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BY RICHARD A. BOOTH*

The Duty to Creditors Reconsidered— Filling a Much Needed Gap in Corporation Law

PERHAPS THE MOST FUNDAMENTAL QUESTION of corporation law is: To whom does the board of directors of a corporation owe its fiduciary duty? This question has been debated in one form or another for the last century.¹ Recently, the question has shifted to whether and under what circumstances the board of directors has a duty to maximize stockholder wealth.² It is probably fair to say that most observers agree that the stockholders are the ultimate owners of a corporation, and are thus entitled to have the board of directors manage the corporation in the manner that would best serve their interests. There is, however, a significant contingent that argues that the duty of the board of directors should be more broadly construed to include other constituencies or stakeholders such as creditors, customers, suppliers, employees, and the community at large.³ This view sounds expansive, but in practice the question whether creditors have standing to recover from management, its

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1. See, e.g., *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919). See generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 196–97 (Rev. ed. 1968); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1156 (1932); Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932); Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. Times, Sept. 13, 1970, Sunday Magazine, at 33.

2. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986); *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1989). See also MICHAEL P. DOOLEY, *FUNDAMENTALS OF CORPORATION LAW* 97 (1994); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 28–30 (1991); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 263 (1999); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 278 (1998); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1176 (1981).

3. See Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2253 (1990); James J. Hanks, Jr., *Non-Stockholder Constituency Statutes: An Idea Whose Time Should Never Have Come*, 3 INSIGHTS 12 (1989); Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1281–82 (1991); Marleen A. O'Connor, *Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 3, 4 (1991). See also Easterbrook & Fischel, *The Proper Role of a Target's Management*, *supra* note 2, at 1192 (“A manager responsible to two conflicting interests is in fact answerable to neither.”).

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agents, or a controlling stockholder usually occurs only if the corporation ends up in bankruptcy.⁴

The conventional wisdom is that creditors can and must protect themselves by contract. They have no standing to sue on grounds that sound in mismanagement or even self-dealing. They cannot ordinarily maintain a derivative action on behalf of the corporation or a direct action on their own behalf for breach of fiduciary duty.⁵ On the other hand, it is clear that parties to a contract owe each other a duty of good faith and fair dealing. Presumably, a creditor may recover from the corporation on such a theory. That is an unremarkable proposition if the corporation is solvent even though it is notoriously difficult for creditors to make out a case in such circumstances.⁶ But what if the corporation is insolvent? Practically speaking, the only question of any real moment is whether creditors can recover from someone else—namely management, its agents, or a controlling stockholder.⁷

4. Although other constituency statutes address the interests of a wider range of stakeholders, presumably only those with monetizable claims (i.e., creditors) would ever be able to recover. This is not to say that other constituency statutes give rise to a cause of action for damages. Most such statutes are permissive rather than mandatory, and needless to say, creditors have independent standing to sue the corporation in the event of default. The precise question addressed here is whether the board of directors may be held liable to creditors personally. Liability may also extend to officers and controlling stockholders under some circumstances. Of course, there may be other potential third party defendants such as accountants, lawyers, banks and others who may have somehow facilitated losses suffered by the corporation. Moreover, in most cases, third parties will have a direct relationship to the corporation that is similar to that of management. In other words, their primary duty or legal relationship is to the corporation and likely cannot be enforced by creditors as third party beneficiaries. On the other hand, creditors presumably may recover from third parties on theories such as interference with contract. But that is essentially an extension of the duty of good faith and fair dealing. Creditors may also recover by piercing the corporate veil. Indeed, it seems quite likely that most cases in which the duty to creditors arises and in which creditors seek monetary relief would also be credible piercing cases. Similar issues also arise when creditors seek equitable subordination of stockholder claims. See, e.g., *Pepper v. Litton*, 308 U.S. 295, 311–12 (1939); *Costello v. Fazio*, 256 F.2d 903, 909–10 (9th Cir. 1958).

5. This proposition is well established as a matter of common law and has been reduced to statute in many jurisdictions insofar as derivative actions may be maintained only by stockholders. See MODEL BUS. CORP. ACT § 7.40 (2005); See A.L.I., PRINCIPLES OF CORP. GOVERNANCE § 7.01, Reporter's Note 1 and 2 (1992).

6. There may be circumstances in which creditors suffer short of bankruptcy. For example, in the 1989 leveraged buyout of RJR Nabisco, the market value of RJR bonds fell dramatically and caused immediate portfolio losses to bondholders even though RJR never became bankrupt. In a sense then, the creditors never really suffered a loss. See *Met. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1526, 1527 (S.D.N.Y. 1989), *vacated*, 906 F.2d 884 (2d Cir. 1990).

7. There is an obvious problem with direct recovery by a creditor. If the corporation is insolvent (or is likely to become so), recovery by a creditor amounts to preferential treatment *vis a vis* other creditors. The answer is to treat such claims as derivative. But some claims may not be derivative. In that case, the answer may be that management owes no duty to creditors (other than a duty of good faith and fair dealing). On the other hand, some such claims succeed. That is exactly what happens in piercing the corporate veil, although in such cases recovery is typically against the stockholders of a closely held corporation. Arguably, it should be easier to recover from the board of directors, because authority to manage the corporation resides in the board of directors. Thus, it might also be argued that veil piercing proves *a fortiori* that creditors should be able to assert derivative claims against management. In those cases in which the courts have recognized that such claims should be derivative, they have usually also held that creditors have no standing to maintain a derivative action. Sometimes the courts offer no explanation for this proposition; sometimes they say it is because the statute says so; and sometimes they say it is because management's fiduciary duty runs only to the benefit of the stockhold-

