

Direct Creditor Claims for Breach of Fiduciary Duty: Is they is, or is they ain't? A Practitioner's Notes From the Field

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Direct Creditor Claims for Breach of Fiduciary Duty: Is they is, or is they ain't?¹

A Practitioner's Notes From the Field

INTRODUCTION

FOR THE PRACTITIONER, THE TOPIC OF CREDITORS' CLAIMS against corporate directors for an alleged breach of fiduciary duty is particularly vexing. There is a dearth of relevant case law, and what case law does exist, by and large, is not the work of the state courts with authority to articulate the corporate law in their jurisdictions, but of the federal courts (generally, the bankruptcy courts), which are called upon to render decisions with little, if any, authoritative state court guidance. This is not a temporary phenomenon—it is endemic to the field. Creditor claims for breach of fiduciary duty typically arise in federal bankruptcy cases, and for that reason, the state courts rarely have an opportunity to address them, or at least to address them directly. Thus, the lack of authoritative state court guidance is perpetuated.

When, as a practitioner, one represents plaintiffs in this context, the clients need to understand that the viability of the claims they seek to advance may itself be unsettled. The success of their claims, therefore, may not depend solely on the development and presentation of the evidence. For defense counsel, and for corporate counsel who seek to advise directors and avoid litigation in the first instance, the situation is no better, and possibly worse: it is relatively easy for professional advisers to prepare and run through a board packet that informs directors of the potential effect of their actions on creditors' interests. It may be difficult, however,

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1. The line is attributed to a 1964 letter from one Estelle Dumbrava to Major Maston Jacks, U.S. Air Force, Project Bluebook. UFO Help, <http://www.ufohelp.com> (last visited Jan. 11, 2007). The full quatrain, of which UFO aficionados are justly fond, runs as follows: "Flying saucers come so near, they leave us mortals filled with fear. So tell me Major, ere I faint, is they is, or is they ain't?"

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to ensure that such an exercise in the duty of care, or any particular decision, will protect directors from liability in all circumstances, or that a motion to dismiss claims brought against them will succeed.

By the same token, the effort under way in some circles to stem the tide of fiduciary-duty claims brought by creditors against corporate directors is, well, like trying to stem the tide. Efforts can be made to channel these legal developments through advocacy and scholarly commentary, but it is either too early or too late to stop the trend altogether. The peculiar dialectical processes of the common law have been trained on this issue and have not yet arrived at a solution set. The doctrinal development, moreover, will be characterized by frequent periods of inactivity, when the economy is essentially healthy and claims of this type are not asserted in any significant number. At some point, it may emerge that we have been chasing a phantom: a string of cases converging more or less on the point that a distinct body of fiduciary duties to creditors is not needed. But we are not there yet.

Given this unsettled backdrop, it is with some trepidation that one advances any substantive thesis in the field, particularly a practitioner. Indeed, the discussion that follows might best be regarded as a series of notes from the field, with all of the roughness, incompleteness, and lack of systematic development that it implies, rather than a fully considered conceptual apparatus. I will, nonetheless, offer two thoughts for consideration.

The first is that when all the dust clears, I believe there will be a place for creditors to assert direct breach-of-fiduciary-duty claims against corporate directors, although I think that will only occur in very limited circumstances. In fact, I believe that the scope of such claims may not extend materially beyond (i) claims for self-dealing, where the challenged conduct results in injury to a particular creditor; (ii) claims for interference with voting rights, in circumstances where secured lenders accede to such rights; and possibly, (iii) claims for "bad faith" or intentional director misconduct, provided that the challenged conduct results in injury to a particular creditor. The description of these types of claims should suggest something of their rarity; the theory will not, I believe, develop into the doctrinal equivalent of a kudzu vine.

The second thought is that the doctrinal model for articulating these issues in a more comprehensive fashion is most likely to be derived from the principles applied to preferred stock—a corporate security that, as long noted, can share significant characteristics with debt instruments. Most litigation involving fiduciary duty to creditors will continue to occur, as it has for the past quarter century, in derivative actions in which the duties of corporate directors, although in flux with respect to the primacy or weight to be given to creditors' interests, are nonetheless assessed in a framework that is reasonably well understood. A construct for evaluating potential direct creditor claims for breach of fiduciary duty does not exist, however, and reference to the treatment of direct preferred stockholder claims may therefore be a useful starting point.

I. CLEARING OUT THE UNDERBRUSH: DISTINGUISHING “WHEN” FROM
“WHAT,” “QUASI-DERIVATIVE” FROM “DIRECT,” AND CLAIMS
BARRED BY THE BUSINESS JUDGMENT RULE AND
SECTION 102(B)(7) CHARTER PROVISIONS

Before commenting on what I consider to be the primary, or most difficult, issues in this area, it may be helpful to identify and distinguish those issues I believe to be secondary. This is not to say that these other issues are unimportant, free from doubt, or unworthy of considerable thought. On the contrary, it is a compliment to them that they are simply not as muddled as the issues on which I would like to focus.

