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Recommended Citation

Stephen M. Bainbridge, *Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies - Presentation of Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. Bus. & Tech. L. 281 (2007)

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STEPHEN M. BAINBRIDGE

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

PRESENTATION OF *MUCH ADO ABOUT LITTLE? DIRECTORS' FIDUCIARY DUTIES IN THE VICINITY OF INSOLVENCY*

RICHARD BOOTH: Our next speaker needs no introduction. Steve Bainbridge is a professor at UCLA, a graduate of the University of Virginia School of Law, and a former clerk for Judge [Frank] Kaufman here in Baltimore. He is going to present a paper titled, "Much Ado About Little: Directors' Fiduciary Duties in the Vicinity of Insolvency."¹

STEPHEN BAINBRIDGE: As with any relational contract, bond indentures and other forms of long-term debt agreements inevitably prove incomplete. Indeed, in a world characterized by uncertainty, complexity, and bounded rationality it cannot be otherwise. The question we have been discussing today is whether the law should invoke fiduciary duties or other extra-contractual rights as gap fillers when the bond agreement or other contractual relationship is silent.

In my remarks today, I focus on three aspects of that question. First, I take issue with how the Delaware courts have framed the problem. They have characterized the duties of directors as running to the corporate entity. I will argue that this approach is incoherent in practice and unsupportable in theory. Instead, courts ought to focus on the terms of the "deal" between the shareholders and the board.

Second, I will briefly discuss the leading argument in favor of imposing fiduciary duties on directors when the corporation is in the vicinity of insolvency; namely, the notion that the shareholders will gamble with the creditors' money. I will argue that this claim is unpersuasive. It is director and manager opportunism, not shareholder opportunism, that is the real concern. Further, bondholders and other voluntary creditors are in a better position to protect themselves against the risk than are shareholders.

Finally, and perhaps anticlimactically, I will suggest that none of this matters very much. Even if the fiduciary duties owed to directors shift in the vicinity of insolvency from shareholders to creditors, the corporate entity, or Mickey Mouse, the vast majority of board-of-director decisions will continue to be governed by the

1. Stephen M. Bainbridge, *Much Ado About Little: Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. Bus. & Tech. L. 335 (2007).

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business judgment rule. In particular, that rule will apply even to decisions in which directors either make or decline to make tradeoffs between the interests of shareholders and those of creditors. As a result, the debate ends up being much ado about nothing, or perhaps more precisely, much ado about very little.

Former Delaware Chancellor William Allen (the father of this mess) said in *Katz v. Oak Industries*,² that the relationship between a corporation and the holder of its debt securities is contractual.³ The contract defines and confines the scope of the corporation's obligations to its bondholders. Now, it is true that the law recognizes limited extra-contractual rights to creditors in the form of the implied covenant of good faith, which we find in all contracts, not just bond indentures. The leading cases, *Katz* and *Metlife*,⁴ make clear, however, that the implied covenant of good faith in this context is limited by reference to the terms of the contract.⁵ Taken together, these decisions reflect a basic principle we might colloquially express as "You made your bed, now you must lie in it."⁶

Do these rules change when the corporation is insolvent or nearly so? In *Credit Lyonnais v. Pathe Communications*,⁷ Allen famously opined that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duties to the corporate enterprise."⁸ Technically, *Credit Lyonnais* thus does not impose director duties running to creditors, but rather holds that directors of corporations in the vicinity of insolvency owe fiduciary duties to the entity.⁹ Of course, that statement is highly problematic. What does it mean to say directors owe duties to the entity? To be sure, we often speak of a distinction between directors' duties owed to the corporate entity and directors' duties owed to shareholders. It is that distinction, for example, that drives the difference between direct and derivative litigation. If directors already owe some fiduciary duties to the entity, however, what, if anything, changes when the corporation is in the vicinity of insolvency?

Second, Allen's highly stylized argument conflated two distinct inquiries: pie expansion and pie division. Suppose the board of directors is faced with a true zero-sum problem in which it is not possible for the board to make everybody better off. Instead, the board is faced with making tradeoffs between the interests of various constituencies. For all of its seeming detail, *Credit Lyonnais* does not provide any guidance for making that decision.

2. 508 A.2d 873 (Del. Ch. 1986).

3. *Id.* at 879.

4. *Metro. Life Ins. Co. v. RJR Nabisco Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989).

5. *Katz*, 508 A.2d at 880; *Metro. Life*, 716 F. Supp. at 1517.

6. WOLFGANG MIEDER, A DICTIONARY OF AMERICAN PROVERBS 42 (Stewart A. Kingsbury & Kelsie B. Harder eds. 1992).

7. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

8. *Id.* at 1155.

