

[25] ROBERT C. CLARK, CORPORATE LAW 682 n.11 (1986) (discussing *Barlow).*

[26] Katz v. Oak Indus., Inc., 508 A.2d 873 (Del. Ch. 1986).

[27] *Id. at* 879.

Long v. Norwood Hills Corp.,[28] a Missouri court observed: "Plaintiff cites many authorities [including *Dodge*] to show that the ultimate object of every ordinary trading corporation is the pecuniary gain of its stockholders and that it is for this purpose the capital has been advanced."[29] The court further stated that it had "no quarrel with plaintiff insofar as the rules of law stated therein govern the actions of majority stockholders and the boards of directors of corporations."[30] Setting aside "a possible exception or two," Robert Clark concludes that "courts have not retreated from the assumption that the primary or residual purpose of a business corporation is to make profits for its shareholders."[31]

Dodge does not stand for the proposition that directors will be held liable for considering the social consequences of corporate actions, however, despite its strongly pro-shareholder wealth maximization rhetoric. To be sure, having found that Ford had failed to pursue shareholder wealth maximization, the court ordered Ford Motor to resume paying its substantial special dividends.[32] Invoking the business judgment rule,[33] however, the *Dodge* court declined to interfere with Ford's plans for expansion and dismissed the bulk of plaintiff's complaint.[34]

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[28] 380 S.W.2d 451 (Mo. Ct. App. 1964).

[29] *Id*. at 476.

[30] *Id.*

[31] CLARK, *supra* note 25, at 682.

[32] *See Dodge*, 170 N.W. at 685 (summarizing holding).

[33] The business judgment rule, of course, pervades every aspect of corporate law, from allegedly negligent decisions by directors, to self-dealing transactions, to board decisions to seek dismissal of shareholder litigation, and so on. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (fiduciary duties of controlling shareholder); Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. 1968) (operational decision); Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979) (dismissal of derivative litigation). Two conceptions of the business judgment rule compete in the case law. One treats the rule as having substantive content. In this version, the business judgment rule comes into play only after one has first determined that the directors satisfied some standard of conduct. *See, e.g.,* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) (holding that plaintiffs rebut the business judgment rule's presumption of good faith by "providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care"). Alternatively, the business judgment rule is seen as an abstention doctrine. Under this version, the court will abstain from reviewing the substantive merits of the directors' conduct unless the plaintiff can rebut the business judgment rule's presumption of good faith. *See, e.g.,* Shlensky v. Wrigley, 237 N.E.2d 776, 779 (Ill. App. 1968) (holding that: "In a purely business corporation ... the authority of the directors in the conduct of the business of the corporation must be regarded as absolute when they act within the law, and the court is

A similar result was reached in one of corporate law's hoariest chestnuts, *Shlensky v. Wrigley*,[35] in which a minority shareholder in the Chicago Cubs sued P.K. Wrigley, the team's majority shareholder, over the latter's famous refusal to install lights at Wrigley Field. Shlensky claimed the decision against lights was motivated by Wrigley's beliefs that baseball was a day-time sport and that night baseball might have a deteriorating effect on the neighborhood surrounding Wrigley Field.[36] Despite Shlensky's apparently uncontested evidence that Wrigley was more concerned with nonshareholder than with shareholder interests, the Illinois Appellate Court dismissed for failure to state a claim upon which relief could be granted.[37] Although this result on superficial examination may appear to devalue shareholder wealth maximization, on close examination the case involves nothing more than a wholly unproblematic application of the business judgment rule.[38]

To be sure, some scholars rely on such outcomes to argue that the business judgment rule is *intended* to allow directors to make trade-offs between the interests of shareholders and nonshareholder constituencies.[39] In fact, however,

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without authority to substitute its judgment for that of the directors."). For reasons developed elsewhere at length, I find the abstention version more persuasive. Stephen M. Bainbridge*, The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004).

[34] *See id.* at 684 ("We are not, however, persuaded that we should interfere with the proposed expansion of the business of the Ford Motor Company.").

[35] 237 N.E.2d 776 (Ill. App. 1968).

[36] *Id*. at 778.

[37] *Id*. at 778-80.

[38] *See* Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPPERDINE L. REV. 971, 978-79 (1992) (discussing *Shlensky*).

[39] *See, e.g.,* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 303 (1999) (arguing that the business judgment rule authorizes directors to make trade offs between shareholder and nonshareholder interests); Kent Greenfield & John E. Nilsson, *Gradgrind's Education: Using Dickens and Aristotle to Understand (and Replace?) the Business Judgment Rule*, 63 BROOKLYN L. REV. 799, 831 (1997) (arguing that the business judgment rule reflects "an underlying distrust of the strict fiduciary duty to maximize shareholder returns"). For an argument that Blair and Stout misinterpreted the law in this area, see David Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001, 1009-20 (2000).

Some of these same scholars have argued that the so-called nonshareholder constituency statutes adopted by many states (although not Delaware) call into question while that may sometimes be the *effect* of the rule, it is an unintended consequence of operationalizing an entirely different policy goal. As the Delaware Supreme Court has explained:

> Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in [Delaware General Corporation Law] § 141(a), the business and affairs of a Delaware corporation are managed by or under its board of directors…. The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors.[40]

On balance, this policy of judicial deference to the board of directors' exercise of discretionary authority redounds to the shareholders' best interests, as I have demonstrated elsewhere in detail,[41] even though the rule occasionally allows directors to escape liability in connection with decisions that failed to maximize shareholder wealth.

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the continuing validity of the shareholder wealth maximization norm. *See, e.g.,* Blair & Stout, *supra*, at 303 n.144; Greenfield & Nilsson, *supra*, at 838-39. As I have argued elsewhere, however, these statutes do not entirely reject the traditional shareholder wealth maximization norm. Instead, they modify the norm by allowing the board to make trade-offs between shareholder and stakeholder interests. Bainbridge, *supra* note 38, at 989-96. As such, the statutes admittedly work an unfortunate change in the basic normative principles underlying corporate law. *See* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423-24 n.2 (1993). Fortunately, courts seem to be ignoring these statutes and, at present, they appear to be little more than dust gathering relics of the 1980s wave of state antitakeover legislation. *See id.* (noting the "dearth of cases"). The nonshareholder constituency statutes were just another example of special interest legislation adopted at the behest of union leaders and managers of target corporations to protect important local businesses from takeovers. Bainbridge, *supra* note 38, at 993.

[40] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). *Cf.* Marx v. Akers, 666 N.E.2d 1034, (N.Y. 1996) (noting that "shareholder derivative actions infringe upon the managerial discretion of corporate boards…. Consequently, we have historically been reluctant to permit shareholder derivative suits, noting that the power of courts to direct the management of a corporation's affairs should be 'exercised with restraint.'"); *see also* Pogostin v. Rice, 480 A.2d 619, 624 (noting that "the derivative action impinges on the managerial freedom of directors").

[41] Bainbridge, *supra* note 33, at 109-29.

Courts have recognized that the business judgment rule rests on shareholder-oriented policy considerations. In *Joy v. North*,[42] for example, Judge Ralph Winter explained that:

> Although the [business judgment] rule has suffered under academic criticism, it is not without rational basis. ... [B]ecause potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. ... Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others. ... A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.[43]

Delaware Chancellor William Allen advanced a slightly different, but still shareholder-focused, rationale for the rule in *Gagliardi v. Trifoods Int'l, Inc.*[44]:

> Corporate directors of public companies typically have a very small proportionate ownership interest in their corporations and little or no incentive compensation. Thus, they enjoy (as residual owners) only a very small proportion of any "upside" gains earned by the corporation on risky investment projects. If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky ... their liability would be joint and several for the whole loss (with I suppose a right of contribution). Given the scale of operation of modern public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects. Given this disjunction, only a very small probability of director liability based on "negligence", "inattention", "waste", etc., could induce a board to avoid authorizing risky investment projects to any extent! Obviously,

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[42] 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

[43] *Id.* at 886. Or, as Chancellor Allen similarly observed in Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049 (Del. Ch. 1996):

> Shareholders can diversify the risks of their corporate investments. Thus, it is in their economic interest for the corporation to accept in rank order all positive net present value investment projects available to the corporation, starting with the highest risk adjusted rate of return first. Shareholders don't want (or shouldn't rationally want) directors to be risk averse. Shareholders' investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital.