First, I agree with other commentators that the question of whether directors may owe fiduciary duties to creditors in the “zone” or “vicinity” of insolvency, or only when the firm is “insolvent in fact,” is of secondary importance analytically.² Make no mistake, the question of when such duties arise (i.e., which financial condition of the firm will trigger such duties) can be of great practical value. If a creditor can, by asserting a “zone” claim, materially expand the period during which it was owed fiduciary duties, that creditor can usually enhance the damages it claims (and hence its potential recovery) significantly. There is no mystery as to why creditors find the theory so irresistible. Nonetheless, it seems to me a more fundamental matter to determine first what these fiduciary duties might be and then to debate when they might arise. My suspicion is that no “when” line can be drawn that is not in some sense arbitrary or that is free of all ambiguity in application. As a practitioner—if forced to choose—I would always prefer to have a grip on what standards may be applied to judge my clients’ conduct and to give them the benefit of that knowledge when they make material corporate decisions.³

Second, I believe that issues relating to creditors’ pursuit of derivative claims on behalf of the corporation are less troublesome, from an analytic perspective, than the subject of direct creditor claims. Here again, the subject of creditors pursuing derivative claims is of substantial practical importance, and this should not be overlooked. In fact, the overwhelming majority of instances in which creditors sue and recover from corporate directors (or, more commonly, from the directors’ liability insurance carrier) are, and will continue to be, cases involving derivative claims. In addition, at the substantive level, the cases themselves confront many of the hard issues in this area. It is in these cases that the debate over the existence and scope of directors’ fiduciary duty to creditors is most commonly litigated—to

2. See, e.g., J. William Callison, *Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice*, 1 J. BUS. & TECH. L. 431 (2007).

3. The “when” and “what” questions are, of course, not completely independent of one another. Indeed, some commentators fairly ask whether, if fiduciary duties to creditors exist in the “vicinity” of insolvency, different levels of attention or deference to creditor interests may be required as one moves from the “vicinity” of insolvency to insolvency in fact, potentially compounding the practical difficulties that directors face in this setting. See *id.*

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whom or what is the duty owed, and how is the duty to be articulated relative to stockholder interests or the broader interests of the corporate enterprise.⁴ In addition, the “direct/derivative” distinction itself can be counted on to generate a few bona fide head-scratchers from time to time, *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*⁵ notwithstanding.

Nonetheless, this subject is less fundamental in my mind for three reasons. First, the practice of granting creditors “derivative standing” to pursue breach-of-fiduciary-duty claims against directors, when the corporation itself and its stockholders fail to do so, is well established as a practical matter, at least in the bankruptcy context, where it most frequently arises.⁶ Second, granting a creditor or creditor group standing to pursue a claim that the corporation or its stockholders could otherwise pursue does not, in and of itself, give rise to new or different liability risks for the directors, nor does it change the *ex ante* advice that should be provided to the directors to guide their conduct; it merely allows a different party to proceed with the claim.⁷ Third, whatever its flaws may be, the notion of granting creditors derivative standing to seek redress for harm to the corporation certainly enjoys more comfortable conceptual footing than its cousin, the direct creditor claim.

Finally, I believe there is less analytic interest in claims barred by the business judgment rule or exculpatory charter provisions, such as those adopted under authority of section 102(b)(7) of the Delaware General Corporation Law (DGCL).⁸ Generally, with regards to the business judgment rule, these include claims that seek to challenge directors’ business decisions (or “actions”) but fall short of alleging, with specific facts, that the directors were subject to a disabling conflict of interest or that they acted in bad faith, failed to exercise due care, or made irrational decisions.⁹ With regards to claims challenging director inaction (other than a conscious decision not to act), the business judgment rule bars the claim unless the plaintiff alleges facts sufficient to show that the directors were grossly negligent, or at least negligent, in failing to act.¹⁰ Finally, in the case of a section 102(b)(7) char-

4. See, e.g., *In re Ben Franklin Retail Stores, Inc.*, 225 B.R. 646, 652–56 (Bankr. N.D. Ill. 1998).

5. 845 A.2d 1031 (Del. 2004).

6. See Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 553 (3d Cir. 2003).

7. The most critical issue, in other words, is not *who* has standing, but *what* the fiduciary duty to creditors is in the first place.

8. DEL. CODE ANN. tit. 8, § 102(b)(7) (2004).

9. See, e.g., *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994); *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989). Language in *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000), suggests that the business judgment rule standard is “predicated upon concepts of gross negligence,” although the interpretation of that comment is subject to dispute.

