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## Fiduciary Duties of Officers and Directors of Distressed Corporations

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## FIDUCIARY DUTIES OF OFFICERS AND DIRECTORS OF DISTRESSED CORPORATIONS

*Royce de R. Barondes\**

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## INTRODUCTION

A significant amount of recent legal scholarship has focused on the incentives created by federal bankruptcy law and its economic effects.<sup>1</sup> The literature has addressed the prospective impact of bankruptcy law on the actions of a debtor while it remains solvent but is considering events that may lead to insolvency,<sup>2</sup> as well as bankruptcy law's impact on the actions taken by a debtor after its insolvency.<sup>3</sup>

According to the well known "overinvestment" theory of finance, as a corporation incurs indebtedness, the resulting capital structure generates incentives for the corporation's directors, who are assumed to act to maximize shareholder returns, to undertake excessively risky transactions.<sup>4</sup> The increased preference for risk arises because the debtholders incur a disproportionate share of the downside risk, relative to the gains they receive if the transactions are successful. The theory postulates that an insolvent firm, or an almost insolvent firm, is an extreme example of a firm governed by those incentives. Thus, analyses of distressed or bankrupt firms' actions tend to take as axiomatic that the firm will engage in excessively risky transactions.<sup>5</sup>

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<sup>1</sup> See Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159, 1159 (1994) [hereinafter Rasmussen, *Ex Ante Effects*]. Recent articles have included Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575 (1995) [hereinafter Adler, *Near-Bankruptcy Investment Incentives*] (discussing the incentives in bankruptcy); Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1994); Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993) (proposing a unique type of security as a contractual arrangement that could eliminate reorganizations); Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523, 526-28 (1992) (discussing various mandatory auction mechanisms); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988) (proposing a unique auction mechanism involving granting various classes of claimants options); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1059 (1992) (arguing managers extract wealth during reorganizations, and proposing the repeal of Chapter 11); Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990) [hereinafter LoPucki & Whitford, *Equity's Share*]; Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993) [hereinafter LoPucki & Whitford, *Corporate Governance*] (providing empirical evidence concerning the bankruptcy process); and Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992) (arguing that firms should have the option to select one of a variety of options to govern upon any insolvency of the firm).

<sup>2</sup> See, e.g., Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 169-70 (1989) (discussing the preference periods set forth in 11 U.S.C. § 547 as reflecting an attempt to control conflicts of interest arising on the eve of bankruptcy).

<sup>3</sup> See, e.g., LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 767-96.

<sup>4</sup> See *infra* Part I.

<sup>5</sup> See, e.g., Adler, *Near-Bankruptcy Investment Incentives*, *supra* note 1, at 590-98 (discussing

This Article argues that this widely-accepted premise for analyzing the incentives created by various alternative structures of federal bankruptcy law is suspect. Part I briefly reviews the economic background of debt financing. Parts II and III challenge the relationship between that theory and actual actions of corporations that are in distress. Part II shows that in many circumstances, when a corporation is in distress, holders of its debt will in fact prefer that the firm engage in transactions more risky than the equityholders would prefer. Consistent with that understanding, Part III reviews recent economic evidence indicating that distressed corporations engage in excessively risky transactions to only a modest extent.

Parts IV and V address developments in corporation law that impose certain incentives on directors of distressed firms. These incentives are far more likely to affect actions of directors of solvent, distressed firms than the incentives created by bankruptcy law. In two recent cases not prominently addressed in legal scholarship, *In re Buckhead America Corp.*<sup>6</sup> and *In re Shultz*,<sup>7</sup> courts have opined that directors of solvent, distressed corporations can be personally liable to creditors for failing to promote the creditors' interests. Other commentators have noted the possibility that courts would hold prior Delaware state court precedent could require the result reached in *In re Buckhead America Corp.* and *In re Shultz*.<sup>8</sup> Part IV of this Article examines that prior Delaware precedent in

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voidable preference law as a mechanism to mitigate "overinvestment"); Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 833-34 (1985) (arguing that fraudulent conveyance law should not permit avoidance of all transactions that harm creditors as a group, on the basis that the "overinvestment" problem necessarily causes firms to engage in additional risk-taking subsequent to their incurring indebtedness); Bebchuk & Fried, *supra* note 1, at 873, 875, 897 (identifying the "overinvestment" theory as the basis for the creation of security interests, which are accorded preferred priority in bankruptcy, and arguing, "Full priority may also cause commercial borrowers and their sophisticated creditors to use a security interest that is less efficient than a set of covenants in order to control inefficient behavior by the borrower after the loan transaction."); Bradley & Rosenzweig, *supra* note 1, at 1052 ("If we think of 'default' as the act by which equity holders relinquish all claims to their firm's net cash flow, it is clear that equity holders have an incentive to generate the social costs discussed above [—'overinvestment' and 'underinvestment'—] only when they perceive that the firm is near default. Accordingly, we refer to these costs as 'near-default' costs, by which we mean the social costs generated by suboptimal operating strategies that cause wealth transfers from bondholders and other corporate stakeholders, and, ultimately, reduce social welfare."); Rasmussen, *Ex Ante Effects*, *supra* note 1, at 1167-1210 (discussing the impact of bankruptcy reform proposals on "overinvestment" and describing the "overinvestment" problem as "long recognized").

<sup>6</sup> Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (*In re Buckhead Am. Corp.*), 178 B.R. 956, 968 (D. Del. 1994). See also *Weaver v. Kellogg*, 216 B.R. 563, 583-84 (S.D. Tex. 1997) ("[C]orporate insiders . . . may have a fiduciary duty to the corporation's creditors even when the corporation was not insolvent. The Court holds that Plaintiff may therefore prevail on his breach of corporate duty claims if he shows, for each allegedly wrongful transaction, that [the debtor] was, at the time, in 'the vicinity of insolvency' . . ." (emphasis added) (citing *Credit Lyonnais*)).

<sup>7</sup> *Miramar Resources, Inc. v. Shultz (In re Shultz)*, 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997).

<sup>8</sup> See John C. Coffee Jr., *Court Has a New Idea on Directors' Duty*, NAT'L L.J., Mar. 2, 1992, at 18 (noting that prior Delaware precedent had used the duty as a "shield," not a "sword," although

greater detail than was expressed in either of *In re Buckhead America Corp.* or *In re Shultz* and concludes that the result in those cases represents the most fair reading of prior Delaware precedent.

Part IV also addresses the substantial incentives these developments in corporation law impose on directors of distressed corporations. Part IV argues that ambiguities inherent in applying these developing duties under corporation law impose a standard directors cannot meet. That Part further provides an expanded review of potentially applicable precedent, concluding that the better reading is that these duties cannot be waived by contract. Part IV then argues that directors will not be able to ameliorate these concerns by purchasing insurance.

These developments indirectly create additional problems for distressed corporations, because liability may subsequently be imposed on investment banks engaged by distressed firms. This risk of liability can be expected ultimately to increase the cost to distressed firms of engaging, and to limit their access to, financial advisors.

Part V discusses the extent to which legal rules imposing incentives on directors of distressed firms need not equally affect different types of creditors. Part V argues that these developments in corporation law uniquely and adversely affect certain classes of creditors who are not easily able to negotiate for alternative treatment, thereby compounding the inefficiency generated by these recent developments in corporation law. Part V also reviews empirical evidence that further supports the view that these developments in corporation law are inefficient.

Based on these concerns, Part VI discusses the benefits of a more limited revision of the fiduciary duties of directors of distressed, solvent corporations—reinforcing the authority of directors to choose to pursue the ongoing solvency of a distressed corporation, even at the expense of foregoing other opportunities potentially providing greater long-term returns. That Part further argues that even allowing creditors to commence derivative lawsuits challenging self-dealing is problematic. This Article then provides some concluding remarks.

## I. THE EFFECT OF DEBT FINANCING ON RISK PREFERENCE

The theory of the corporate enterprise has long recognized that conflicting incentives are created when a corporation issues debt.<sup>9</sup> When

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creditors could “have a field day” using that precedent in bankruptcy courts); see also *infra* note 75 and accompanying text.

<sup>9</sup> See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 334 (1976); see also WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 255-58 (5th ed. 1993); Baird & Jackson, *supra* note 5, at 833-34; Bebchuk & Fried, *supra* note 1, at 873; Bradley & Rosenzweig, *supra* note 1, at 1052; F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1426-27

part of the capital structure of a corporation consists of bonds, the return to shareholders from pursuing risky strategies increases, by virtue of the disproportionate share of the risk of failure allocated to debtholders. The theory further predicts that when a corporation is insolvent<sup>10</sup> or on the verge of insolvency, the incentive to pursue risky investment strategies may increase.<sup>11</sup> These incentives can become very powerful for a corporation

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(1986); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 67 (1982); LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 683-84; Rasmussen, *Ex Ante Effects*, *supra* note 1, at 1166-70.

<sup>10</sup> There are alternative tests of insolvency, which depend on the context. Under federal bankruptcy law, a corporate debtor is insolvent when the sum of its debts exceeds the value of all its property (excluding exempted property and property fraudulently concealed, etc.), at a "fair valuation." 11 U.S.C. § 101(32)(A) (1994). Section 2 of the Uniform Fraudulent Transfer Act, 7A U.L.A. 648 (master ed. 1985), adopts the definition of insolvency used in the bankruptcy code. See Bruce A. Markell, *Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital*, 21 IND. L. REV. 469, 486 (1988). For this purpose, "A debtor who is generally not paying his [or her] debts as they become due is presumed to be insolvent." UNIF. FRAUDULENT TRANSFER ACT § 2(b), 7A U.L.A. 648 (1985).

Under Delaware corporation law, a debtor may be considered insolvent, which triggers the right of a creditor to petition a court for the appointment of a receiver, "where liabilities exceed assets, or where the corporation is unable to meet its current obligations arising in the ordinary course of business." FOLK ON THE DELAWARE GENERAL CORPORATION LAW: FUNDAMENTALS § 291.2, at 749 (Edward P. Welch & Andrew J. Turezyn eds., 1997) [hereinafter FOLK]. The court in *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784 (Del. Ch. 1992), suggested that insolvency under either a negative net assets test or a cash flow test was sufficient to create liability of directors of a corporation to its creditors under state corporation law, discussed *infra* Part IV.A. The opinion references both tests, citing Webster's Collegiate Dictionary, but omits further relevant discussion. See *Geyer*, 621 A.2d at 789. The *Geyer* opinion thus leaves some uncertainty concerning the proper definition of insolvency in this context. See Mike Roberts, *The Conundrum of Directors' Duties in Nearly Insolvent Corporations*, 23 MEMPHIS ST. U. L. REV. 273, 289 (1993).

<sup>11</sup> See Adler, *Near-Bankruptcy Investment Incentives*, *supra* note 1, at 576-77; Katherine H. Daigle & Michael T. Maloney, *Residual Claims in Bankruptcy: An Agency Theory Explanation*, 37 J.L. & ECON. 157, 157 (1994) (stating that shareholders' incentives to engage in excessive risk-taking are "particularly acute" when the firm is distressed); Daniel L. Keating, *Foreword: A Bankruptcy Conference for the '90s*, 72 WASH. U. L.Q. 797, 807 (1994) (referencing "the inherent conflict between creditors and shareholders that heightens as a firm approaches and enters a state of insolvency"); Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1486, 1488-91 (1993); LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 684; George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 912 (1993). *But see* Philippe Aghion et al., *Improving Bankruptcy Procedure*, 72 WASH. U. L.Q. 849, 854 (1994) (arguing that self-interest, and not a desire to promote the interests of shareholders, rules the actions of managers of nearly insolvent, large, public firms).

There also is a theoretical argument that an insolvent firm will in fact "underinvest" in projects, i.e., fail to enter into transactions that would be profitable from the perspective of the firm as a whole, due to indifference. See KLEIN & COFFEE, *supra* note 9, at 258-61; James W. Bowers, *Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses*, 72 WASH. U. L.Q. 955, 971 (1994); Bradley & Rosenzweig, *supra* note 1, at 1052; Daniel E. Ingberman, *Triggers and Priority: An Integrated Model of the Effects of Bankruptcy Law on Overinvestment and Underinvestment*, 72 WASH. U. L.Q. 1341, 1342 (1994); Lin, *supra*, at 1496; Rasmussen, *Ex Ante Effects*, *supra* note 1, at 1171; Triantis, *supra*, at 911 (discussing this theory). This theory is based on the notion that shareholders will not invest new equity (or other efforts) needed to permit implementation of a new project having a positive return, if the portion of the return to be realized by shareholders will be inadequate, because the returns will be given to other stakeholders, i.e., creditors. See KLEIN &

approaching insolvency, because the shareholders may be essentially indifferent as among all outcomes involving a non-positive return, negative returns of a distressed corporation being almost entirely borne by the creditors.<sup>12</sup>

Recent empirical finance literature has attempted to identify the relationship between the extent to which firms take risk and the adoption of a form of business organization that permits separate debt financing. This evidence supports the notion that creating debt interests separate from equity interests may increase the firm's risk-taking.

One study examined excessive risk-taking by reviewing the relative risk-taking activities by thrift institutions, based on whether they are organized as mutual companies—where the fixed claims of the customers are not separable from ownership—or stock companies.<sup>13</sup> The study found that thrift institutions organized as stock companies experienced significantly greater variability in profit than thrift institutions organized as mutual companies.<sup>14</sup> Other authors found that property liability insurance companies organized as stock companies, as compared to property liability insurance companies organized as mutual companies, (i) have more total risk, (ii) have relatively more business in the lines with the greatest risk, and (iii) have a greater concentration of business in geographic areas hav-

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COFFEE, *supra* note 9, at 258-61; Triantis, *supra*, at 911.

<sup>12</sup> A similar perverse incentive is involved in an auction of an insolvent entity (or group of assets sold separately in insolvency proceedings) in which a claimant having a senior security interest in the assets being sold can "bid in" its claim, i.e., deliver as payment for a successful bid in the auction consideration in the form of the claim, valued at its face amount. In such an auction, the senior claimant can bid up to the value of its claim, including the extent to which the face amount of the claim exceeds the value of the assets, with no adverse economic consequence upon a successful bid. *See, e.g.,* Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1057 (Del. Ch. 1997) (giving an example). (This problem is widely recognized in the community of commercial lawyers having at least a passing familiarity with reorganization negotiations.) This fact, coupled with the economic analysis named the Winner's Curse, creates a pattern in which a senior claimant acquiring an insolvent debtor's assets in an auction forming part of the insolvency proceedings may cause the equityholders to suffer losses greater than might otherwise be anticipated, by deterring third parties from bidding on the debtor's assets. *Cf., e.g.,* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 625-28 (1989) (discussing the Winner's Curse, in the context of takeovers). In such a circumstance, at least where all assets in which a senior claimant has a senior interest are sold as a unit and at a price less than the senior claim, the senior claimant is not adversely affected by making a successful bid in excess of the value of the collateral, because it pays the excess to itself. Other bidders need to provide bids lower than their estimates of value, in order to assure that they do not overpay (and suffer the Winner's Curse). This bidding framework is not particularly inviting for potential bidders other than senior claimants, and might adversely affect the junior claimants, even if the senior claimants ultimately determined not to bid. These incentives create serious problems for proposals to substitute mandatory auctions of insolvent debtors' assets, where the auctions are structured in a traditional format, for reorganizations under Chapter 11, if the senior claimants can bid. *See infra* note 137 for a discussion of such proposals.

<sup>13</sup> *See* Benjamin C. Esty, *Organizational Form and Risk Taking in the Savings and Loan Industry*, 44 J. FIN. ECON. 25 (1997).

<sup>14</sup> *See id.* at 36.

ing the greatest risk.<sup>15</sup>

Thus, there is some recent empirical support for the general proposition that inclusion in an enterprise's capital structure of debt separate from equity is associated with the enterprise undertaking relatively more risk.<sup>16</sup>

## II. THE EFFECT OF FINANCIAL COVENANTS ON EXCESSIVE RISK-TAKING

This theoretical perspective, under which corporations are expected to have increased preferences for risk as they increase their leverage, is based on an abstract view of the corporate form in which the details of the terms of the debt are disregarded. However, when one considers the details of some customary debt terms (separate from direct restrictions on entering new lines of business<sup>17</sup> or capital expenditures), one can conclude that for solvent but distressed firms, some debtholders may prefer that the distressed firm adopt strategies involving more risk than the strategies preferred by shareholders. The terms thus create incentives for firms not to engage in excessive risk-taking.

When a corporation has long-term, fixed-rate debt, there is on the order of a fifty percent chance that interest rates at any point in time are less than the market rates in effect at the time the corporation borrowed money, ignoring the possibility that interest rates are exactly the same. Thus, assuming all other events being equal and ignoring the costs of refinancing, half of the time a long-term lender would prefer to require repayment and refinancing of all a debtor's currently outstanding loans. This figure is only an approximation, if one assumes that the yield curve for debt is in a customary form, i.e., interest rates increase for increasing terms to maturity. Nevertheless, a significant portion of the time, a long-term lender would prefer to require a particular debtor to refinance its fixed-rate debt at then-prevailing interest rates.

But many firms in financial distress will be in financial positions significantly worse than their financial positions when their outstanding long-term debt was originally incurred. Numerous creditors of such firms would like to have the opportunity to renegotiate the long-term, fixed-rate

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<sup>15</sup> See Joan Lamm-Tennant & Laura T. Starks, *Stock Versus Mutual Ownership Structures: The Risk Implications*, 66 J. BUS. 29, 37, 44 (1993).

<sup>16</sup> Of course, this separation only arises where shareholders are not personally liable on the debt. As Baird notes, small closely-held firms, which account for 38% of the United States GNP, typically have a single institutional lender that "frequently" receives a personal guarantee from the "owner-manager," eliminating for a vast set of businesses the possibility of perverse incentives. Douglas G. Baird, *The Reorganization of Closely Held Firms and the "Opt Out" Problem*, 72 WASH. U. L.Q. 913, 920-21 (1994).

<sup>17</sup> Van Der Weide argues that the ability of a firm to engage in excessive risk-taking is limited where the firm is engaged in a single line of business. Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27, 45-46 (1996).



debt. Once triggered,<sup>18</sup> a financial covenant gives a creditor the opportunity either (i) to renegotiate the terms of outstanding debt, by threatening to accelerate the indebtedness if the debt is not refinanced on terms more favorable to the creditors<sup>19</sup>—which could be viewed as extracting a “bribe” to prevent the exercise of remedies—or (ii) to exercise restraint on management, either directly, because the covenant grants that right, or indirectly, by threatening to accelerate the debt if specified changes are not implemented.<sup>20</sup> Therefore, creditors of firms that are nearly insolvent, and close to triggering financial covenants in their long-term debt, may have an incentive to cause the covenants to be triggered, thereby creating the opportunity to renegotiate the terms of existing debt.<sup>21</sup>

<sup>18</sup> The documents under which a secured loan is extended typically will require that the debtor periodically confirm in writing that there is no existing event of default. See, e.g., JAMES J. CUNNINGHAM ET AL., STRUCTURING SECURED COMMERCIAL LOAN DOCUMENTS 12-10 (1991) (discussing a sample security agreement for a secured loan requiring the chief financial officer to deliver such a statement on a monthly basis). Potential personal liability for fraudulently certifying the absence of a default should temper any desire to fail to report an existing default.

<sup>19</sup> The recent difficulties of Sunbeam Corporation include an example of creditors conditioning waiver of a covenant triggered by adverse developments in the debtor's business, in exchange for a higher interest rate. Sunbeam Corporation had obtained a \$1.7 billion loan in March 1998. See Martha Brannigan, *Sunbeam Gets Six-Month Waiver on Covenants but a Higher Rate*, WALL ST. J., July 13, 1998, at B4. The loan matures in part in 2005 and in part in 2006. See Sunbeam Corporation, Quarterly Report on Form 10-Q 6 (Mar. 31, 1998), available in LEXIS, Fedsec Library, Filing File. In exchange for a waiver of a covenant breach, the lenders required that Sunbeam increase the annual interest rate by one-half percentage point. See Brannigan, *supra*.

<sup>20</sup> Creditors in fact exercise their contractual rights to control the business decisions of nearly insolvent debtors. See Jackson & Scott, *supra* note 2, at 170; see also Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms: Empirical Evidence*, 72 WASH. U. L.Q. 1005, 1008-10 (1994) (identifying the extent to which debtors of firms that successfully restructured their debt “out of court” granted the creditors additional control rights as a part of the work-out). *But cf. id.* at 1024 (noting that the replacement of a CEO (or certain changes in his pay) by creditors was not related in a statistically significant way to the proximity of the debtor to insolvency).

But, creditors participating in the daily management of a firm risk having their claims equitably subordinated in any subsequent bankruptcy under 11 U.S.C. § 510(c) (1994). See Gilson & Vetsuypens, *supra*, at 1005; Lin *supra* note 11, at 1504-05. See generally JOSEPH W. BARTLETT, CORPORATE RESTRUCTURINGS, REORGANIZATIONS, AND BUYOUTS § 3.4, at 46 (1991) (noting in discussing those actions by creditors that will constitute “egregious misconduct” and thereby cause those creditors’ claims to be equitably subordinated, “The results in the reported cases are fact-specific in the extreme.”). Alternatively, those creditors may be subject to liability to the debtor on a lender liability theory. Gilson & Vetsuypens, *supra*, at 1005.