Id. at 1052.

[44] 683 A.2d 1049 (Del. Ch. 1996).

> it is in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss."[45]

Drawing this distinction between the business judgment rule's *intent* and *effect* is supported by those cases in which the business judgment rule does not apply, especially those involving a board of director's response to an unsolicited takeover bid. In *Unocal Corp. v. Mesa Petroleum Co.*,[46] for example, the Delaware Supreme Court held that the board could consider "the impact of the bid on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community)."[47] In that case, however, a "corporate raider with a national reputation as a 'greenmailer'" faced Unocal's board with a structurally coercive bid.[48] Accordingly, the directors reasonably believed that the bid was not in the best interests of any corporate constituency and, on the facts before the court, there arguably was no conflict between shareholder and stakeholder interests.

Other situations are less clear. Suppose, for example, the bidder makes a fairly priced, non-coercive offer, but also announces plans to close plants and lay off numerous workers. The target's board of directors reasonably concludes that the negative impact on its employees exceeds the gains shareholders will garner. Did *Unocal* permit the board to turn down such an offer?

In *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*,[49] the Delaware Supreme Court answered that question in the negative, adding two crucial provisos to *Unocal*. The first is of general applicability, forbidding the target's

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[45] *Id*. at 1052.

[46] 493 A.2d 946 (Del. 1985). Several judicial opinions outside Delaware suggest that boards may consider nonshareholder interests in making structural decisions. *See, e.g.*, Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255 (2d Cir. 1984); Herald Co. v. Seawell, 472 F.2d 1081 (10th Cir. 1972); GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016 (S.D.N.Y. 1985); Enterra Corp. v. SGS Assoc., 600 F. Supp. 678 (E.D. Pa. 1985); Abramson v. Nytronics, Inc., 312 F. Supp. 519 (S.D.N.Y. 1970). It is difficult to form a coherent picture from these cases, as most courts outside of Delaware face corporate law issues on a sporadic basis, which precludes sustained doctrinal development. *Cf.* Treadway Cos., Inc. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980) ("The law in this area is something less than a seamless web.").

[47] *Id*. at 955.

[48] *Id.* at 956.

[49] 506 A.2d 173 (Del. 1986).

board from protecting stakeholder interests at the expense of shareholder interests. Rather, any management action benefiting stakeholders must produce ancillary shareholder benefits.[50] In other words, directors may only consider stakeholder interests if doing so would benefit shareholders.[51] Second, where a corporate control auction triggering the so-called *Revlon* duties has begun, stakeholders become entirely irrelevant. Instead, shareholder wealth maximization is the board's only appropriate concern.[52] As such, when the business judgment rule does not apply to insulate the directors' decisions from judicial review, the board will violate its fiduciary duty of shareholder wealth maximization if it considers any interests other than those of the shareholders.[53] In turn, this confirms that the duty to maximize shareholder wealth is the principal obligation of directors, albeit one as to which judicial scrutiny is sometimes barred by the business judgment rule.

B. Fiduciary Duties to Creditors?

Consistent with the conclusions drawn in the preceding section, the dominant view is that neither the corporation itself nor its officers and directors owe fiduciary duties to bondholders or other creditors.[54] Instead, "the relationship between a corporation and the holders of its debt securities, even convertible debt

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[50] *See id.* at 182 ("A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."). A somewhat weaker formulation was used in Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989), which allows consideration of nonshareholder interests provided they bear "some reasonable relationship to general shareholder interests." *Id*. at 1282 n. 29.

[51] *Compare* Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209, 231-32 (S.D. Ohio), *aff'd*, 815 F.2d 76 (6th Cir. 1987) (employee stock ownership plan invalidated because there was "no evidence in the record as to how the ESOP would benefit the stockholders nor as to how Ropak's tender offer posed a threat to Buckhorn's employees") *with* Shamrock Holdings, Inc. v. Polaroid Co., 559 A.2d 257, 276 (Del. Ch. 1989) (employee stock ownership plan upheld because it was "likely to add value to the company and all of its stockholders").

[52] *Revlon*, 506 A.2d at 182.

[53] Black & Decker Corp. v. American Standard, Inc., 682 F. Supp. 772, 786-87 (D. Del. 1988); C-T of Virginia Inc. v. Barrett, 124 Bankr. 689 (W.D.Va. 1990); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 185 (Del. 1986).

[54] *See, e.g.,* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989); Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

securities, is contractual in nature."[55] The contract thus both defines and confines the scope of the corporation's obligations to its bondholders.

To be sure, a few cases purportedly hold to the contrary. Most of these cases, however, involved fraudulent schemes or conveyances actionable outside the bounds of corporate fiduciary obligation.[56] Other cases in this genre involve recharacterization of nominal debt securities as equity.[57] Still others are mere dicta.[58]

The limited extra-contractual rights of bondholders thus are provided solely by the implied covenant of good faith found in all contracts. *Katz v. Oak Industries*,[59] for example, held that the implied covenant is breached when it is clear from the express terms of the indenture that the parties would have prohibited the challenged act if they had thought to negotiate about it:

> [T]he appropriate legal test is not difficult to deduce. It is this: is it clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with

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[55] Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986).

[56] *See* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524 (S.D.N.Y. 1989) (analyzing cases).

[57] *See, e.g.,* Eliasen v. Green Bay & W. R.R. Co., 569 F. Supp. 84 (E.D. Wis. 1982) (discussing theory and cases). In *Eliasen*, the Class B debentures in question had economic rights more closely resembling those of common stock than normal debt. The Class B debentures had no right to regular payment of interest, but were paid interest only when the board chose and only after the nominal stockholders had been paid, and the debentures came last in a liquidation. The court nevertheless declined to treat the debentures as the equivalent of stock because the Class B debentures had no voting rights and, moreover, were originally issued in a reorganization of an insolvent debtor to creditors who would have been entitled to nothing in a liquidation. *Id*.

[58] The classic example is Green v. Hamilton Int'l Corp., 437 F. Supp. 723 (S.D.N.Y. 1977), in which the court opined that "[a]s holders of convertible debentures, plaintiffs were part of 'the entire community of interests in the corporation—creditors as well as stockholders' to whom the fiduciary duties of directors and controlling shareholders run." *Id*. at 729 n.4 (quoting Justice Douglas' famous dictum in Pepper v. Litton, 308 U.S. 295, 307 (1939)). The passage from *Green* is mere dicta because the court simply determined that plaintiff's claim of fraud under Securities Exchange Act Rule 10b-5 could survive a FRCP 12(b)(6) motion to dismiss. In addition, while *Green* purported to interpret Delaware law, the Delaware Supreme Court specifically disavowed *Green* in Simons v. Cogan, 549 A.2d 300, 303-04 (Del. 1988).

[59] Katz v. Oak Indus., Inc., 508 A.2d 873 (Del. Ch. 1986).

> respect to that matter. If the answer to this question is yes, then, in my opinion, a court is justified in concluding that such act constitutes a breach of the implied covenant of good faith.[60]

The oft-cited *Met Life* decision likewise invoked an implied covenant of good faith, although its treatment of that covenant differed somewhat from *Katz*.[61] In the latter, the Chancery Court suggested that an implied covenant of good faith is part of every contract.[62] In *Met Life*, however, the court suggested that a covenant of good faith is implied only when necessary to ensure that neither side deprives the other side of the "fruits of the agreement."[63] The court then seemingly limited the fruits of the bond indenture to regular payment of interest and ultimate repayment of principal.[64] In any case, the court made clear that "the implied covenant will only aid and further the explicit terms of the agreement and will never impose an obligation which would be inconsistent with other terms of the contractual relationship."[65] Consequently, the implied covenant will not give bondholders any extra-contractual rights inconsistent with those set out in the indenture.

Despite these and some minor semantic differences, however, the two cases are quite similar in a number of respects. In particular, both *Katz* and *Met Life* constrain the implied covenant of good faith by reference to the express terms of the contract.[66] Taken together, the two decisions reflect a basic principle, which can be expressed colloquially as "you made your bed, now you have to lie in it."

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[60] *Id.* at 880. The facts of *Katz* are discussed infra notes 78-86 and accompanying text.