In practice, none of this matters much. When a corporation falls into bankruptcy, the bankruptcy court may or may not appoint a trustee.⁸ If not, the debtor in possession (DIP) is unlikely to pursue claims against the board of directors that may have arisen in the zone of insolvency or indeed after insolvency. If a trustee is appointed—a likely occurrence only if there has been a pattern of questionable transactions—the trustee stands in the shoes of the corporation and may pursue any claim that the corporation itself could pursue, presumably including claims based on breach of fiduciary duty.⁹ The third possibility is that, for some reason, the corporation remains outside bankruptcy.¹⁰

ers. See A.L.I., PRINCIPLES OF CORP. GOVERNANCE § 7.02, Reporter's Note 1 and 2 (1992). Although few would object to such a statement of the law, it is in fact a rather extreme position. One would think that management has a duty to the corporation rather than the stockholders. Indeed, to say that management owes a duty to the stockholders is to suggest that the stockholders should be able to recover directly for most claims of mismanagement. Yet clearly that is not the case. Most such claims belong to the corporation and thus must be pursued derivatively. This is true of both common law claims and most statutory claims such as recovery of illegal dividends and payments due in connection with issue of stock. As to the latter, the statute typically provides that liability runs to the corporation. See, e.g., MODEL BUS. CORP. ACT § 8.33 (2005). So why then are creditors prohibited from maintaining derivative actions? One fallback position is that fiduciary duty should be interpreted in light of the interests of stockholders. In other words, what we mean when we say that management owes its fiduciary duty to the stockholders is that that duty should be interpreted in light of what the stockholders would want. Thus, a creditor is not an adequate representative plaintiff in a derivative action. It may also be that stockholders are precluded from direct action for other reasons. As a general rule, stockholders cannot force a distribution of corporate assets. In effect, they agree to leave assets in corporate solution and rely instead on their ability to sell their shares to others in order to exit the business. Thus, fiduciary duty (in particular the duty of care) may be seen as the quid pro quo for forgoing the right to force dissolution and liquidation.

8. See 11 U.S.C. § 1104 (2000).

9. See, e.g., *Pepper*, 308 U.S. at 307–08; *Costello*, 256 F.2d at 909. Thus, in practice, management's fiduciary duty does in fact run to creditors because trustees can enforce such duties on behalf of creditors. One way to resolve this puzzle is to relegate it to a question of jurisdiction. In other words, although state courts have generally held that fiduciary duty runs to the stockholders only, the law that applies in federal bankruptcy court is otherwise. The problem with that view is that the bankruptcy courts are supposed to apply the otherwise applicable law. An alternative way to resolve this puzzle, is to think of the rule that fiduciary duty runs only to the stockholders as a heuristic—a way for courts to sort out the meaning of fiduciary duty in a non-bankruptcy setting. In other words, the courts do not really mean it when they say that fiduciary duty runs only to the stockholders. What they mean is that as long as the corporation is solvent they will interpret fiduciary duty as if it runs only to the stockholders, perhaps on the theory that creditors have nothing to complain about in such circumstances, or that the stockholders can be trusted to protect the interests of creditors, or that stockholders are the best position to assert such claims. There is a third possibility—that a bankruptcy trustee should not ever be permitted to recover on grounds of breach of fiduciary duty.

10. This is an unusual situation in the United States because there is almost no disincentive for a corporation to file a voluntary bankruptcy petition. The situation is different in other countries. For example, in Germany, a company must declare bankruptcy if its legal capital falls below statutory requirements. The directors are liable for any losses incurred if the company fails to do so. After declaring bankruptcy, operation of the company must be turned over to a trustee. There is no such thing as a DIP. See Andreas Engert, *Life Without Legal Capital: Lessons from American Law* 23–24 (Legal Capital in Eur. Working Paper Group, 2006), available at <http://ssrn.com/abstract=882842>. Accordingly, some German legal scholars find it difficult to imagine that there could be any rule other than that the board of directors has a duty to maximize the value of the firm as a whole. Thus, it seems clear that the precise contours of fiduciary duty depend on the whole of the legal and business culture in which they operate. See Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2072–74 (2001). It may also be that the state courts have shied away from such claims out of a sense that federal bankruptcy law somehow preempts the field. Although there

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I. CREDIT LYONNAIS BANK NEDERLAND, N.V. V. PATHE COMMUNICATIONS CORP.

The courts have seldom discussed whether creditors have standing to assert claims based on breach of fiduciary duty, because it is relatively unusual for a state court to address issues that are usually handled by the federal bankruptcy courts, and probably also because the issue is one that gives rise to rather strong feelings.¹¹ In short, the issue was the third rail of corporation law until 1991 when the Delaware Court of Chancery issued its opinion in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*¹² In that case, Chancellor Allen held that "where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the [stockholders], but owes its duty to the corporate enterprise."¹³ In such circumstances, management is not disloyal in failing to act in the interest of the stockholders.¹⁴ Rather, management owes "supervening loyalty to . . . the corporate entity."¹⁵ 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."¹⁶

In a fateful and now famous footnote, Chancellor Allen stated "[t]he possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors."¹⁷ He then proceeded to describe a situation in which the board of directors might be tempted to gamble with the corporation's assets in order to maximize return to the stockholders under circumstances in which the creditors would suffer the loss in the event of failure.¹⁸ Specifically, he posits a situation in which a corporation has a single asset consisting of a judgment against a solvent debtor.¹⁹ There is a chance that the judgment will either be modified or reversed on appeal. If the judgment is reversed the corporation will be rendered insolvent.²⁰ The debtor has offered to settle the claim for an amount that would permit the corporation to pay off its own creditors but

should be little doubt that there is a role for state law here given that most states have statutes that authorize the appointment of a receiver for a corporation on grounds of insolvency, the flurry of cases addressing the zone of insolvency in Delaware and elsewhere would seem to confirm the matter.