A creditor may also not want to participate in the debtor's management where the debtor may have significant environmental liabilities. Such participation could cause the creditor to become responsible for those liabilities. See generally Kelley *ex rel.* Mich. Nat'l Resources Comm'n v. Tiscornia, No. 94-1403, 1996 U.S. App. LEXIS 33616, at \*6-\*9 (6th Cir. Dec. 19, 1996) (affirming the lower court's holding that the lender had not participated in management, within the meaning of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, 42 U.S.C. § 9607, as amended by the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996, Pub. L. No. 104-208, §§ 2501-05, 110 Stat. 3009-462 to -469 (1996)).

<sup>21</sup> Lin identifies a variant of this perspective. She discusses a proposed legal rule in which creditors could bargain for the right to have the firm's directors maximize firm value if the firm were to become distressed. In addressing creditors who had bargained for such a right, she states:

One potential drawback of this rule is that it may be subject to abuse by creditors.

An example illustrates the extent to which a creditor's ability to extract a payment in exchange for a covenant waiver can create incentives under which a creditor may desire the firm to adopt strategies entailing more risk than is desired by shareholders. Consider a corporation that has outstanding long-term debt of \$10 million, with interest payable annually at eight percent and with the principal due in ten years. Assume that the firm's loan agreement has a cash flow coverage ratio, which requires that any project in which the firm invests must generate net cash flow that exceeds the interest payments due on the loan by at least a factor of 1.3. Assume further that interest rates have risen, so that were the loan extended today, it would bear interest at ten percent per annum.

The firm may pursue two possible investment strategies. Investment Strategy One involves a 100% chance of a \$1.1 million annual return in perpetuity (with all payments commencing on the anniversary of the strategy's adoption), after all payments other than those due on the debt. Before payment of principal and interest on the debt, this strategy has a value of \$11 million (at a ten percent annual discount rate).<sup>22</sup> Investment Strategy Two has two possible outcomes. In one outcome, the firm's loan cannot be called because the firm breaches no debt covenant. In the other outcome, the firm breaches a debt covenant, resulting in the loan being called and refinanced at the current interest rate. The expected value of this strategy, excluding payment on the debt, is \$11,189,540. These two strategies are depicted below.

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For example, Company X has a long-term note with a fixed interest rate at ten percent per annum. Although the loan does not mature for another ten years, *because of a steady increase in the level of inflation*, the current interest rate for a loan with similar terms is fifteen percent per annum. Under these circumstances, to escape unfavorable terms creditors may have an incentive to claim that the directors have breached the loan agreement by failing to maximize the firm's value. If creditors can declare default and accelerate the maturity of their loan, they will be able to earn a higher rate of return by lending their funds at the new rate.

Lin, *supra* note 11, at 1506 (emphasis added).

Secured creditors of a distressed firm also may have an incentive to cause the debtor to adopt certain policies that enhance the value of the secured creditors' collateral, at the expense of other creditors. See Jackson & Scott, *supra* note 2, at 173 n.38.

<sup>22</sup> A 10% rate is used to discount all payment streams in the example. One might argue that a higher discount rate should be used to compute the values of the payment streams in Strategies Two and Three, because those strategies involve greater risk in the payment streams. Incorporation of that additional complexity does not affect the accuracy of the proposition that the examples illustrate, although it would obscure the point of the examples with a necessarily heuristic discussion of the selection of the risk-adjusted interest rates incorporated.

**Strategy One**

<u>Probability</u> 100%	<u>Return Each Year</u> \$1,100,000	<u>Present Value at 10%</u> \$11,000,000
<u>Expected Value of Strategy (Before Debt Payments)</u> \$11,000,000	<u>Interest Payments</u> \$800,000 per year	<u>Value of Long-Term Debt</u> \$8,771,087
	<u>Value of Equity</u> \$2,228,913	

**Strategy Two**

<u>Probability</u> 50%	<u>Return Each of First Five Years</u> \$1,000,000	<u>Annual Return Thereafter</u> \$1,100,000	<u>Present Value at 10%</u> \$10,620,922
50%	\$1,300,000	\$1,100,000	\$11,758,158
<u>Expected Value of Strategy (Before Debt Payments)</u> \$11,189,540	<u>Interest Payments</u> \$1,000,000 per year, if return less than \$1,040,000, in the first year	<u>Value of Equity</u> <sup>23</sup> .5 x \$620,922 + .5 x 2,987,071 = \$1,803,997	<u>Value of Long-Term Debt</u> .5 x \$10,000,000 + .5 x \$8,771,087 = \$9,385,543
	\$800,000 per year, if return at least \$1,040,000, every year		

<sup>23</sup> The value of the equity and the value of the long-term debt are computed by reference to the value of the firm as a whole (under the caption *Present Value at 10%*). First, the value of the long-term debt is computed for each of the two possible outcomes. Then, the value of the equity is computed by subtracting the value of the long-term debt from the value of the firm.

In the first listed possible outcome, involving an annual return of \$1,000,000 in each of the first five years, the long-term debt is in default. It is assumed that the outcome of the strategy (whether the return will be \$1,000,000 or \$1,300,000 in each of the first five years), is revealed immediately after the strategy is adopted. The long-term debt consequently is assumed to be immediately accelerated, with the entire outstanding principal amount, \$10,000,000, returned to the creditor and loaned at the then-prevailing 10% interest rate. Because that outcome results in the immediate return to the lender of \$10,000,000, that outcome thus has a present value to the creditor of \$10,000,000.

This computation includes a simplification used to facilitate the presentation of the arithmetic. In an ordinary case, a default would not be declared until the end of the first year. The assumption has been made merely to simplify the calculations presented.

The value of the equity in that outcome equals (i) the value of the firm after all claims other than the long-term debt minus (ii) the value of the long-term debt (\$10,620,922 - \$10,000,000 = \$620,922).

The value to the debt in the second possible outcome, involving a return of \$1,300,000 in each of the first five years, is computed as follows: The debt cannot be accelerated, because the cash flow coverage ratio is met. Consequently, the value of the long-term debt equals the present value, discounted at 10% per annum, of (i) \$800,000 at the end of each of the nine following years plus (ii) \$10,800,000 (representing interest for the last year plus the return of the principal) at the end of 10 years. That value is computed as follows: \$4,607,219 + \$4,163,868 = \$8,771,087. The value of the equity in that outcome equals (i) the value of the firm after all claims other than the long-term debt minus (ii) the value of the long-term debt (\$11,758,158 - \$8,771,087 = \$2,987,071).

The shareholders prefer Strategy One because it produces the highest return to the equity, even though the aggregate return from the strategy desired by the equity is less than that of an available alternative. However, the debtholders prefer Strategy Two because that strategy produces a greater return to the debt.

Note, however, if the firm is presented with a choice between Strategy One and a third option described below having a present value of \$10,810,461, Strategy Three, the debtholders would still prefer not to choose Strategy One, even though the expected return to the firm as a whole is greater in Strategy One than in Strategy Three.

### Strategy Three

<u>Probability</u>	<u>Return Each of First Five Years</u>	<u>Annual Return Thereafter</u>	<u>Present Value at 10%</u>
50%	\$1,000,000	\$1,100,000	\$10,620,922
50%	\$1,100,000	\$1,100,000	\$11,000,000
<u>Expected Value of Strategy (Before Debt Payments)</u>	<u>Interest Payments</u>	<u>Value of Equity</u> <sup>24</sup>	<u>Value of Long-Term Debt</u>
\$10,810,461	\$1,000,000 per year, if return less than \$1,040,000, in the first year	.5 x \$620,922 + .5 x \$2,228,913 = \$1,424,917	.5 x \$10,000,000 + .5 x \$8,771,087 = \$9,385,543
	\$800,000 per year, if return at least \$1,040,000, every year		

The capital structure of an actual firm is more complex, and this complexity exacerbates the problems for management. A firm's long-term debt may consist of both privately placed debt—under which the creditors are either banks or other investors such as pension funds and insurance companies—and publicly issued debt. A creditor usually is not a third party beneficiary of financial covenants in debt instruments to which the creditor is not a party.<sup>25</sup> As a result, creditors not parties to a debt instru-

<sup>24</sup> The components of the value of the equity are computed as described *supra* note 23. The value of the equity in the first possible outcome, in which the debt is accelerated, is computed as follows: \$10,620,922 - \$10,000,000 = \$620,922. The value of the equity in the second possible outcome is computed as follows: \$11,000,000 - \$8,771,087 = \$2,228,913.

<sup>25</sup> Cf. CUNNINGHAM ET AL., *supra* note 18, ¶ 15.05, at 15-5 (1991) (providing in a form loan security agreement, a section stating that the agreement is "binding upon and inure[s] to the benefit of" the successors and assigns of the parties, without any indication of third parties being beneficiaries). Where third parties are not named, it will be difficult for them to argue that they are intended beneficiaries, without whose consent the agreement cannot be modified. Cf., e.g., John St. Leasehold LLC v. FDIC, No. 95 Civ. 10174, 1996 U.S. Dist. LEXIS 19050, at \*5, \*30 (S.D.N.Y. Dec. 24, 1996) (holding that there was no intent indicated to grant a borrower a right to recover for a breach of a participation agreement, under which participations in the loan to the borrower were conveyed to other lenders, where the participation agreement stated that the agreement "shall inure to the benefit of and be bind-

ment cannot enforce its covenants or object to their waiver. Thus, a creditor frequently can waive compliance with a particular covenant in exchange for a more favorable interest rate or some other compensation that need not be shared with the other creditors, and the other creditors' ability to "free ride" on the benefits flowing from that covenant is substantially reduced.<sup>26</sup>

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ing upon the parties hereto and their respective assigns," language indistinguishable from the provision in the form security agreement reproduced in CUNNINGHAM ET AL., *supra* note 18, ¶ 15.05, at 15-5); *MacDraw, Inc. v. CIT Group Equip. Fin., Inc.*, No. 91 Civ. 5153, 1994 U.S. Dist. LEXIS 363, at \*38 (S.D.N.Y. Jan. 18, 1994) (citing language in loan documentation that the agreement shall be binding upon, and inure to the benefit of, the parties and their successors and assigns, as "demonstrat[ing] that the parties specifically intended not to confer third party beneficiary status upon anyone"); RESTATEMENT (SECOND) OF CONTRACTS § 302(1) (1981) (limiting intended beneficiaries, to whom performance is owed under section 304 of the Restatement, to only those persons as to whom "recognition of a right to performance in the beneficiaries is appropriate to effectuate the intention of the parties and . . . the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance.").

<sup>26</sup> Some commentators argue that parties granted security interests monitor a debtor's activities on behalf of all stakeholders. *See, e.g., Levmore, supra* note 9, at 54-59 (arguing that secured financing prevents free riding on secured parties' monitoring by other creditors). Drawing on that argument, two commentators make a similar argument concerning the proper level of covenants. Bebchuk and Fried argue that creditors do not use an optimal level of contractual covenants, and instead accept security interests of which they necessarily are the sole beneficiaries, because creditors who obtain contractual benefits in the form of covenant protection will garner only a portion of the benefits of the covenants. Bebchuk & Fried, *supra* note 1, at 900. But monitoring compliance with financial ratios is not similar to monitoring the status of particular assets. "Monitoring" compliance with financial ratios, in many circumstances, may merely consist of confirming that no default is indicated on the periodic report. *See generally* CUNNINGHAM ET AL., *supra* note 18, ¶ 12.07, at 12-10 (providing form security agreement for a secured loan, in which the debtor's chief financial officer is required to certify every month that there is no event constituting a breach of, or an "Event of Default" under, the security agreement). The secured creditor, therefore, may not perform any material "monitoring," in the sense of actually performing tasks requiring material effort or unique skill. This "monitoring" consists of merely administrative activity requiring minimal effort.

This conclusion is particularly true of trustees under indentures for publicly issued bonds. Those trustees obtain the contractual right to rely on the periodic reports of no default delivered by the respective issuer. *See, e.g.,* MODEL SIMPLIFIED INDENTURE § 7.02(a), *reprinted in Model Simplified Indenture*, 38 BUS. LAW. 741, 759 (1983); AMERICAN BAR FOUND., COMMENTARIES ON INDENTURES 257 (1971) (commenting on section 6-3(f) of the American Bar Foundation, Sample Incorporating Indenture, All Registered Issues (1967)). *See generally* Yakov Amihud et al., *A New Governance Structure for Corporate Bonds* 37 (Jan. 8, 1998) (unpublished manuscript, on file with author) (noting that a trustee under an indenture for publicly issued debt provides minimal monitoring, stating that a trustee has disincentives to monitor intensively and citing a case in which a rating agency detected a covenant breach before it was identified by the trustee). Levmore, however, draws a different conclusion, asserting, "The reliability of the trustee as monitor, however, is enhanced by its high reputational interest." Levmore, *supra* note 9, at 72-73. *See also* Van Der Weide, *supra* note 17, at 35 (asserting that a trustee under an indenture can monitor a firm's management).

As to some types of covenants, a lender's inability to attribute a dollar value to the harm arising to the lender from a breach of those covenants may prevent the lender from excluding third parties from benefitting from those covenants. Covenants requiring maintenance of the debtor's property may be such covenants. *See generally* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1169-70 (1979) (asserting that an unsecured creditor cannot rely on monitoring by a secured creditor, because the secured creditor can accept a payment in consideration of waiver of compliance). But a creditor who has extended a long-

A debt agreement may contain a provision under which the debt becomes due and payable upon the acceleration of other indebtedness.<sup>27</sup> If a corporation has outstanding publicly-issued debt, other creditors will attempt to negotiate defaults that permit them to exercise remedies, and negotiate a satisfactory outcome, before either public debt is in default or the debtor's position becomes hopeless.<sup>28</sup>

A creditor benefitting from these covenants could extract from a debtor having debt bearing interest at less than the then-current market rate, based on the *then-current* risk of nonpayment, up to the additional cost to the debtor of refinancing both the debt that could be accelerated and all other debt that would become due upon its acceleration.<sup>29</sup> In fact, a bank that (i) had extended credit that was at the then-current, risk-adjusted market rate and (ii) had the ability to declare the loan in default under a covenant, could still extract compensation from the debtor, if the debtor had outstanding long-term debt at a below-market rate owed to other creditors that would become due and payable on a declaration of a default by the bank.<sup>30</sup>

An example can illustrate this argument. Assume that a corporation has outstanding long-term bank debt whose payments have a present value of \$80 and a face amount of \$100. Assume that the corporation also has outstanding long-term public debt having a present value of \$80 and a

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term loan to a debtor whose financial fortunes have deteriorated is much more likely to demand that payment, in the form of an increased interest rate. Financial covenants in this context, therefore, can present a right on which third party creditors cannot free ride.

<sup>27</sup> See AMERICAN BAR FOUND., *supra* note 26, at 215; Lin, *supra* note 11, at 1507 (stating that the existence of a cross-default provision in an agreement makes the debtor's compliance with that provision more likely).

<sup>28</sup> Collective action problems applicable to the holders of publicly issued debt limit the ability of bondholders to negotiate waivers of compliance with bond covenants. Other lenders therefore may view covenants in public debt to be difficult to waive. See generally Royce de R. Barondes, *An Economic Analysis of the Potential for Coercion in Consent Solicitations for Bonds*, 63 *FORDHAM L. REV.* 749 (1994) (discussing the process by which those covenants can be waived). A bank or other limited group of financial institutions that negotiates directly with a borrower in connection with the original extension of credit prefers to be able to negotiate with a debtor in financial distress *before* a default occurs under publicly issued indebtedness. That is, a bank would view an event triggering a default under public debt as one that would have a high probability of resulting in the bankruptcy of the debtor. Thus, a bank prefers to have the opportunity to make adjustments in the debtor's management and strategies before a default arises under public debt.

<sup>29</sup> Firms frequently have only one institutional lender. See Baird, *supra* note 16, at 921; Robert E. Scott, *A Relational Theory of Secured Financing*, 86 *COLUM. L. REV.* 901, 949 (1986). For these firms, therefore, the institutional lender's ability to extract the value of below-market interest rate on debt would be limited.

<sup>30</sup> This relationship differs from the "underinvestment" phenomenon generally discussed in the finance literature. See *supra* note 11. Underinvestment arises from a *de minimis* equity value causing shareholders to be indifferent among certain investment strategies, resulting in "properly" risky transactions not being consummated. The circumstance discussed here is one in which shareholders have a clear preference, but that preference is to pursue less risky strategies than would be pursued were the capital structure not to include debt.

face amount of \$100. If the bank debt were in default and the public debt were not in default but would be in default were the bank debt accelerated, the bank could extract up to \$40 from the corporation in exchange for not accelerating the bank debt, as long as this side payment would not bankrupt the debtor.

One might argue that competition from other lenders would prevent an existing lender from extracting the amount representing the extent to which debt owed to other creditors was below market. This argument posits that if the current bank attempts to charge more than \$20, the debtor will merely arrange to have another lender pay off the existing bank loan. However, institutional lenders must expend significant resources to review their debtors' financial status. Therefore, existing lenders have a cost advantage in extending loans to their debtors.<sup>31</sup>

These costs therefore limit competition from other lenders and increase an existing lender's ability to extract amounts from those to whom it has already extended credit. Moreover, a loan that is in default may not be subject to prepayment without a premium.<sup>32</sup> Therefore, under these circumstances, lenders may be able to extract more than the value that they would receive from refinancing their own extension of credit at current market rates.

This analysis demonstrates the possibility that the financial covenants in outstanding long-term debt may restrain a debtor from taking excessive risks involving potentially adverse outcomes that would result in the firm being sufficiently close to insolvency so as to trigger one or more covenants. It is the lender's ability to extract consideration from the debtor in exchange for not accelerating the debt that can deter risk-seeking. It is important to note, however, that the above analysis does not depend on creditors' frequently extracting payments in the course of actual commercial lending at every available opportunity. Extracting those payments would probably alienate borrowers and taint the respective lender's reputation. One would expect such payments to be extracted only in an end-game strategy with the borrower, which could arise when the adverse financial condition was caused by excessive risk-taking.

This Part has discussed the effect that debt financing has on the risk preference of firms operating in the vicinity of insolvency. The traditional "overinvestment" theory, on which much of the law and economics literature discussing bankruptcy incentives is premised, would predict

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<sup>31</sup> See Jackson & Kronman, *supra* note 26, at 1174 (arguing that the informational advantage gained by individual lenders explains why debtors engage in "repeat" transactions with particular creditors); Rasmussen, *Ex Ante Effects*, *supra* note 1, at 1195.

<sup>32</sup> Yield maintenance provisions are common in privately placed debt, but not publicly offered debt. See William A. Klein et al., *The Call Provision of Corporate Bonds: A Standard Form in Need of Change*, 18 J. CORP. L. 653, 666 n.57 (1993) (stating that 85% of a sample of private redeemable debt contained yield maintenance provisions, which are uncommon in redeemable public debt).

rampant risk-taking by very distressed firms, absent other control mechanisms. Covenants that restrict capital expenditures without the consent of a lender or that limit lines of business directly restrain excessive risk-taking, independent of the debtor's financial status. Financial covenants in long-term, fixed-rate debt—covenants that permit acceleration of the debt upon failure of results of operations or balance sheet information to meet certain numbers or ratios—can create indirect but powerful incentives that can significantly restrain excessive risk-taking by distressed firms.

### III. RISK-TAKING BY NEARLY INSOLVENT FIRMS; CAUSES OF BANKRUPTCY

The theoretical refinement in Part II of the implications of the “overinvestment” theory merely identifies the possibility that financial covenants may restrain excessive risk-taking by financially distressed firms. Of course, other factors may limit excessive risk-taking, such as covenants directly restricting investments, ethical considerations or a manager's reputational interest in not being affiliated with a business that fails.

Perhaps particularly significant are managers' incentives to prolong the firms' operations to continue their employment. Not surprisingly, one recent study found, “Almost *one-third* of the CEOs in our sample are replaced in a given year around default.”<sup>33</sup> Frequently, substantial reductions in compensation are imposed on the CEOs who continue employment notwithstanding default.<sup>34</sup> Another study found that only one-fourth of original CEOs remained in place throughout bankruptcy proceedings.<sup>35</sup> Managers who realize insolvency is likely to result in the termination of their employment thus have substantial personal incentives to avoid strategies that increase the probability of financial distress.<sup>36</sup> A manager's inability to diversify this risk magnifies this incentive's significance.<sup>37</sup> Con-

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<sup>33</sup> Stuart C. Gilson & Michael R. Vetsuypens, *CEO Compensation in Financially Distressed Firms: An Empirical Analysis*, 48 J. FIN. 425, 426 (1993).