9. *Id.*

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In addition, it is quite difficult to square Allen's notion of a duty running to the corporation when it is in the vicinity of insolvency with the proposition that the Delaware corporate law ought to have stability and predictability. Indeed, there are a number of key ambiguities that plague Allen's analysis. What does it mean to be in the vicinity of insolvency? How close can you get before you are in the neighborhood? It is also difficult to know what content to ascribe to the duties that arise in that setting. Former Delaware Chief Justice [E. Norman] Veasey wrote an article in the *University of Pennsylvania Law Review*, in which he observed that this is "certainly an area where directors of troubled companies and their counsel face particular challenges and need expert counseling."¹⁰

In addition to being doctrinally incoherent, the notion that directors owe duties to the corporate entity is inconsistent with the dominant contractarian thesis of the firm. Put simply, the board of directors is the nexus of a set of contracts with various constituencies that the law collectively treats as the legal fiction called the corporation. As such, it makes no sense to think of the board of directors as owing fiduciary duties to the corporate entity. The legal fiction we call the corporate entity is properly understood as a vehicle by which the board of directors hires factors of production. Thus, it is in some sense akin to saying that the board of directors owes fiduciary duties to itself.

In sum, the straightforward duty to shareholders that Chancellor Allen set out in the *Katz* case has always struck me as being considerably more sensible from the doctrinal perspective than the rather odd formulations he came up with in *Credit Lyonnais*.

I think Larry Ribstein is going to make this argument this afternoon, and I agree completely with this part of Larry's paper: All of this zone of insolvency business is just dicta piled upon dicta.¹¹ Allen's justification relied in large part on the notion that limited liability creates incentives for shareholders to externalize risk on to creditors. We are all familiar with that story, of course. The discrepancy in risk preference between shareholders and creditors is present even in solvent corporations, but it does become especially pronounced when the corporation is either insolvent or in the vicinity of insolvency.

I have the good pleasure of regularly taking my dogs for a hike in the Will Rogers State Park, and I'm frequently reminded of a famous aphorism often attributed to Will Rogers: "It is not the return *on* my money that I'm concerned with; it's the return *of* my money that I'm concerned with."¹² Certainly, if you are an investor in a corporation in the vicinity of insolvency, it is the return of your money that you are starting to worry about, because you face the risk that the company will go under and you will lose your investment in the firm. Under those circumstances,

10. E. Norman Veasey, *What Happened in Delaware Corporate Law and Governance from 1992–2004?*, 153 U. PA. L. REV. 1399, 1432 (2004).

11. Larry E. Ribstein & Kelli A. Alces, *Directors' Duties in Failing Firms*, 1 J. BUS. & TECH. L. 529 (2007).

12. Jed Graham, *Low-Risk Investing Gets Upgrade*, INVESTOR'S BUS. DAILY, Dec. 19, 2001, at A9.

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you are going to prefer that the corporation invest in very high-risk projects. If the project does not pay off, so what? You are already going to lose your investment, and limited liability means they cannot come after you.

Conversely, if the high-risk project pays off, creditors get paid, the company remains in business, and you might even get dividends someday. Good deal. So, Allen's quite right that shareholders might gamble with the creditor's money. But so what? First, creditors can protect themselves *ex ante*. Here again, of course, I am focusing on voluntary creditors. Creditors can protect themselves *ex ante* either by negotiating contractual limitations on debtor behavior, by negotiating for a share of the upside, by insisting on cash rather than credit, and so forth. So, in this way, voluntary creditors can pass on the risk of default to the shareholders even in a system of limited liability.

Second, the shareholder-as-gambler argument, what we might call the Kenny Rogers argument,¹³ has traction only with respect to firms in which shareholders exercise effective control. As such, it has no application to publicly held corporations characterized by the separation of ownership and control. Rather, the Kenny Rogers argument applies only to closely held corporations or quasi-public corporations that have a controlling shareholder. It is only in those corporations that the shareholders can actually effect their preferences. Of course, it is precisely in those corporations in which the cost of bargaining between creditors and shareholders also will be low enough for creditors to negotiate for their own protections.

In the true publicly held corporation, where we have dispersed share ownership with no controlling shareholders, the power to decide what kind of investments the firm makes rests not with the shareholders but with the board of directors and subordinate managers. It is not clear that managers will necessarily favor either shareholder or creditor interests. A manager of a financially troubled company might prefer to take high risks in hopes that high returns will restore the firm to viability, thereby preserving the manager's investment in firm-specific capital, preserving the manager's job, and so on.