11. There are also relatively few law review articles addressing the question. See Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1510-13 (1993).

12. Civ. A. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). See also *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) ("[W]hen the insolvency exception . . . arise[s], it creates fiduciary duties for directors for the benefit of creditors.").

13. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, Civ. A. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991).

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.* at *34 n.55.

18. *Id.*

19. *Credit Lyonnais*, 1991 WL 277613, at *34 n.55.

20. *Id.*

with little left over for the stockholders. If the judgment is affirmed the creditors can be paid off and the stockholders will enjoy a significant return.²¹ The stockholders would presumably prefer to decline the settlement and risk that the judgment will be affirmed. The creditors would presumably prefer that the corporation take the settlement. Chancellor Allen states (somewhat cryptically) that because the board of directors has an obligation to maximize the value of the firm as a whole, it should accept any settlement that is equal to or greater than the risk adjusted value of the judgment.²² Thus, the duty of the board of directors is not an all-or-nothing duty to any one constituency.²³

This concept is easily explained if one uses specific numbers.²⁴ Suppose that a corporation has one and only one asset, a judgment for \$100 million, and liabilities of \$20 million. According to the corporation's lawyers, there is a twenty percent chance that the judgment will be affirmed and an eighty percent chance that it will be reversed. The risk-adjusted value of the judgment is shown in the following chart:

	PAYOFF	PROBABILTY	VALUE
AFFIRM	100	.20	20
REVERSE	0	.80	0
TOTAL	—	1.00	20

The overall value of the judgment is just enough to pay off the creditors. The creditors would presumably prefer that the corporation accept an offer to settle the case for \$20 million. But from the point of view of the stockholders, there is a twenty percent chance that they will get \$80 million if the judgment is affirmed and the creditors are paid off. Thus, from their point of view the judgment is worth \$16 million and they would reject any settlement of less than \$36 million.

The point is that it is not apparent as to what the board of directors should do. In *Credit Lyonnais*, Chancellor Allen says that the board of directors should maximize the value of the firm as a whole.²⁵ But that begs the question: What does it

21. *Id.*

22. *Id.* It is not clear that this is correct as a matter of logic. One could equally well say that because the board of directors has an obligation to maximize the value of the firm, they should not accept a settlement simply because it is equal to or greater than the risk adjusted value of the judgment.

23. *Credit Lyonnais*, 1991 WL 277613, at *34 n.55. It is arguable that this statement is *dictum*. The plaintiff's claim was based on a purported contract by which a bank agreed to lend additional funds to a subsidiary corporation if the parent and subsidiary paid down a specified amount of existing borrowings. The court held that the agreement had never been executed by the bank, that it had been obtained through fraud, that the agreed repayments had never been made, and that the subsidiary would have been under no obligation to distribute funds to the parent if it had sold the assets in question.

24. Chancellor Allen's footnote sets forth an example with specific numbers, but the numbers are so peculiar that the example is difficult to follow.

25. 1991 WL 277613, at *34.

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mean to maximize firm value in the zone of insolvency situation? Furthermore, whose value should be maximized? Chancellor Allen says that the board of directors should take the deal.²⁶ But that does not necessarily follow from a rule of value maximization. Chancellor Allen may have meant to say that the board of directors should first assure the survival of the firm, but that is not what he said. Moreover, that is not an uncontroversial proposition. If the stockholders are well diversified, they may not care whether the firm survives.²⁷ Not surprisingly, *Credit Lyonnais* gave rise to an avalanche of cases and commentary. As of April 1, 2006, *Credit Lyonnais* has been cited in 45 other cases and in 157 law review articles.

II. PRODUCTION RESOURCES GROUP, L.L.C. V. NCT GROUP, INC.

In 2004, Vice Chancellor Strine sought to put the matter to rest in *Production Resources Group, L.L.C. v. NCT Group, Inc.*,²⁸ 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 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 encumbering the assets of the corporation.²⁹ The court presumed that the debtor corporation was insolvent as a result of its inability or refusal to satisfy an apparently valid obligation.³⁰

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.³¹ In other words, *Credit Lyonnais* protects the board of directors from an action by the stockholders grounded on the board's failure to seek an advantage for the stockholders at the expense of creditors.³²

Strine is probably correct in his interpretation of *Credit Lyonnais*, which involved a *controlling stockholder* challenge to a board decision not to undertake a sale of assets at fire sale prices in order to pay down an outstanding line of credit and

26. *Credit Lyonnais*, 1991 WL 277613, at *34 n.55.

27. Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 430 (1998); Richard A. Booth, *Who Owns a Corporation and Who Cares?*, 77 CHI.-KENT L. REV. 147, 155 (2001).

28. 863 A.2d 772 (Del. Ch. 2004).

29. *Id.* at 779–80.

30. *Id.* at 783–84.

31. *Id.* at 788.