<sup>34</sup> See *id.*

<sup>35</sup> Brian L. Betker, *Management's Incentives, Equity's Bargaining Power, and Deviations from Absolute Priority in Chapter 11 Bankruptcies*, 68 J. BUS. 161, 174 (1995). Betker uses “original CEO” to refer to the CEO “who held office 2 years prior to the firm's first debt default.” *Id.* at 172.

<sup>36</sup> See LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 684 (“[A] manager whose job and company are not immediately in jeopardy might prefer investments with risks that are lower than those preferred by the company's investors.”). Adler makes the opposite argument—that managers of an insolvent firm will attempt to pursue an excessively risky strategy in order to rescue a firm from insolvency. Adler, *Near-Bankruptcy Investment Incentives*, *supra* note 1, at 590. Adler's model only applies to corporations that are in fact insolvent (although he indicates it might be extended to solvent firms), see *id.* at 602 & n.97, and thus is not relevant to understanding the incentives governing distressed, solvent corporations, which are discussed in this Article.

<sup>37</sup> See Rasmussen, *Ex Ante Effects*, *supra* note 1, at 1173-75 (asserting that golden parachutes may eliminate this bias to some extent); cf. LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 710 n.157.



sequently, a variety of circumstances, in addition to those addressed in Part II, present incentives contrary to those contemplated by the “overinvestment” theory.

In analyzing whether the “overinvestment” theory identifies incentives that dominate the other incentives discussed above, and thus whether bankruptcy law or corporation law should be revised to ameliorate those incentives, it is sensible to review empirical evidence of the actions that distressed debtors actually take. If corporations engage in increased risk-taking before bankruptcy, that fact would indicate that the incentives presented by the “overinvestment” theory dominate. If, on the other hand, corporations do not engage in excessive risk-taking before bankruptcy, that fact would support concluding that some factors—the theoretical refinements articulated in this Article or those factors previously addressed by others—limit distressed firms’ risk-taking. This Part reviews recent empirical evidence addressing risk-taking by distressed firms.

A survey of forty-one firms reorganized or liquidated in bankruptcy found that only forty-six percent (i.e., nineteen out of forty-one) had “made acquisitions or started new ventures” in the five years preceding bankruptcy.<sup>38</sup> This information estimates the *upper bound* of excessive risk-taking. For the remaining fifty-four percent of the firms, it is clear they did not initiate excessively risky new lines, because during that five year period they entered no new lines at all. Only a portion of the forty-six percent that entered new lines undertook excessively risky expansions—which portion is not currently known. This evidence undermines the belief that a firm’s proximity to insolvency exacerbates the incentives created by the issuance of debt to an extent requiring a shift in the fiduciary duties of directors of nearly insolvent corporations.<sup>39</sup>

Most recently, Andrade and Kaplan examined thirty-one firms that engaged in highly leveraged transactions (management buy-outs or lever-

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<sup>38</sup> See Daigle & Maloney, *supra* note 11, at 183. Those authors included in their sample firms reported in the *Wall Street Journal* as filing for bankruptcy or reorganizing since 1979, which was reduced to the subset of firms for which “detailed information about [the] confirmed reorganization plans” was available. *Id.* at 168. Four of the 41 firms were liquidated, only one of which engaged in new lines. *See id.* at 170-71 tbl.1, 184-85 tbl.8. (The above information is based on tables in Daigle & Maloney, *supra* note 11. The accompanying textual description of the information in those tables overstates by one the number of firms that were liquidated, relative to those firms identified in those tables as having liquidated. *See id.* at 168.)

<sup>39</sup> A portfolio’s beta measures the relationship between the returns of the portfolio and market returns, measuring the portfolio’s nondiversifiable risk. *See* ARTHUR J. KEOWAN ET AL., *BASIC FINANCIAL MANAGEMENT* 220 (7th ed. 1996). A beta greater than one indicates that the portfolio’s nondiversifiable risk is greater than that of the market. *See id.* at 221.

Daigle and Maloney find that firms that ultimately become bankrupt have an estimated portfolio beta of 1.4, from which the authors conclude that the firms that ultimately become bankrupt “have found a way to redirect the behavior of the firm toward high variance projects as a way of expropriating the bondholder wealth,” although they note that alternative explanations are available. Daigle & Maloney, *supra* note 11, at 186.

aged recapitalizations) and subsequently became financially distressed.<sup>40</sup> No evidence was found indicating that one or more firms had engaged in unusually risky ventures.<sup>41</sup>

For some debtors—those with directors having small equity holdings in the firm and focusing on entrenchment—the incentives identified by the “overinvestment” theory have decreased force. In these situations, the assumption that management acts on behalf of the shareholders may be questionable. The debtors in Andrade and Kaplan’s survey are particularly appropriate for applying the “overinvestment” theory to distressed firms. Seventy-four of the debtors had been the subject of a buyout involving management or a controlling shareholder.<sup>42</sup> For these debtors, the circumstances imply that the interests of the shareholders and those of the managers were closely aligned. Nevertheless, no debtor was observed engaging in excessively risky transactions.

Evidence concerning the causes of corporate bankruptcies further supports concluding that excessive risk-taking by distressed firms actually occurs in limited circumstances. If excessive risk-taking occurred in practice, one would expect unwarranted expansion or other managerial blunders would be a prominent cause of business bankruptcies. However, a survey of firms for which information was publicly available indicates that other factors cause firms to become bankrupt. Only eight percent of all bankruptcies surveyed identified ambitious expansion as one of the causes of bankruptcy, and in only eight percent were various managerial blunders identified as causes.<sup>43</sup> That is, in at least 84% of the cases, managerial actions of these types played no part. The primary causes were an inability to obtain financing (31%), a liquidity/cash flow shortage (27%), and an industry/market slump (26%).<sup>44</sup> Furthermore, because managerial blunders and ambitious expansion may not have been entirely caused by attempts to engage in excessively risky activity, for the vast majority of bankruptcies, excessive risk-taking was not a factor in the respective firm’s demise.<sup>45</sup>

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<sup>40</sup> Gregor Andrade & Steven N. Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed* (July 1997) (preliminary unpublished manuscript, on file with author).

<sup>41</sup> See *id.* at 18.

<sup>42</sup> See *id.* app. I.

<sup>43</sup> See Sudip Datta & Mai E. Iskandar-Datta, *Reorganization and Financial Distress: An Empirical Investigation*, 43 J. FIN. RES. 15, 18 tbl.1 (1995). More than one cause may be attributed to a bankruptcy, so the number as to which either was a cause may be less than 16%. The sample for the study includes the 135 firms that filed petitions in Chapter 11 during the 1980s for which the relevant data were available. See *id.* at 17. The causes of bankruptcy reported in the survey were “provided by management and analysts for bankruptcy in the [Wall Street Journal].” *Id.*

<sup>44</sup> See *id.* at 18 tbl.1.

<sup>45</sup> One could argue that excessive risk-taking could have been the reason underlying the bankruptcy of firms, where the respondents identified as a cause either “unable to obtain financing” or “liquidity/cash flow shortage,” because entering into excessively risky projects would ultimately cause a bankruptcy through a process that involved a cash flow shortage for which the debtor could not

The notion that firms that ultimately become insolvent do not engage in excessively risky acquisitions or business expansions while in distress is further supported by a recent review of the effect on the stock price of such firms arising from announcements of acquisitions or other business expansions. Khanna and Poulsen examined 128 public firms that filed for protection under Chapter 11 from 1980 through 1990, and prepared a control sample of 118 firms similar in size and industry to the 128 firms that ultimately filed for bankruptcy protection.<sup>46</sup> Only nineteen of the 128 firms that ultimately filed under Chapter 11, or fifteen percent, announced an acquisition or expansion in the three years preceding the Chapter 11 filing (compared to twenty-nine percent of the control sample).<sup>47</sup> Khanna and Poulsen found no statistically significant effect on the stock price of those firms that ultimately filed under Chapter 11 arising from those acquisition or expansion announcements.<sup>48</sup> If these firms were engaged in acquisitions or expansions that stock market participants could identify as excessively risky, those announcements should have resulted in a statistically significant effect on the stock price. The absence of statistically significant returns in this context thus is consistent with the conclusion that excessive risk-taking is not substantially exacerbated by financial distress.

Based in part on some of the issues discussed above, and in part on the uncertain application of corporate fiduciary duties, discussed in Part IV.E, one group of commentators concluded, "The agents' lack of awareness about the firm's changed financial status, coupled with the shifting nature of the agents' fiduciary duty, makes any meaningful economic analysis of the agents' incentives virtually impossible."<sup>49</sup>

The empirical evidence surveyed in this Part strongly supports the conclusion that distressed corporations do not engage in the excessive risk-taking predicted by the "overinvestment" theory. Surveys of firms that become bankrupt or distressed do not identify prior excessive risk-taking. The evidence appears particularly compelling in a circumstance where managers' interests are closely aligned with those of the shareholders. The absence of adverse stock price reactions to announcements of expansions or acquisitions by firms that ultimately become bankrupt suggests that the stock market does not identify those expansions or acquisitions as exces-

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obtain additional financing. That construction would not be reasonable, however. Virtually any insolvency could be prevented with an increase in cash flow or greater access to capital. A more reasonable construction of the responses is that insolvency was attributed to a cash flow shortage or an inability to obtain financing only where another more specific cause, such as a managerial blunder in engaging in excessive risk-taking, could not be identified.

<sup>46</sup> Naveen Khanna & Annette B. Poulsen, *Managers of Financially Distressed Firms: Villains or Scapegoats?*, 50 J. FIN. 919, 924-25 (1995).

<sup>47</sup> See *id.* at 928 tbl.III.

<sup>48</sup> *Id.* at 929, 930 tbl.IV.

<sup>49</sup> Ramesh K.S. Rao et al., *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. CORP. L. 53, 64 (1996).

sively risky. This empirical evidence thus supports the argument in Part II that the “overinvestment” theory does not accurately predict actions taken by distressed firms. Analyses of the incentives presented to distressed corporations by federal bankruptcy law premised on the “overinvestment” theory are founded on a questionable assumption.

Two recent cases, building on the controversial Delaware Chancery Court opinion in *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*,<sup>50</sup> have construed corporation law in a fashion that creates substantial incentives that may dominate over any other incentives presented by federal bankruptcy law to managers of distressed, solvent corporations. Part IV turns to the background of those cases.

#### IV. APPLICABLE CORPORATION LAW PRINCIPLES

##### A. *Insolvent Firms*

A traditional economic justification for the proposition that corporations typically are managed for the benefit of the shareholders is that shareholders are the owners of the residual value of the firm.<sup>51</sup> Where a corporation is insolvent, and the creditors in fact bear the risk of decreases in the residual value of the corporation, the traditional justification for promoting exclusively the shareholders’ interests disappears.<sup>52</sup> This fact, and the variations in incentives that arise as a firm approaches insolvency,<sup>53</sup> are reflected in changes in a board of directors’ fiduciary duties. The majority rule, and the law in Delaware, is that, upon insolvency, a board’s duties are owed to the creditors of the enterprise.<sup>54</sup>

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<sup>50</sup> Civil Action No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991).

<sup>51</sup> See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 67-70 (1991); see also Gilson & Vetsuypens, *supra* note 20, at 1005-06.

<sup>52</sup> See EASTERBROOK & FISCHER, *supra* note 51, at 69; Steven L. Schwarcz, *Rethinking a Corporation’s Obligations to Creditors*, 17 CARDOZO L. REV. 647, 667-68 (1996) (describing creditors of insolvent firms as having “equity-type rights”).

<sup>53</sup> See *supra* Part I.

<sup>54</sup> See *Pepper v. Litton*, 308 U.S. 295, 307 (1939) (stating, in holding that a bankruptcy court may disallow as a claim a fraudulently obtained judgment in favor of the controlling stockholder, “While normally that fiduciary obligation [of a director] is enforceable directly by the corporation, or through a stockholder’s derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.” (footnotes omitted)); *Unsecured Creditors Comm. of Debtor STN Enters., Inc. v. Noyes (In re STN Enters.)*, 779 F.2d 901, 904-05 (2d Cir. 1985) (“Thus, the ‘majority rule’ permits recovery by creditors of an insolvent corporation for mismanagement as if the corporation itself were plaintiff, while the ‘minority rule’ precludes suit by injured creditors of an insolvent corporation, although a suit for misappropriation or diversion of corporate property may stand on different and more solid footing.” (citations and footnote omitted)); *American Nat’l Bank v. MortgageAmerica Corp. (In re MortgageAmerica Corp.)*, 714 F.2d 1266, 1269, 1277 (5th Cir. 1983); *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir. 1982) (stating,

There is some controversy concerning whether the existence of such a duty owed directly to creditors has a strong basis in traditional jurisprudence. The “trust fund doctrine” is the seminal theory.<sup>55</sup> Under this doctrine, as originally formulated, creditors could pursue remedies against holders of assets improperly distributed by debtor corporations.

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“when the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors,” and quoting a case to the effect that the shift arises “when a corporation becomes insolvent, or in a failing condition” (quoting *Davis v. Woolf*, 147 F.2d 629, 633 (4th Cir. 1945)); *Clarkson Co. v. Shaheen*, 660 F.2d 506, 512 (2d Cir. 1981); *Bank Leumi-Le-Israel, Philadelphia Branch v. Sunbelt Indus., Inc.*, 485 F. Supp. 556, 559 (S.D. Ga. 1980) (stating that the directors and officers of an insolvent corporation “stand as trustees of corporate properties for the benefit of creditors first and stockholders second”); *Committee of the Creditors of Xonics Med. Sys., Inc. v. Haverty (In re Xonics, Inc.)*, 99 B.R. 870, 872 (Bankr. N.D. Ill. 1989) (stating, under Delaware law, “When a corporation is insolvent its officers and directors stand in a position of trust not only to the corporation and its shareholders, but also to its creditors.”); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) (“[N]either party seriously disputes that when the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors.”); accord 3A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 1182, 1185 (perm. ed. rev. vol. 1994) (stating that the general rule is that creditors of an insolvent corporation may bring an action to enforce the fiduciary obligations of directors, at least where the corporation has declined to bring the action, and the proper theoretical basis is that directors are liable to the corporation as a result of any breach of their obligations, “which may be enforced in equity, as other equitable assets may be collected, for the purpose of satisfying the claims of creditors”).

Although the above states the traditional rule, some courts hold otherwise. See 3A FLETCHER ET AL., *supra*, §§ 1175, 1181, at 427 (“The minority rule is that creditors of [insolvent] corporations cannot, in general, maintain an action against directors for default in duty owed to the corporation, although the creditors may be injured as a result. In other words, some courts hold that mere creditors of an insolvent bank or other corporation cannot sue, even in equity, to hold the directors or other officers liable for losses due to mere negligence, unless so provided by statute, . . . on the ground that there is no trust relation between the officers and creditors.”).

LoPucki and Whitford argue that the “better view” is that fiduciary duties are owed to both shareholders and creditors of insolvent corporations, which, the authors assert, implies, “the law of fiduciary duty does not provide a reliable way for either creditors or shareholders to check management when it acts in an otherwise appropriate manner on matters with regard to which the interests of creditors and shareholders conflict.” LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 709.

Lin asserts, “All of the decisions in which the courts have allowed creditors to recover for breach of fiduciary duty have involved directors of an insolvent corporation diverting corporate assets for the benefit of insiders or preferred creditors.” Lin, *supra* note 11, at 1513. Although the litigated cases have involved factual patterns that she can categorize in that fashion, that pattern does not mean that the rule is limited to that paradigm, where the *language* of the cases themselves does not express that limitation. Additionally, any transaction by an insolvent firm, which transaction could be characterized as excessive risk-taking, would meet the pattern identified by Lin, where the directors and officers had a significant equity interest in the debtor.

Coffee raises the interesting question of whether the existence of this fiduciary duty to creditors should cause issuer repurchases of debt securities by nearly insolvent issuers to be subject to fiduciary duties. Coffee, *supra* note 8.

<sup>55</sup> See Norwood P. Beveridge, Jr., *Does a Corporation’s Board of Directors Owe a Fiduciary Duty to Its Creditors?*, 25 ST. MARY’S L.J. 589, 594 (1994); Ann E. Conaway Stilson, *Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors’ Duties to Creditors*, 20 DEL. J. CORP. L. 1, 87-89 (1995); Stephen R. McDonnell, Comment, *Geyer v. Ingersoll Publications Co.: Insolvency Shifts Directors’ Burden from Shareholders to Creditors*, 19 DEL. J. CORP. L. 177, 186-87 (1994).

Thus, in *Wood v. Dummer*, the court held that a bank's capital stock cannot be withdrawn prior to payment of all debts, because the capital stock is "deemed a pledge or trust fund for payment of the debts contracted by the bank."<sup>56</sup> And courts subsequently held that when a corporation is insolvent and has ceased to do business, creditors have standing to maintain an action for a director's breach of a fiduciary duty.<sup>57</sup>

Permitting creditors to pursue remedies against holders of assets improperly distributed by a debtor corporation does not necessarily require that such creditors have the right to participate in, or oversee, the management of the business of an insolvent corporation. Nor does it require that such creditors have a right to bring an action against the directors for failing to pursue strategies believed to be in creditors' best interest. Notwithstanding academic criticism,<sup>58</sup> courts have held that certain transactions by insolvent corporations not in the process of liquidating may be considered to violate an enforceable duty to creditors.<sup>59</sup>

#### B. Corporations in the Vicinity of Insolvency

In *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*,<sup>60</sup> the Delaware Chancery Court created a third, intermediate standard—when a corporation is in the vicinity of insolvency, the corporation's board of directors' duty of loyalty is owed to the corporate enterprise as a whole. The court stated:

At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise. . . .

. . .

. . . [I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

. . . [T]he [issuer] board or its executive committee had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.<sup>61</sup>

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<sup>56</sup> *Wood v. Dummer*, 30 F. Cas. 435, 436 (C.C.D. Me. 1824) (No. 17,944).

<sup>57</sup> See *supra* note 54 and accompanying text.

<sup>58</sup> See *Beveridge*, *supra* note 55, at 592 (stating that the doctrine was never intended to create such duties); *Stilson*, *supra* note 55, at 87 (describing the trust fund doctrine as "superfluous" to the decision in *Wood v. Dummer*). Attempting to determine whether a fiduciary duty should be owed to creditors directly, based on whether such a holding was necessary to decide a corporation law case heard in the early 1800s, is a curious exercise.

<sup>59</sup> See *supra* note 54 and accompanying text.

<sup>60</sup> Civil Action No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991).

<sup>61</sup> *Id.* at \*108-\*109 & n.55. *Roe* foreshadowed this holding. See Mark J. Roe, *Bankruptcy and*

That is, the directors are to disregard conflicting incentives of the various claimants and must not attempt to promote the interests of one group at the expense of another. In reaching this holding, the court relied on the "overinvestment" theory.<sup>62</sup>

*Credit Lyonnais* did not clearly address whether the duties articulated in the case are affirmatively enforceable by creditors, i.e., whether creditors of a distressed corporation can bring a lawsuit against the directors for pursuing business strategies that do not promote the firm's long-term wealth creating capacity. The case could be read as merely granting directors of distressed corporations an additional basis on which they could defend against lawsuits filed on behalf of disgruntled shareholders. This Article argues that the former interpretation is a more fair reading of the case; that reading also is consistent with recent case law. The rationale for that interpretation of *Credit Lyonnais* relies in part on other case law—the law governing directors of solvent corporations in choosing time horizons by which possible strategies are to be judged. Part IV.C discusses that case law. Part IV.D then discusses the duties of directors of distressed corporations under corporation law.<sup>63</sup>

### C. Time Horizon

Corporation law generally provides that a corporation's directors, and officers appointed by directors, are delegated the responsibility for managing the corporation, with shareholder participation in management generally excluded.<sup>64</sup> The court in *Paramount Communications, Inc. v. Time Inc.* held that one of those delegated aspects of managing a solvent business is deciding upon the appropriate investment horizon.<sup>65</sup>

*Paramount* arose out of a transaction that was originally structured as a merger of Warner Communication, Inc., into a subsidiary of Time Incorporated. Shares of Warner would have been converted into shares of Time Incorporated.<sup>66</sup> Had the transaction been consummated on those

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*Debt: A New Model for Corporate Reorganizations*, 83 COLUM. L. REV. 527, 583 (1983) (discussing the incentives of a firm on the brink of insolvency, and stating "[t]his problem might be avoided by a concept of corporate duty of officers and directors to the abstract firm, not just to its shareholders").

<sup>62</sup> *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at \*108 n.55.

<sup>63</sup> The discussion of corporation law in the remainder of this Article is restricted to Delaware corporation law.

<sup>64</sup> See Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but Not Too Late*, 43 AM. U. L. REV. 379, 388-89, 394, 456-57 (1994); Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 348-49 (1991).

<sup>65</sup> *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1990). At the time of the transaction in question in *Paramount*, the author was employed by outside counsel that represented Time in the transaction, although the author did not participate in that representation.