10. The doctrine here, although gravitating toward the gross negligence standard, remains a bit unsettled. See, e.g., *Seminaris v. Landa*, 662 A.2d 1350, 1355 (Del. Ch. 1995) (gross negligence standard); *In re Baxter Int’l, Inc. S’holders Litig.*, 654 A.2d 1268, 1270–71 (Del. Ch. 1995) (implied gross negligence standard). *Cf.* *Rabkin v. Philip A. Hunt Chem. Corp.*, No. Civ.A. 7547, 1987 WL 28436, at *3 (Del. Ch. Dec. 17, 1987) (negligence standard).

ter provision, the recovery of damages from directors is barred with respect to direct stockholder and derivative “due care” claims that survive the business judgment rule, but do not rise to the level of bad faith or intentional misconduct.¹¹ Assuming that the business judgment rule continues to exist, that no corporation would intentionally fail to include a section 102(b)(7) provision in its charter, that the majority of creditor “due care” claims continue to be derivative, and that section 102(b)(7) provisions will remain relatively easy to prove and enforce (the strange saga of *Emerald Partners v. Berlin*¹² notwithstanding), it seems to me of less importance to ask whether creditors might assert such claims.

II. APPROACHING THE “HARD ISSUES”; WHAT HAS PASSED THROUGH THE FILTERS?

After applying the various screens and filters referenced above, what potential direct creditor claims exist? The candidates are basically of two types: (i) direct claims for injunctive or other equitable relief,¹³ and (ii) limited categories of direct claims for damages.

Close scrutiny of what remains reveals that further sorting is required, however, if specific candidates for direct creditor claims are to be isolated for review. In the rubric of section 102(b)(7), the categories of damages claims that survive are potentially four in number: (i) claims for breach of the duty of loyalty, including transactions from which a director derived an “improper personal benefit”;¹⁴ (ii) claims for acts or omissions that were not in good faith, or that involved intentional misconduct or a knowing violation of law; (iii) claims under DGCL section 174 for unlawful dividend payment, stock purchase, or redemption;¹⁵ and possibly (iv) direct creditor claims for breach of the duty of care. Except for the third category, however, each of these covers a broad array of potential claims.

In addition, the range of potential direct claims for injunctive or other equitable relief remains vast—nearly as broad as the equitable jurisdiction of the Delaware

11. An interesting question is whether a creditor can or should be able to assert a direct claim for a breach of the fiduciary duty of care that falls short of the section 102(b)(7) standard of “bad faith.” DEL. CODE ANN. tit. 8, § 102(b)(7) (2004). Technically, section 102(b)(7) authorizes exculpation of directors only for liability “to the corporation or its stockholders.” *Id.* (emphasis added). Thus, a section 102(b)(7) charter provision may not by its terms bar a direct creditor claim for the recovery of damages for an ordinary breach of the duty of care. This is an anomaly. Is it possible that disinterested directors of an insolvent firm, or a firm in the “zone,” could act in a grossly negligent or reckless fashion (and hence breach the duty of care), and do so in a way that does not harm the corporation generally (that would be a derivative claim), but does harm one or more creditors specially? I believe it can be said with some confidence that the drafters of section 102(b)(7) did not draft the provision to preserve this issue, as the entire focus at that time was upon blunting the fallout from *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), which did not involve creditor claims. Nonetheless, the issue exists, although it may be more theoretical than real.

12. 726 A.2d 1215 (Del. 1999).

13. Only claims for damages are barred by a section 102(b)(7) charter provision. DEL. CODE ANN. tit. 8, § 102(b)(7) (2004) (referring to “monetary damages”).

14. *Id.*

15. *Id.* § 174.

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Court of Chancery or courts of chancery or general jurisdiction in other states as to matters of corporate law. These include claims regarding voting rights, actions to compel annual meetings, election contests, requests for corporate books and records, corporate disclosure disputes, challenges to defensive mechanisms (poison pills, white knights, defensive charter or bylaw amendments, and the like), and challenges to mergers and acquisitions (the *Revlon/QVC*¹⁶ duty and related doctrines), to name a few.

III. ANNOUNCING THE CANDIDATES: FOUR CATEGORIES OF POTENTIAL DIRECT CREDITOR CLAIMS

After the preceding winnowing and sorting, and as a first approximation, four categories of potential direct creditor claims initially stand out, at least in my mind: (1) stockholder favoritism claims; (2) inter-creditor favoritism coupled with self-dealing claims; (3) inter-creditor favoritism, without self-dealing claims; and (4) voting rights and related doctrines.