On the other hand, a manager of a financially troubled company might think, "We have plenty of trouble without taking on additional risk. We should actually be taking lower risk projects so as to preserve the assets of the company to the extent possible." If agency cost economics teaches us anything, it tells us to suspect that, regardless of which of those two choices is optimal for the management of a particular company, management will pick the strategy that is optimal for management under its particular circumstances.

Thus, the real risk present when a publicly held corporation is in the vicinity of insolvency is that of managerial opportunism. If I am right about that, which constituencies can best protect themselves against the risk of managerial misconduct? In the contractarian theory of the firm, fiduciary duties are viewed as gap fillers by

13. Kenny Rogers, *The Gambler*, on *The Gambler* (Dream Catcher 1978).

which courts resolve disputes falling through the cracks of incomplete contracts. In particular, fiduciary duties come into play when there are appropriable quasi-rents available to corporate directors and officers that were unanticipated and thus not contracted for when the firm was formed. The shareholders' investment, Oliver Williamson argues, is a transaction-specific asset.¹⁴ In contrast, many corporate constituencies do not make firm-specific investments in either human capital or otherwise. Opportunism by the board is not a particular concern for those constituencies whose relationship with the corporation does not create appropriable quasi-rents.

In addition, relative to many non-shareholder constituencies, shareholders are poorly positioned to extract contractual protections. Unlike bondholders, for example, whose term-limited relationship to the firm is subject to extensive negotiation and detailed contracts, shareholders have an indefinite relationship that is rarely the product of detailed negotiations. The dispersed nature of stock ownership, moreover, makes bilateral negotiation of specialized contracts especially difficult.

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 bond holders should be satisfied with their ability to enforce their contractual rights. This is precisely what the law would provide for them were it not for *Credit Lyonnais*. That case, however, threatens to give bondholders a windfall for which they have not bargained.

So much for theory. Let's turn to practicalities. Does any of this matter? My guess is not very much. Consider the facts of *Katz v. Oak Industries*,¹⁵ which I think is a particularly useful hypothetical for our purposes. Oak Industries was in deep financial trouble, having experienced unremitting losses for the previous forty-five months. The common stock price had plummeted from thirty dollars to two dollars per share. Its debt traded at substantial discounts to par. In hopes that a new infusion of equity capital would turn things around, Oak entered into an agreement with Allied Signal, pursuant to which Allied Signal would purchase certain of Oak's assets for 160 million in cash and would invest an additional fifteen million in Oak by purchasing newly issued common stock and warrants.

Allied Signal conditioned the deal on a restructuring of Oak's debt to be effected through 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 that would amend the indentures to eliminate various protections, including most of the financial covenants. Without these amendments, Allied Signal was unwilling to enter into either the equity investment or the asset purchase.

14. Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1210 (1984).

15. 508 A.2d 873 (Del. Ch. 1986).

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Assume that Oak was in the vicinity of insolvency at the time the restructuring plan was approved by Oak's board of directors. Also assume that a creditor sues the board alleging a breach of the *Credit Lyonnais* duty. The creditor argues that the deal was structured to disadvantage creditors to the shareholders' benefit. What standard of review would a Delaware court apply on these facts, assuming *arguendo* that the creditor—or, if you prefer, the corporate entity—is owed some sort of fiduciary duty under *Credit Lyonnais*?

As we have heard several times this morning, and as I think we will hear several times this afternoon, the answer is the business judgment rule. As 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 simply refuse to review the substantive merits of the board's decision, regardless of who is suing or to whom the duty runs.

The rationale for applying the business judgment rule in this context follows in part from the same policy considerations we have already been discussing. Vice Chancellor Strine has said

*[c]reditors 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 . . .*¹⁶

—I assume what he means here are the duties owed to them by contract or by specific statutory provisions—

*. . . 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. 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. . .*¹⁷

Although Strine makes a good case for applying the business judgment rule in this context, the basic architecture of corporate governance provides another reason for that result. I have been writing a series of articles, as some of you know, about what I call director primacy.¹⁸ My good friend Larry Ribstein has correctly said that I should have called it board primacy, but after including director primacy in the title of perhaps half a dozen law review articles, it's too late to unscramble

16. Prod. Res. Group, LLC v. NCT Group, Inc., 863 A.2d 772, 790 (Del. Ch. 2004).

17. *Id.*

18. See, e.g., Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. REV. 547 (2003).

those eggs. In any event, the gist of my argument has been that the business judgment rule operationalizes an intuition about the role of fiat—or centralized decision-making authority—in corporate governance.