<sup>66</sup> *Id.* at 1146.

terms, former shareholders of Warner would have owned approximately 62% of Time. Paramount subsequently made an unsolicited offer to purchase all outstanding shares of Time Incorporated at \$175 per share, in cash, conditioned on, *inter alia*, the termination of the Time-Warner transaction.<sup>67</sup> Time's stock price rose from \$126 to \$170 on the following day.<sup>68</sup> In response, the Time-Warner transaction was restructured, with Time making an offer to purchase 51% of Warner for \$70 in cash, the remaining shares of Warner to be purchased for a combination of cash and stock at a later time.<sup>69</sup> Paramount then raised its offer to purchase Time shares to \$200 per share. Time rejected Paramount's offer, and Paramount filed suit to enjoin the tender offer for Warner by Time.<sup>70</sup> The trial court found that Time's Board of Directors expected that the short-term return of the initially contemplated transaction would be less than that of Paramount's offer:

[T]he board understood that it was foreclosing for the present . . . the option for Time shareholders to realize \$175 cash for their shares—indeed it understood that \$175 could be realized from [Paramount's CEO] and perhaps substantially more from him or others and, more significantly, the board understood that immediately following the effectuation of a Warner merger, the stock market price of Time stock was likely to be materially lower than the \$175 then "on the table," perhaps \$150, but more likely, within the wide range of \$106-\$188.<sup>71</sup>

On appeal, the Delaware Supreme Court stated, "Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board of representatives. The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders."<sup>72</sup>

This distinction might be problematic for some. One could argue that the current market price of a firm's stock should reflect the value of all long-term strategies to be pursued. Therefore, if a firm adopts a long-term strategy at the expense of short-term returns, but with correspondingly greater long-term return, that strategy should create a higher current market price for the firm's stock than alternative strategies having lesser long-term returns. The notion that management has the authority to select the time horizon, at least for public corporations required to disclose all material information, therefore could be seen as conflicting with the view that

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<sup>67</sup> See *id.* at 1147.

<sup>68</sup> See *id.*

<sup>69</sup> See *id.* at 1148.

<sup>70</sup> See *id.* at 1142, 1148.

<sup>71</sup> *Paramount Communications Inc. v. Time Inc.*, Civil Action Nos. 10866, 10670, 10935 (Consolidated), 1989 Del. Ch. LEXIS 77, at \*53 (Del. Ch. July 17, 1989) (citation omitted), *aff'd*, 571 A.2d 1140 (Del. 1989). The opinion implies that Time's board did not believe that it was obligated to consummate a transaction with Warner until it restructured the transaction with Warner *after* the initial \$175 per share offer for Time was made. See *id.* at \*47.

<sup>72</sup> *Paramount*, 571 A.2d at 1154 (citation omitted).



market prices for common stock accurately reflect all currently available information. This distinction nevertheless is permissible in the field of corporation law.<sup>73</sup>

Similarly, in *Unitrin, Inc. v. American General Corp.*, in the context of determining the reasonableness of a stock repurchase program, the court stated, “[D]istinctions among types of shareholders are neither inappropriate nor irrelevant for a board of directors to make, e.g., distinctions between long-term shareholders and short-term profit-takers, such as arbitrageurs, and their stockholding objectives.”<sup>74</sup>

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<sup>73</sup> An extract from the chancery court opinion in *Paramount* explains the rationale in detail: The legal analysis that follows treats the distinction that the Time board implicitly drew between current share value maximization and long-term share value maximization. For some, this is a false distinction. “The lawyers may talk about a premium for control. But to a true believer of efficient markets, there cannot be a premium for control.” Therefore, before turning to the legal analysis that does employ that distinction, I pause to address in some brief way the notion that the distinction between any long-term and short-term stock value, at least where there is a large, active, informed market for the shares of the company, is an error; that the nature of such markets is precisely to discount to a current value the future financial prospects of the firm; and that markets with their numberless participants seeking information and making judgments do this correctly (at least in the limited sense that no one without inside information can regularly do it better).

This view may be correct. It may be that in a well-developed stock market, there is no discount for long-term profit maximizing behavior except that reflected in the discount for the time value of money. It may be the case that when the market valued the stock of Time at about \$125 per share following the announcement of the merger, an observer blessed with perfect foresight would have concurred in that value now of the future stream of all returns foreseen into eternity. Perhaps wise social policy and sound business decisions ought to be premised upon the assumptions that underlie that view. But just as the Constitution does not enshrine Mr. Herbert Spencer’s social statics, neither does the common law of directors’ duties elevate the theory of a single, efficient capital market to the dignity of a sacred text.

Directors may operate on the theory that the stock market valuation is “wrong” in some sense, without breaching faith with shareholders. No one, after all, has access to more information concerning the corporation’s present and future condition. It is far from irrational and certainly not suspect for directors to believe that a likely immediate market valuation of the Time-Warner merger will undervalue the stock. The record in this case refers to instances in which directors did function on a theory that they understood better than the public market for the firm’s shares what the value of their firm was, and were shown by events to be correct. . . .

On the level of legal doctrine, it is clear that under Delaware law, directors are under no obligation to act so as to maximize the immediate value of the corporation or its shares, except in the special case in which the corporation is in a “Revlon mode.” Thus, Delaware law does recognize that directors, when acting deliberately, in an informed way, and in the good faith pursuit of corporate interests, may follow a course designed to achieve long-term value even at the cost of immediate value maximization.

*Paramount*, 1989 Del. Ch. LEXIS 77, at \*55-\*58 (citations and footnotes omitted).

<sup>74</sup> *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1386 (Del. 1995).

#### D. *Persons Who May Assert the Obligation*

This background illuminates the meaning of the duties of directors of distressed corporations created in *Credit Lyonnais*. *Credit Lyonnais* may be read as creating an *obligation to stakeholders* who are not *shareholders* that those stakeholders can enforce.<sup>75</sup> In the alternative, *Credit Lyonnais* may merely be permissive—it may permit directors of nearly insolvent corporations to consider interests whose consideration otherwise would be improper under otherwise applicable fiduciary duty of loyalty requirements.

In *Credit Lyonnais*, the court upheld decisions by management that conflicted with the desires of the majority stockholder. Whether creditors may assert a cause of action alleging a violation of this duty therefore was not presented in *Credit Lyonnais*. The same Chancellor who wrote the opinion in *Credit Lyonnais* in a subsequent case summarized *Credit Lyonnais* as follows:

[W]here foreseeable financial effects of a board decision may importantly fall upon creditors as well as holders of common stock, as where [the] corporation is in the vicinity of insolvency, an independent board *may* consider impacts upon all corporate constituencies in exercising its good faith business judgment for [the] benefit of the “corporation” . . . .<sup>76</sup>

The Chancellor’s summary suggests *Credit Lyonnais* does not create a duty that creditors can enforce affirmatively. Yet one district court presented with the issue held that such an affirmatively enforceable duty exists.<sup>77</sup> And another court, citing *Credit Lyonnais*, held that a director of a corporation that was on “the brink of insolvency” was a “trustee of the

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<sup>75</sup> *Credit Lyonnais* was read in this fashion in Henry T.C. Hu, *Hedging Expectations: “Derivative Reality” and the Law and Finance of the Corporate Objective*, 73 TEX. L. REV. 985, 1029 (1995), and Rima Fawal Hartman, Note, *Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?*, 50 WASH. & LEE L. REV. 1761, 1764 (1993). This Article provides a more detailed analysis of that issue, further supporting those opinions, and provides new case authority supporting that conclusion.

But Sparks, a prominent practitioner, draws a different conclusion: Significantly, footnote 55 [of *Credit Lyonnais*] does not create a direct fiduciary duty running from directors to creditors, with the result that creditors cannot sue directly to enforce a director’s breach of footnote 55 duties to the corporate enterprise. Presumably, however, a trustee in bankruptcy would have standing to sue on behalf of the bankrupt estate to recover from directors for willful or grossly negligent breaches of footnote 55 duties.

A. Gilchrist Sparks, III, *Fiduciary Duties of Financially Troubled Delaware Corporations*, 1 26TH ANN. INST. ON SEC. REG. 759, 784-85 (1994). Sparks notes, however, “[I]t could be argued that the direct cause of action by creditors against directors of insolvent corporations sanctioned by *Geyer* also extends to a violation of footnote 55 duties.” *Id.* at 792.

<sup>76</sup> *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1042 n.2 (Del. Ch. 1997) (emphasis added).

<sup>77</sup> Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (*In re Buckhead Am. Corp.*), 178 B.R. 956, 968 (D. Del. 1994).

corporation with the res being the corporate assets.<sup>78</sup> These two opinions thus clarify that, at least in these courts, the duties owed by directors of solvent, distressed corporations can be affirmatively enforced by creditors. The nature of the duty created by *Credit Lyonnais* and the context of that opinion provide perspective to an understanding of whether other courts can be expected to reach similar holdings.

As discussed in Part IV.C, *supra*, while directors are obligated to manage a corporation for the benefit of the shareholders, directors are not required to exercise that managerial power in compliance with all unambiguously expressed desires of the shareholders. Shareholders in that circumstance need to remove the directors in order to have their policies pursued.

If the opinion in *Credit Lyonnais* contemplated a duty that could not be enforced against directors, the discussion of the incentives created when firms issue debt would have been unnecessary. This aspect of the case could have been resolved by simply discussing settled principles under which managers need not follow the unambiguously expressed desires of their constituencies. As *Credit Lyonnais* references these incentives, the opinion clearly suggests that an allegedly aggrieved non-shareholder who nevertheless is a corporate constituent can affirmatively enforce the duties.

This reading of *Credit Lyonnais* is further supported by the fact that the opinion specifies the time frame of the wealth creating capacity that is to be maximized. As discussed in Part IV.C of this Article, the Delaware Supreme Court in *Paramount*<sup>79</sup> held that the determination of the appropriate time horizon by which strategies are to be judged is delegated to management.<sup>80</sup> *Paramount* was decided in 1990, before the 1991 decision in *Credit Lyonnais*. Therefore, the discussion of a time horizon in the *Credit Lyonnais* opinion<sup>81</sup> only has meaning if it is intended to exclude

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<sup>78</sup> *Miramar Resources, Inc. v. Shultz (In re Shultz)*, 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997). The language of that case is somewhat confusing. The quoted language is part of a discussion of the trust fund doctrine. However, the quote continues, "the beneficiaries being the other directors and the shareholders, and the affirmative duties being to act in the best interest of the corporation, including the other directors and shareholders." *Id.* at 729. That discussion is not consistent with the traditional application of the trust fund doctrine, in which the creditors are the beneficiaries. See *supra* notes 55-57 and accompanying text. The failure of the court to mention creditors is therefore somewhat odd. But as the trust fund doctrine is a theory that permits a direct action against the directors, this case supports the notion that the duty created by *Credit Lyonnais* is one that can be enforced against a director, i.e., subject him to personal liability.

<sup>79</sup> *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1990). Varallo and Finkelstein draw a parallel between *Time* and *Credit Lyonnais*, noting that in both, the board can act in a fashion contrary to the expressed interests of the shareholders. Gregory V. Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239, 243 n.15 (1992).

<sup>80</sup> *Paramount*, 571 A.2d at 1154.

<sup>81</sup> *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, Civil Action No. 12150, 1991 Del. Ch. LEXIS 215, at \*108-\*109 (Del. Ch. Dec. 30, 1991).

a reference to another time horizon, i.e., shorter time horizons. Since *Paramount* generally grants directors the authority to select the relevant time horizon, including shorter time horizons, *Credit Lyonnais* limits the discretion otherwise available to the board. For that limitation to have any effect, someone must have the right to bring an action against the corporation or the board in the event the requirements of this limitation are not followed by the directors.

What types of constituents would have the right to bring an action asserting a violation of this duty? *Credit Lyonnais* creates a rule intended to address the concern that directors may excessively promote the interests of shareholders, which means the persons who assert this right necessarily will not be the shareholders.

The rationale behind *Credit Lyonnais* strongly supports the conclusion, expressed in other judicial opinions, that creditors have the right to bring a cause of action against directors, alleging a corporation's directors failed to promote the creditors' interests when the corporation was nearly insolvent.

#### E. *Incentives for Directors of Distressed Corporations Created by Corporation Law; Impact on Financial Advisors*

The duty of directors of corporations operating in the vicinity of insolvency to maximize the corporation's long-term wealth creating capacity imposes an obligation that is very difficult to fulfill. Current case law does not provide clear authority for permitting a waiver of the duty to be enforced.<sup>82</sup> Moreover, under current law, the nature of the duty makes it unlikely that potential personal liability can be limited by insurance.<sup>83</sup> This Article now discusses these concerns.

The difficulty in satisfying the obligation arises from its ambiguity. Whether one defines insolvency as an excess of liabilities over assets or as an inability to pay debts generally as they become due,<sup>84</sup> application of these definitions in a particular factual pattern may be difficult, and reasonable individuals may reach different conclusions.<sup>85</sup> Difficulties in determining when a corporation is "in the vicinity of insolvency" are compounded by uncertainty as to the proper accounting treatment of write-offs

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<sup>82</sup> See *infra* notes 103-14 and accompanying text.

<sup>83</sup> See *infra* notes 115-19 and accompanying text.

<sup>84</sup> See *supra* note 10.

<sup>85</sup> See Hu, *supra* note 75, at 1029; McDonnell, *supra* note 55, at 196, 206; see, e.g., *Askanase v. Fatjo*, Civil Action No. H-91-3140, 1993 U.S. Dist. LEXIS 7911, at \*2, \*16-\*19 (S.D. Tex. Apr. 22, 1993) (stating that the evidence was in "equipoise" concerning whether the debtor was insolvent at a particular time, where amounts paid to a defendant, which was beneficially owned by a former director of the debtor, could be recovered, under the trust fund doctrine, if the debtor had been insolvent at that time).

during reorganizations.<sup>86</sup> A firm may retroactively restate its balance sheet after seeking bankruptcy protection, resulting in write-offs that cause a formerly positive shareholders' equity to become negative. Commentators have argued that this fact implies that managers "may well be unaware that the corporation is 'in the vicinity of insolvency' or has crossed the threshold and entered the realm of insolvency."<sup>87</sup>

But the standard announced in *Credit Lyonnais* creates uncertainty of entirely different dimensions, compared to the uncertainty in deciding whether a corporation is insolvent. The court did not even announce an imprecise test as to when a corporation is in the vicinity of insolvency. In *Credit Lyonnais* itself there was a dispute concerning whether the corporation was insolvent under the much more clear bankruptcy insolvency standard.<sup>88</sup> If uncertainty necessarily exists as to whether a corporation's financial position meets a well-articulated test—one of the multiple definitions of insolvency—this uncertainty is compounded as to whether a corporation's financial position meets an imprecise test.<sup>89</sup>

The ambiguity inherent in these developing corporation law standards is not limited to the definition of "vicinity of insolvency." The objective announced in *Credit Lyonnais* is maximizing the firm's "wealth creating capacity." As in any such formulation, the meaning of "wealth" is not self-evident.<sup>90</sup> The indeterminacy of "wealth" cannot be ameliorated by substituting "net income," because that criterion also is not necessarily deterministic<sup>91</sup> and finance theorists have previously rejected that metric

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<sup>86</sup> See Roberts, *supra* note 10, at 288.

<sup>87</sup> Rao et al., *supra* note 49, at 64.

<sup>88</sup> Certain creditors had filed an involuntary bankruptcy petition, *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, Civil Action No. 12150, 1991 Del. Ch. LEXIS 215, at \*30 (Del. Ch. Dec. 30, 1991), which was subsequently dismissed. See *id.* at \*108.

<sup>89</sup> McDonnell criticized the imposition of personal liability on directors of insolvent corporations for failure to promote the interests of directors, as contemplated by *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784 (Del. Ch. 1992), on similar grounds. McDonnell, *supra* note 55, at 206-07. He concludes that the imposition of this liability may cause directors more frequently to fail to act prior to insolvency, and this rule may accelerate the time when management files for bankruptcy protection, to assure the identity of the group whose interests management is to promote. See *id.* Stilson similarly argues that *Credit Lyonnais* will result in "defensive management" of nearly insolvent firms. Stilson, *supra* note 55, at 61.

<sup>90</sup> Cf. Van Der Weide, *supra* note 17, at 28-29 ("Statutes and case law are silent or at least unhelpful, however, on the question of what it means for a manager to act in the best interests of the corporation.").

<sup>91</sup> See WALTER T. HARRISON, JR. & CHARLES T. HORNGREN, FINANCIAL ACCOUNTING 495 (2d ed. 1992) (noting that the Generally Accepted Accounting Principles (GAAP) allow "a choice among acceptable accounting methods—in inventory, depreciation and other areas," which can limit comparability of financial statements, and noting that generally accepted accounting principles obligate a business to disclose any change in accounting methods). See generally Lou R. Kling et al., *Summary of Acquisition Agreements*, 51 U. MIAMI L. REV. 779, 809 (1997) (noting that acquisition agreements typically require that the closing balance sheet and the pre-signing balance sheet be prepared consistently).

One extreme example is provided by *Sonitrol Holding Co. v. Marceau Investissements*, 607

for a variety of reasons.<sup>92</sup> Additionally, businesses frequently are presented with strategy options for which returns cannot be quantitatively estimated without an unjustified expenditure on information. Other strategies' returns can be quantified only through the exercise of business judgment as to which reasonable businessmen may differ. The court in *Equity-Linked Investors, L.P. v. Adams* was presented with precisely such a problem, and did not attempt to make its own determination of value.<sup>93</sup> Only in rare circumstances will a court be presented with analyzing a business strategy capable of reduction to precise probabilities.<sup>94</sup>

Thus, even if "wealth" references profits determined in accordance with Generally Accepted Accounting Principles ("GAAP"), consistently applied, a court frequently would be unable independently to assess whether a particular decision made by directors maximized "wealth." The

A.2d 1177 (Del. 1992), in which a seller sought to avoid complying with certain provisions in a stock and note purchase agreement adverse to the seller, which were triggered if certain projections were not met. See *id.* at 1178. The method unsuccessfully adopted by the seller consisted of first changing the basis on which financial statements were prepared from U.S. GAAP to United Kingdom generally accepted accounting principles and second preparing financial statements complying with U.S. GAAP but based on different asset amortization periods than were used in the projections.

<sup>92</sup> Frankfurter recounts the following reasons why finance theory discusses maximizing "wealth," as opposed to "profits":

[T]he innovators of the field [of finance] argued that profits are a bad thing to maximize, because:

- (i) they are defined by accounting principles that are historical, and any correspondence between historical and future performance is incidental at best, nonexistent at worst;
- (ii) accounting data are subject to measurement error of several sources;
- (iii) profits are a short-term measure;
- (iv) profits can and will be manipulated by management; and (the most compelling argument of all),
- (v) no one can sell an asset at a price higher than what the market will pay for it, regardless of what accounting data show.

George M. Frankfurter, *Is a Misconception a Paradox?*, 1 EUR. J. FIN. 31, 32 (1995).

Formerly, courts not burdened with these theoretical distinctions were able to state the goals of management more succinctly:

A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself . . . .

*Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (emphasis added), quoted in Van Der Weide, *supra* note 17, at 29 n.7.

<sup>93</sup> *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1058-59 (Del. Ch. 1997).

<sup>94</sup> *Dwyer v. Jones (In re Tri-State Paving, Inc.)*, 32 B.R. 2 (Bankr. W.D. Pa. 1982), is an anomalous example of a strategy that may be capable of reduction to probabilities. It involved officers who withdrew all the funds the debtor had in its bank account and gambled it all in Las Vegas "to win enough money . . . to pay the corporate-debtor's creditors." *Id.* at 3. The strategy was unsuccessful. See *id.* at 4-5. Of course, it is unlikely that a reported case would involve managers who successfully adopted such a strategy. Yet such a strategy may be beneficial for creditors. See Lin, *supra* note 11, at 1491 n.19 (reporting that the founder of Federal Express successfully adopted such a strategy during a period of financial difficulty).

ambiguity as to the definition of “wealth” thus creates additional uncertainty.

Even more problematic is the test’s ambiguity regarding the extent to which the firm’s capital structure is incorporated in the wealth assessment. That is, the opinion does not resolve the level of abstraction at which the “wealth creating capacity” is judged. A firm’s capital structure may affect its ability to pursue various strategies. Access to capital may require incurring transaction costs that vary depending on the firm’s current capital structure.

Consider, for example, a creditor’s opportunity to extract a payment from a debtor in exchange for waiving a default under a financial covenant, discussed above.<sup>95</sup> Outcomes involving those payments raise difficult questions concerning how one determines the return to the relevant constituencies from various strategies. If a nearly insolvent firm pays a creditor in exchange for not accelerating below-market rate indebtedness, that payment could be considered a cost, in which case those strategies that include outcomes involving such payments would have to reflect the amount of the payment as a cost. In the alternative, such a payment could merely be a redistribution among relevant stakeholders, in which case the payment would not be considered to be a cost.<sup>96</sup>

The *Credit Lyonnais* court created a variation in the fiduciary duties arising from financial distress to protect the interests of creditors such as these lenders. These creditors are members of the “community of interest that sustained the corporation.”<sup>97</sup> The language of the opinion addressing this fiduciary duty provides no basis for stating that certain returns to these creditors (or other members of the relevant community) are part of the corporation’s relevant “wealth creating capacity,” but other returns, such as payments made in exchange for a lender not accelerating outstanding debt, are not.