With regard to the first category, stockholder favoritism claims, I believe I travel with the herd in suspecting that creditors already have adequate, express remedies against wayward directors, including most notably under DGCL section 174,¹⁷ independent of any remedies that may exist against the corporation by statute or contract. Accordingly, although further work would be required to verify that creditors are in fact fully protected against director misconduct in this area, I will not devote further attention to this category here. What is worth noting is the obvious—although section 174 is a rare instance in which the DGCL provides a remedy for creditors directly against the directors of a troubled corporation for negligent or willful misconduct, it does demonstrate that the concept is not entirely alien to, or wholly at odds with, the DGCL.

The second category is more interesting. Delaware law appears already to provide for a direct creditor claim for inter-creditor favoritism that is coupled with self-dealing, at least where the corporation is insolvent. This includes situations in which the corporation favors a creditor who is a director and situations in which a favored creditor entity is affiliated with a director. Two cases from the early 1930s indicate that a direct creditor claim will exist in such circumstances.¹⁸ In this category of cases, one might say generally that the insolvent corporation has a faithless fiduciary, coupled with a “supine” board,¹⁹ and that the fiduciary’s self-dealing has

16. See *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 43 (Del. 1994); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 185 (Del. 1986).

17. DEL. CODE ANN. tit. 8, § 174 (2004).

18. *Pa. Co. for Ins. on Lives & Granting Annuities v. S. Broad St. Theatre Co.*, 174 A. 112, 116 (Del. Ch. 1934) (so holding); *Asmussen v. Quaker City Corp.*, 156 A. 180, 181 (Del. Ch. 1931) (dicta).

19. *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989) (finding board “torpid, if not supine, in its efforts to establish a truly independent auction”). See *Pa. Co. for Ins. on Lives & Granting Annuities*, 174 A. at 115 (“I cannot escape the conclusion that in so far at least as the interests of the Realty

worked to the disadvantage of one or more creditors. Is the unstated rationale of these cases that duty of loyalty issues are of such a nature that the courts will grant an aggrieved and, therefore, properly motivated creditor a direct claim that would ordinarily belong to the insolvent corporation itself or its stockholders? Language in *Pennsylvania Co. for Insurances on Lives & Granting Annuities v. South Broad St. Theatre Co.*, although ambiguous, suggests such a rationale:

Let the theory under the rule be phrased as it may, analysis in the end will resolve all the reasons underlying the rule into the one simple proposition that it is, as stated by Judge Kenyon in Stuart v. Larson, but "merely applied common honesty" that a director of an insolvent corporation should not be allowed as it sinks to take advantage of his position by rushing ahead to a place in the life boat, if I may use the figure, ahead of his fellow passengers.²⁰

One puzzle is that the case, proceeding on the "trust fund" theory, grants relief akin to what might be obtained in a derivative action (i.e., a constructive trust over the funds in the hands of the favored insider-creditor, for the benefit of all creditors).²¹ Nowhere does the court consider, however, whether the claim might more properly have been considered derivative. Was this feature of the decision intentional, or was the issue simply not brought to the court's attention? Nothing on the face of the decision addresses the issue, and therefore it is fair to ask whether a direct claim would be permitted on similar facts today, in light of subsequent Delaware decisions that more clearly distinguish direct from derivative claims. I believe that is unlikely—a creditor seeking to advance a duty-of-loyalty claim on a direct basis today would be required to demonstrate an injury independent of injury to the corporation or creditors generally, and it can fairly be anticipated that cases in which that showing can be made will be relatively rare.

Skipping ahead, category four is also intriguing. Many credit agreements include a stock pledge—often the stock of the borrower's subsidiaries, pledged as collateral—coupled with a grant of voting rights and an irrevocable proxy, exercisable upon specified uncured events of default. If a creditor lawfully gains corporate voting rights, should the creditor not also have the benefit and protection of those fiduciary-duty doctrines that the Delaware courts have found necessary to extend to stockholders, in order to protect the statutory franchise? For example, what if the directors refuse to acknowledge an act of the party holding sole or majority voting power (e.g., replacing the board through consent)? Or where the directors seek to subvert the franchise?²² One often-forgotten fact is that the famous *Credit*

Corporation [the director-affiliated creditor] were concerned, the directors of the Theatre Company [the debtor], if they were not subservient to, were at least responsive to, [the interested director's] wishes").

20. *Pa. Co. for Ins. on Lives & Granting Annuities*, 174 A. at 116 (citation omitted).

21. *Id.* at 117.

22. See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

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*Lyonnais*²³ case began as an action under section 225 of the DGCL,²⁴ in which the secured lender sought a judicial determination that it had validly elected a new board of directors for MGM after exercising its rights under a voting trust agreement.²⁵ In that case, the bank was apparently deemed entitled to bring a section 225 action as “the legal (registered) owner” of the stock “at least for purposes of voting it.”²⁶ If permitted to invoke the statutory remedy *qua* stockholder, could the bank not also invoke common-law fiduciary duty claims on the same basis?

