FOREWORD (AND UPDATE)

By Richard A. Booth

The papers in this issue of the Journal of Business & Technology Law were presented at the fourth annual business law conference at the University of Maryland School of Law on Friday, November 4, 2005. The focus of the 2005 conference – *Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies* – was the trend among numerous courts toward the imposition of a common law fiduciary duty running from a corporation's board of directors to the corporation's creditors in situations in which the corporation is insolvent or is on the brink of insolvency. On the one hand, this trend appears to be quite at odds with the traditional idea that the board of directors owes a fiduciary duty exclusively to the stockholders as residual beneficiaries. On the other hand, if a corporation is insolvent, the creditors are the residual beneficiaries because *ex hypothesis* the corporation cannot pay the creditors in full. The creditors thus have an interest in any increase or decrease in value of the corporation. But the creditors do not have the *only* interest here. The stockholders still have an interest in the possibility that the corporation will recover by more than enough to pay off the creditors however faint it may be. Although it is clear that the creditors have an interest here that is akin to that of stockholders in a solvent corporation, the courts have not often addressed the question of creditor standing because the corporation is almost always in bankruptcy at that point. There is also a gap between these two situations. What if the corporation faces a choice between a strategy that will assure its mere solvency and another that offers the possibility of a rich return for stockholders but a significant chance of insolvency?

In the 1991 case, *Credit Lyonnais Bank Nederland v. Pathe Communications Corporation,* Chancellor Allen stated that "where a corporation is operating in the vicinity of insolvency, the board of directors is not merely the agent of the stockholders, but owes its duty to the corporate enterprise." In such circumstances, management is not disloyal in failing to act in the interest of the stockholders. Rather, management owes "supervening loyalty to the corporate entity." It has "an obligation to the community of interest that sustain[s] the corporation to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."[1]

Credit Lyonnais gave rise to an avalanche of case and commentary as the footnotes in this issue of JBTL attest. Then, in 2004, Vice Chancellor Strine sought to put the matter to rest in *Production Resources Group, LLC v. NCT Corporation,*[2] a case in which a creditor sought the appointment of a receiver for the debtor corporation or direct recovery from the debtor corporation based on the theory that the board of directors owed a fiduciary duty to the creditors of the corporation. In *Production Resources,* the debtor

[1] Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 Del. Ch. LEXIS 215. *See also* Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. Ch. 1992) ("[W]hen the insolvency exception [arises], it creates fiduciary duties for directors for the benefit of creditors.")

[2] Production Resources Group v. NCT Corporation, 863 A.2d 772 (Del. Ch. 2004).

corporation had gone to extraordinary lengths to avoid payment to the complaining creditor while at the same time expending corporate resources on generous salaries and consulting contracts with the controlling stockholder and further encumbering the assets of the corporation. The court presumed that the debtor corporation was insolvent as a result of its inability or refusal to satisfy an apparently valid obligation. Noting that some courts and commentators have interpreted *Credit Lyonnais* as creating a new body of creditor rights, Strine argues that what *Credit Lyonnais* really did was to extend the shield of the business judgment rule to decisions in which the board seeks to maximize total firm value rather than just stockholder value. In other words, *Credit Lyonnais* protects the board of directors from an action by the stockholders grounded on the board's failure to seek advantage for the stockholders at the expense of creditors. The problem is that Strine went on to hold that the creditor in question did in fact have standing to assert a derivative claim based on fiduciary duty against the presumptively insolvent corporation. And he left open the possibility that a creditor might be able to assert a direct claim in an appropriate case.

At the time of the conference, some of the papers published in this issue of JBTL were almost finished, while others were almost started. Either way, there have been developments in the meantime that should be considered when one reads the papers that follow. The decision in Production Resources was discussed approvingly and at some length in *Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC* and *Trenwick America Litig. Trust v. Ernst & Young, L.L.P.*[3] The most significant development was the decision by the Delaware Supreme Court in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla,* 2007 Del. LEXIS 227 (NACEPF), where the court held that creditors may not assert direct claims for breach of fiduciary duty when a corporation is either insolvent or in the zone of insolvency. The court further stated that creditors do have standing to maintain a derivative action for breach of fiduciary duty when a corporation is in fact insolvent. The latter statement is arguably dictum in that the plaintiff in NACEPF did not assert a derivative claim. It is also noteworthy that the court chose at least in passing to discuss the zone of insolvency as distinct from insolvency in fact, thus leaving open questions about exactly what the difference is between the two and exactly when creditors gain standing to maintain a derivative action. Thus, it is not clear that much has been resolved by NACEPF.

Other questions have not been addressed at all. No one has suggested that stockholders *lose* the right to maintain a derivative action in such circumstances. How then should the courts sort out the competing claims of stockholders and creditors if both groups seek to maintain a derivative action? Nor is it really clear that directors owe direct fiduciary duties to stockholders in the sense that creditors seek to assert them. A direct claim by a stockholder is usually defined as one that implicates some contractual right of the stockholders to participate in the corporate enterprise. Creditors have their own contractual rights. But creditors seem to think that stockholders have some additional mystical right to assert claims for mismanagement that might open a door to a new source of riches, namely, the personal wealth of directors and officers. Stockholders have no

[3] Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC, 2006 Del. Ch. LEXIS 59; Trenwick America Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006).

such magical powers to penetrate the force field of the business judgment rule or provisions that absolve directors and officers of personal liability for good faith business decisions. There is no reason that creditors should gain such powers. Ultimately the issue is one of limited liability.

The Heisenberg Uncertainty Principle asserts that it is impossible to observe an event without affecting it in some way. The same is true here. The papers written for this conference have been cited in both *Big Lots* and *NACEPF*. Thus, while the circumstances are no longer exactly as they were when the papers were prepared, the papers are to some extent responsible for the circumstances as they are today. We hope that will make for even more interesting reading.