The “community of interest that sustained the corporation” will extend beyond those creditors under obligations for money borrowed. For example, amounts that one normally views as costs to a solvent firm arising from raising capital, such as accounting fees, are payable to persons who provide ongoing services to the corporation and who may have ex-

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<sup>95</sup> See *supra* notes 18-32 and accompanying text.

<sup>96</sup> Cf. Lynn M. LoPucki & William C. Whitford, *Compensating Unsecured Creditors for Extraordinary Bankruptcy Reorganization Risks*, 72 WASH. U. L.Q. 1133, 1144 (1994) (proposing that bankrupt firms expressly be required to adopt the investment strategy “that maximizes the company value, regardless of its distributional effects”).

<sup>97</sup> *Credit Lyonnais* involved a shareholder’s challenge to the management of the corporation under a “Corporate Governance Agreement,” which was executed at the instigation of a commercial bank as part of the corporation’s receiving additional credit. *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215, at \*3 (Del. Ch. Dec. 30, 1991). The agreement abrogated the typical governance structure of the debtor, divesting a controlling shareholder of certain power. See *id.* at \*3, \*32.

tended trade credit. A significant portion of the "direct costs" of a corporation's bankruptcy may well be paid to members of the "community of interest that sustained the corporation," such as accountants. To the extent that *Credit Lyonnais* requires directors of a nearly insolvent firm to accord a positive value to an outcome in which the corporation becomes a vehicle for generating fees to creditors, directors would be required to adjust substantially the manner in which the return to a firm is determined.

The alternative approach would require a nearly insolvent corporation's directors to consider various corporate strategies without reference to distributions to third parties, i.e., "costs," created by the firm's specific capital structure and capitalization. That viewpoint would be consistent with the view of the firm expressed by Modigliani and Miller.<sup>98</sup> Although such an approach would facilitate judicial review, by diminishing the dimensions of the decisions that a court would have to review, it also is unsatisfactory.

*Credit Lyonnais* creates a legal rule applicable to firms likely to become insolvent. Any material cost associated with bankruptcy cannot be ignored in articulating a rule that addresses the rights of competing claimants in firms with significantly higher than normal likelihoods of becoming insolvent.

Thus, these developments in corporation law impose an amorphous standard. Whether these duties apply to a particular set of directors, i.e., whether a corporation is "in the vicinity of insolvency," will not necessarily be clear. The extent to which payments to non-shareholder constituencies should be considered as "costs" cannot be determined.

Of course, the law frequently creates vague standards. One reason for creating vague standards is to deter undesirable conduct.<sup>99</sup> However, inherent in such a rationale is that there is no cause of action where one is, in fact, deterred. If *Credit Lyonnais* creates an affirmatively enforceable duty, directors who attempt to follow its dictates when deciding among

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<sup>98</sup> Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 268 (1958) ("[T]he market value of any firm is independent of its capital structure and is given by capitalizing its expected return at the rate . . . appropriate to its class."); cf. Jackson & Kronman, *supra* note 26, at 1154-55 (applying the concept articulated by Modigliani and Miller to argue that absent monitoring costs, the benefit gained by a debtor arising from a reduced interest rate paid to secured creditors should exactly offset the increase that other creditors would charge arising from the granting of a security interest to another creditor). The Modigliani and Miller thesis has gained "general acceptance." Rasmussen, *Ex Ante Effects*, *supra* note 1, at 1166. Perhaps a more practically oriented view, derived disregarding the firm's capital structure, would be that a capitalized expected value of the firm's returns forms an upper bound on the firm's value, although various capital structures may impose material costs, e.g., agency costs, that decrease the value of the enterprise as a whole by adversely affecting the returns estimated without reference to those costs.

<sup>99</sup> See, e.g., Niels B. Schaumann, *The Lender as Unconventional Fiduciary*, 23 SETON HALL L. REV. 21, 31, 45 (1992) (stating that the scope of conduct prohibited by fiduciary duties is vague, to induce fiduciaries to act conservatively).



alternative strategies, but fail to predict accurately when a court will determine that a corporation is “operating in the vicinity of insolvency,” will necessarily be subject to liability. If the directors incorrectly believe the corporation is not “in the vicinity of insolvency,” the directors will promote the shareholders’ interest and be subject to liability in an action brought by creditors.<sup>100</sup> If they instead gravitate to promoting the interests of creditors and the corporation is not “in the vicinity of insolvency,” directors will be subject to liability to the shareholders. If *Credit Lyonnais* creates an affirmatively enforceable standard, directors have to be precisely correct in determining whether the standard is met. This legal framework imposes extraordinarily powerful economic incentives that can be expected to affect significantly the actions of managers of nearly insolvent firms, and perhaps precipitate managerial defections, to the detriment of distressed firms.<sup>101</sup>

The burden on firms operating in the vicinity of insolvency in that context would be increased by the possibility that outside professionals, such as investment banks, that facilitate consummation of transactions approved by boards of directors also may be subject to liability. An investment bank that provides substantial assistance in the consummation of a transaction that the investment bank knows or should know to be in violation of a board’s fiduciary duty aids or abets the board’s primary violation and thus will be liable to the beneficiary of the duty.<sup>102</sup> The cost of that risk ultimately will be reflected in fees paid to such professionals by firms operating in the vicinity of insolvency.

*Unenforceability of a Waiver of the Duty.* The impact of these incentives could be diminished, if a corporation were able to release its directors from these obligations. However, current law is ambiguous as to whether the duties of a director to promote the interests of a specified constituency can be released by contract. The fiduciary duty of loyalty requires that directors of solvent corporations promote the interests of the shareholders. The shifting duties contemplated by *Credit Lyonnais* represent refinements of those duties of loyalty. Under corporation law, duties

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<sup>100</sup> It may be that personal liability to creditors would only arise where the debtor ultimately became insolvent, due to intricacies of the law of derivative actions. This technical issue moderates the potential personal liability of directors to a level insufficient to have any material effect on the undesirable features and consequences of this rule.

<sup>101</sup> Cf. Stilson, *supra* note 55, at 61. Additional evidence of the negative effect on the value of a firm operating in the vicinity of insolvency arising from increasing the liability risks of directors of the firm is provided by Brook and Rao. They found a positive reaction in the price of the stock of poorly performing corporations adopting provisions limiting the liability of officers or directors, but they found no such reaction for all firms as a whole. See Yaron Brook & Ramesh K. S. Rao, *Shareholder Wealth Effects of Directors’ Liability Provisions*, 29 J. FIN. & QUANTITATIVE ANALYSIS 481, 481 (1994).

<sup>102</sup> See *Brandt v. Hicks, Muse & Co. (In re Healthco Int’l, Inc.)*, 195 B.R. 971, 986 (Bankr. D. Mass. 1996).

of loyalty typically cannot be altered by contract, in the sense that a director cannot be relieved of his duty to promote those interests that are protected by the duty of loyalty.<sup>103</sup> The law in Delaware on this matter seems rather clear:

[A corporation's] certificate of incorporation may also contain any or all of the following matters: . . . (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders . . .<sup>104</sup>

Moreover, a court has narrowly construed this provision, holding that it does not permit elimination of liability that would be owed by persons other than directors, i.e., those aiding or abetting a violation.<sup>105</sup>

Stilson analyzes the issue by referring to the law pertaining to limited liability companies. She notes that duties of loyalty owed to Delaware limited liability companies and limited partnerships can be waived.<sup>106</sup> There is no obvious reason for treating limited liability companies and corporations differently in this context. Nevertheless, Delaware law does not appear to permit a corporation to waive the right to pursue a director for a breach of the duty of loyalty.<sup>107</sup> The absence of a clear rationale for the distinction does not provide a basis for disregarding the language of controlling a statute.<sup>108</sup>

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<sup>103</sup> See DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1996) (providing that a corporate charter cannot relieve a director from liability for breaches of a duty of loyalty); FOLK, *supra* note 10, § 102.14; Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 250 (1995).

However, Moskowitz and Effross have written: "In 1989, however, a Delaware Chancery Court implied that a corporation might amend its certificate of incorporation to eliminate or limit directorial liability when a breach of the duty of loyalty occurs, in contrast to section 102(b)(7) of the Delaware Code." Theodore D. Moskowitz & Walter A. Effross, *Turning Back the Tide of Director and Officer Liability*, 23 SETON HALL L. REV. 897, 916 (1993). For this proposition, they cite *Siegmán v. Tri-Star Pictures, Inc.*, Civil Action No. 9477, 1989 Del. Ch. LEXIS 56, at \*26-\*27 (Del. Ch. May 30, 1989), *claims dismissed in part*, 1990 Del. Ch. LEXIS 80 (Del. Ch. June 14, 1990), *aff'd in pertinent part and rev'd in part*, 634 A.2d 319 (Del. 1993). A portion of the case cited by Moskowitz and Effross is in conflict with the conclusion that they draw: "Thus, at least one scenario (and perhaps others) could plausibly be constructed where Article Six would eliminate or would limit the liability of Tri-Star directors for breach of their fiduciary duty of loyalty—a result proscribed by § 102(b)(7)." *Siegmán*, 1989 Del. Ch. LEXIS 56, at \*26.

<sup>104</sup> DEL. CODE ANN. tit. 8, § 102(b) (Supp. 1996).

<sup>105</sup> In *Brandt v. Hicks, Muse & Co. (In re Healthco Int'l, Inc.)*, 208 B.R. 288, 308-09 (Bankr. D. Mass. 1997), the court stated, "The statute's exemption from liability for lack of care extends only to directors. Section 102(b)(7) [of the Delaware General Corporation Law] purports to grant no protection to third parties who aid and abet directors in the violation of their obligations of either care or loyalty."

<sup>106</sup> See Stilson, *supra* note 55, at 7.

<sup>107</sup> See DEL. CODE ANN. tit. 8, § 102(b)(7)(i) (Supp. 1996).

<sup>108</sup> Even if one were to decide to disregard the terms of the statutes, in an attempt to harmonize the provisions applicable to limited liability companies and corporations, this goal provides no basis for determining which of the two statutory provisions should be disregarded. One could argue with

A more forceful argument is that the duties owed to creditors upon insolvency contemplated by *Credit Lyonnais* present a situation similar to those involving conflicting claims between two classes of stock. A line of cases involving multiple classes of stock holds that management can take actions to the detriment of the holders of preferred stock, to the extent that the preferred stock has provisions that address in general terms the type of transaction being taken but do not expressly prevent the consummation of the particular transaction formulated by the directors. Typical in this line of cases are *HB Korenvaes Investments, L.P. v. Marriott Corp.*<sup>109</sup> and *Moore Business Forms, Inc. v. Cordant Holdings Corp.*<sup>110</sup> Those cases uphold certain contractual provisions that modify fiduciary duties. One could thus argue that the duties to creditors contemplated by *Credit Lyonnais* present a similar circumstance involving multiple classes of claimants having diverse, conflicting interests and, therefore, a contractual resolution of these conflicting interests should be enforceable in both types of cases.

Furthermore, those cases address circumstances in which the duty being extinguished resulted in granting directors greater freedom to promote the interests of shareholders (both cases involved conflicts between holders of common stock and preferred stock, in which the holders of preferred stock were unsuccessful). Similarly, one could view a waiver of the fiduciary duties to creditors as extinguishing a duty that derogates from the

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equal force that it makes no sense to permit fiduciary duties owed to limited liability companies to be waived, so a waiver of duties of loyalty to limited liability companies should not be enforceable.

<sup>109</sup> Civil Action No. 12922, 1993 Del. Ch. LEXIS 90 (Del. Ch. June 9, 1993). *HB Korenvaes Investments, L.P. v. Marriott Corp.* involved a strategic corporate restructuring—splitting a single corporation, Marriott Corporation, into two separate, publicly-held corporations—that adversely affected the value of the preferred stock. The split was to be effected by conveying a majority of the corporation's cash-generating assets to a wholly owned subsidiary of the issuer and distributing the stock of that new subsidiary to the current common shareholders of the corporation. *See id.* at \*3.

The preferred was entitled to 8.25% cumulative dividends and was convertible, at the option of the holder, into common stock. Marriott announced that it would suspend paying dividends on the preferred stock after consummation of the distribution, and that dividends would initially be payable on the distributed stock in an amount equal to the then-current dividends on Marriott's common stock. The court, assuming that the transaction was for the benefit of the common stock only, held that the transaction did not violate the fiduciary duty owed to preferred stockholders, on the basis that the preferential rights of the preferred stockholders were limited to the express anti-dilution protection. *See id.* at \*18-\*21.

<sup>110</sup> Civil Action No. 13911, 1995 Del. Ch. LEXIS 134 (Nov. 2, 1995), *claims dismissed again*, 1996 Del. Ch. LEXIS 61 (Del. Ch. May 15, 1996). In this case, the issuer had outstanding a class of preferred stock, callable at the option of the issuer, upon the occurrence of certain events, at a price per share equal to the appraised per share value of the common stock. The call price was to be determined through an appraisal by a "big eight" accounting firm. The complaint alleged that the issuer "improperly selected [the accounting firm] to value the Preferred Stock, . . . unfairly excluded [the plaintiff] from participating in the valuation process; and . . . as a result, improperly selected a flawed valuation methodology that grossly undervalued the Preferred Stock." *Id.* at \*12.

The court held that the fiduciary duties owed to holders of preferred stock did not extend to this circumstance. *See id.* at \*18. The rights in question were contractual, and the plaintiff could not prevail by asserting that the defendant's actions violated alternative fiduciary duties owed to the plaintiff. *See id.*

general principle that fiduciary duties are owed to shareholders. Thus, this line of cases may support the enforceability of a waiver of the duties created by *Credit Lyonnais*.

The process of dealing with creditors probably makes it impracticable for a corporation to waive these duties were the corporation required to document the waiver with each creditor. Because directors' personal assets are at risk under the duty, essentially *all*, and not merely most, creditors must be bound by a waiver, if such a waiver were to release directors from the harsh consequences of the duty. The relative scale of business corporations' and individuals' assets means that frequently there is a size of claim against the corporation that will be immaterial to the corporation that nevertheless would be very material to a director required personally to discharge the claim. Additionally, waiver of these rights other than through a single act that bound all creditors (e.g., a waiver executed individually with each creditor) often could not give the directors an assurance that all claims had been waived. The transaction costs to confirm on an ongoing basis that all creditors had signed a waiver frequently would be prohibitive.

The natural method by which a corporation could attempt to create a single waiver binding all creditors would be through adopting a charter provision. Shareholders could argue that this provision should be enforceable, just as a shareholder takes subject to senior rights of preferred stock, as long as the stock certificate references that the charter provides for the relative rights of classes of stock.<sup>111</sup> The express terms of the seniority need not be delivered to the shareholder, absent an express request.<sup>112</sup>

Creditors could argue that such a provision would not be sufficient to deprive them of important rights granted by law. Creditors typically need not review a corporate charter to determine whether their rights are subordinated. Thus, for example, creditors could powerfully argue that permitting the fiduciary duty owed to creditors to be waived in a charter would be similar to permitting a corporate charter to subordinate some of a corporation's debt, which would be of substantially questionable enforceability.<sup>113</sup>

Additionally, if a charter provision could waive the duties to creditors of distressed corporations, the same theory would permit a corpo-

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<sup>111</sup> See DEL. CODE ANN. tit. 8, § 151(f) (1991).

<sup>112</sup> See *id.*

<sup>113</sup> Cf. *In re Bicoastal Corp.*, 600 A.2d 343, 350 (Del. 1991) (stating that "[a] certificate of incorporation is viewed as a contract among shareholders," which reference does not include creditors as parties); cf. also *Searle v. Mechanics' Loan & Trust Co.*, 249 F. 942, 945 (9th Cir. 1918) (noting that a subordination agreement signed by approximately 90% of a distressed corporation's creditors did not bind creditors who did not sign the agreement); *In re Geo. P. Schinzel & Son, Inc.*, 16 F.2d 289, 289 (S.D.N.Y. 1926) (indicating that an agreement in which some creditors of a distressed corporation agreed to subordinate their claims to future creditors did not bind creditors who did not sign the agreement).

ration to waive in its charter the duties of directors to creditors upon the corporation's insolvency. A partial waiver of liability that otherwise would arise under the trust fund doctrine may be permitted.<sup>114</sup> However, enforceability of the entire abrogation of the duties of directors to act on behalf of creditors upon insolvency would seem to be the logical, inexorable extension of enforcing a corporate charter provision waiving the duties to creditors upon a firm becoming distressed. But that legal result is substantially suspect.

*Insurance.* Although there are plausible arguments on both sides of the issue, it would seem more likely that the duties of loyalty owed by directors of corporations operating in the vicinity of insolvency cannot be waived. One might argue that the potential for personal liability of directors will not affect the decisionmaking process, because directors will merely insure this risk. For a variety of reasons, this possibility does not mitigate the undesirable consequences of *Credit Lyonnais*. Coverage under directors and officers' insurance usually excludes claims brought by or on behalf of the corporation itself.<sup>115</sup> A lawsuit by creditors or a creditors' committee against directors and officers for breach of the fiduciary duty created by *Credit Lyonnais* consequently may not be covered by such insurance policies.<sup>116</sup> Moreover, insurance policies may not be enforceable to the extent that they purport to eliminate liability for a breach of a duty of loyalty.<sup>117</sup> Thus, without considering deductibles and policy limits, directors cannot obtain assurance that they will not be subject to personal liability for a breach of this duty.

Based on a study published in 1991, Kraakman, Park and Shavell assert that because shareholder lawsuits are generally settled before a trial,

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<sup>114</sup> See *Murphy v. Panton*, 165 P. 1074, 1077-78 (Wash. 1917) (holding that a release under a subscription agreement of one who had subscribed to purchase stock did not eliminate liability of the subscriber under the trust fund doctrine to a creditor, because the creditor extended credit to the debtor from time to time, even though no credit was outstanding as of the time the subscription agreement was canceled).

<sup>115</sup> See Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573, 604-06 (1996). This exclusion typically does exclude from coverage claims arising from shareholder derivative actions. See *id.* at 604.

<sup>116</sup> See *Reliance Ins. Co. v. Weis*, 148 B.R. 575, 583 (E.D. Mo. 1992) (holding that a lawsuit filed by a plan committee of a debtor liquidated under Chapter 11 against the debtor's former management alleging breach of fiduciary duty and negligence asserted a claim excluded by such a policy provision), *aff'd in part*, 5 F.3d 532 (8th Cir. 1993).

<sup>117</sup> See Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1745 n.33 (1994). However, prior holdings to this effect might not be applicable where the duty breached involves violating the duty of loyalty as expanded in *Credit Lyonnais*. The traditional cause of action alleging a breach of a fiduciary duty of loyalty concerns directors promoting their personal interests, at the expense of the shareholders. Because the duty created by *Credit Lyonnais* may be violated without causing personal benefit to flow to the fiduciaries, a court might find that insurance covering a breach of the duty in the type of circumstances contemplated by *Credit Lyonnais* does not violate public policy.

the fact that insurance policies are unenforceable to the extent they insure against breaches of duties of loyalty does not prevent payments being made.<sup>118</sup> Based on the typical outcomes in shareholder litigation, one might speculate that directors may be able to obtain a high degree of confidence that they will not be subject to personal liability, as insurance companies will settle most cases, obviating the concern about the enforceability of their insurance policies. But, for a variety of reasons, this experience in the context of shareholder suits is not directly applicable lawsuits to be brought in the future by creditors alleging a violation of the duty created in *Credit Lyonnais*.

Lawsuits by creditors alleging a breach of the *Credit Lyonnais* duty are less likely to be settled. Ownership of creditors' claims is more likely to be concentrated than ownership of stock.<sup>119</sup> The creditors therefore generally will have a greater personal interest in a lawsuit alleging violation of the duties created in *Credit Lyonnais* than shareholders have in a typical shareholder derivative action. A quick settlement controlled by lawyers to assure payment of a significant legal fee for minimal work is less likely. Moreover, creditors generally will bring such lawsuits when the debtor ultimately becomes insolvent. The marginal cost to the creditors of litigating the issue will be reduced, as the creditors will already have counsel involved in the bankruptcy proceedings. These circumstances make it less likely that plaintiffs will be willing to accept significant reductions in the amount to be received from directors or their insurers in the context of a lawsuit alleging a violation of the duty created in *Credit Lyonnais*. Settlements are therefore less likely to be achieved.

Even if Kraakman, Park and Shavell's analysis were applicable to lawsuits alleging violation of this duty, one would expect that insurance for directors of nearly insolvent firms ultimately would become prohibitively expensive. Insurance companies would realize the high likelihood that directors of such firms would not follow the requirements of the nebulous standard created by *Credit Lyonnais*. Insurance against a risk so likely to be realized necessarily would be expensive.