[61] Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989). *Met Life* arose out of the leveraged buyout of RJR Nabisco by Kohlberg Kravis Roberts & Co. The new RJR Nabisco debt issued to finance the LBO had the same bankruptcy priority as RJR Nabisco's pre-LBO debt. RJR Nabisco's equity cushion thus was substantially diminished and the value of the existing debt was substantially reduced. The pre-LBO bondholders claimed that their contract rights had been violated. Because the express terms of the contract had not been violated, the court focused on the implied covenant of good faith.

[62] *Katz*, 508 A.2d at 880.

[63] *Met Life,* 716 F. Supp. at 1517.

[64] *See id.* at 1518 (explaining that "the substantive 'fruits' guaranteed by" the indenture "include the periodic and regular payment of interest and the eventual repayment of principal").

[65] *Id.* at 1517.

[66] *Compare Katz*, 508 A.2d at 880 (limiting the covenant to situations in which it is "clear from what was expressly agreed upon that the parties who negotiated the express

Do these rules change when the corporation is insolvent[67] or nearly so? In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp*.,[68] Delaware Chancellor William Allen famously opined 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, but owes its duty to the corporate enterprise.[69]

Or, as Vice Chancellor Leo Strine explained:

> The obligation of directors in that context of high risk and uncertainty … was not "merely [to be] the agent of the residue risk bearers" but rather to remember their fiduciary duties to "the corporate enterprise" itself, in the sense that the directors have an obligation "to the community of interest that sustained the corporation ...." and to preserve and, if prudently possible, to maximize the corporation's value to best satisfy the legitimate claims of all its constituents, and not simply to pursue the course of action that stockholders might favor as best for them.[70]

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terms of the contract would have agreed to proscribe the act later complained of") *with Met Life,* 716 F. Supp. at 1517 (holding that the implied covenant may only be invoked to "further the explicit terms of the agreement").

[67] *See* FDIC v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982) (stating that "when the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors"); Henderson v. Buchanan (In re Western World Funding, Inc.), 52 B.R. 743, 763 (Bankr. D. Nev. 1985) (holding that when a "corporation is insolvent" the fiduciary of directors "run to creditors"); Production Resources Group, LLC v. NCT Group, Inc., 863 A.2d 772, 790-91 (Del. Ch. 2004) ("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. [FN58] This is an uncontroversial proposition …."); Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. Ch. 1992) (observing that "when the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors"). On the question of when a corporation is insolvent, see Zipora Cohen, *Directors' Negligence Liability to Creditors: A Comparative and Critical View*, 26 J. CORP. L. 351, 377-79 (2001).

[68] 1991 WL 277613 (Del. Ch. 1991).

[69] *Id.* at *34. Cohen calls attention to "the distinction that exists between the theory of the trust fund [applicable where the corporation is insolvent] and the ruling of the Delaware Chancery Court in the *Credit Lyonnais* case. Whereas the former theory sees the interests of the creditors as the sole interests which corporate directors are allowed to take into account in situations of insolvency, the judgment in the *Credit Lyonnais* case suggests consideration be given to the interests of the firm as a whole." Cohen, *supra* note 67, at 381.

[70] Production Resources Group, LLC v. NCT Group, Inc., 863 A.2d 772, 788 (Del. Ch. 2004).

Admittedly, this approach has a certain superficial appeal. A corporation presently in the vicinity of insolvency likely eventually will end up in bankruptcy for either liquidation or reorganization. In bankruptcy, assuming the shareholders' claim is wiped out, the creditors effectively become the residual claimants to the corporation's remaining assets. Because fiduciary duties generally are owed to the residual claimant, there is an argument for extending fiduciary duties to the creditors benefit.

Before one assumes that *Credit Lyonnais* is settled Delaware law, however, consider this cautionary note recently advanced by former Delaware Supreme Court Chief Justice Norman Veasey:

> The Delaware Supreme Court has never directly addressed the vicinity of insolvency issue, although one case involving the issue was appealed to the court in 2000. The court affirmed the case on the basis of the Court of Chancery's opinion and expressly stated that it did not reach the issue of "whether or to what extent directors of a corporation said to be in the so-called 'vicinity of insolvency' owe fiduciary duties to preferred stockholders." Thus, the questions of what is the "vicinity of insolvency" and how must directors carry out their fiduciary duties in that milieu are areas of future development in the Supreme Court's jurisprudence of fiduciary duties and the business judgment rule.[71]

At the very least, this passage must been seen as a signal that the issue remains open; it may even signal that the issue is in some doubt.

III. The Policy

As noted earlier, many scholars reject the shareholder wealth maximization principle on normative grounds; instead, they believe that, as a matter of sound social policy, directors should have obligations to various nonshareholder constituencies or, at the very least, be able to consider the impact of corporate actions on those constituencies.[72] In contrast, I have repeatedly defended the shareholder wealth maximization norm on normative grounds.[73] Accordingly, I do not intend to rehash herein the general arguments in favor of the shareholder

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[71] E. Norman Veasey & Christine T. di Guglielmo, *What Happened in Delaware Corporate Law and Governance From 1992–2004? A Retrospective on Some Key Developments*, 153 U. PENN. L. REV. 1399, 1432 (2005).

[72] *See supra* note 1 and accompanying text.

[73] *See, e.g.,* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 419-29 (2002); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 574-92 (2003); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993).

wealth maximization norm. Instead, I propose to focus on those arguments most directly relevant to a corporation operating in the vicinity of insolvency.

A. A Duty to the Corporation?

Technically, *Credit Lyonnais* does not stand for the proposition that directors of a corporation in the vicinity of insolvency owe fiduciary duties to creditors of the corporation. Instead, Chancellor Allen held that the board of directors of such a corporation "owes its duty to the corporate enterprise."[74] In a famous footnote, Chancellor Allen went on to explain how such a duty differed from the usual conception that directors owe their duties to the shareholders, which is worth quoting at full length given its importance to the analysis:

> The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors. Consider, for example, a solvent corporation having a single asset, a judgment for $51 million against a solvent debtor. The judgment is on appeal and thus subject to modification or reversal. Assume that the only liabilities of the company are to bondholders in the amount of $12 million. Assume that the array of probable outcomes of the appeal is as follows:

			Expected Value
25%	chance of affirmance	($51mm)	$12.75
70%	chance of modification	($4mm)	2.8
5%	chance of reversal	($0)	0
	Expected Value of Judgment on Appeal		$15.55

> Thus, the best evaluation is that the current value of the equity is $3.55 million. ($15.55 million expected value of judgment on appeal-$12 million liability to bondholders). Now assume an offer to settle at $12.5 million (also consider one at $17.5 million). By what standard do the directors of the company evaluate the fairness of these offers? The creditors of this solvent company would be in favor of accepting either a $12.5 million offer or a $17.5 million offer. In either event they will avoid the 75% risk of insolvency and default. The stockholders, however, will plainly be opposed to acceptance of a $12.5 million settlement (under which they get practically nothing). More importantly, they very well may be opposed to acceptance of the $17.5 million offer under which the residual value of the corporation would increase from $3.5 to $5.5 million. This is so because the litigation alternative, with its 25% probability of a $39 million outcome to them ($51 million - $12 million = $39 million) has an expected value to the residual risk bearer of $9.75 million ($39

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[74] Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 WL 277613 at *34 (Del. Ch. 1991).

> million x 25% chance of affirmance), substantially greater than the $5.5 million available to them in the settlement. 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 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.[75]

Former Delaware Supreme Court Chief Justice Veasey has likewise embraced an understanding of the problem centered on the notion that directors owe duties to the corporate entity in this context, although we shall see that Veasey’s analysis ultimately proves to be somewhat more nuanced:

> … it is important to keep in mind the precise content of this “best interests” concept—that is, to whom this duty is owed and when. Naturally, one often thinks that directors owe this duty to both the corporation and the stockholders. That formulation is harmless in most instances because of the confluence of interests, in that what is good for the corporate entity is usually derivatively good for the stockholders. There are times, of course, when the focus is directly on the interests of stockholders. But, in general, the directors owe fiduciary duties to the corporation, not to the stockholders. This provides a doctrinal solution to the incentive problem that is entirely consistent with the emphasis on board governance, namely, that the board’s duty is to do what is best for the corporation.[76]

From a doctrinal perspective, this emphasis on fiduciary duties to the corporate entity is essentially incoherent. As to solvent corporations, the law already distinguishes between duties running to the corporate entity and to the shareholders. This distinction is what differentiates direct from derivative

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[75] *Id*. at *34 n.55.