This brings us to category three—the direct creditor claim for inter-creditor favoritism without self-dealing. In this category, unlike categories two and four, there seem to be no collateral considerations that provide a means of avoiding confrontation with the core issue. There is no duty-of-loyalty issue, and hence the notion of creditors functioning as advance guards against faithless fiduciaries, or perhaps rear guards, has no traction. In addition, in no sense has the creditor stepped directly into the stockholders’ shoes, as with stock voting rights. Is there even such a category of claims? In discussing such a situation in *Production Resources*, the Delaware Court of Chancery recently said: “[T]here might, possibly exist circumstances in which the directors display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor.”²⁷

To be plain, this is a highly unsettled area. There is ample doubt about whether direct creditor claims should even exist, and this is where I believe the most difficult issues lie. First, the room available for a creditor to assert a direct, as opposed to a derivative, claim is exceedingly small. In the absence of self-dealing, the claim would have to be one for lack of due care, for bad faith, or for intentional misconduct. In the vast run of cases, any harm to a particular creditor associated with such claims is likely to have been associated with injury to the corporation as well, giving rise to a derivative claim. In the words of the *Production Resources* court, one must suppose a situation in which

*the directors of an insolvent firm do not undertake conduct that lowers the value of the firm overall, or of creditors in general, but instead take action that frustrates the ability of a particular creditor to recover, to the benefit of the remainder of the corporation’s creditors and of its employees.*²⁸

23. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. Civ.A. 12150, 1991 WL 277613, at *1 (Del. Ch. Dec. 30, 1991).

24. DEL. CODE ANN. tit. 8, § 225 (2005).

25. *Credit Lyonnais*, 1991 WL 277613, at *1.

26. *Id.*

27. *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 798 (Del. Ch. 2004) (footnote omitted).

28. *Id.* at 797.

In *Production Resources*, the key allegation in this regard appeared to be that “capital infusions have often been put into the coffers of [the debtor’s] subsidiaries precisely to frustrate the ability of [the plaintiff-creditor] to collect on debts due it from [the debtor].”²⁹ Yet even with this allegation, the Court of Chancery did not squarely hold that a direct creditor claim had been stated, but only that it was “*not prepared to rule out the possibility* that [the plaintiff creditor] can prove that the [debtor’s] board has engaged in conduct towards [the creditor] that *might support a direct claim* for breach of fiduciary duty by it as a particular creditor.”³⁰

Furthermore, even if a creditor is able to make factual allegations that comport with the guidance provided in *Production Resources*, it does not necessarily follow that the courts would recognize the need for a fiduciary duty cause of action (i.e., a cause of action in equity). The *Production Resources* court went on in its discussion to state:

*In general, equity is reluctant to create remedies when adequate legal remedies already exist. It may well be, for example, that upon close examination, existing principles of tort or contract law are sufficient when applied with the understanding that directors bear a fiduciary relation to creditors when a firm is insolvent.*³¹

Thus, part of the project—at least as envisioned in *Production Resources*—is to review those existing remedies in detail and then to ask whether there is any need for additional claims that creditors may pursue specifically against corporate directors. In this regard, there may be some high-level convergence between this project, as framed by the doctrinal analysis, and the recent work of certain scholars that suggests director and manager opportunism may be the key issue that requires attention in this area, and not, as previously assumed and likely exaggerated, the divergence between the interests of “gambling” stockholders and “Nervous Nelly” creditors.³²

The difficulties I have with the *Production Resources* project are twofold. First, the thought of having to rifle through all potentially applicable tort and contract theories and, in each case, to consider how each would be applied with the understanding that the parties are in a fiduciary relationship is daunting, to put it mildly. That, in and of itself, is not a substantive objection, of course. In addition, something like the first part of the project—canvassing existing remedies to assess whether an adequate remedy at law already exists against wayward corporate direc-

29. *Id.* at 781.

30. *Id.* at 800 (emphasis added).

31. *Id.* at 801 (citation omitted) (footnote omitted).

32. See, e.g., Stephen M. Bainbridge, *Much Ado About Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335 (2007); Simone M. Sepe, *Directors’ Duty to Creditors and the Debt Contract*, 1 J. BUS. & TECH. L. 553 (2007).

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tors—is surely necessary. It is with the second part of the project—considering how these doctrines are to be applied in light of the parties' fiduciary relationship (i.e., how the doctrines might be interpreted or applied differently in this special circumstance)—with which I have difficulty.