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<sup>118</sup> See *id.* (citing Roberta Romano, *The Shareholder Suit: Litigation Without Foundation*, 7 J.L. ECON. & ORG. 55, 84 (1991)). Yet recently, insurers have endeavored to remedy this problem, by providing in directors and officers insurance policies that the parties agree to use their best efforts to negotiate a reasonable allocation of amounts, where a claim presents matters that are covered by insurance only in part. See Monteleone & Conca, *supra* note 115, at 618. Most recently, some insurers have issued policies that provide for a pre-determined allocation of responsibility in certain claims arising from the sale of securities. See *id.* at 618-20.

<sup>119</sup> Cf. Andrew L. Bab, Note, *Debt Tender Offer Techniques and the Problem of Coercion*, 91 COLUM. L. REV. 846, 882 (1991) (indicating that ownership of most classes of non-investment grade bonds is spread among 15 to 30 holders).

## F. *Conclusions*

This Part argues that *Credit Lyonnais*, as interpreted by *In re Buckhead America Corp.*<sup>120</sup> and *In re Shultz*,<sup>121</sup> creates potential liability for directors of distressed corporations that can be very substantial. This potential liability, of course, can only affect the actions of individuals aware of the potential liability. These developments in corporation law are recent; to date, only a few cases have been found involving attempts to assert fully violations of the duties articulated in *Credit Lyonnais*. But as more creditors realize the full implications of these duties and more cases involving these duties are litigated, the potential liability will become more apparent to directors.

Over time, the incentives created by these duties are capable of overwhelming any incentives presented to directors of distressed, solvent corporations by the potential application of federal bankruptcy law upon any subsequent insolvency. *Credit Lyonnais* creates a rule imposing *personal* liability on directors. Incentives creating the possibility of personal liability are more likely to govern directors' actions than federal bankruptcy law's allocation of corporate assets between various claimants. Even the possibility of voiding payments to insiders as preferences<sup>122</sup> cannot be anticipated to create incentives as important as those created by *Credit Lyonnais*.

This Part further argues that the incentive scheme imposed by *Credit Lyonnais* is extraordinarily vague, creating a risk of personal liability that cannot be eliminated by "erring on the side of caution." Attempts to relieve directors from these liabilities, by contract or through insurance, are unlikely to be effective. Even if customary insurance policies were revised to cover these losses and the policies were found to be enforceable (or payments otherwise were made by the insurer), the high likelihood of a claim being made would make the insurance prohibitively expensive.

These developments in corporation law also may subject investment banks (or other professionals) assisting distressed firms to liability for failure to comply with an amorphous standard. It will be difficult for such an investment bank plausibly to deny knowledge of the firm's financial condition, eliminating the defense otherwise most likely to be available. Imposing a risk of liability on investment banks is not without cost to distressed firms. The natural consequences will be increased costs borne by distressed firms and diminished access to necessary assistance, both of which are likely to increase the likelihood of ultimate insolvency.

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<sup>120</sup> Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (*In re Buckhead Am. Corp.*), 178 B.R. 956, 968 (D. Del. 1994).

<sup>121</sup> Miramar Resources, Inc. v. Shultz (*In re Shultz*), 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997).

<sup>122</sup> See 11 U.S.C. § 547(b) (1994).

## V. COSTS OF INSOLVENCY AND IMPACT ON TRADE CREDITORS

*Credit Lyonnais* announced a legal rule that affects management decisions governing distressed corporations. That rule, to the extent that it is followed, will cause the managers of these corporations to adopt policies that affect the probability that the firms will become insolvent. For example, managers of a distressed corporation cannot, under *Credit Lyonnais*, adopt a strategy that contemplates (i) providing a reasonable, but not unusually high, long-term wealth creating capacity and (ii) maximizing the short-term cash flow (thereby minimizing the likelihood of bankruptcy proceedings), where an alternative strategy has significantly higher expected long-term wealth creating capacity, with a trade-off of a higher likelihood of insolvency.

It is curious that such a legal rule has been adopted in the name of increasing the efficiency of corporation law. The legal rule regulates sophisticated commercial actors. Whenever a legal rule is adopted in the pursuit of increased economic efficiency, revising the legal relationship created among economic actors who have the opportunity to negotiate the terms of their relationship, it is natural to inquire as to the reasons why those actors did not themselves contractually adopt the legal rule that a court imposes. If this relationship is more efficient, why did these actors not contract for it themselves?<sup>123</sup> A court's imposition of such duties on sophisticated<sup>124</sup> actors suggests that the putative increase in efficiency may be ephemeral and is worthy of scrutiny.

One customary justification for creating a particular legal rule in a commercial context is that the legal rule is one that most parties would adopt.<sup>125</sup> But that justification depends on permitting others in circumstances that make the default choice inefficient to vary from the choice otherwise provided by law. This Part argues that the standard announced in *Credit Lyonnais* cannot be defended on that basis.

Understanding the efficiency of these developments in corporation

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<sup>123</sup> See Van Der Weide, *supra* note 17, at 84-85 ("If corporations could efficiently make managers fiduciaries for all stakeholders, presumably corporations would do so in exchange for cheaper labor, supplies, and debt."). *But cf.* Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 669-70 (1998) (arguing that a status quo bias may cause inefficient types of contractual relationships to persist). Rasmussen makes a similar argument in connection with various proposals to change the contours of federal bankruptcy law. His argument is that debtors should be given the ability to specify contractually which of a number of possible bankruptcy regimes should apply to the debtor if the debtor becomes insolvent. See Rasmussen, *Ex Ante Effects*, *supra* note 1, at 1210.

<sup>124</sup> The rule was applied in the context of a large commercial corporation. Of course, very small businesses managed by unsophisticated individuals can be incorporated under general incorporation statutes.

<sup>125</sup> See, e.g., Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 (1983); Korobkin, *supra* note 123, at 613-14.



law requires an understanding of the economic consequences of bankruptcy. Part V.A examines the costs associated with a corporation becoming insolvent. Various circumstances may cause a corporation's bankruptcy to have a disparate impact on classes of creditors having the same priority. Part V.B analyzes those differential impacts within classes of creditors. Part V.C then argues that the rule of *Credit Lyonnais* favors those classes of creditors that can vary the choice by contract at the expense of the interests of classes of creditors who cannot as easily vary the choice by contract. Thus, the rule of *Credit Lyonnais* conflicts with the traditional rationale for selecting a default rule of commercial law.

### A. *Costs of Insolvency*

As discussed above,<sup>126</sup> *Credit Lyonnais* does not identify those expenditures that should be viewed as "costs." Following the traditional convention that all payments made by the corporation to its creditors, and profits lost, are considered costs, the total cost incurred by a firm by virtue of becoming insolvent is difficult to quantify. Among the most easily quantified costs are the legal fees and other professional and administrative fees associated with any bankruptcy proceeding (whether in liquidation or in reorganization), referenced as "direct costs" of the proceeding.<sup>127</sup> One study of exchange-listed firms estimated those direct costs represent, on average, 20.6% of the market value of the equity or 3.1% of the book value of debt plus the market value of equity, or 2.8% of the book value of total assets.<sup>128</sup> But the vast majority of bankruptcy proceedings do not involve exchange-listed firms.<sup>129</sup> For these smaller firms, the direct costs may be more significant. Whitford indicates, "In cases involving smaller

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<sup>126</sup> See *supra* notes 95-98 and accompanying text.

<sup>127</sup> See Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067, 1067 (1984); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 288 (1990).

<sup>128</sup> See Weiss, *supra* note 127, at 289, 291 (discussing a sample that included 31 firms, a majority of which were reorganized). Another study found direct costs of bankruptcy to be six percent of the total value of the firm just prior to bankruptcy (computed based on the aggregate value of the firm's outstanding equity, debt and capitalized leases), in a sample of 12 retailers and 7 industrial firms. See Altman, *supra* note 127, at 1074 tbl.I, 1075 tbl.II, 1077. Altman does not clearly identify the extent to which these firms were liquidated or reorganized. See generally Karen Hopper Wruck, *Financial Distress, Reorganization, and Organizational Efficiency*, 27 J. FIN. ECON. 419, 436-39 (1990) (collecting a variety of estimates of direct and indirect costs).

<sup>129</sup> It has been estimated that 30% of the Chapter 11 cases involve corporations, and the vast majority of cases involving corporations do not involve publicly held firms. See Samuel L. Bufford, *What Is Right About Bankruptcy Law and Wrong About Its Critics*, 72 WASH. U. L.Q. 829, 832 (1994). Warren and Westbrook indicate that only .17% of business bankruptcy filings in a recent year were made by public companies. Elizabeth Warren & Jay Lawrence Westbrook, *Searching for Reorganization Realities*, 72 WASH. U. L.Q. 1257, 1276 n.37 (1994). Bradley and Rosenzweig find that from 1980 to 1989, only 162 firms listed on either the New York Stock Exchange or the American Stock Exchange filed Chapter 11 petitions. Bradley & Rosenzweig, *supra* note 1, at 1059.

corporations, direct costs commonly represent a sizeable percentage of the bankruptcy estate."<sup>130</sup>

Other costs of bankruptcy, "indirect costs," are more difficult to quantify.<sup>131</sup> Operating costs of the firm increase when the firm approaches insolvency.<sup>132</sup> Whitford asserts that management becomes paralyzed during reorganization proceedings, which "is likely to be a major source of indirect bankruptcy costs."<sup>133</sup> Problems arising from the firm's insolvency distract management from their pursuit of other, productive activities.<sup>134</sup> Similarly, customers who seek assurance of performance under long-term obligations, such as warranties, may decline to do business with a firm in a precarious financial position, decreasing the revenues of such a firm.<sup>135</sup> Altman estimated indirect costs of bankruptcy arising from decreased sales in the years preceding the bankruptcy filing as 10.5% of the firm value (the firm value computed as of the year of the bankruptcy filing), as compared to an estimate of direct costs of bankruptcy of 6.2% of the firm value.<sup>136</sup> These indirect costs are thus significant.

A final element of the costs of bankruptcy consists of the costs arising from the liquidation of the firm. A fundamental assumption underlying the structure of Chapter 11 is some bankrupt firms are worth more as a going concern than the value that would be realized in a forced sale.<sup>137</sup>

<sup>130</sup> William C. Whitford, *What's Right About Chapter 11*, 72 WASH. U. L.Q. 1379, 1381 (1994).

<sup>131</sup> One commentator analyzed the change in value of Federated Department Stores during its bankruptcy proceedings to show that bankruptcy proceedings need not impose excessive costs. See Steven N. Kaplan, *Federated's Acquisition and Bankruptcy: Lessons and Implications*, 72 WASH. U. L.Q. 1103, 1104 (1994). Although for some firms, that the firm is in a bankruptcy proceeding may cause the firm to adopt beneficial cost-cutting or other strategies that would not have been adopted had the firm not entered insolvency proceedings, for other firms these proceedings may just be a distraction that prevents fulfillment of goals that would produce a greater return.

<sup>132</sup> See Jensen & Meckling, *supra* note 9, at 341.

<sup>133</sup> Whitford, *supra* note 130, at 1385.

<sup>134</sup> See Altman, *supra* note 127, at 1070-71.

<sup>135</sup> See *id.* at 1071; Jensen & Meckling, *supra* note 9, at 341-42.

<sup>136</sup> Altman, *supra* note 127, at 1073, 1078. See generally Michelle J. White, *Bankruptcy Costs and the New Bankruptcy Code*, 38 J. FIN. 477, 485 (1983) (providing an estimate of the upper bound of costs "due to firms making inefficient decisions vis-a-vis continuing, reorganizing or liquidating").

<sup>137</sup> See, e.g., Jagdeep S. Bhandari & Lawrence A. Weiss, *The Untenable Case for Chapter 11: A Review of the Evidence*, 67 AM. BANKR. L.J. 131, 133 (1993); Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1689 (1996). See generally *Associates Commercial Corp. v. Rash*, 117 S. Ct. 1879, 1886 & n.6 (1997) (holding that property, subject to a security interest, to be retained by the debtor in a cram down under Chapter 13, without the consent of a secured creditor, is to be valued at its replacement value, and not the value that could be realized at a foreclosure sale).

Professors Baird and Jackson have argued that the proper legal rule might require that an insolvent firm be sold. THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 209-24 (1986); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 136-45 (1986). See also Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633 (1993) (discussing mandatory auctions). Although such an approach would eliminate questions of the valuation of the firm, such a procedure will not necessarily produce the greatest return to creditors. The dissemination of credible information adequate to permit an appropriate valuation of the bankrupt may well be not feasible. See Aghion et al., *supra* note 11, at 855-57 (questioning the efficacy of such

The costs of judicial rules that make managers choose strategies that are more likely to cause corporations to become bankrupt include the costs arising from the liquidation of firms that (i) are more valuable reorganized but (ii) are liquidated as a result of a failure of negotiations.

Although an assessment of the number of such firms is difficult to generate, a sense of the potential costs can more easily be provided. The parties' actions in some circumstances provide a lower bound estimate of the excess of the costs of liquidation relative to a reorganization. One manifestation of these costs is the extent to which there are positive deviations in the payments, among creditors having the same priority, to those creditors, such as trade creditors, whose satisfaction with the proceedings is necessary to permit a reorganization to proceed.<sup>138</sup> Similarly, some amounts are paid to shareholders that are necessary to facilitate a reorganization, in lieu of a liquidation, when more senior claimants are not paid in full.<sup>139</sup> To the extent that a group of creditors or holders of other interests, whose ongoing participation is necessary for a successful reorganization, receives in a bankruptcy reorganization an amount greater than the group would receive were distributions made in strict accord with priority rules, those amounts, aggregated for each firm, represent an amount *less than a lower bound* on the parties' assessment of the differential in the value of the firm on a going concern basis and the value of the firm were it liquidated.<sup>140</sup> That is, these aggregate amounts represent less than the creditors'

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a rule); LoPucki & Whitford, *Corporate Governance*, *supra* note 1, at 759 n.289. Roe questioned the efficacy of an auction of the entire firm, where the firm was large, on the basis that "[o]nly a few firms may be able to absorb entire operations of a large enterprise." Roe, *supra* note 61, at 573. Easterbrook has further questioned the efficiency of a mandatory auction, on the basis that the persistence of legal rules in the United States that do not mandate such an auction supports the conclusion that the current legal rules are efficient. Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 413 (1990). Part I notes that the Winner's Curse, coupled with the ability of the senior claimant to make a bid in excess of the amount of the value of its claim, without adverse economic impact, make some sales structured in certain fashions unlikely to realize the actual value of the firm. See *supra* note 12.

<sup>138</sup> Cf. Brian L. Betker, *An Empirical Examination of Prepackaged Bankruptcy*, FIN. MGT., Spring 1995, at 3, 5, 8 (noting that 22 out of 49 firms in a sample of firms reorganizing in a prepackaged bankruptcy obtained judicial approval to pay trade creditors in the ordinary course, and 41 of the 49 paid trade creditors in full, concluding that these payments were made to avoid costs of disruptions that otherwise would have arisen).

<sup>139</sup> See Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457, 1458, 1468 (1990) ("The length of the delay in the bankruptcy proceedings is negatively related to the proportion of the total distribution that shareholders are given in violation of the [absolute priority rule].").

<sup>140</sup> A similar analysis applies to any discrepancy in deviations from the priority rules between out-of-court reorganizations and reorganizations under Chapter 11. Franks and Torous argue that differences in deviations from the priority rules between formal and informal reorganizations represent a lower bound on the decrease in the value of the firm attributable to the proceedings avoided. Julian R. Franks & Walter N. Torous, *A Comparison of Financial Recontracting in Distressed Exchanges and Chapter 11 Reorganizations*, 35 J. FIN. ECON. 349, 350 (1994). However, they do not discuss the extent to which this amount in fact represents only a fraction of a lower bound. See generally Lucian

assessments of the excess of the direct and indirect costs of liquidation over the direct and indirect costs of reorganization.

An example can illustrate this point. Consider a bankrupt firm with unsecured, unsubordinated creditors consisting of a bank, representing 75% of the claims in bankruptcy, and trade creditors, representing 25% of the claims in bankruptcy. Assume that the property distributed in a reorganization has an aggregate value of \$800, of which the bank receives 65% and the trade creditors receive 35%. That is, the trade creditors get ten percentage points, or \$80, more than their pro rata portion of the property distributed. If the bank is to agree to this distribution, the bank must believe that it is better off in this circumstance than it would be were the firm liquidated. That is, the bank must believe that were the entity liquidated, the amount realized multiplied by .75 would be less than 65% of \$800, or \$520. If the entity were liquidated and the amount realized were \$693, the bank's distribution would be  $\$693 \times .75$ , or \$520. Thus, we can conclude that the bank's willingness to pay the trade creditors \$80 more than they would receive in liquidation means that the bank estimates that the entity, if liquidated, would yield no more than the value of the firm on a reorganized basis less \$107. Thus, the differential in values between the firm on a liquidated and a reorganized basis must be greater than the additional portion of the value of the firm distributed to the trade creditors.<sup>141</sup>

One study of reorganizations found that shareholders, on average, received 7.6% of the aggregate value of the distributions to all claimants (i.e., 7.6% of the value of the reorganized firm), over and above that which they would have received had the priority rules been followed.<sup>142</sup> As that percentage represents only a fraction of the lower bound of the differential of the value of the firm reorganized over its value on a liquidated basis,<sup>143</sup> it is clear that the costs of liquidating a firm that should be reorganized may be significant. Of course, there may be a selection bias, in that those firms in which reorganization negotiations are unsuccessful may be more likely to involve a smaller differential between liquidation value and reorganization value. Thus, the data support only the conclusion that the cost

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Arye Bechuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization*, 8 J.L. ECON. & ORG. 253, 254 (1992) (developing a sequential bargaining model of the negotiations in corporate reorganizations under Chapter 11).

<sup>141</sup> A more general derivation of this principle is provided in Appendix I.

<sup>142</sup> See *infra* notes 151-57 and accompanying text.

<sup>143</sup> For many of the firms in that study, the amount of the payments to the stockholders represents the lower bound, and not a fraction of the lower bound, because the value distributed to the stockholders was sufficiently small that the creditors would not have been paid in full, even had they retained all distributions made to the stockholders. See Eberhart et al., *supra* note 139, at 1463 tbl.II. Thus, for those firms, as used in Appendix I,  $F_{B,L}=1$ . See *infra* Appendix I.

of failed reorganization negotiations may be substantial for a particular debtor, but the amount of the cost is not now capable of precise quantification.

### B. *Differential Impact on Classes of Creditors*

The literature includes some discussion of whether solvency-related changes in fiduciary duties should benefit particular classes of constituencies. One commentator asserts that it is appropriate to treat equally banks, on the one hand, and bondholders, on the other hand.<sup>144</sup> Harvey, on the other hand, in discussing the benefits of a fiduciary duty owed to creditors, distinguished bondholders from trade or other creditors.<sup>145</sup> In his view, creditors other than bondholders have certain other protections, such as the priority for wages in bankruptcy.<sup>146</sup> Thus, he indicates, the argument in favor of extending a fiduciary duty to creditors to limit "overinvestment" is of diminished force in respect of creditors other than bondholders.<sup>147</sup> This Article also addresses different types of concerns arising from the distinctions among different types of creditors, but reaches different conclusions.

Selecting the long-term time horizon as that which directors of distressed corporations should promote may have a curious and obscure restriction on the range of corporate actions that are permissible. *Credit Lyonnais* authorizes or requires directors of distressed corporations to modify the criteria by which corporate strategies are judged. The opinion discusses high risk transactions, which may be preferred by the shareholders, as well as strategies that maximize the corporation's long-term wealth creating capacity.<sup>148</sup> But *Credit Lyonnais* does not expressly authorize the consideration of strategies that promise a greater likelihood of ongoing solvency in exchange for a diminished long-term wealth creating capacity. Yet strategies that promote a firm's ongoing solvency are significant, as LoPucki has noted that managers of nearly insolvent firms, instead of undertaking last-minute excessively risky transactions, often persistently pursue actions designed principally to maintain their firms' solvency at the expense of maximizing profits.<sup>149</sup>

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<sup>144</sup> See Roberts, *supra* note 10, at 288-89. That commentator, in discussing *Credit Lyonnais*, groups "bondholders and convertible debt or debenture holders" as creditors who have "the barest and certainly most contingent and defeasible interest in the equity or shareholdership status of the company." *Id.* at 289.

<sup>145</sup> David M.W. Harvey, *Bondholders' Rights and the Case for a Fiduciary Duty*, 65 ST. JOHN'S L. REV. 1023, 1025 n.8 (1991).

<sup>146</sup> See 11 U.S.C. § 507(a)(3) (1994).

<sup>147</sup> See Harvey, *supra* note 145, at 1025 n.8.

<sup>148</sup> See *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, Civil Action No. 12150, 1991 Del. Ch. LEXIS 215, at \*108 n.55 (Del. Ch. Dec. 30, 1991).