[76] Veasey & Guglielmo, *supra* note 71, at 1431.

shareholder litigation, after all.[77] But if directors already owe some duties to the corporate entity, what changes doctrinally when the corporation is in the "vicinity of insolvency"?

Allen's highly stylized hypothetical, moreover, conflates issues of pie expansion and pie division. Suppose the board of directors was faced with a true zero sum decision, in which the sole issue is how to divide a static sum between two or more corporate constituencies. For all its detail, Allen's analysis fails to offer directors any guidance for making that decision. This is so because, in the zero sum case, the value of the corporate entity by definition will be unaffected by the decision.

Similarly, it is difficult to square Allen's analysis here with his analysis in *Katz v. Oak Industries*.[78] *Katz* involved the common situation in which a debtor attempts to avoid bankruptcy through a workout including an exchange offer with bondholders. Oak undertook a drastic down-sizing and recapitalization involving the sale of a major part of its business to Allied-Signal.[79] The buyer also agreed to purchase $15 million of newly issued common stock, but that obligation was conditioned on a restructuring of Oak's debt.[80] Oak agreed to effect a series of exchange offers in which at least 85% of Oak's debt securities would get cash or stock worth substantially less than the principal amount of their present securities.[81] Covenants in Oak's indentures prohibited both the recapitalization and the exchange offers.[82] Accordingly, Oak had to obtain bondholder approval of appropriate amendments to the various indentures.[83] To do so, Oak required the bondholders to consent to the requisite amendments as a condition of participating in the exchange offer.[84] Plaintiff objected to the transaction on the grounds that it was "coercive."[85] Chancellor Allen framed the issue not as whether plaintiff was

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[77] *See* Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, (Del. 2004) ("The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation.).

[78] Katz v. Oak Indus., Inc., 508 A.2d 873 (Del. Ch. 1986).

[79] *Id.* at 876.

[80] *Id.*

[81] *Id.*

[82] *Id.* at 877.

[83] *Id.*

[84] *Id.*

[85] *Id.* at 879.

coerced, but as whether such coercion, if any, was "wrongful."[86] He explained why the issue must be so framed in the following passage:

> … 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 indenture provisions designed to afford such protection.[87]

Instructively, "Oak's financial results" during the relevant time period showed "it unmistakably to be a company in deep trouble."[88] It is thus quite difficult to square Allen's forthright recognition of the pie division issue in *Katz* with *Credit Lyonnais.* It's also quite difficult to square his forthright defense of shareholder wealth maximization in *Katz* with the inherently ambiguous duty to the corporate entity laid out in *Credit Lyonnais.*

It is worth noting in passing that it is also quite difficult to square Allen's notion of a duty running to the corporation in this context with the Delaware Chancery Court's well-known observation that "[i]t is obviously important that the Delaware corporate law have stability and predictability."[89] Two key ambiguities plague the *Credit Lyonnais* analysis. First, what does it mean to be in the "vicinity of insolvency?"[90] Second, as we have just seen, it is difficult to know what content to ascribe to the duties that arise in that setting. Former Delaware Chief Justice Veasey thus put it quite mildly when he observed that this "is certainly an area where directors of troubled companies and their counsel face particular challenges and need expert counseling."[91]

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[86] *Id*. at 879-80.

[87] *Id.* at 879.

[88] *Id.* at 875.

[89] Harff v. Kerkorian, 324 A.2d 215, 220 (Del. Ch. 1974).

[90] *See* Veasey & Guglielmo, *supra* note 71, at 1430 (noting "the vicinity of insolvency—*whatever that is*"; emphasis supplied).

[91] *Id.* at 1432.

In addition to being doctrinally incoherent, the notion that directors owe duties to the corporate entity is inconsistent with the dominant contractarian theory of the firm. The insistence that the firm is a real entity is a form of reification—i.e., treating an abstraction as if it has material existence.[92] Reification is often useful, or even necessary, because it permits us to utilize a form of shorthand—it is easier to say General Motors did so and so than to attempt in conversation to describe the complex process which actually may have taken place. Indeed, it is very difficult to think about large firms without reifying them. Reification, however, can be dangerous. It becomes easy to lose sight of the fact that firms don't do things, people do things.[93]

The corporation thus is not a thing to which duties to can be owed, except as a useful legal fiction. Instead, in contractarian theory, the corporation is thought of as a nexus of contracts.[94] Although this is a very useful and important concept, however, it too is somewhat misleading. After all, to say that the firm *is* a nexus is to imply the existence of a core or kernel capable of contracting. But kernels do not contract – people do. In other words, it does us no good to avoid reifying the firm by reifying the nexus at the center of the firm. Hence, it is perhaps best to understand the corporation as *having* a nexus of contracts.

If the corporation has a nexus, where is it located? The Delaware code, like the corporate law of every other state, gives us a clear answer: the corporation's "business and affairs . . . shall be managed by or under the direction of the board of directors."[95] Put simply, the board of directors is the nexus of a set of contracts with various constituencies that the law collectively treats as a legal fiction called the corporation.[96] As such, it simply makes no sense to think of the board of

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[92] *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 117-18 (9th ed. 2004) (critiquing reification of the corporation).

[93] *See* G. Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887, 891 (2000) (arguing that "it is dangerous to ignore the reality that firms transact only through individuals").

[94] *See, e.g.*, HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 18 (1996) (describing the firm as "a nexus of contracts," by which he means that the "firm is in essence the common signatory of a group of contracts" among various factors of production).

[95] DEL. CODE ANN., tit. 8, § 141(a) (2000). For a summary of comparable state corporation code provisions, see MOD. BUS. CORP. ACT. ANN. § 8.01 at 8-10 (1997 supp.).

[96] I developed this argument at length in Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002).

directors as owning fiduciary duties to the corporate entity. Indeed, since the legal fiction we call the corporate entity is really just a vehicle by which the board of directors hires factors of production, it is akin to saying that the board owes duties to itself.

Former Chief Justice Veasey seemingly recognized at least some of these difficulties with the formulation both he and former Chancellor Allen adopted. For example, Veasey observed that:

> … when a corporation is in the vicinity of insolvency … creditors may be considered to be in the pool of residual owners, and therefore become beneficiaries of the fiduciary duties owed to the residual owners. Creditors' inclusion in the pool need not imply that stockholders are thereby excluded, however.[97]

Likewise, he further observed that:

> … the directors' judgment could shade toward rights of creditors if that course of action comports with the best interests of the corporate entity. Thus, it is important to keep in mind the precise content of this "best interests" concept—that is, to whom this duty is owed and when. … This means that, as the corporation slides toward insolvency, the benefits of maximizing the value of the corporation will shift from stockholders to creditors, but, on this view, the duties of the board remain the same.[98]

In Veasey's formulation, the directors' duties to the shareholders thus morph into a duty that somehow runs to both shareholders and creditors when the corporation is in the vicinity of insolvency.[99] While this solves the conceptual difficulties with a duty running to the corporation, however, it introduces a new problem; namely, the "two masters" issue.[100] Suppose that the board of directors is considering closing an obsolete plant. The closing will harm the plant's workers and the local community, but will benefit shareholders, creditors, employees at a more modern plant to which the work previously performed at the old plant is transferred, and communities around the modern plant. Assume that the latter

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[97] Veasey & Guglielmo, *supra* note 71, at 1430.

[98] *Id.* at 1431.

[99] Veasey does not explain why the fiduciary duties of directors "shade toward rights of creditors" when the corporation is in the vicinity of insolvency, but not towards any of the corporation's many other stakeholders. Why, for example, does his formulation not permit those duties not shade towards the firm's workers, who obviously are adversely affected by insolvency at least as much as creditors or shareholders? I have been unable to find any Delaware precedent answering that question.