This second aspect of the *Production Resources* project is not, to my knowledge, an exercise we have engaged in elsewhere. To the contrary, part of the point of having a separate body of fiduciary law is that it stands on its own and is not a kind of catalytic agent for producing hybrid contract and tort doctrines for special use. Indeed, our classic contract and tort doctrines were built on the premise that they were to govern nonfiduciary relationships. It seems to me that we risk a bigger muddle if we attempt to develop a body of “modified” tort and contract principles to be applied when creditors sue corporate directors, as opposed to simply examining the body of fiduciary law we already have, and determining how it might be interpreted and applied in this particular setting.

The suggestion is, instead of engaging in the second part of the *Production Resources* project, we turn to a preexisting body of comparable fiduciary-duty principles and apply them to the problem of direct creditor fiduciary-duty claims. If, as appears to be the case, we are required to accept that corporate directors owe fiduciary duties to creditors—at least once the firm is insolvent in fact—then the most comparable existing model to use in analyzing and evaluating those duties is the model that we apply to claims by preferred stockholders.

In point of fact, it is remarkable how much general similarity there is between the courts' treatment of preferred stockholder rights and the contractual rights of bondholders and other creditors. To be sure, preferred stock enjoys with the common, and has equal means to enforce, the protection of the core fiduciary duties of care, loyalty, and good faith. Beyond that, however, any special rights of the preferred stockholder—liquidation preferences, antidilution and participation, director nomination, conversion, and so on—are interpreted like any other contractual right.³³ In particular, such rights are not implied but must be stated expressly, and they are not subject to expansion or modification by a vague application of fiduciary principles.³⁴ As the Delaware Court of Chancery stated in *Benchmark Capital*,

[A court's function in ascertaining the rights of preferred stockholders] is essentially one of contract interpretation against the backdrop of Delaware precedent. These precedential parameters are simply stated: Any rights, preferences

33. See, e.g., *Elliot Assocs., L.P. v. Avatex Corp.*, 715 A.2d 843, 852–53 (Del. 1998); *Benchmark Capital Partners IV, L.P. v. Vague*, No. Civ.A. 19719, 2002 WL 1732423, at *6 (Del. Ch. July 15, 2002), *aff'd sub nom*; *Benchmark Capital Partners IV, L.P. v. Juniper Fin. Corp.*, 822 A.2d 396 (Del. 2003); *Superwire.com, Inc. v. Hampton*, 805 A.2d 904, 910 (Del. Ch. 2002); *Sanders v. Devine*, No. CIV. A. 14679, 1997 WL 599539, at *5 (Del. Ch. Sept. 24, 1997).

34. *Benchmark Capital*, 2002 WL 1732423, at *6; *Hampton*, 805 A.2d at 910. In this respect, the model appears to be somewhat akin to what Sepe has in mind when he refers to “[a] default duty of directors to creditors, paired to a regime of textualist interpretation of the debt contract . . .” See Sepe, *supra* note 32, at ___.

*and limitations of preferred stock that distinguish that stock from common stock must be expressly and clearly stated, as provided by statute. Therefore, these rights, preferences and liquidations will not be presumed or implied.*³⁵

Similarly, in *Sanders*, the Court of Chancery stated:

*The rights of preferred stockholders, to the extent they are provided in [the] certificate [of designations], are primarily contractual in nature, thus, the scope of the duties owed are measured by reference to the specific provisions of the certificate of designations, rather than any general fiduciary standard. The Court's function in this context is merely to construe the contract by employing the well established methods of contract interpretation.*³⁶

In addition, the courts' application of the implied covenant of good faith and fair dealing to the terms of preferred stock and debt instruments is nearly identical.³⁷ In *Sanders*, for example, the Court of Chancery dismissed an implied covenant claim that paralleled the preferred stockholder's defective fiduciary duty claim, stating, "[f]or the same reason that the express contractual terms of the Shares define the scope of the defendants' fiduciary duties in connection with the cash-out, those terms preclude the implication of a more generalized duty of 'good faith and fair dealing' to require behavior inconsistent with them."³⁸

On this model, a fiduciary duty claim advanced by a creditor—like a preferred stockholder's fiduciary duty claim—would have to pass through all of the familiar tests applicable to such claims: demand and pleading requirements for derivative claims and an injury apart from injury to the corporation or creditors generally for direct claims; the business judgment rule and, at least with respect to derivative claims, any section 102(b)(7) charter provision; materiality standards and other tests for director interest and independence where loyalty claims are asserted; and so on.

For clarity, I do not say that the principles applicable to preferred stock can and should be applied without modification to creditors' fiduciary duty claims, but only that the preferred stock model is the most comparable doctrinal model to use as a tool and a starting point in analyzing and evaluating such claims. Among the particular issues that would have to be confronted, for example, is how director "interest" is to be defined in light of the fact that directors and their affiliates will generally be holders of corporate equities (or rights to acquire equities) and not debt instruments. The courts in Delaware, however, have already begun to develop

35. *Benchmark Capital*, 2002 WL 1732423, at *6 (citing *Elliot Assocs.*, 715 A.2d at 852–53).