<sup>149</sup> Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy*

Which creditors' interests are promoted by selecting the long-term time-frame, to the exclusion of strategies that merely promote ongoing firm solvency? Are there concerns with promoting that group's interests?

One method by which one can determine the extent to which a debtor's insolvency has a differential impact on various classes of claimants involves examining the results of consensual reorganizations of corporations outside the auspices of bankruptcy proceedings. In a voluntary reorganization, negotiating differential treatment of creditors having the same priority is costly. Doing so entails assessing the relative values of different types of consideration to be distributed. No such assessment is required if each member of the same priority level receives the same type of consideration. If creditors voluntarily agree to distribute different types of consideration among claimants of the same priority, that differential treatment would indicate that the debtor's insolvency does not equally affect the different types of creditors. Such differential treatment is, in fact, common.

*Facts of Consensual Reorganizations.* When firms are reorganized in bankruptcy proceedings, as opposed to being liquidated, distributions frequently are made that either (i) provide for disproportionate payments to a subset of creditors having the same seniority or (ii) provide for payment to a class of creditors or claimants notwithstanding that a more senior class is not paid in full.<sup>150</sup> For example, one researcher found that the priority

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*System*, 1982 WIS. L. REV. 311, 338.

<sup>150</sup> An "absolute priority rule" is set forth in 11 U.S.C. § 1129(b)(2), which has been described as follows:

Except as specifically modified by statute for the period of court-supervised reorganization, a plan of reorganization may not allocate any property whatsoever to any junior class on account of their interests or claims in a debtor unless all senior classes consent, or unless such senior classes receive property equal in value to the full amount of their allowed claims or the debtor's reorganization value, whichever is less.

7 COLLIER ON BANKRUPTCY ¶ 1129.04[4][a][i], at 1129-85 (Lawrence P. King ed., 15th ed. rev. 1998). As used in this Article, the phrase "deviation from priority rules" and correlative phrases include deviations from those priority rules with the consent of holders of senior claims. Others may describe such consensual deviations as violations of the absolute priority rule, which would not be technically accurate. See generally William Beranek et al., *Much Ado About Nothing: Absolute Priority Deviations in Chapter 11*, FIN. MGMT., Autumn 1996, at 102, 103-04 (criticizing the characterization of distributions to junior creditors with the consent of senior creditors who are not paid in full as deviations from the absolute priority rule).

For purposes of computing the compliance with the absolute priority rule, a variety of factors may cause property to be valued in a fashion that does not reflect its market value. For example, selecting an unreasonably low interest rate at which to value future payment streams to be given to a secured creditor may cause a secured creditor to receive less than the amount that would be received in liquidation. See Baird, *supra* note 16, at 915. The issue of selecting a discount rate for deferred payments also arises in connection with unsecured claims. One commentator has stated:

There are few cases specifically addressing the interest rate that must be paid to yield present value for an unsecured claim. The analysis of interest rates for secured claims is generally equally applicable to unsecured claims, which would probably require a higher rate due to greater risk. A couple of cases, however, have concluded that a "market" rate analysis is not required for unsecured claims,

rules were violated in 87% of the twenty-four Chapter 11 reorganizations he studied.<sup>151</sup> Other researchers found that shareholders receive, on average, 7.6% of the total award to all claimants in reorganizations (i.e., 7.6% of the firm value) over that which they would receive were the priority rules followed.<sup>152</sup>

A firm's insolvency may have varying effects on different types of creditors within the same priority level. These variations may arise in terms of the value of the property distributed, as well as in terms of the type of property distributed. Weiss found that "[w]ithin the various classes of unsecured creditors . . . , strict priority of claims rarely holds."<sup>153</sup> A recent survey addressed the variations in the type of consideration received. In that survey of forty-five distressed firms that restructured their debt "informally," i.e., in an exchange offer for publicly listed securities outside Chapter 11, 88% of the distributions to trade debt were in cash, with the

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but merely an interest sufficient to cover inflation or a "real" interest rate, with no factor for risk or profit.

4 NORTON BANKRUPTCY LAW AND PRACTICE § 93:11, at 121 (William L. Norton, Jr., ed., 2d ed. Supp. 1997) (footnote omitted).

Treatment of holders of unsecured claims can be even more uncertain, because these claimants may receive any type of property, *see id.* § 93:11, at 93-37 to 93-38, creating an entirely different dimension of uncertainty.

On a larger scale, the assignment of a value to an entity suffers from similar uncertainty. A variety of methods may be used and, "[r]egardless . . . of the method used, the result will rarely, if ever, be without doubt or variation." 7 COLLIER ON BANKRUPTCY, *supra*, ¶ 1129.06[2][c], at 1129-170. A bankruptcy court retains significant discretion, because these valuations constitute matters of fact that will be upheld on appeal unless clearly erroneous. *See id.*

<sup>151</sup> *See* Weiss, *supra* note 127, at 294. Weiss studied 37 firms, two of which, Ronco Teleproducts and Tenna Corp., were liquidated under Chapter 7. *Id.* at 291, 308 tbl.4, 311 tbl.4. Weiss found priority rules were violated for 29 of the 37 firms. *Id.* at 299. As the priority rules were not violated in either of the liquidations under Chapter 7, *see id.* at 295 tbl.3, the priority rules were violated in 29 of the 35 cases filed under Chapter 11, or 83%. *See id.* Five of these 29 firms nevertheless were liquidated. *Id.* at 302-04 tbl.4, 307 tbl.4 (Brody, Crompton Co., Flanigan's Enterprises, Garland Corp. and Morton Shoe). Of the remaining 24 firms that filed under Chapter 11 that were not liquidated, the priority rules were not violated in the reorganizations of only three, or 13%. *See id.* at 295 tbl.3.

Beranek et al. argue that Weiss overstates the deviations from the priority rules, by categorizing as such deviations distributions to general unsecured creditors, made *pari passu* with distributions to secured creditors, in respect of the undersecured portion of secured creditors' claims. Beranek et al., *supra* note 150, at 105-06.

Professor Whitford has argued that the disparate outcomes in reorganizations may be, at least in part, a result of the fact that there may be a divergence among types of creditors in respect of the extent to which each type is a "repeat" player. William C. Whitford, Comment, 72 WASH. U. L.Q. 1027, 1028-29 (1994).

<sup>152</sup> *See* Eberhart et al., *supra* note 139, at 1458 (discussing a sample of 30 reorganizations). For purposes of calculating the amount of the deviation from the priority rules, Eberhart, Moore and Roenfeldt value securities traded on a market that are distributed in a reorganization on the basis of market prices on the respective distribution dates, to the extent available. *Id.* at 1462. However, as noted above, a bankruptcy judge has significant latitude in making required valuation decisions in a cram down under 11 U.S.C. § 1129(b) (1994). *See supra* note 150. These results therefore do not necessarily reflect the amounts of the deviations from the priority rules, if any, that would be attributed to the respective plans in judicial proceedings.

<sup>153</sup> Weiss, *supra* note 127, at 294.

remainder allocated between senior debt and equity.<sup>154</sup> For the same firms, the distributions to junior debt were 2% in cash, 11% in senior debt, 13% in junior debt, 3% in preferred stock, 67% in equity and 3% in other property.<sup>155</sup> Even for senior debt, only 29% of the distributions were in cash.<sup>156</sup> Similar results were seen in distributions in Chapter 11 reorganizations, but with each group receiving a greater percentage of distributions in cash.<sup>157</sup> Thus, trade creditors receive substantially disproportionate distributions in the form of cash.

*Additional Losses by Trade Creditors.* The cost of negotiating differential treatment between and within classes of creditors in consensual reorganizations indicates that different classes of creditors are affected differently by a debtor's bankruptcy. These facts indicate that where a debtor having trade creditors and other creditors is liquidated with the trade creditors and other creditors receiving in cash identical fractions of their claims,<sup>158</sup> the harm per dollar of claim will be greater to trade creditors than to other creditors. However, even in respect of debtors that are reorganized outside Chapter 11, evidence indicates that a portion of the value of the distressed firm's assets—a portion that otherwise would accrue to trade creditors—is diverted to third parties who profit by purchasing trade claims. A brief review of that market, and a review of the evidence of gains realized by third parties who purchase trade claims, follows.

The market for claims against debtors being reorganized under Chapter 11 has been growing in recent years,<sup>159</sup> and the topic has been increasingly important to practicing lawyers, as firms have attempted to use this market to facilitate unsolicited acquisitions of firms being reorganized under Chapter 11.<sup>160</sup> Within the market for claims against debtors being reorganized under Chapter 11, transactions in trade claims are becoming increasingly prominent.<sup>161</sup> It has been estimated that the market for these claims is over \$1 billion annually.<sup>162</sup> It should be noted, however,

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<sup>154</sup> See Franks & Torous, *supra* note 140, at 350, 356 tbl.3.

<sup>155</sup> See *id.* at 356 tbl.3.

<sup>156</sup> See *id.*

<sup>157</sup> See *id.*

<sup>158</sup> See 11 U.S.C. § 726(b) (1994) (requiring pro rata distributions among holders of each separate kind of claim).

<sup>159</sup> See Chaim J. Fortgang & Thomas Moers Mayer, *Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 2 (1990).

<sup>160</sup> See *id.* at 2-3 (citing examples).

<sup>161</sup> See Rich Wilner, *Last Six Months a Feast for Vulture Funds*, DAILY NEWS REC., Feb. 12, 1996, at 10 ("In more and more cases, vendors are taking advantage of the liquidity of their claims and selling them off to use the cash in purchasing more raw materials for their businesses.").

<sup>162</sup> See Rich Wilner, *Explosion in Trade Claims Market Is Good News, Fast Cash for Vendors*, DAILY NEWS REC., Oct. 11, 1995, at 2. The annual trading volume in distressed bank debt for 1993 was estimated at almost \$1 billion. See Stuart C. Gilson, *Investing in Distressed Situations: A Market Survey*, FIN. ANALYSTS J., Nov.-Dec. 1995, at 8. These two figures are not directly comparable, as



that the market for claims is generally limited to reorganizations (as opposed to liquidations), and even then the trading is only in the claims of firms that are reporting companies under the Securities Exchange Act of 1934.<sup>163</sup>

The available evidence, which is somewhat anecdotal as a result of the absence of data, supports the notion that large profits are available to those who purchase trade creditors' claims against bankrupt firms. Based on a review of forty-three reorganizations of large firms in Chapter 11, LoPucki and Whitford argue that the original public securityholders and trade creditors do not benefit from deviations from the priority rules. Rather, they indicate that profits are extracted by third parties who purchase those claims.<sup>164</sup> Returns of twenty-five percent to those who purchase trade claims for a typical holding period of six months are the norm.<sup>165</sup> Tilton and Lewis note the following examples of such trading in claims:

For example, in *In re Revere Copper and Brass Inc.*, Phoenix Capital Corp. purchased 28 trade claims against the debtor for approximately 20 cents on the dollar. Less than a month later, The Wall Street Journal reported that the debtor was preparing to file a plan which would pay creditors between 65 and 100 cents on the dollar. Concerned that unsophisticated creditors may not be aware of their rights and options under Chapter 11, the court provided each assignor, a 30 day option to rescind its trade.

Similarly, in the LTV case, the court refused to approve the transfer of over 400 claims purchased for 33 cents on the dollar. The court found that the purchaser failed to provide its sellers with adequate information which included that [sic] fact that the purchaser was actually a front for a company trying to acquire control of LTV Energy Products

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one appears to address the amount outstanding, whereas the other represents the amount traded within a specific period.

<sup>163</sup> See Herbert P. Minkel, Jr. & Cynthia A. Baker, *Claims and Control in Chapter 11 Cases: A Call for Neutrality*, 13 CARDOZO L. REV. 35, 44 n.32 (1991).

<sup>164</sup> LoPucki & Whitford, *Equity's Share*, *supra* note 1, at 183. However, there is evidence indicating that there are no abnormal returns to purchasers of distressed bonds. See Alan C. Eberhart & Richard J. Sweeney, *Does the Bond Market Predict Bankruptcy Settlements?*, 47 J. FIN. 943, 969 (1992). Gilson indicates that although no empirical studies have been done on the returns to those who purchase trade credit or bank claims, "the existence of profitable trading rules seem unlikely here." Gilson, *supra* note 162, at 13.

<sup>165</sup> Wilner, *supra* note 162 (stating that brokers have hurdle rates of 25% and that the claims are typically held for six months and then resold to "mutual fund operators or other investors," not clearly identifying the 25% hurdle rate as a per annum figure). Significantly, these claims are frequently resold to others, with a view to making a further profit. See also William Beranek & Steven L. Jones, *The Emerging Market for Trade Claims of Bankrupt Firms*, 23 FIN. MGMT., Summer 1994, at 78 (stating that investors in trade claims "indicated they require a return of 20% to 30%, which they believe is commensurate with the risk they bear"); Valerie Seckler, *Vultures' Wings Cast Dark Shadow in Chap. 11 Cases*, DAILY NEWS REC., Sept. 14, 1994, at 10 ("For the most part, sources said[,] vultures tend to reap handsome returns on their investments because they are big-money players with sophisticated knowledge bases, both essential traits for obtaining the windfall profits they're seeking.").

Inc. through claims purchases and that it intended to propose a 100 cent plan after acquiring the claims.<sup>166</sup>

*Reasons the Market for Trade Claims Is Not Efficient.* That unusual profits may be available to those purchasing trade claims requires that the market not be efficient. The nature of the market supports the conclusion that the market is not efficient.<sup>167</sup> One purchasing a trade claim, as an assignee of a trade creditor, takes the claim subject to all defenses the debtor has against the trade creditor, absent an agreement to the contrary.<sup>168</sup> In this regard, the purchase of trade claims raises legal issues to a greater extent than the purchase of claims arising under an extension of credit for money borrowed. For example, one purchasing a trade claim may acquire an asset subject to a defense arising out of a breach of warranty.<sup>169</sup> Such a defense generally would not arise against an assignee of right to receive payment of money borrowed.<sup>170</sup>

A typical resolution of this legal issue involves requiring the seller of a trade claim to provide warranties as to title to the claim and the absence of any defense to the claim.<sup>171</sup> A purchaser relying on the seller's warranty assumes the risk that the seller will be unable to perform its warranty obligations. Purchasers of trade claims therefore usually investigate the solvency of the sellers before agreeing to purchase claims.<sup>172</sup> Thus, relative to the market for bank debt (and other debt for money borrowed) of distressed corporations, the market for trade claims of those debtors involves additional types of risks (the potential insolvency of a seller of a claim) and additional documentation and negotiation costs. These factors distinguish the market for trade claims from the market for other claims against bankrupt corporations.

*Willingness of Trade Creditors to Sell at Low Prices.* A variety of

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<sup>166</sup> Richard N. Tilton & Kenneth M. Lewis, *Trading in Claims: The Case for a Free Market*, N.Y. L.J., Oct. 7, 1993, at 5 (footnote omitted). That a few courts have identified and attempted to provide some remedy to holders of trade claims in the most egregious cases does not imply that the judicial system limits large profits in the market as a whole to any material extent.

<sup>167</sup> See generally Bufford, *supra* note 129, at 846 ("Bankruptcy is overwhelmingly a result of imperfect markets and high transaction costs. Permitting the functioning of imperfect markets is much of what Chapter 11 is about. Virtually no market in which bankruptcy operates is a perfect market.").

<sup>168</sup> See RESTATEMENT (SECOND) OF CONTRACTS § 336 (1981).

<sup>169</sup> See *id.*; U.C.C. § 9-318 (1995); see, e.g., *First Nat'l Bank v. Master Auto Serv. Corp.*, 693 F.2d 308, 313 (4th Cir. 1982).

<sup>170</sup> Of course, there is a possibility that the transaction was part of a fraudulent conveyance. Absent fraud by the seller of the claim, determination of whether there is a possibility that there is a fraudulent conveyance defense should initially be straightforward.

<sup>171</sup> See Beranek & Jones, *supra* note 165, at 79. Similar types of warranties can nevertheless be sought in connection with the purchase of claims arising under obligations for money borrowed. Yet the provision of such representations and warranties in connection with the sale of all claims of bankrupts is not universal, and disagreements on the scope of any representations and warranties may prevent consummation of a sale where there has been an agreement on the other (i.e., financial) terms. See Fortgang & Mayer, *supra* note 159, at 18-19.

<sup>172</sup> See Beranek & Jones, *supra* note 165, at 79.

factors may contribute to the willingness of trade creditors to participate in a market in which third parties realize large profits at trade creditors' expense, including information asymmetries and other business requirements of trade creditors.

Even though, as noted above,<sup>173</sup> the market for claims against insolvent debtors is generally confined to firms that are reporting companies, trade creditors frequently lack the ability to assess accurately the value of their claims against a bankrupt firm. Transactions costs limit the extent to which trade creditors can obtain the contractual right to obtain non-public financial information from the debtor, which a bank or other institutional lender can acquire more easily. Notably absent from the process of trading in claims is a requirement that the purchaser provide a disclosure statement to the seller. In fact, purchasers are not even required to disclose the terms of prior purchases.<sup>174</sup> There is some suggestion that trade creditors in fact receive overly pessimistic information, which is a factor in the significant profits obtained by those who purchase trade claims.<sup>175</sup> The information available from services reporting on the solvency of debtors is not an adequate substitute.<sup>176</sup>

Even the public availability of significant amounts of information about a distressed corporation may not eliminate bargain sales of trade claims. Although trade creditors are sometimes large firms, that fact does not necessarily imply they will have the expertise to assess accurately the value of a trade claim in light of available information.<sup>177</sup> Making such

<sup>173</sup> See *supra* note 163 and accompanying text.

<sup>174</sup> See Joy Flowers Conti et al., *Claims Trafficking in Chapter 11—Has the Pendulum Swung Too Far?*, 9 BANKR. DEVS. J. 281, 299 (1992); Fortgang & Mayer, *supra* note 159, at 4. Disclosure of the consideration paid was required in some contexts under a former version of Bankruptcy Rule 3001. See *id.* at 22-23.

<sup>175</sup> See, e.g., *The Operation of the Bankruptcy System Before the House Judiciary Comm. Commercial and Administrative Law Subcomm.* (Apr. 16, 1997) (Prepared Statement of Charles Tattelbaum, Vice President for Research, American Bankruptcy Institute), available in LEXIS, News Library, Allnews File ("It is claimed that creditors (especially smaller creditors) often received exaggerated 'doomsday' assertions or disinformation in an attempt to purchase the claim at a lower price.").

<sup>176</sup> See Bebcuk & Fried, *supra* note 1, at 885 n.103 (stating that such services provide information of "limited value," because their information is incomplete, fails to include significant details and is often inaccurate and untimely). *But cf.* Note, *Creditors' Derivative Suits on Behalf of Solvent Corporations*, 88 YALE L.J. 1299, 1306 n.38 (1979) ("The existence of Dun & Bradstreet . . . and myriad other credit-rating agencies is persuasive evidence that trade creditors, like other investors, take risk into account before committing their resources.").

<sup>177</sup> See Bebcuk & Fried, *supra* note 1, at 885 ("Even trade suppliers . . . are believed to have neither the time nor the expertise to evaluate precisely individual firm risk."); Tung, *supra* note 137, at 1700; Wilner, *supra* note 162 (quoting one market participant as saying, "Institutional investors like us have experience in taking on risk while vendors don't have experience gauging investment risk. That's not their business."). *But see* Shehzad L. Mian & Clifford W. Smith, Jr., *Accounts Receivable Management Policy: Theory and Evidence*, 47 J. FIN. 169, 172 (1992) (arguing that trade creditors can monitor debtors as a part of regular visits to their customers).

Schwarcz disputes the notion that trade creditors are at a disadvantage in contracting with debtors. Schwarcz, *supra* note 52, at 663 ("It is not compelling to argue that [trade creditors] are

assessments may require the expenditure of significant sums not justified by the amount of a particular claim.<sup>178</sup>

Additionally, the cash requirements generated by a trade creditor's business may pressure trade creditors to sell quickly trade claims against insolvent debtors, even at the expense of yielding significant profits to those who purchase the claims. Reorganization under Chapter 11 commonly lasts at least four years.<sup>179</sup> A variety of commentators has noted that, in this context, trade creditors willingly take a significant loss, in order to receive cash promptly.<sup>180</sup>

*Inability to Diversify.* The costs to trade creditors of the insolvency of a debtor are compounded by limitations on the ability to diversify. Firms that extend trade credit are likely to extend credit to firms in similar lines of business. Trade credit is necessarily extended by a firm to firms that purchase the types of goods or services that the trade creditor provides. For example, a firm that manufactures and sells computer components is likely to extend trade credit to firms that assemble and sell computers, although the component manufacturer might also have customers in other industries. Defaults on the trade claims that the component manufacturer holds will occur in bunches or groups, making its portfolio of trade claims volatile.<sup>181</sup> Banks and insurance companies can diversify by lending to corporations in different industries. Trade creditors, on the other hand, can diversify only by manufacturing products that are sold to differ-

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'weaker' than the corporate debtors with which they deal . . .").