32. *Id.* See also *Angelo, Gordon & Co., L.P. v. Allied Riser Commc'ns Corp.*, 805 A.2d 221, 229 (Del. Ch. 2002) (“[E]ven where the law recognizes that the duties of directors encompass the interests of creditors, there is room for application of the business judgment rule.”).

avoid triggering a voting trust agreement by which the creditor would assume voting control of the corporation. If *Production Resources* had held simply that the board of directors is protected by the business judgment rule in zone-of-insolvency situations, there would be little more to say about it. The problem is that in *Production Resources* a creditor sought to assert a positive claim against the board of directors. It is one thing to say that a stockholder has no claim if the board of directors fails to maximize stockholder wealth, but it is quite another to say that a creditor has a claim if the board of directors favors the stockholders at the expense of creditors. The fact that stockholders have no remedy does not imply that creditors do have a remedy. Nevertheless, Strine upheld the claim at least in part.³³ Thus, although at first blush it appears that Strine seeks to debunk the notion that *Credit Lyonnais* broke new ground, Strine himself breaks that ground in *Production Resources*. He then goes on to hold that Delaware General Corporation Law § 102(b)(7) protects the board of directors from such claims to the same extent that it protects the directors from claims by stockholders.³⁴ But Strine declines to dismiss the complaint, because the plaintiff in this case pleaded specific facts that suggest that the board may have acted disloyally or in bad faith.³⁵

Strine states that it is well-settled under case law that the board of directors owes its fiduciary duty to the corporation as an entity and that, when a firm is insolvent, the board of directors owes its fiduciary duty to the creditors because the creditors have assumed the position of residual claimants.³⁶

It is not clear, however, that stockholder wealth maximization is a bad rule even if it sometimes leads the board to follow strategies that reduce creditor wealth. Presumably, such a rule would lead to higher overall stock prices than would a rule requiring maximization of firm value. And presumably stockholders as an investor class would favor such a rule. Even though the rule would lead to bankruptcy in some cases, diversified stockholders would still be better off because their gains

33. *Prod. Res. Group*, 863 A.2d at 793–95.

34. *Id.* at 777.

35. *Id.* Strine also addresses two other related issues without deciding them. First, what is the pleading standard that applies to a derivative claim by a creditor of an insolvent firm? *Id.* at 795–96. For example, must the plaintiff plead that demand on the board is excused? Second, what does the direct and derivative distinction mean when a firm is insolvent? *Id.* at 796–97. That is, are there circumstances in which a creditor plaintiff can recover directly? As to the first question, he does not reach an answer because he holds that the plaintiff has pleaded particularized facts raising questions about the good faith of the board in the sense that its efforts to resist paying the plaintiff are difficult to justify on any rational basis. *Id.* at 800. This is somewhat curious in that Strine himself has expressed doubt that waste can ever be the basis for overcoming the business judgment rule. As to the second question, he declines to answer until all of the evidence has been presented at trial. *Id.* at 800–01. One further question that is left unanswered by *Production Resources* is why the defendant company was not in bankruptcy. The simple answer may be that it takes three creditors to file a petition for involuntary bankruptcy.

36. *Prod. Res. Group*, 863 A.2d at 787. Curiously, Strine cites *Revlon* as support for this proposition. *Id.* at 787 n.48. He also notes that *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003), may be to the contrary. *Id.* at 788 n.51. In other words, Strine seems to agree with the notion that *Credit Lyonnais* affords fiduciary rights to creditors. His only disagreement seems to be with the characterization of such rights as new.

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would outweigh their losses. And creditors will presumably respond to a rule of stockholder wealth maximization by insisting on contractual protections designed to contain such strategies.³⁷ Moreover, if the default rule is one that requires maximization of firm value, it is not clear that stockholders can do anything to impose a rule that maximizes stockholder value. Aside from the fact that the default rule would likely be seen as mandatory, it is difficult to see how one could reduce a rule of stockholder wealth maximization to contract. This suggests that the rule of stockholder wealth maximization is not so much about stockholder welfare as it is about ensuring that the burden of contracting is clearly imposed on creditors.³⁸

III. MIND THE GAP

Strine argues that creative lawyers and scholars have used *Credit Lyonnais* to fill non-existent gaps in the coverage of fiduciary duty.³⁹ But it is also possible to interpret *Credit Lyonnais* as holding that there are desirable gaps in the law. As I have argued elsewhere, the supposed duty of the board of directors to maximize stockholder wealth is one that is honored mostly in the breach.⁴⁰ The only situation in which the board of directors is held to such a duty is a situation in which the sale or break-up of the company appears to be inevitable.⁴¹ In other situations, the board is free to pursue an adequate profit for the stockholders even though it may be clear that the stockholders would prefer for the board to maximize stockholder value. But the board of directors *may* be held liable if it invests the assets of the corporation in a way that is sure to lose money or break even at best.⁴² In short, the board of directors is under an obligation to try to make a profit, but not necessarily the maximum profit. Thus, the board of directors may legitimately choose to seek less profit at less risk even though it is clear that stockholders prefer a more aggressive strategy.⁴³ There is nothing that the stockholders can do about this as a matter of law. But a company that fails to maximize stockholder value may become the

37. See *Met. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1526, 1530 (S.D.N.Y. 1989), *vacated*, 906 F.2d 884 (2d Cir. 1990).

38. See Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 Nw. U. L. Rev. 140, 157 (1994).

39. *Prod. Res. Group*, 863 A.2d. at 789. Or as Gig Young was wont to say in *Lovers and Other Strangers*, "No gap here." *LOVERS AND OTHER STRANGERS* (Am. Broad. Co. 1970).

40. See Booth, *Stockholders, Stakeholders, Stakeholders, and Bagholders*, *supra* note 27, at 463-73 (discussing supposed duty to maximize stockholder value); *Principles of Corp. Governance: Analysis and Recommendations*, 2 A.L.I. § 2.01 (1992) (corporation should be managed so as to enhance corporate profit and shareholder gain). Regarding the peculiar notion of an unenforceable duty, the breach of which gives rise to no cause of action, see *Strougo v. Bassini*, 282 F.3d 162, 175 (2d Cir. 2002).

41. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

42. See *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982), *cert. denied*, *Citytrust v. Joy*, 460 U.S. 1051 (1983) and *Baldwin v. Joy*, 460 U.S. 1051 (1983); *Selheimer v. Manganese Corp. of Am.*, 224 A.2d 634, 644 (Pa. 1966); *Litwin v. Allen*, 25 N.Y.S.2d 667, 678 (N.Y. App. Div. 1940).

43. See *Joy*, 692 F.2d at 886; *Principles of Corp. Governance*, *supra* note 40, at § 2.01 cmt. f.

target of a takeover. In other words, the market provides sufficient discipline here—there is no need for fiduciary duty.⁴⁴

As for the interests of creditors, it is unlikely that a corporation in a zone-of-insolvency situation would opt to bet the farm in the real world. As in *Credit Lyonnais*, a CEO would likely reason that he must keep the company afloat to keep his job.⁴⁵ Thus, most CEOs would likely be inclined to accept a settlement even if it was only a break even deal.⁴⁶ The CEO might even try to negotiate with the creditors to see if they would accept some lesser amount.⁴⁷

44. This assumes that the company is publicly traded. The optimal rule may be otherwise for a closely held corporation or if the stockholders are unable to diversify. In such a situation, the stockholders are likely to be concerned about both risk and return. See, e.g., *Brane v. Roth*, 590 N.E.2d 587, 589–91 (Ind. Ct. App. 1992). To be sure, statutory corporation law is largely the same whether or not there is a public market for shares, leaving aside the statutory close corporation election and various isolated provisions such as MODEL BUS. CORP. ACT. § 7.32 and § 14.34 (2005). Thus, one not-very-good argument for a rule of firm wealth maximization is that we need a rule that works for all companies. On the other hand, the courts have been quite willing to fashion the law of fiduciary duty around the existence (or not) of a market for the shares of a corporation. See *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505, 518–19 (Mass. 1975).

45. On the other hand, a board of directors consisting mostly of independent directors may not be averse to taking a big risk. The board of directors, as a board, has little to lose (or gain) other than possibly being held liable for a breach of fiduciary duty. Moreover, if fiduciary duty is interpreted to require stockholder wealth maximization or is widely thought to so require, there is some chance that making the wrong decision could give rise to liability. So the law may matter here. To be sure, DEL. CODE ANN. tit. 8 § 102(b)(7) (2001) may protect the directors against most good faith mistakes. But knowing failure to maximize stockholder wealth could be seen as a breach of good faith and thus remain actionable. This raises a further question—what is the role of the board *vis a vis* the CEO? The board of directors is seldom in a position to manage a business actively. The board of directors can approve or reject strategies proposed by the CEO, but it cannot realistically devise and execute a business strategy on its own. If the circumstances are such that the board of directors can manage the corporation, and it chooses to do so, then the board is presumably subject to the entire range of fiduciary duties, including (possibly) a duty to maximize stockholder wealth. But the statutes permit the board of directors to assume a more supervisory role. See DEL. CODE ANN. tit. 8 § 141(a) (2001); MODEL BUS. CORP. ACT § 8.01(b) (2000); A.L.I., PRINCIPLES OF CORP. GOVERNANCE § 3.02 (1992). Realistically, a supervisory board cannot maximize stockholder wealth. It can only encourage the CEO to do so and veto strategies and deals that reduce stockholder wealth. To be sure, there may be situations in which the board of directors can do more. As illustrated by *Revlon*, one such situation is the sale or breakup of the company. In such circumstances, the board of directors is in a good position to act as auctioneer and to guard against efforts by the CEO to manipulate the process, because the goal is clearly defined. If this is the correct view, then there is a subtle danger in the notion that an independent board of directors is a good thing particularly in combination with the notion that the goal of the board should be to maximize stockholder wealth. It is precisely the danger that Chancellor Allen describes in Footnote 55. Thus, the ideal board of directors may be one with a significant equity stake as championed by Charles Elson. See Charles M. Elson, *Executive Overcompensation - A Board-Based Solution*, 34 B.C. L. REV. 937 (1993); Charles M. Elson, *Director Compensation and the Management-Captured Board - The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996); Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649 (1995). See also R. Franklin Balotti, et al., *Equity Ownership and the Duty of Care: Convergence, Revolution, or Evolution?* 55 BUS. LAW. 661 (2000); Sanjai Bhagat, et al., *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885 (1999).

46. That is essentially what happened in *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003). But the Delaware Supreme Court held that the board was required to consider a subsequent offer that would give more to the common stockholders despite an otherwise enforceable contract to take the first offer. *Id.* at 936.

47. It is worth pondering whether the CEO might even be precluded by fiduciary duty from negotiating with the stockholders to see if they would accept a lesser payout. Some commentators seem to suggest that

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If this is the correct view then it is simply wrong to say that creditors gain standing to assert claims based on breach of fiduciary duty when a corporation is in the zone-of-insolvency or is in fact insolvent. Creditors may accede to the same status as stockholders in such circumstances, but neither has a cognizable claim about whether or not the board of directors should seek to maximize the value of the firm. In other words, there is nothing special about a zone-of-insolvency situation. Stockholders cannot ordinarily assert claims based on failure to maximize stockholder wealth, nor can they do so in the zone-of-insolvency.⁴⁸ Moreover and more problematic, extending the benefits of fiduciary duty to creditors under any circumstances leads to intractable conflicts and ultimately back into the confusion created by *Credit Lyonnais* in the first place.