36. *Sanders*, 1997 WL 599539, at *5 (citations omitted).

37. See, e.g., *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1517 (S.D.N.Y. 1989); *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 880 (Del. Ch. 1986).

38. *Sanders*, 1997 WL 599539, at *6 (citation omitted).

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a jurisprudence to address similar issues that arise when the interests of different classes or series of stock conflict, including the preferred stock cases³⁹ and the tracking-stock cases.⁴⁰ Similarly, consideration would have to be given to whether certain offshoots of the core fiduciary duties, such as the *Caremark* duty of oversight,⁴¹ the duty of candor,⁴² and the *Revlon/QVC* duty (which is explicitly phrased in terms of stockholder value),⁴³ can or should have any application to creditors, and, conversely, whether creditors who accede to substantial stock voting positions might themselves owe fiduciary duties to the corporation after the pattern of majority or controlling stockholders.⁴⁴

At the same time, certain collateral advantages of employing this model, at least as a starting point, are apparent. For one, the model offers a platform for accommodating the fact that the providers of capital to modern corporations—senior and subordinated secured lenders; unsecured noteholders, both convertible and nonconvertible; general unsecured creditors; voting and nonvoting preferred stockholders; common stockholders; and so on—are more credibly described as existing along a continuum, and not in a quasi-Cartesian dualism of “equity” and “debt.” Current models have difficulty embracing this reality.

In addition, the basic structure of the model is itself a kind of a bulwark against wayward doctrinal excursions. The model starts with a core conception of basic duties of loyalty, care, and good faith that apply to directors in all circumstances and is generally characterized by an overarching duty to seek to maximize long-term firm value.⁴⁵ In addition, the model exists within a system that is process-oriented and, through the business judgment rule, affords substantial deference to the substantive business decisions made by corporate directors.⁴⁶ In particular, the model recognizes that directors will be required to make tradeoffs among various corporate constituencies and generally respects those decisions, provided they are not irrational, a product of a flawed process, or tainted by self-interest or other improper motives.⁴⁷

These structural features, in my view, help to insulate the model from being hijacked by a particular stakeholder or stakeholder constituency, or from generat-

39. See, e.g., *Elliott Assocs.*, 715 A.2d at 852–53; *Benchmark Capital*, 2002 WL 1732423, at *6; *Hampton*, 85 A.2d at 910; *Sanders*, 1997 WL 599539, at *5.

40. See, e.g., *Solomon v. Armstrong*, 747 A.2d 1098, 1105 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000); *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 613 (Del. Ch. 1999).

41. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971–72 (Del. Ch. 1996).

42. See, e.g., *Malone v. Brincat*, 722 A.2d 5, 11 (Del. 1998).

43. *QVC Network*, 637 A.2d at 43; *Revlon*, 506 A.2d at 185.

44. See, e.g., *Kahn v. Lynch Comm'n Sys., Inc.*, 638 A.2d 1110, 1114 (Del. 1994) (noting that a director told board members that, “[y]ou must listen to us. We are 43 percent owner. You have to do what we tell you”), *aff'd*, 669 A.2d 79 (Del. 1995).

45. See *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986).

46. See *Aronson v. Lewis*, 473 A.2d 805, 811–12 (Del. 1984), *overruled by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

47. See, e.g., *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d at 618–19.

ing rules of conduct (and risks of liability) that are inconsistent with the fundamental premises of the model. In contrast, the *Production Resources* project of reviewing existing tort and contract doctrines with an eye toward special application of those doctrines to the claims of creditors of insolvent firms invites the claimant to go outside the model and develop theories for claims against corporate directors that are not process-oriented, but instead tend toward micromanagement and the curtailment of responsible decision-making discretion through the development and imposition of case and stakeholder-specific substantive rules.

Importantly, it remains to say exactly how best to articulate the directors' fiduciary duty once the company is insolvent and to decide whether that or a similar duty applies in the zone of insolvency. It is generally clear that responsible directors need to tread more carefully, and naturally would, if their corporation is financially troubled or the directors are contemplating a "bet the company" strategic move. What is not clear is whether the corporate law needs to dictate the primacy of any one stakeholder group or formulate specific decision-making rules or criteria in this area.⁴⁸

If, in any event, we are required to start with the doctrinal premise that at some point, directors will owe fiduciary duties to creditors, it seems preferable to work from a model that has already substantially evolved and has done so in consideration of the fact that preferred stock can have contractual rights that exceed the rights of the common and partake of some of the qualities of debt. The alternative path—to start essentially from scratch on a new project that is not in keeping with the basic premises and structure of fiduciary duty law—is, to my mind, both less efficient and more likely to go astray. In addition, it seems to me that pursuing this project with particular reference to direct creditor claims, rather than derivative claims, is most likely to impose rigor on the analysis. It is altogether too easy, in discussing a derivative claim, to draw comfort from the fact that harm to the corporation is being redressed and to gloss over technical difficulties as a result. When a creditor seeks to recover directly from a corporate director, and the creditor will itself retain any winnings, one is more inclined, I think, to sit up and take notice.