<sup>178</sup> Wilner states that buyers of claims who participated in a Financial Roundtable discussion "[e]ach . . . said [he] consult[s] financial experts for the valuations and bankruptcy attorneys for an estimated length of time the retailer is expected to remain in Chapter 11. With these results in hand, the vulture funds can then calculate the present value of money and then price the claim." Wilner, *supra* note 161.

<sup>179</sup> See Fortgang & Mayer, *supra* note 159, at 6.

<sup>180</sup> See Conti et al., *supra* note 174, at 299 (quoting *Bankruptcy Proposals to Curb Judicial Activism in Trade Claim Sales*, CORP. FINANCING WK., Aug. 13, 1990, at 1, to the following effect: "Small suppliers, the owners of the trade claims, often need to make payroll and have liquidity needs that force them to sell immediately at large discounts, such as 20 cents on the dollar, because they cannot wait the three to five years it might take for the company to file a reorganization plan that is accepted by all the parties."); Gilson, *supra* note 162, at 23; cf. Fortgang & Mayer, *supra* note 159, at 7 ("Most creditors are in business to collect cash from their debtor—cash back for cash advanced, cash paid for goods sold, or cash received for services rendered. Many of these creditors do not want securities from their debtor under a plan of reorganization unless the securities can immediately be sold for cash, which may not always be the case."); Roe, *supra* note 61, at 543 ("Although trade creditors should be interested in maximizing firm viability, thus enhancing a market for the trade creditors' product, the average trade creditor is ill-suited to provide a long-term commitment voluntarily. The cost of voluntarily converting a claim to a long-term interest, the cost of negotiating for the viable structure, and the benefit of an immediate cash payment for its claim are likely to outweigh the amorphous, uncertain benefit of increasing the long-run viability of one customer.").

<sup>181</sup> See Jackson & Scott, *supra* note 2, at 168 n.26. More precisely, one might say that the trade creditor's aggregation of a group of trade claims has produced a portfolio less diversified than would be produced were the portfolio to include claims against debtors in various industries. So the portfolio does not eliminate industry-specific risk.

ent industries—a more difficult and sometimes impossible task.<sup>182</sup>

*Value Provided by Purchasers of Trade Claims.* One could argue that purchasers of trade claims realize these profits because they add value to the distressed corporation. Two possible sources of additional value are (i) a decrease in collective action problems and (ii) the provision of managerial advice. Only a heuristic discussion of these viewpoints can be provided.

*Credit Lyonnais, In re Buckhead America Corp. and In re Shultz* impose on directors a duty to adopt strategies that make it more likely that corporations will become insolvent. These developments in corporation law essentially represent a “tax” on the corporate form. That is, they transfer some portion of a corporation’s value to third parties upon insolvency. Arguing that those purchasing trade claims of insolvent corporations add value by decreasing collective action problems assumes the incorrect frame of reference. Absent these legal principles, directors could choose alternative strategies that would increase the chance that there would be no insolvency—that the collective action problems would not arise at all.

These costs necessarily affect the value of the corporate form as a whole. Creditors must ultimately include in the cost of goods the expected value of any such transfers to those purchasing trade claims. Those costs represent a “tax,” in the sense that they increase the cost of doing business.<sup>183</sup> A legal framework that diverts some portion of value of doing business in the corporate form to third parties necessarily decreases social welfare. Entrepreneurs and venture capitalists, when considering engaging in a new business, do not ascribe a positive value to payments to third parties. At the margin, as costs of goods and services acquired on trade credit increase, otherwise potentially profitable ventures become marginally unprofitable and not worth pursuing.

One possible alternative explanation for the extraordinary profits earned by those purchasing trade claims is that by participating in the firm’s management or reorganization, they add value to the firm. In this view, these purchasers add expertise, and they command large, short-term returns, in exchange for sharing that expertise with an insolvent firm.

It is difficult to identify the extent to which those purchasing trade claims in fact add value in the form of contributing management expertise, although there is some evidence to support that conclusion. Hotchkiss and Mooradian found a statistically significant, positive effect on the debtor’s

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<sup>182</sup> One might assert that trade creditors can diversify by making passive investments in other industries. But that resolution would not be satisfactory to the trade creditors’ own lenders. Such a firm would be able to engage in the near-insolvency excessive risk-taking predicted by the economic theory underlying *Credit Lyonnais*.

<sup>183</sup> See generally Jensen & Meckling, *supra* note 9, at 308, 313 (identifying the welfare loss of a principal arising from an agency relationship and arguing that the original owner-manager, as opposed to outside equity investors, will bear this loss).

industry-adjusted, post-bankruptcy financial performance was associated with (i) a vulture<sup>184</sup> gaining control of the debtor, (ii) an affiliate of a vulture becoming chairman of the board or chief executive officer of the debtor, and (iii) such an affiliate otherwise becoming a member of the debtor's board of directors.<sup>185</sup> However, no such effect arose where a vulture acquired an interest in the debtor but did not participate in its management in one of those three capacities, which represented forty-seven percent of the sample of debtors identified by Hotchkiss and Mooradian.<sup>186</sup>

To the extent that those purchasing trade claims realize profits from adding value to debtors, those profits do not represent a societal loss. However, a large majority of the profits realized at the expense of trade creditors are not attributable to value added by vultures. As noted above,<sup>187</sup> much of the gains realized in purchasing claims from trade creditors are realized by those who resell the claims (and who thus, one would expect, do not provide this type of benefit to debtors). And a vulture necessarily provides no benefit to the debtor in the significant number of cases where the vulture does not participate in the debtor's management.

*Significance of Trade Creditors.* Adoption of a rule of corporation law that disadvantages trade creditors would be inconsequential if trade credit represented an insignificant portion of all corporate debt. That is not the case.

Trade creditors may hold claims representing a material portion of a firm's outstanding debt. For example, in manufacturing companies, trade credit represents twenty-eight percent of the aggregate of trade credit plus long-term bank debt and other long-term debt.<sup>188</sup> In addition, small firms rely on trade credit as a source of financing to an even greater extent than larger firms,<sup>189</sup> which firms, as discussed above,<sup>190</sup> represent the vast ma-

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<sup>184</sup> Vultures are firms that purchase assets or securities of distressed businesses. See JERRY M. ROSENBERG, *DICTIONARY OF INVESTING* 358 (1993).

<sup>185</sup> See Edith S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401, 415 (1997).

<sup>186</sup> See *id.* at 417, 420-21.

<sup>187</sup> See *supra* note 165 and accompanying text.

<sup>188</sup> See U.S. DEP'T OF COMMERCE, *QUARTERLY FINANCIAL REPORT FOR MANUFACTURING, MINING, AND TRADE CORPORATIONS, FIRST QUARTER 1996*, at 4. This percentage represents  $264.5 / (264.5 + 209.8 + 485.5)$  (in \$ billions). See *id.* Excluded from this computation are current portions of long-term debt as well as other non-current liabilities. As of the first quarter of 1996, the Department of Commerce reports for the sampled corporations engaged in manufacturing and nondurable manufacturing industries that such firms had, in the aggregate, \$264.5 billion of trade debt, \$60.6 billion of short-term loans from banks, \$82.2 billion in other short-term debt, including commercial paper, \$57.6 billion in current portion of long-term debt, long-term loans from banks of \$209.8 billion, other long-term debt of \$485.5 billion and other non-current liabilities, including deferred income taxes, capitalized leases and minority stockholders' interest in domestic corporations, of \$525.1 billion. See *id.*

<sup>189</sup> See EUGENE F. BRIGHAM & LOUIS C. GAPENSKI, *FINANCIAL MANAGEMENT* 746 (6th ed. 1991).

<sup>190</sup> See *supra* note 129.

jority of debtors in Chapter 11 proceedings.

### C. *Disparate Abilities to Negotiate Differential Rights*

Part V argues that, at least in some contexts, the rule announced in *Credit Lyonnais* is not the most efficient approach to governing distressed corporations. Significantly, the rule promotes the interests of creditors who could negotiate for alternative terms and disfavors those creditors—trade creditors—who cannot as easily contract around the rule created in *Credit Lyonnais*.

Even if the duty to maximize a corporation's long-term wealth creating capacity is one that cannot be waived, in the sense of releasing directors from personal liability for violations of the duty, a corporation could more easily "opt out" of the rule were another time horizon selected. A corporation could negotiate a negative covenant with creditors providing that when the corporation is in the vicinity of insolvency, the corporation will not take any one of a specified set of activities without the lender's consent, if the activity is not consistent with maximizing the corporation's long-term wealth creating capacity.

This covenant would be enforceable. Corporations often agree not to undertake certain actions without the consent of lenders. Debt instruments are replete with such covenants.<sup>191</sup> This method of "opting out" of a legal rule would be effective only where the change intended to benefit creditors who, as a part of extending credit, already negotiate covenants. Banks and other lenders negotiate covenants, but such negotiations frequently will not be part of the extension of trade credit.<sup>192</sup> Thus, although a legal rule that benefitted trade creditors in this context could be varied by contract, the default disadvantaging trade creditors can be varied by contract only with greater difficulty. The rule of *Credit Lyonnais*, *In re Buckhead America Corp.* and *In re Shultz* thus creates a default rule that disadvantages those claimants who are less able to vary the default by contract—a curious outcome for a rule putatively adopted in the name of efficiency.

## VI. AN ALTERNATIVE STRUCTURE FOR FIDUCIARY DUTIES IN DISTRESSED CORPORATIONS

Thus far, this Article has argued that there is little evidence that distressed corporations engage in the excessive risk-taking predicted by

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<sup>191</sup> See, e.g., AMERICAN BAR FOUND., *supra* note 26, at 402, 457-67 (stating that indentures commonly restrict the payment of dividends and providing nine alternative samples of covenants restricting investments).

<sup>192</sup> Transaction costs would predominate in any attempt by a bank to negotiate provisions benefiting the trade creditors.

the “overinvestment” theory. Nevertheless, based on that theory, Delaware precedent<sup>193</sup> holds that directors of distressed, solvent corporations owe fiduciary duties to constituencies broader than shareholders, that are enforceable by those other constituencies.

Although there are a variety of problems in the line of cases beginning with *Credit Lyonnais*, that fact does not mean that there is no room for improvement in the manner in which corporation law has traditionally addressed the conflicts that line of cases addresses. More modest, less problematic improvements are possible. The absolute delegation rule would traditionally protect directors of a distressed corporation who determined to attempt to minimize the likelihood that the corporation ultimately became insolvent, even at the expense of foregoing a strategy that offered increased long-term returns. Such a determination should constitute the selection of a “time horizon” delegated to the board of directors under *Paramount*.<sup>194</sup> Nevertheless, a clear articulation of that rule would be desirable to eliminate any possibility that directors would incur liability to shareholders who were able to construe statements made in the course of managing a distressed corporation as indicating that actions were taken for the benefit of creditors at the expense of the shareholders.

Such a holding does not constrain shareholders to any large degree—presumably they could still remove the directors. But it would prevent shareholders looking at the occasion as an option, in which they could remain passive during the decisionmaking process and yet retain the right to assert a claim against the directors if their decisions proved to be unfavorable. Because this rule is only defensive, i.e., it merely grants directors an additional defense against a claim, ambiguity in the definition of “vicinity of insolvency” does not suffer from the same difficulties as when the duty is one that can be affirmatively enforced against the directors by non-shareholder constituencies.

A restructured formulation of the duties of directors of distressed firms might also help restrain self-dealing. Financial distress does not eliminate directors’ incentives to engage in self-dealing. However, when the firm is in distress, shareholders may have diminished incentives to monitor or prevent the self-dealing. One might thus conclude that creditors should have a limited right to initiate a derivative lawsuit, on behalf of the corporation, challenging any self-dealing transactions by directors of a firm that was “in the vicinity of insolvency.”

Even this limited right would be potentially problematic. As to

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<sup>193</sup> *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, Civil Action No. 12150, 1991 Del. Ch. LEXIS 215, at \*108-109 (Del. Ch. Dec. 30, 1991); see also *Miramar Resources, Inc. v. Shultz* (*In re Shultz*), 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997); Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (*In re Buckhead Am. Corp.*), 178 B.R. 956, 968 (D. Del. 1994).

<sup>194</sup> *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1990).



holders of long-term debt, it is not clear why such a rule would benefit creditors who did not obtain by contract the right to bring an action to restrain self-dealing.<sup>195</sup> Granting such a right to holders of publicly issued bonds would be particularly problematic, if it were intended that directors of the debtor would engage in self-dealing when the debtor was clearly solvent. If a trustee possessed such a right, the trustee's desire to avoid personal liability might result in frequent challenges to transactions with insiders.

Additionally, the ability of creditors to avoid preferential transfers made to insiders within one year of a bankruptcy<sup>196</sup> limits the circumstances in which such a rule could additionally benefit creditors. Ultimately, it is difficult to imagine that, as to holders of long-term debt, a rule permitting an action to enjoin self-dealing transactions would benefit the corporate form in excess of the costs arising from potential bad faith extractions of fees in exchange for consents to otherwise proper transactions.

The conclusions are less certain as to two types of creditors—trade creditors and tort claimants. A rule benefitting trade creditors is less likely to be abused. Trade creditors typically are in an ongoing relationship with the debtor. These relationships, which trade creditors generally would prefer to continue, would restrain the extent to which trade creditors would improperly commence a derivative action seeking to enjoin self-dealing.

Tort claimants generally do not have the opportunity to negotiate for the right to benefit from a fiduciary duty imposed on directors. These involuntary creditors may present the most compelling situation calling for increased creditors' rights.

But in any such case, one would have to inquire as to the result that should obtain if, after full disclosure, the shareholders were to approve the transaction. Typically, corporate directors make full disclosure in transactions in which they have a personal interest, and seek shareholder approval, in order to comply with the requirements of Section 144 of the Delaware General Corporation Law.<sup>197</sup> It would be troublesome to adopt a legal rule allowing creditors to initiate or maintain derivative lawsuits challenging a transaction approved by the shareholders. As shareholders retain the right to elect directors while the corporation remains solvent, that legal rule would be likely to result in a quasi-deadlock. Therefore, even a limited ability for creditors to commence derivative lawsuits challenging self-dealing would appear to have little value.

One small benefit could be provided to creditors, however. It

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<sup>195</sup> Such provisions can be and are written (although they may apply even if the debtor is not distressed). *See, e.g.,* RJR NABISCO CAPITAL CORP., PROSPECTUS, 10½% SENIOR NOTES DUE 1998, at 88 (Apr. 18, 1991) (on file with author).

<sup>196</sup> *See* 11 U.S.C. § 547(b) (1994).

<sup>197</sup> DEL. CODE ANN. tit. 8, § 144 (1991).

would not be unreasonable for a distressed corporation to be required to disclose to trade creditors, or other creditors, prior to a material extension of credit, any self-dealing transactions made when the corporation was in distress. Requiring full disclosure (i.e., conditioning an absence of directorial liability on such disclosure) would facilitate a trade creditor's independent assessment of whether to extend further credit. Nevertheless, the minor benefit created by such a rule may not justify the additional complexity it would add to corporation law jurisprudence.

## CONCLUSIONS

The available economic evidence supports the notion that the "overinvestment" problem does not dominate the actions of directors of distressed corporations. Distressed corporations are not characterized by a frenzy of excessive risk-taking. Terms of debt directly addressing excessive risk-taking (those that restrict expenditures) without consent necessarily play a role. This Article has provided an expanded discussion of the methods by which other covenants—financial covenants—can provide powerful incentives increasingly restricting risk-taking as a corporation becomes closer to distress or insolvency. The evidence supports the notion that an analysis of the incentives presented by various possible bankruptcy law reforms should not assume that "overinvestment" by distressed corporations produces social costs that cannot be adequately addressed with contractual devices under current law.

Nevertheless, under a legal theory derived from a presumption that distressed corporations will engage in excessive risk-taking, courts have recently held that directors of distressed corporations owe fiduciary duties that are enforceable by creditors. These cases do not represent awkward constructions of that precedent. In fact, a detailed review of the precedent indicates that this construction is well supported.

These developments in corporation law present substantial concerns. Directors of distressed corporations face potential personal liability for failure to conform their conduct to an amorphous standard. As others have noted, there is no clear basis for determining when this new duty arises. Just as significant is that the rule attributes a positive value to payments to creditors (offsetting the loss to the shareholders from the payment). Thus, virtually any payment made by a distressed corporation is accompanied by a receipt by a constituency whose interests the directors are to promote. There is no feasible algorithm to distinguish those payments to creditors that have a positive value (in the sense that the *receipt* promotes the debtor's interests separate from its permitting the debtor's retention of consideration in exchange) from payments to the same constituency whose receipt has no value. And unlike other circumstances in

which the law adopts a nebulous standard to deter undesirable conduct, a decisionmaker's intentional bias in favor of one class of constituents does not reduce the risk of liability.

Financial distress may cause a corporation to need the services of an investment bank. But recent developments in corporation law impose substantial additional risks on those advisors, for aiding or abetting a violation of the same nebulous standard. The imposition of such risks must ultimately inure to the detriment of distressed corporations, by either eliminating access to advisors or increasing the cost.

Shifting fiduciary duties arising upon a corporation's becoming financially distressed also have a differential impact on various types of creditors. The duty, by its terms, does not permit the adoption of a strategy designed to promote ongoing solvency if doing so is at the expense of a greater long-term return. A substantial portion of a firm's creditors typically will consist of trade creditors. Evidence suggests that these creditors are particularly harmed by a corporation's bankruptcy. Trade creditors of insolvent firms in practice appear willing to forego significant profits in order to secure immediate, if partial, payment in cash. That is, these creditors are particularly harmed by outcomes that result in their receipt of non-cash consideration. Contrary to traditional theory for the selection of an efficient default rule of contract, this rule harms that set of creditors least capable of negotiating an alternative contractual resolution.

This Article argues that a more modest development in this area would be desirable—giving directors of distressed firms greater assurance that strategies designed to enhance ongoing solvency will not result in personal liability for failing to pursue other strategies. One might seek to permit creditors of distressed corporations to bring derivative actions challenging any self-dealing transactions. But as failure to allow a distressed corporation to consummate transactions approved by the shareholders would be problematic, even granting creditors the power to bring a derivative action challenging self-dealing by management offers only limited benefits.

## APPENDIX I

Assume, without loss of generality, that there are two creditors, a bank and a trade creditor. The trade creditor provides firm-specific inputs, such that a reorganization cannot be successful if the trade creditor is not satisfied. If the bank receives a fraction  $F_{B,O}$  of the reorganized firm, whereas the bank would have received a greater fraction  $F_{B,L}$  of the firm, had it been liquidated, a condition necessary for the bank voluntarily to pay the "bribe" is that:

$$F_{B,O} V_O \geq V_L F_{B,L}$$

Where $F_{B,O}$ represents	the fraction of the firm's value distributed to the bank when the firm is reorganized, i.e., it remains <i>ongoing</i>
$F_{B,L}$ represents	the fraction of the firm's value that would be distributed to the bank were the firm <i>liquidated</i> and the bank and the trade creditor paid pro rata
$V_O$ represents	the aggregate value of all property distributed in the reorganization to the bank and the trade creditor
$V_L$ represents	the aggregate value of all property that would be distributed in a liquidation to the bank and the trade creditor

Otherwise, the bank would not agree to pay the bribe.

This inequality implies that the bank must believe that the value of the firm, as liquidated, does not exceed the following, assuming  $F_{B,L} > 0$ :

$$V_L \leq \frac{F_{B,O} V_O}{F_{B,L}}$$

Thus, the disparity in the firm value, depending on whether the firm remains ongoing or is liquidated,  $V_O - V_L$ , is represented by the following:

$$\text{Disparity} = (V_O - V_L) \geq V_O - \frac{F_{B,O} V_O}{F_{B,L}}$$

$$\text{Disparity} \geq V_O \left( 1 - \frac{F_{B,O}}{F_{B,L}} \right)$$

This disparity is always greater than  $V_O (F_{B,L} - F_{B,O})$ . This result can be shown by demonstrating that the disparity minus  $V_O (F_{B,L} - F_{B,O})$  is always greater than zero, assuming  $F_{B,L} > F_{B,O}$ :

$$V_O \left( 1 - \frac{F_{B,O}}{F_{B,L}} \right) - V_O (F_{B,L} - F_{B,O})$$

Rearranging this expression yields the following:

$$\frac{V_O}{F_{B,L}} \left( (F_{B,L} - F_{B,O}) - (F_{B,L}^2 - F_{B,O} F_{B,L}) \right)$$

$$\frac{V_O}{F_{B,L}} (F_{B,L} - F_{B,O}) (1 - F_{B,L})$$

Where  $F_{B,L}$  and  $F_{B,O}$  are positive, this expression is always positive for  $F_{B,L} > F_{B,O}$  and  $F_{B,L} < 1$ , indicating that the bank's estimate of the value of the liquidation cost of the firm exceeds the product of the increase in the fraction of the reorganized firm paid to the trade creditors multiplied by the value of the firm, as reorganized on an ongoing basis— $V_O (F_{B,L} - F_{B,O})$ .