[100] *Cf.* MATTHEW 6:24 (stating: "No one can serve two masters.").

groups cannot gain except at the former groups' expense. By what standard should the board make the decision? Shareholder wealth maximization provides a clear answer—close the plant. Once the directors are allowed—or, required—to deviate from shareholder wealth maximization, however, they must inevitably turn to indeterminate standards balancing the interests of multiple parties. Veasey recognized that such standards are highly problematic.[101]

Standards that require the directors to balance the interests of multiple constituencies, shading between them from case to case, as Veasey puts it, deprive directors of the critical ability to determine ex ante whether their behavior comports with the law's demands, raising the transaction costs of corporate governance. The conflict of interest rules governing the legal profession provide a useful analogy. Despite many years of refinement, these rules are still widely viewed as inadequate, vague, and inconsistent—hardly the stuff of which certainty and predictability are made.[102]

Second, absent clear standards, directors will be tempted to pursue their own self-interest. Directors who are responsible to everyone are accountable to no one. In the foregoing hypothetical, for example, if the board's interests favor keeping the plant open, we can expect the board to at least lean in that director. The plant likely will stay open, with the decision being justified by reference to the impact of a closing on the plant's workers and the local community. In contrast, if directors' interests are served by closing the plant, the plant will likely close, with the decision being justified by concern for the firm's shareholders, creditors, and other benefited constituencies.

One may celebrate the virtues of granting directors largely unfettered discretion to manage the business enterprise without having to ignore the agency costs associated with such discretion. Discretion should not be allowed to camouflage self-interest. Whether one characterizes *Credit Lyonnais* as pointing the directors' duties towards the corporate entity or its shareholders, the decision threatens to provide just such camouflage. The straightforward duty to shareholders Chancellor Allen set out in *Katz* thus seems far preferable to the odd formulations espoused in *Credit Lyonnais* and its progeny.

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[101] Veasey & Guglielmo, *supra* note 71, at 1431 ("The obvious tension between the interests of creditors and those of stockholders is palpable and a vexing challenge for directors.").

[102] *See* Nancy J. Moore, *Conflicts of Interest in the Simultaneous Representation of Multiple Clients: A Proposed Solution to the Current Confusion and Controversy,* 61 TEX. L. REV. 211 (1982); Marc I. Steinberg & Timothy U. Sharpe, *Attorney Conflicts of Interest: The Need for a Coherent Framework*, 66 NOTRE DAME L. REV. 1, 2 (1990).

B. Will Shareholders Gamble with the Creditors Money?

Chancellor Allen's justification for the *Credit Lyonnais* principle rests in large part on the notion that shareholders will have very different risk preferences than will creditors.[103] Insofar as it goes, of course, the point is indisputable.

Limited liability effectively allows shareholders to externalize risk onto creditors. Suppose a corporation borrowed $2,000 from a bank to invest. There are two available investments: A and B, each of which has three possible pay-offs: best case, worst case, and break even.[104]

Investment A

	Probability	Nominal Value	Expected Value
Best-case	10%	$3,000	$300
Break-even	80%	$2,000	$1,600
Worst-case	10%	$1,000	$100
Expected Value			$2000

Investment B

	Probability	Nominal Value	Expected Value
Best-case	20%	$5,000	$1,000
Break-even	60%	$2,000	$1,200
Worst Case	20%	$0	$0
Expected Value			$2,200

Investment B is the more risky of the two options. Both default risk (the risk that the company won't be able to pay back its debt) and volatility risk (the likelihood of an outcome other than the break-even scenario) are much higher in Investment B.

In a world of zero transaction costs and unlimited liability—i.e., one in shareholders are personally liable for corporate debts—the bank would be indifferent as to which investment the company made. If the company fails, the bank can simply collect from the shareholder. In a world of limited liability—i.e., one in which the shareholders have no liability for the corporation's contract debts—the bank will prefer Investment A. Even in the worst case scenario, the bank will get half its money back, plus there's a 90% probability the bank will be repaid in full. The bank will not be impressed that Investment B offers a higher

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[103] *See supra* text accompanying note 75 (quoting Allen's analysis).

[104] The example is a modified version of one used in MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 33-34 (1995), which in turn drew on WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 228-229 (5th ed. 1992).

expected return, because the bank has no claims on the residual. Anything over $2,000 goes to the shareholders, not the bank (ignoring interest).

Conversely, shareholders will strongly prefer Investment B. Because creditors (like the bank) have a prior claim on the firm's assets and earnings, they get paid first; shareholders get the residual—whatever is left over. Shareholders thus prefer projects offering potentially high rate of returns, so there will be something left over after the creditors get paid.

The problem, of course, is that high return projects usually involve high levels of risk.[105] The greater the risk, the more likely it becomes that the project will be unsuccessful. In that event, it becomes more likely that the firm's income will not suffice to pay the creditors, let alone leave anything over for the shareholders. Shareholders will not care about Investment B's greater risk, however, because the doctrine of limited liability means their personal assets are not at risk. Limited liability thus generates negative externalities by creating incentives for shareholders to cause the company to invest in higher risk projects than would the firm's creditors. Because shareholders do not put their personal assets at jeopardy, they effectively externalize some portion of the risk associated with such investments to creditors.

Although this discrepancy in risk preference is present even in solvent corporations, it becomes especially pronounced when the corporation is insolvent or in the vicinity of insolvency.[106] Under those conditions, the shareholders may well be inclined to recall Will Roger's famous aphorism: "It's not so much the return on my money that concerns me as much as the return of my money." Because the corporation is on the edge of a liquidation or reorganization in which the shareholders are likely to receive neither a return on their investment nor, more importantly, the return of their investment, they now have an incentive to cause the corporation to engage in particularly high risk ventures. If the venture pays off with a substantial return, they may be able to at least recoup their initial investment in the corporation. If the venture fails, they have lost nothing. Creditors thus bear the entire risk associated with such ventures.[107]

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[105] KLEIN & COFFEE, *supra* note 92, at 45.

[106] *See* Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1489 (1993) ("When the corporation is insolvent or at the brink of insolvency, the difference in risk preference between shareholders and creditors is magnified with respect to corporate investment policies.").

[107] *See* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 683-84 (1993).

This analysis jibes closely with Allen's justification for the *Credit Lyonnais* principle. Recall, for example, his argument that "insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors,"[108] which is precisely what the preceding analysis suggests will happen. The decision might thus be justified as necessary to prevent "the shareholders, who were about to wind up with nothing," from taking "an unreasonable gamble with the money that would have otherwise gone to the creditors upon the dissolution of the firm."[109]

Unfortunately for the proponents of *Credit Lyonnais*, the argument suffers from two major flaws. First, creditors could protect themselves *ex ante* either by negotiating contractual limitations on corporate behavior, such as restrictions on the types of projects in which the firm may invest, or by negotiating for a share of the up-side, such as through the use of convertible debt securities.[110] Alternatively, creditors can force shareholders to internalize those risks by charging a higher interest rate that compensates the creditor for the higher risk of default. Indeed, the distinguishing characteristic of voluntary creditors (as opposed to involuntary creditors) is that they can allow for the risk of default in the initial contract with the corporation.[111] Lenders, for example, factor in the risk

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[108] Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 WL 277613 at *34 n.55 (Del. Ch. 1991).

[109] Morgan N. Neuwirth, *Shareholder Franchise—No Compromise: Why the Delaware Courts Must Proscribe All Managerial Interference with Corporate Voting*, 145 U. PA. L. REV. 423, 473 n.273 (1996). *See also* Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45, 49-51 (1998).

[110] Delaware Vice Chancellor Leo Strine observes:

> It is presumed that creditors are capable of protecting themselves through the contractual agreements that govern their relationships with firms. Furthermore, a specific body of law--the law of fraudulent conveyance--exists precisely to protect creditors. And, of course, important elements of federal bankruptcy law also protect creditors. Given that these legal tools exist to protect creditors, our corporate law (and that of most of our nation) expects that the directors of a solvent firm will cause the firm to undertake economic activities that maximize the value of the firm's cash flows primarily for the benefit of the residual risk-bearers, the owners of the firm's equity capital. So long as the directors honor the legal obligations they owe to the company's creditors in good faith, as fiduciaries they may pursue the course of action that they believe is best for the firm and its stockholders.

Production Resources Group, LLC v. NCT Group, Inc., 863 A.2d 772, 787 (Del. Ch. 2004).

[111] *Cf.* Jonathan C. Lipson, *Director's Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1245 (2003) (arguing for

of default in calculating the interest rate. Thus, it matters little to the lender if an individual corporation goes bankrupt (assuming diversification of risk). While the lender will sustain a loss as a result of the transaction with the bankrupt corporation, it will recoup that loss through the interest rate it receives from other borrowers. In this way, voluntary creditors pass on the risk of default to the shareholders, even in a system of limited liability.