First, as Strine clearly and correctly recognizes in *Production Resources*, stockholders enjoy some potential for gain even in an insolvent business if it rebounds to a value in excess of creditor claims.⁴⁹ Thus, the board of directors presumably continues to have some sort of duty to the stockholders of an insolvent firm. Accord-

fiduciary duty should constrain managers from seeking excessive pay at least in the absence of a truly independent compensation committee. See Lucian A. Bebchuk, et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002). If so, this is another argument for not extending fiduciary duty to creditors. Again, stockholders are adequately protected from unduly conservative management by the threat of takeover.

48. There is a potential problem with this interpretation of Footnote 55. Some scholars have argued that the rule of *Revlon* is focused on end period transactions in which the board of directors should not consider the long-term interests of the firm or stockholders because sale or break-up is inevitable. See Charles M. Elson & Robert B. Thompson, *The Limits Of Judicially Enforced Constraints And The Promise Of Proprietary Incentives*, 96 Nw. U. L. REV. 579, 582 (2002). One could characterize a Footnote 55 situation as such a predicament in the sense that as far as the stockholders are concerned there is no reason to think about the long-term. But one could equally well characterize a Footnote 55 situation as one in which the long term survival of the firm is a central concern. That is, the board could choose to maximize stockholder wealth (or not) free of *Revlon* constraints. One possible interpretation of Footnote 55 is that Chancellor Allen intended it as an argument from absurdity for the extension of fiduciary duty to creditors in the zone of insolvency. It may be that what Allen meant to say was: (1) if there is no fiduciary duty to creditors in such circumstances, the board of directors might see itself as required to bet the farm for the benefit of the stockholders, (2) that is clearly an absurd result, and (3) therefore there must be a fiduciary duty to creditors under such circumstances. Indeed, some commentators have argued that the only sensible rule is one that requires or at least encourages directors to maximize firm value. Any other rule, they argue, is suboptimal from a societal point of view. See Andreas Engert, *Life Without Legal Capital: Lessons from American Law* 23–24 (Legal Capital in Eur. Working Paper Group, 2006), available at <http://ssrn.com/abstract=882842>. I have argued myself that the duty of care should be interpreted as running to the company rather than as running to the stockholders. See Booth, *Stockholders, Stakeholders, and Bagholders*, *supra* note 27, at 430. My point however, consistent with my position here, is not that stockholder wealth maximization is the wrong norm, but rather that in most circumstances it can be enforced only by the market. Another possible interpretation of Footnote 55, or at least another basis on which the case could have been decided if the financing agreement were enforceable, is that the decision not to sell assets at fire-sale prices was in fact one designed to maximize stockholder wealth over the long haul and that the board simply ignored the peculiar interests of one particular stockholder who was more concerned with maintaining control. *Credit Lyonnais* could be interpreted as a potential entrenchment case and, as such, quite within mainstream doctrine. One problem with this interpretation is that it makes the footnote superfluous. That is not necessarily a problem in the real world, but as a matter of academic interest, the footnote is the issue. It does no good to dismiss it as dictum.

49. *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d. 772, 776–77 (Del. Ch. 2004).

ingly, Strine holds that fiduciary duty in insolvency runs to both stockholders and creditors.⁵⁰ In doing so, he thus rejects the so-called *trust fund theory* that the duty of the board of directors is merely to marshal the assets of an insolvent firm. But what happens when the interests of the stockholders and the creditors conflict? It is not at all difficult to imagine a situation in which a firm that is in fact insolvent has a risky opportunity that carries the potential of gain for the stockholders. In other words, it is easy to extend Chancellor Allen's logic to a firm that is in fact insolvent.

Second, if fiduciary duty extends to creditors, what is to keep creditors from overreaching? Strine himself worries that if we find a fiduciary duty to creditors in the zone of insolvency, creditors may use their rights to assert claims against firms that turn out to be solvent and that creditors, for example, may use their standing to get discovery and otherwise disrupt business.⁵¹ The same worry arises if creditors have standing to assert fiduciary claims when a firm is in fact insolvent, because it is unclear whether decisions that result in insolvency may also be actionable. In other words, *Production Resources* itself may expose the board of directors to creditor claims about the conduct of business before insolvency. It seems clear that there should be some limit on the ability of creditors to pursue claims against the board of directors, but where does one draw the line? To say that a duty to creditors arises only when the firm becomes insolvent is hollow protection. But to posit a duty in the zone of insolvency is to open a can of worms.⁵²

50. *Id.* at 789.

51. *Id.* at 789–91.