In Kenneth Arrow's book *The Limits of Organization*,¹⁹ Arrow explains that authority and accountability ultimately cannot be reconciled: "If every decision of A is to be reviewed by B, then all we really have is a shift in the locus of authority from A to B and hence no solution to the original problem."²⁰ If you stop and think about it for a minute, you will likely agree that that insight explains virtually everything we do as corporate lawyers. It explains the business judgment rule. It explains the demand requirement. It explains the restrictions on shareholder voting. It explains *Unocal*.²¹ It explains why a majority of disinterested directors can insulate self-dealing transactions from judicial review. Somebody has to decide—will it be the courts, or will it be the board of directors?

Judicial abstention from merit review of board decisions has several critical advantages. First, judges necessarily have less information about the needs of a particular firm than do the firm's directors. In addition, although market forces work a sort of Darwinian selection on corporate decision makers, no matter how imperfectly, no such forces constrain erring judges. As such, rational shareholders might well 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 have been satisfied. All else being equal, as we have seen, the residual claimant therefore would prefer high-risk projects. The problem is that board decisions rarely involve black-and-white judgments. 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 but erroneous management 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, directors will be discouraged from taking the very risks they have been tasked with taking.

The critical point for present purposes is that nothing in the preceding summary of the rationale for the business judgment rule depends on your answer to the question, to who are directors accountable? There will be an unavoidable tension between authority and accountability whether directors owe duties to the share-

19. KENNETH JOSEPH ARROW, *THE LIMITS OF ORGANIZATION* (1974). I also should acknowledge the debt director primacy owes to Professor Michael Dooley's "Authority Model," whose "heart" is said to be "the universally recognized requirement for the establishment of, and vesting of supreme authority in, the board of directors." Michael P. Dooley, *Two Models of Corporate Governance*, 42 *BUS. LAW.* 461, 467 (1992).

20. ARROW, *supra* note 19, at 78.

21. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (holding that "enhanced scrutiny," an intermediate level of judicial review, applies to decisions made by the board of directors of a target company responding to tender offers or other threats to corporate control).

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holders, the creditors, the entity, or some combination thereof. Allowing courts to review the merits of board decisions will inevitably shift some of the board's authority to courts, whether such review is triggered by shareholders, 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.

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 the suit is brought by shareholders, creditors, the entity or some combination thereof.

To be sure, in some cases, the business judgment rule may not apply, but most of those suits would be derivative and any recovery therefore would go to the entity regardless of whether suit is brought by shareholders or creditors.

As a result, the only cases in which today's debate matters are those as to which (i) the business judgment rule does not apply, (ii) shareholder and creditor interests conflict, and (iii) a recovery would go directly to those who have standing to sue. In those cases, I put it to you, Chancellor Allen got it right in *Katz* when he opined that there is a very 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.²²

In conclusion, it was Halloween earlier this week and this is the only law school I know of that has catacombs with real graves in its basement. So, it seems entirely appropriate to conclude with the suggestion that what this conference ought to do is to drive a stake through the heart of *Credit Lyonnais* once and for all. If we do nothing else but that, we will have done good work, and we will have had a good day. Thank you very much.

RUSSELL SILBERGLIED: How do you account for the fact that cases very often get past the business judgment rule at a pleading stage, even if the rule would ultimately apply at trial, resulting in costs as the case goes forward? Doesn't that imply that this is more important, or that this whole theory is more important than you are saying it is?

STEPHEN BAINBRIDGE: No. I think what it implies is that the courts have been misapplying the business judgment rule. While there definitely has been a trend in the direction you suggest, one of the functions of the business judgment rule is supposed to be to cut these cases off. I think about an old chestnut like *Shlensky v. Wrigley*,²³ in which Shlensky, a shareholder, is not even allowed, if I can use an appropriate metaphor, to get up to bat. He loses on a demurrer because of the business judgment rule. One of the things that has happened in business judgment

22. *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 880 (Del. Ch. 1986).

23. 237 N.E.2d 776 (Ill. App. Ct. 1968).

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rule jurisprudence is an erosion of the notion that the business judgment rule is an appropriate ground for getting rid of a case on a Rule 12(b)(6) motion.²⁴ This is part of what I think former Delaware Chief Justice Veasey was doing in cases like *Brehm v. Eisner*,²⁵ with his insistence that plaintiffs make use of the “tools at hand” before filing suit.²⁶ I think he was trying to get back to a place where the business judgment rule would actually have teeth at the motion to dismiss stage. I see it as a problem with business judgment rule jurisprudence and not a problem with the theory.