Second, the shareholder incentive argument has traction only with respect to firms in which the shareholders exercise effective control. As such, it has no application to publicly held corporations, which are characterized by a separation of ownership and control.[112] Instead, the shareholder incentive argument applies only to closely held corporations or quasi-public corporations in which there is a controlling shareholder (or shareholder group). And, of course, it is in precisely such firms where the costs of bargaining between shareholder(s) and creditors will be low enough to allow the latter to negotiate *ex anta* particularized protections, such as shareholder guarantees of corporate debts.

In the true public corporation, with no controlling shareholders, power to decide whether the firm invests in particular high risk projects thus rests in the hands of the board of directors and its subordinate managers. It is not clear that managers will necessarily favor either the interests of shareholders or creditors:

> A manager tainted by the company's financial problems might prefer to take high risks because only they could lead to returns sufficiently high to restore the manager to favor. On the other hand, a manager whose job and company are not in immediate jeopardy might prefer investments with risks that are lower than those preferred by the company's investors.[113]

If agency cost economics teaches us anything, however, it causes us to suspect that at least some managers will put their own interests ahead of those of either shareholders or creditors at least some of the time.[114] As such, the real risk present

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greater protection of creditors who have "low levels of volition, cognition, and exit," principally involuntary creditors).

[112] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 84-89 (1932).

[113] LoPucki & Whitford, *supra* note 107, at 684.

[114] Of course, various forces will constrain manager incentives. Accordingly, it is not surprising that LoPucki and Whitford found only very limited evidence that managers of insolvent corporations were able to exercise control so as to benefit themselves at the expense of other constituencies. *See* LoPucki & Whitford, *supra* note 107, at 751 (summarizing findings of a study of insolvent corporations).

when a public corporation is in the vicinity of insolvency is that of managerial opportunism rather than strategic behavior by shareholders.

C. Which Constituencies Can Help Themselves?

Whether the corporation is in the vicinity of insolvency or not, but perhaps especially when it is in that neighborhood, boards of directors often face decisions in which it is not possible to achieve a Pareto optimal result.[115] Instead, they often face decisions that will leave at least one constituency better off but also leave at least one worse off. Suppose, for example, the board is faced with a decision having a pay off for one constituency of $150 that leaves another constituency worse off by $100. As a whole, the organization is better off by $50. In economic terms, this decision is Kaldor-Hicks efficient.[116] What should the board do?

With this background in mind, the shareholder wealth maximization norm can be described as a bargained-for term of the board-shareholder contract by which the directors agree not to make Kaldor-Hicks efficient decisions that leave shareholders worse off. A commonly used justification for adopting Kaldor-Hicks efficiency as a decision-making norm is the claim that everything comes out in the wash.[117] With respect to one decision, I may be in the constituency that loses, but next time I will be in the constituency that gains. If the decision-making apparatus is systematically biased against a particular constituency, however, that justification fails. If shareholders suspect that their constituency would be systematically saddled with losses, for example, they will insist on contract terms precluding directors from making Kaldor-Hicks decisions that leave shareholders worse off. Specifically, shareholders would bargain for terms imposing fiduciary duties on directors and officers that incorporate the shareholder wealth maximization norm.

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[115] A Pareto superior transaction makes at least one person better off and no one worse off. *See generally* DAVID M. KREPS, A COURSE IN MICROECONOMIC THEORY 154-55 (describing Pareto efficiency).

[116] Kaldor-Hicks efficiency does not require that no one be made worse off by a reallocation of resources. Instead, it requires only that the resulting increase in wealth be sufficient to compensate the losers. Note that there does not need to be any actual compensation, compensation simply must be possible. ROBERT COOTER AND THOMAS ULEN, LAW AND ECONOMICS 41-42 (2d ed. 1997).

[117] The validity of Kaldor-Hicks efficiency as a guide to public policy is sharply disputed. *See Richard A. Posner, The Economics of Justice* 91-94 (1981); Bruce Chapman, *Trust, Economic Rationality, and the Corporate Fiduciary Obligation,* 43 U. TORONTO L. REV. 547, 554-55 (1993).

In contractarian theory, fiduciary duties are viewed as gap fillers by which courts resolve disputes falling through the cracks of incomplete contracts.[118] In particular, fiduciary duties come into play when corporate directors and officers seek to appropriate quasi-rents through opportunistic conduct unanticipated when the firm was formed (and, accordingly, not dealt with *ex ante* by contract). Quasi-rents arise where investments in transaction specific assets create a surplus subject to expropriation by the contracting party with control over the assets.[119] A transaction specific asset is one whose value is appreciably lower in any other use than the transaction in question.[120] Once a transaction specific investment has been made, it generates quasi-rents—i.e., returns in excess of that necessary to maintain the asset in its current use.[121] If such quasi-rents are appropriable by the party with control of the transaction specific asset, a hold up problem ensues. Investments in transaction specific assets therefore commonly are protected through specialized governance structures created by detailed contracts. As we have seen, however, under conditions of uncertainty and complexity, bounded rationality precludes complete contracting.[122] Under such conditions, accordingly, fiduciary duties provide an alternative source of protection against opportunism.

The shareholder's investment in the firm is a transaction specific asset, because the whole of the investment is both at risk and turned over to someone else's control.[123] In contrast, many corporate constituencies do not make firm specific investments in either human capital or otherwise. Because the relationship between such constituencies and the corporation does not create appropriable quasi-rents, opportunism by the board is not a concern for them.

Consequently, shareholders are more vulnerable to director misconduct than are most nonshareholder constituencies. To be sure, some scholars assert that "when directors use their corporate position to steal money from the firm, every" constituency suffers.[124] Consider, however, a classic case of self-dealing. Assume

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[118] EASTERBROOK & FISCHEL, *supra* note 5, at 92.

[119] *See* Benjamin R. Klein et al., *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, 21 J. L. & ECON. 297 (1978).

[120] Bengt Hölmstrom & John Roberts, *The Boundaries of the Firm Revisited*, 12 J. ECON. PERSP. 73, 74 (1998).

[121] *Id.* at 74 n.1. The asset may also generate true rents—i.e., returns exceeding that necessary to induce the investment in the first place—but the presence or absence of true rents is irrelevant to the opportunism problem. *See id.* (discussing true rents).

[122] *See supra* note 6 and accompanying text.

[123] Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1209 (1984).

[124] Blair & Stout, *supra* note 39, at 299.

a solvent corporation able to pay its debts and other obligations (especially employee salaries) as they come due in the ordinary course of business. Further assume that the corporation has substantial free cash flow—i.e., cash flows in excess of the positive net present value investments available to the corporation. If the directors siphon some portion of the corporation's free cash flow into their own pockets, shareholders are clearly hurt, because the value of the residual claim has been impaired. Yet, in this case, there is no readily apparent injury to the value of the fixed claim of all other corporate constituents.

For the sake of argument, however, I will assume herein that appropriation of quasi-rents is an equally severe problem for both shareholders and nonshareholder constituencies. This is most obvious in the case of employees who invest in firm specific human capital.[125] Creditors may also develop firm specific expertise, however, particularly in long-term relationships with a significant number of repeat transactions.[126]

Relative to many nonshareholder constituencies, shareholders are poorly positioned to extract contractual protections.[127] Unlike bondholders, for example, whose term-limited relationship to the firm is subject to extensive negotiations and detailed contracts, shareholders have an indefinite relationship that is rarely the product of detailed negotiations. The dispersed nature of stockownership, moreover, makes bilateral negotiation of specialized safeguards especially difficult:

> 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 [therefore] define the corporation's obligation to its bondholders.[128]

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[125] Roberta Romano, *Corporate Law and Corporate Governance*, 5 INDUSTRIAL & CORP. CHANGE 277, 280 (1996).

[126] *Id.*

[127] The analysis herein applies mainly to voluntary constituencies of the firm, although the political process point is not wholly inapt with respect to involuntary constituencies. In any case, corporate law is an exceptionally blunt instrument with which to protect involuntary constituencies (and voluntary constituencies, as well, for that matter). Tort, contract, and property law, as well as a host of general welfare laws, provide them with a panoply of protections. *See generally* Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991).

[128] Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986).