52. Again, these issues are likely to arise only in cases in which a trustee has been appointed. It seems unlikely that a DIP would assert such claims. To be sure, we could rely somewhat on the discretion of the trustee about what claims to pursue. But it would be easier to do so if it were clear that fiduciary duty is off limits. Bankruptcy law struggles somewhat with these problems too. Although there seems to be little doubt that trustees in bankruptcy do assert claims based on fiduciary duty, bankruptcy law also holds that the duty of the board of directors is the same in bankruptcy as outside bankruptcy. In addition, bankruptcy law may recognize the claims of stockholders in situations in which new value is created while also holding directors accountable for decisions that result in deepening insolvency. See generally Eric BRUNSTAD, JR., *Bankruptcy and the Problems of Economic Futility: A Theory on the Unique Role of Bankruptcy Law*, 55 BUS. LAW. 499 (2000); see also Sabin Willett, *The Shallows of Deepening Insolvency*, 60 BUS. LAW. 549, 552–57 (2005). In short, the role of the board of directors of an insolvent corporation is fraught with conflicts even as a matter of bankruptcy law. But the conflicts that arise in bankruptcy may be the result of ambiguity in state law. Presumably, the bankruptcy courts would be required to follow clearly articulated state law to the effect that creditors have no standing to assert claims sounding in fiduciary duty under any circumstances. See, e.g., *In re RSL COM Primecall, Inc.*, Nos. 01-11457 and 01-11469, 2003 Bankr. LEXIS 1635 (Bankr. S.D.N.Y. Dec. 11, 2003) (debtor corporation's claim that directors breached their fiduciary duty by not liquidating upon insolvency failed because the decision to postpone a bankruptcy filing was subject to the business judgment rule); *Floyd v. Hefner*, No. H-03-5693, 2006 U.S. Dist. LEXIS 70922, at *20–21 (S.D. Tex. Sept. 29, 2006) (former directors of debtor did not owe creditors any broad fiduciary duties under Texas common law, so decision to mortgage debtor's assets was actionable only if trustee established violation of a legal obligation that caused damage). See also *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 174, 206–07 (Del. Ch. 2006) (creditors failed to plead facts showing that directors or third party advisers had a disloyal motive, that they were less than diligent, or that they misunderstood their roles; court refused to embrace the deepening insolvency claim characterizing it as a hopeful prediction of state law by federal courts). Thus, the answer to the question whether the board of directors owes a fiduciary duty to creditors has implications not just for those rare cases in which state courts must address fiduciary duty in insolvency, but also for common cases in which bank-

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Finally, and closely related, it is not clear when one is in the zone-of-insolvency. In a world of diversified investors who favor focused, non-diversified companies, many choices about basic business strategy may turn out to be bet-the-farm decisions. A company that is serious about seeking to maximize stockholder wealth is likely to face such choices as a routine matter. If creditors can recover when that strategy fails, and it often will, few companies will in fact seek to maximize stockholder wealth.

In short, *Production Resources* resolves nothing. Indeed, it raises many more questions than it answers. What Strine should have said was that creditors simply cannot assert claims sounding in fiduciary duty under any circumstances, while making it clear that the board of directors is protected by the business judgment rule from any claim that they failed to maximize stockholder wealth outside a *Revlon*⁵³ situation. Instead, by holding that fiduciary duty extends to creditors in insolvency and recognizing that the board of directors continues to owe a duty to stockholders even in insolvency,⁵⁴ Strine left open the possibility of conflicting interpretations as to the meaning of fiduciary duty in insolvency.

IV. WHAT IS GOOD FAITH AND FAIR DEALING?

Does this mean that the board of directors has no duty of any kind to creditors and that it can never be held liable to creditors no matter how egregiously it has behaved? Certainly not. Creditors can always seek appointment of a receiver.⁵⁵ Although the burden is on creditors to protect themselves, they are also protected by the duty of good faith and fair dealing that all parties to a contract owe to each other.⁵⁶ In one sense, the duty of good faith and fair dealing is similar to fiduciary duty—it is an open-ended duty whose requirements cannot be fully stated in advance. Like fiduciary duty, it has that you-know-it-when-you-see-it quality. Nevertheless, the courts have been reluctant to find that much of anything violates the duty of good faith and fair dealing, perhaps because they find it difficult to distinguish the duty from fiduciary duty.⁵⁷ Moreover, courts have recently begun to find that fiduciary duty includes a duty of good faith,⁵⁸ thus further confusing things.

ruptcy courts must determine whether a trustee has standing to assert claims sounding in fiduciary duty and if so whether his standing extends to the entire range of fiduciary duty or is limited (for example) to duty of loyalty claims or some subset thereof. See also *Bank of Am. v. Musselman*, 222 F. Supp. 2d 792, 798–99 (E.D. Va. 2002) (creditor bank and receiver could not sue insolvent company's officers or directors for breach of fiduciary duty to recover defaulted loan amounts in absence of allegations of self-dealing).

53. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

54. *Prod. Res. Group*, 863 A.2d at 787–91 (Del. Ch. 2004).

55. See DEL. CODE ANN. tit. 8, § 291 (2001); MODEL BUS. CORP. ACT § 4.32 (2000) (both expressly recognizing the standing of creditors).

56. See, e.g., *Wood v. Lucy, Lady Duff-Gordon*, 118 N.E. 214, 214 (N.Y. 1917). Ironically, it has been incorrectly argued that *Wood* amounts to the imposition of a fiduciary duty in the context of a contract granting an exclusive license. See, e.g., *Mellencamp v. Riva Music Ltd.*, 698 F. Supp. 1154, 1158 (S.D.N.Y. 1988).

57. See, e.g., *Mellencamp*, 689 F. Supp. at 1156–59.

58. *Id.*

So is there anything certain regarding the duty of good faith and fair dealing? One thing is clear—it must be somehow different from fiduciary duty if we want to avoid falling into the morass of the zone of insolvency. In addition, as we have seen here, creditors should have no standing to assert a claim that management failed to seek a profit or to maximize that profit. Thus, incidental harm to creditors cannot constitute a breach of duty to creditors.⁵⁹ On the other hand, the intentional diversion of creditor wealth to stockholders would seem to cross the line. For example, it would seem to constitute a breach of good faith and fair dealing for the board of directors to drive down the value of the corporation's bonds in order to buy them back at bargain-basement prices and thereby generate stockholder gain.⁶⁰ Similarly, if the corporation arranges its affairs in such a way as to render it unable to pay one or more creditors, that too would seem to cross the line. In both cases, such tactics amount to simple refusal to pay an obligation recognized as valid as in *Production Resources*. But in such cases it would seem that the express remedy of receivership under the state corporation law is adequate to the task and that the availability of an express remedy precludes the implication of other remedies such as those available for breach of fiduciary duty.⁶¹