IV. PULLING THE PIECES TOGETHER

By way of recapitulation, what do we seem to have? First, we have a statute that authorizes creditors to sue directors, and not merely the corporation, for certain payouts to stockholders. Depending on one's point of view, the statute may be considered either a kind of "ice-breaker" in the debate on direct creditor claims or evidence that the legislature can and does provide for such remedies when, and to the extent, it deems appropriate, and, as a result, supplementation from the courts (at least in the form of additional fiduciary duty doctrine) is unnecessary.

48. See, e.g., Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 *Bus. Law.* 429, 430–38 (1998).

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Second, we have a pair of decisions from the 1930s that suggest that a creditor may bring a direct claim against the director of an insolvent corporation when the director is alleged to have engaged in self-dealing and favored himself (or his affiliated corporation) as a creditor of the insolvent corporation. Whether those cases can be used today to support the assertion of a direct claim is an open question. If the claim meets the modern *Tooley*⁴⁹ test for direct claims, however, the cases likely remain valid authority for the proposition that on such facts, a creditor can assert a duty-of-loyalty claim against a corporate director.

Third, a more recent decision suggests, in a decidedly more tentative fashion, that a creditor might be able to pursue a fiduciary duty claim against the directors of an insolvent corporation when the directors are alleged to have engaged in intentional, bad-faith conduct toward the creditor.⁵⁰ To my knowledge, no case addresses whether a creditor can assert a direct claim for damages for an ordinary breach of the duty of care, and it is difficult to conceive of such a claim not being derivative.⁵¹ Among each of the types of claims examined here, this grouping is most in need of a more comprehensive or systematic doctrinal assessment, and the suggestion is to use the principles applicable to direct claims by preferred stockholders as a model and tool for analysis.

Finally, we have the observation that when a creditor accedes to stock voting rights, the creditor might also accede to the fiduciary-duty claims that normally belong to stockholders to protect the franchise. As relevant to this category, we have a reasonably recent case, *Credit Lyonnais*, that allowed a creditor, acting *qua* stockholder under a voting trust agreement, to bring a *statutory* action to settle a contested election.⁵² This category of potential claims would appear to arise independent of the corporation's insolvency, because voting rights are typically acquired by creditors as a result of uncured loan defaults. Needless to say, as a practical matter the two may go hand-in-hand in many, if not most, cases.

V. CONCLUSION

In sum, the universe of potential direct creditor claims for breach of fiduciary duty appears to be very limited, and most creditor claims are litigated in the context of

49. 845 A.2d 1031, 1031 (Del. 2004).

50. It is perhaps worth noting that the "bad faith" claim in *Production Resources* is distinct from the "bad faith" claims that have recently drawn much attention in the *Disney* and *Integrated Health* cases. See Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. *ex rel.* Integrated Health Servs., Inc. v. Elkins, No. Civ.A. 20228-NC, 2004 WL 1949290, at *1 (Del. Ch. Aug. 24, 2004); *In re* The Walt Disney Co. Derivative Litig., 825 A.2d 275, 288–89 (Del. Ch. 2003). In the *Disney* and *Integrated Health* cases, the central issue, at risk of oversimplification, was whether disinterested directors showed such a marked lack of attention to, or over-delegated responsibility for, significant corporate decisions that they should be held liable for breach of fiduciary duty. In *Production Resources*, in contrast, the claim was premised on allegations of *active* or *overt* director misconduct. 863 A.2d 772, 799–800 (Del. Ch. 2004). In the interests of full disclosure, the Author represented certain of the defendants in the *Integrated Health* case.

51. See *supra* note 11.

52. No. Civ.A. 12150, 1991 WL 277613, at *1 (Del. Ch. Dec. 30, 1991).

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derivative actions. So long as directors, however, are held to owe fiduciary duties to creditors (at least with respect to insolvent corporations), and so long as secured creditors may acquire stock voting rights, direct creditor claims for breach of fiduciary duty will exist. A better model is needed, however, to analyze and assess the bases of these potential claims, to determine by what standards the decisions of directors of troubled companies will be judged, and to determine when such claims can be stated as a matter of law. The doctrines that are already applied to the fiduciary-duty claims of preferred stockholders provide the most comparable, and potentially useful, model for this analysis.