Put another way, bond indentures necessarily are incomplete.[129] Even so, they still provide bondholders with far greater contractual protections than shareholders receive from the corporate contract as represented by the firm's organic documents.[130]

In addition, as implied in the passage just quoted from former Chancellor Allen's *Katz* opinion, the underwriting process ensures that the indenture will contain efficient protections for bondholders. Some argue that the underwriters have a pecuniary interest in pleasing the issuer, not the bondholders,[131] but the relationship between underwriters and bondholders is a classic repeat transaction phenomenon. Underwriters will not sully their reputation with bondholders for the sake of one issuer.[132] In a firm commitment underwriting, moreover, the underwriters buy the securities from the issuer. If the indenture does not provide adequate levels of protection, the underwriters will be unable to sell the bonds.[133]

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[129] *See* Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 234 (1999) (stating that "[a]ll contracts have gaps"). The claim here is simply that the shareholder-corporation contract is especially "gappy." The ownership-like rights conferred by the shareholder's contract follow from this phenomenon. *Cf.* George P. Baker and Thomas N. Hubbard, *Empirical Strategies in Contract Economics: Information and the Boundary of the Firm*, AEA PAPERS & PROCEEDINGS, May 2001, at 189, 192 (finding that technological developments promoting contractibility within the trucking industry led to vertical integration).

[130] Unlike secured creditors or employees with firm specific human capital, the shareholder's transaction specific investment is not associated with particular assets. Romano, supra note 125, at 279. Also unlike other corporate constituents, shareholders have no right to periodic renegotiation of the firm's of their relationship with the firm. As a result, the shareholders' interest in the firm is more vulnerable to both uncertainty and opportunism than are those of other corporate constituents. Unlike those corporate constituents whose interests are adequately protected by contract, shareholders therefore require special protection. Hence, both the shareholder right to elect directors and the fiduciary obligation of those directors to maximize shareholder wealth. *See id.*

[131] *See, e.g.,* Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1183 (1990); *see also* Dale B. Tauke, *Should Bonds Have More Fun? A Reexamination of the Debate Over Corporate Bondholder Rights*, 1989 COLUM. BUS. L. REV. 1, 24-26 (noting potential conflicts of interest on the part of underwriters).

[132] Marcel Kahan, *The Qualified Case against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 591-92 (1995).

[133] *Cf.* Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 660 (1996) (noting that "underwriters negotiate the covenants in anticipation of selling the bonds to investors"). The issuer's board and management has a

Portfolio theory further suggests that bondholders are fully compensated for the risks posed by potential breaches of fiduciary duty. Arguably such risks are unsystematic in nature, so that the bondholders can eliminate them by holding a diversified portfolio.[134] Even if such risks are characterized as systematic risks, moreover, the pricing mechanism will ensure a rate of interest that compensates the bondholders for those risks.

Accordingly, we can confidently predict the majoritarian default that would emerge from the hypothetical bargain. Shareholders will want the protections provided by fiduciary duties, while bondholders will be satisfied with the ability to enforce their contractual rights, which is precisely what the law provides.[135] *Credit Lyonnais* thus threatens to give bondholders a windfall for which they have not bargained.

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strong self-interest in holding down the corporation's cost of capital—e.g., avoiding takeovers, maximizing personal wealth, and avoiding the adverse consequences of firm failure. Because directors and managers cannot diversify away the risk of firm failure, as shareholders may, they are more risk averse than shareholders with respect to conduct that could raise the firm's cost of debt capital. If directors and managers pursue shareholder wealth at the expense of bondholders, however, such conduct will come back to haunt management the next time it uses the bond market to raise capital. Coupled with the fact that their non-diversifiable interest in firm failure means that board and officer risk preferences typically are closer to those of creditors than of shareholders, their self-interest provides significant protections for bondholders.

[134] Unsystematic risk can be thought of as firm-specific risk. STEPHEN A. ROSS ET AL., CORPORATE FINANCE 287 (6th ed. 2002). In contrast, systematic risk can be regarded as market risk, because systematic risks affect all firms to one degree or another. *Id.* Investors can eliminate unsystematic risk by diversifying their portfolio. *Id.* at 288. Thus, even though the actual rate of return earned on a particular investment is likely to diverge from the expected return, the actual return on a well-diversified portfolio is less likely to diverge from the expected return. A well-diversified investor thus need not be concerned with unsystematic risk and therefore will not demand to be compensated for that risk. *Id.* Systematic risk by definition cannot be eliminated by diversification, because it effects all stocks. *Id.* Accordingly, investors will demand to be compensated for bearing systematic risk. *Id.*

[135] *See, e.g.,* Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (holding that "the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature"); *see also* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989); Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988); Revlon, Inc. v. MacAndrews & Forbes, Inc., 506 A.2d 173, 182 (Del. 1986).

D. Summation

Credit Lyonnais was a doctrinal innovation that departed significantly from pre-existing Delaware law, which had limited creditors to their bargained-for contractual rights and obliged directors to focus on shareholder wealth maximization. As doctrinal innovations go, moreover, *Credit Lyonnais* was particularly unsound. It introduced uncertainty into the law, depriving directors of the *ex ante* guidance on which Delaware corporate law appropriately prides itself.[136]

As a matter of public policy, *Credit Lyonnais* was equally unsound. Its notion that directors owe fiduciary duties to the corporate entity when that entity is in the vicinity of insolvency is untenable as a matter of economic theory and difficult to operationalize in practice. The concern that shareholders will gamble with the creditors' money, which implicitly underlies *Credit Lyonnais*, is unpersuasive. In corporations where that might be a concern due to the presence of controlling shareholders able to determine corporate policy, the creditors can protect themselves *ex ante* through negotiations with that shareholder, as by insisting on the shareholder giving a personal guarantee.[137] In true public corporations, the real concern is not shareholder but managerial opportunism. As between shareholders and creditors, the latter again are better able to protect themselves

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[136] *See* Barondes, *supra* note 109, at 72-73 (discussing how *Credit Lyonnais* introduced various sources of uncertainty into the law); Lipson, *supra* note 111, at 1211 ("The chief criticism is that the holding of the case—if there is one—creates uncertainty."); *cf*. Schwarcz, *supra* note 133, at 671 ("Directors who are expected to labor under a dual loyalty must be able to determine when that loyalty arises.").

[137] Some scholars contend that trade creditors of a close corporation cannot protect themselves by bargaining and, accordingly, posit that the rule of limited liability should be relaxed with respect to them. *See, e.g.,* William P. Hackney and Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837, 860-64 (1982). The same concern might motivate support for *Credit Lyonnais.* But concern for trade creditors is misplaced. Trade creditors concerned about limited liability should simply raise their interest rates or refuse to transact except on a cash basis. *See* Schwarcz, *supra* note 133, at 663 (pointing out that "trade creditors have various ways to protect themselves at the initial transaction stage, such as shortening payment terms or requiring contemporaneous or even prior payment. Trade creditors seeking additional protection can even demand purchase money security interests to secure repayment."). If limited liability increases the risk of default, the lender is fully compensated for that risk by the higher interest rate. In any event, the transaction costs of differentiating between incorporated and unincorporated businesses may well not be worth it for trade creditors, as evidenced by the widespread use of standardized prices and terms by such creditors.

through *ex ante* contracting. *Credit Lyonnais* thus gives bondholders and other creditors a second bite at the apple.[138]

In sum, the default rule of corporate law ought to recognize that shareholders bargained for the right to gamble with the creditors' money even when the corporation is in the vicinity of insolvency. Creditors who object to that right can and should protect themselves *ex ante*. If they fail to do so, the law should take the "you made your bed, now you must lie in it" attitude that motivated should former Chancellor Allen's *Katz* opinion rather than following *Credit Lyonnais.*

IV. Does it Matter?

Consider the facts that were at issue in *Katz*.[139] Oak Industries was in deep financial trouble, having experienced unremitting losses for the previous 45 months. The common stock's market price had fallen from $30 to $2 per share and Oak's debt traded at substantial discounts to par. In hopes that an infusion of new equity capital would turn things around, Oak entered into an agreement with Allied Signal, pursuant to which the latter would purchase certain of Oak's assets for $160 million in cash and also would invest an additional $15 million in Oak by purchasing newly issued common stock and warrants.

Allied Signal conditioned the deal on a restructuring of Oak's existing debt to be effected via a tender offer in which Oak would buy back some debt at a premium over the debt's then current market price but at a discount to par. Debt holders accepting the offer would be obliged to execute exit consents authorizing indenture amendments eliminating various protections, including all financial covenants. Without the amendments, Allied Signal was unwilling to enter into either the equity investment or asset purchase.