For the most part, creditors are adequately protected from abusive tactics designed to enrich stockholders at creditor expense. The rules relating to distributions by corporations together with fraudulent transfer law and the law of receivership more or less assure that there remains value in the corporation and that creditors will eventually get paid to the extent that the corporation can pay.⁶² It is somewhat odd that creditors have no standing to assert claims based on corporation law as it relates to distributions, but it is easy for a creditor to negotiate for well defined limitations in this connection. Inasmuch as such claims are statutory and not based on fiduciary duty, they are presumably fair game for a trustee in bankruptcy. Moreover, fraudulent transfer law covers all of the situations that are covered by the rules relating to distributions.⁶³ To be sure, there is nothing in either of these regimes that addresses the problem of gambling with creditor wealth. Indeed, the fact that there is no such limitation enshrined in fraudulent transfer law—which explic-

59. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (board of directors must maximize stockholder wealth in the sale of a corporation even if creditors are harmed in the process). Indeed, it is difficult to see how the board of directors can be said to have an obligation to maximize stockholder wealth under any circumstances—even if it does entail betting with the money of others—if the board also has a fiduciary duty to creditors under any circumstances.

60. See *Eisenberg v. Chi. Milwaukee Corp.*, 537 A.2d 1051, 1058–59 (Del. Ch. 1987). See also *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1053 (2d Cir. 1982), *cert. denied*, 460 U.S. 1012 (1983) (construing rights of bondholders to accelerate in circumstances in which it appeared that sale of assets might be part of a scheme to drive down value of bonds).

61. In Delaware, the Court of Chancery has no jurisdiction over such cases unless they involve a breach of fiduciary duty. See *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, No. Civ. A. 1456-N, 2006 WL 2588971, at *6–7 (Del. Ch. Sept. 1, 2006).

62. See *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 199 (Del. Ch. 2006) (discussing remedies available to injured creditors under fraudulent transfer and receivership laws).

63. *Id.*

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itly addresses transactions that leave a business undercapitalized—suggests a positive policy decision.

It is perhaps arguable that creditors, in contrast to shareholders, need the protections of fiduciary duty in cases in which those who control the corporation seek to favor themselves. The situation in *Production Resources* comes to mind, but here too fraudulent transfer law seems equal to the task. If the terms of an insider transaction are unfair, the transaction can be attacked under fraudulent transfer law equally as well as a matter of fiduciary duty.⁶⁴ And even if the terms are fair, the deal can often be avoided as a matter of bankruptcy law. Thus, there is no identifiable benefit from extending the protections of fiduciary duty to creditors. Indeed, the protections afforded by fiduciary duty may be narrower than those that creditors otherwise enjoy. Be that as it may, the confusion that results from the extension of fiduciary duty is significant.⁶⁵

CONCLUSION

In the end, it seems clear that fiduciary duty should remain focused on and limited to stockholders. Creditors have no need for its protections even though they might prefer a rule that favors them when the board of directors is tempted to endorse a risky business strategy. As things stand, such decisions are left to the unquestionable discretion of the board of directors—the stockholders cannot challenge such decisions. Therefore, neither should the creditors be able to do so. Luckily, the cases thus far in which creditors have prevailed are cases in which they should have prevailed anyway under fraudulent transfer law. Nevertheless, there remains a substantial body of case law which indicates creditors can assert fiduciary duty claims. Until recently, most such decisions have come from the bankruptcy courts.⁶⁶ The state courts that have primary jurisdiction with regard to the interpretation of corporation law have had few opportunities to say otherwise. Still the decisions of the Delaware Court of Chancery in *Credit Lyonnais* and *Production Resources* have generally affirmed the idea that the protections of fiduciary duty extend to creditors at least when a corporation is in fact insolvent. These decisions have encouraged further loose talk from the bankruptcy courts in an area in which they are already

64. *Id.*

65. For example, many courts and commentators have suggested that the duty to creditors arises only in cases in which directors have violated the duty of loyalty. See, e.g., *Bank of America v. Musselman*, 222 F. Supp. 2d 792, 798–99 (E.D. Va. 2002) (creditor bank and receiver could not sue insolvent company's officers or directors for breach of fiduciary duty to recover defaulted loan amounts in absence of allegations of self-dealing). But such claims invariably also run afoul of fraudulent transfer law. The fact that a stockholder would have a claim for breach of fiduciary duty may be an interesting coincidence, but it does not imply that creditors have a claim for breach of fiduciary duty.

66. See, e.g., *SubMicron Sys. Holdings I Inc. v. KB Mezzanine Fund II, LP* (*In re SubMicron Sys. Corp.*), 432 F.3d 448, 463 n.17 (3d Cir. 2006); *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1005 (9th Cir. 2005); *Carrieri v. Jobs.com Inc.*, 393 F.3d 508, 534 n.24 (5th Cir. 2004); *Diaz v. Ozarowski* (*In re Ozarowski*), No. 02-52981 (RTL), 2006 WL 3694547, at *7 (Bankr. D. N.J. Dec. 12, 2006); *In re Romano*, Nos. 04-11263-JNF and 05-16880-RS, 2006 WL 3081034, at *17 (Bankr. D. Mass. Oct. 30, 2006).

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challenged by applying state law in a difficult context. The law would be better served if the courts made it clear once and for all that fiduciary duty is about the stockholders and no one else.