RUSSELL SILBERGLIED: Isn't the real problem that it is easy to plead a director conflict? That it is easy to plead that the directors were aligned with equity or were aligned with creditors or whatever because of some conflict? Although that may not be possible to be prove later, doesn't a judge who hears that type of pleading, which meets all of the standards and is well pled, have to say at the pleading stage, “I have to accept this”?

STEPHEN BAINBRIDGE: The heart of the problem is that the Delaware Supreme Court had been a little reluctant to let the Court of Chancery throw out the first complaint with prejudice without giving the plaintiff multiple cracks at coming up with a well-pleaded complaint that does exactly what you are talking about.

RICHARD BOOTH: Going back to the first part of the paper, you were saying it is really manager opportunism instead of shareholder opportunism and that shareholders don't have the incentive to gamble with the creditor's money. What about stock options?

STEPHEN BAINBRIDGE: Let me be precise. Managers may have the incentive to gamble with the creditor's money, but they may also have the countervailing incentive to take very low risk projects in hope of preserving the firm's assets. Management interests are not necessarily aligned with either shareholders or creditors. The one thing we can be confident of is that managers' interests will be aligned with management's interests. Accordingly, the general problem is not that the shareholders will gamble with the money, but that managers are likely to do something that is either not in the interest of the shareholders or not in the interest of the creditors. What do we do about that? Should we hold management accountable? Trying to do so bumps up against the countervailing value in corporate governance of deference to fiat. How do we weigh these competing values? I think the business judgment rule, tweaked as we were just discussing it, is the way that corporate law historically and appropriately seeks to reconcile the competing values of authority and accountability in this context.

RICHARD BOOTH: Probably about half of compensation is still either equity or stock options and most of the equity is options, even though it's been tailing off a

24. FED. R. CIV. P. 12(b)(6).

25. 746 A.2d 244 (Del. 2000), *aff'd in part, rev'd in part and remanded*, 825 A.2d 275 (Del. Ch. 2003).

26. *Id.* at 266–67.

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little bit. It seems to me the problem is even worse than we made it out to be because managers only get paid if the stock goes up. Stockholders have an interest at that point in the stock at least maintaining some kind of value. Managers get paid nothing unless the value goes up. Even though the board of directors has an incentive to preserve their jobs, there is also a countervailing incentive to take risky projects that may destroy shareholder value.

STEPHEN BAINBRIDGE: This is an interesting argument, which I addressed in a paper published in the *Texas Law Review*²⁷ about Lucian Bebchuk and Jesse Fried's executive compensation book.²⁸ They say there is never an excuse, when management stock options are underwater, for giving managers new options that are, effectively, repriced. As I understand it, of course, the way executive compensation works these days is you don't reprice options because that would require you to expense them; you just give managers a bunch of new options. Bebchuk and Fried say there's absolutely no excuse for that. The argument I made in my Texas article was precisely the argument that you just made: If management has a bunch of underwater options and the firm is in financial trouble, that can give management incentives to take greater risks than either the creditors or the shareholders might want.²⁹ One argument for giving them new options to replace the old ones is that it brings their incentives more back into line with those of the shareholders as a whole. So, I think you are absolutely right. I think that we do often see firms that are in financial trouble issuing new options to management; your point might be a justification for that practice. Maybe.

ROGER LANE: If you assume there is a fiduciary duty, at least upon insolvency, and if you take *Geyer*³⁰ at face value, do you have a theory on when you would deem a board to be conflicted and not disinterested in a shareholders versus debt choice situation? Would you go to *Technicolor*³¹ and say, "Well, it depends on how much stock they have and if it was personally material to them"? It's a hard issue.

STEPHEN BAINBRIDGE: That's a good question. My immediate reaction would be to ask if the stock ownership is personally material to the director. As an initial reaction, that seems to be the most sensible approach. But it's not an issue I've thought about.

RICHARD BOOTH: Now that we found an issue that Steve has not thought about, I think that we ought to take a break. Thank you, Steve.

27. Stephen M. Bainbridge, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, 83 TEX. L. REV. 1615 (2005) (book review).

28. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (Harv. Univ. Press 2004).

29. *Id.* at 1429-32.

30. *Geyer v. Ingersoll Publ'n Co.*, 621 A.2d 784 (Del. Ch. 1992) (holding that upon insolvency in fact a corporate director owes a duty to the corporation's creditors).

31. *Cede & Co. v. Technicolor, Inc.*, 884 A.2d 26 (Del. 2005) (upholding the prior statutory appraisal).