Assume Oak was in the vicinity of insolvency at the time the restructuring plan was approved by Oak's board of directors. A creditor sues the board alleging breach of the *Credit Lyonnais* fiduciary duty. The creditor argues that the deal was structured to disadvantage creditors to the shareholders' benefit.

To justify that claim, the creditor offers the following analysis of the transaction's effect: I hold 5 Oak bonds, each having a par value of $1,000. The prevailing market price is around $600, but I believe that bondholders would realize $700 pre bond if Oak was forced into a liquidation or reorganization in bankruptcy. Oak is offering us $650 per bond in the tender offer, but in order to

[138] *Cf.* C. Robert Morris, *Directors' Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais*, 19 J. CORP. L. 61, 64-65 (1993) (criticizing “"judicial insulation from" the risk of corporate default as "over-protection").

[139] Katz v. Oak Indus., Inc., 508 A.2d 873 (Del. Ch. 1986).

accept the offer I must execute a consent that will amend the indenture to eliminate covenants prohibiting the payment of dividends and the incurrence of debt senior to my bonds. If I hold onto your bonds, and a majority of other holders tender, the bonds I will be left with, stripped of their protective covenants, will be worth $575. I therefore face a classic prisoners' dilemma. I will accept the $650 offered by Oak, and execute the consent, in order to protect myself against the risk of winding up with bonds worth only $575.

What standard of review will a Delaware court apply on these facts, assuming *arguendo* that the creditor is owed some sort of fiduciary duty under *Credit Lyonnais?* The answer almost certainly is the business judgment rule:

> The *Credit Lyonnais* decision's holding and spirit clearly emphasized that directors would be protected by the business judgment rule if they, in good faith, pursued a less risky business strategy precisely because they feared that a more risky strategy might render the firm unable to meet its legal obligations to creditors and other constituencies.[140]

In other words, so long as the board of directors is independent and disinterested and otherwise satisfies the preconditions for application of the business judgment rule, the court will abstain from reviewing the merits of the board's decision.[141]

The rationale for applying the business judgment rule in this context follows in part from the same policy considerations evaluated in the preceding Part:

> Creditors are often protected by strong covenants, liens on assets, and other negotiated contractual protections. The implied covenant of good faith and fair dealing also protects creditors. So does the law of fraudulent conveyance. With these protections, when creditors are unable to prove that a corporation or its directors breached any of the specific legal duties owed to them, one would think that the conceptual room for concluding that the creditors were somehow, nevertheless, injured by inequitable conduct would be extremely small, if extant.

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[140] Production Resources Group, LLC v. NCT Group, Inc., 863 A.2d 772, 788 (Del. Ch. 2004). *See also* Angelo, Gordon & Co., L.P. v. Allied Riser Communications Corp., 805 A.2d 221, 229 (Del. Ch. 2002) ("My preliminary view is that, even where the law recognizes that the duties of directors encompass the interests of creditors, there is room for application of the business judgment rule."); Veasey & Guglielmo, *supra* note 71, at 1430 ("Directors will normally have discretion to exercise their business judgment, provided they do so in good faith.").

[141] *Cf.* Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000) (stating that "directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available").

> Having complied with all legal obligations owed to the firm's creditors, the board would, in that scenario, ordinarily be free to take economic risk for the benefit of the firm's equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm's value.[142]

In addition, and perhaps more importantly, however, application of the business judgment rule follows necessarily from the basic architecture of corporate governance. As the Delaware Supreme Court has explained:

> Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in [Delaware General Corporation Law] § 141(a), the business and affairs of a Delaware corporation are managed by or under its board of directors.... The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors.[143]

The business judgment rule thus operationalizes the intuition that fiat— i.e., centralization of decisionmaking authority—is the essential attribute of efficient corporate governance.[144]

As Nobel laureate economist Kenneth Arrow explains, authority and accountability cannot be reconciled:

> [Accountability mechanisms] must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.[145]

The business judgment rule prevents such a shift in the locus of decision-making authority from boards to judges. It does so by establishing a limited system for

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[142] Production Resources Group, LLC v. NCT Group, Inc., 863 A.2d 772, 790 (Del. Ch. 2004).

[143] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). *Cf.* Marx v. Akers, 666 N.E.2d 1034, (N.Y. 1996) (noting that "shareholder derivative actions infringe upon the managerial discretion of corporate boards…. Consequently, we have historically been reluctant to permit shareholder derivative suits, noting that the power of courts to direct the management of a corporation's affairs should be 'exercised with restraint.'"); *see also* Pogostin v. Rice, 480 A.2d 619, 624 (noting that "the derivative action impinges on the managerial freedom of directors").

[144] *See generally* Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002).

[145] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 78 (1974).

case-by-case oversight in which judicial review of the substantive merits of those decisions is avoided. The court begins with a presumption against review.[146] It then reviews the facts to determine not the quality of the decision, but rather whether the decision-making process was tainted by self-dealing and the like.[147] The questions asked are objective and straightforward: Did the board commit fraud? Did the board commit an illegal act? Did the board self-deal? Whether or not the board exercised reasonable care is irrelevant, as well it should be.[148] The business judgment rule thus erects a prophylactic barrier by which courts pre-commit to resisting the temptation to review the merits of the board's decision.

As I have explained elsewhere in much more detail,[149] judicial abstention from merits review of board decisions has several critical advantages. First, judges necessarily have less information about the needs of a particular firm than do that firm's directors. *A fortiori*, judges will make poorer decisions than the firm's board. In addition, while market forces work a sort of Darwinian selection on corporate decision makers, no such forces constrain erring judges.[150] As such, rational shareholders might prefer the risk of managerial error to that of judicial error.

Second, the firm's residual claimants do not get a return on their investment until all other claims on the corporation have been satisfied. All else equal, the

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[146] *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (explaining that the rule creates a presumption that the directors or officers of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company).

[147] *See, e.g.*, Kamin v. American Express Co., 383 N.Y.S.2d 807, 811 (N.Y. Sup. 1976) (stating that absent "fraud, dishonesty, or nonfeasance," the court would not substitute its judgment for that of the directors).

[148] *See, e.g.,* Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) (stating: "While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading.... Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule."); Brehm v. Eisner, 746 A.2d 244, 262-64 (Del. 2000) (rejecting plaintiff's contention that the business judgment rule includes an element of "substantive due care" and holding that the business judgment rule requires only "process due care").

[149] *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004).

[150] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 100 (1991).

residual claimant—whether it be a shareholder or, in insolvency, a creditor—therefore will prefer high return projects. Because risk and return are directly proportional, however, implementing that preference necessarily entails choosing risky projects. Board decisions rarely involve black-and-white issues, however; instead, they typically involve prudential judgments among a number of plausible alternatives. Given the vagaries of business, moreover, even carefully made choices among such alternatives may turn out badly. Unfortunately, both residual claimants and judges will find it difficult to distinguish between competent and negligent management. By virtue of the hindsight bias, bad outcomes are often regarded, ex post, as foreseeable ex ante. If bad outcomes result in liability, however, managers will be discouraged from taking risks.[151]

The critical point for present purposes is that nothing in the preceding précis of the rationale for the business judgment rule depends on the question "to who are directors accountable?" There will be an unavoidable tension between authority and accountability whether directors owe duties to the shareholders, the creditors, the entity, or some combination thereof. Allowing courts to review the merits of board decisions will inevitably shift some aliquot of the board's authority to courts whether such review is triggered by shareholders, the creditors, the entity, or some combination thereof. Accordingly, absent a disabling conflict of interest on the part of the board, the business judgment rule should be the standard of review whether fiduciary litigation is brought by shareholders, the creditors, the entity, or some combination thereof.

V. Conclusion

In sum, the zone debate is mostly much ado about nothing. Or, more precisely, about very little. In the vast majority of cases, the business judgment rule will preclude judicial review regardless of whether suit is brought by shareholders or creditors. In some cases, the business judgment rule may not apply, but suit will be derivative in nature and any recovery will go to the entity regardless of whether suit is brought by shareholders or creditors. As a result, the only cases in which the zone of insolvency debate matters are those to which the business judgment rule does not apply, shareholder and creditor interests conflict, and a recovery could go to directly to those who have standing to sue. In those cases, moreover, there is a strong policy argument that creditors should be limited to whatever rights the contract provides or might be inferred from the implied covenant of good faith.

[151] Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996).