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CORPORATE FIDUCIARY − INSOLVENT: THE FIDUCIARY RELATIONSHIP YOUR CORPORATE LAW PROFESSOR (SHOULD HAVE) WARNED YOU ABOUT [*]

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INTRODUCTION

The fiduciary obligation of directors and officers of troubled companies has generated a significant body of case law as well as a wealth of commentary. [1] Unfortunately, the case law appears hopelessly confused and conflicting and the commentary generally surveys the case law in varying degrees of detail, or economically justifies (or criticizes) the current scheme. Most fail to propose a method of analysis or a justification for altering the traditional fiduciary obligation.

This thesis first examines the origin and development of general fiduciary law. The inquiry then narrows to the fiduciary obligation of a solvent corporation's directors and officers. It then proposes a justification for the existence of a fiduciary obligation to creditors upon the corporation's insolvency. [2]

Finally, this thesis proposes that the fiduciary obligation of an insolvent corporation's directors and officers should replicate as much as possible the fiduciary obligation that exists while the corporation is solvent. The existing solvent mechanism does need some alteration to account for the corporation's insolvency and the addition of creditors as beneficiaries to the corporate fiduciary relationship.

I.FIDUCIARY RELATIONSHIP − GENERALLY

The fiduciary relationship has been a part of Anglo−American jurisprudence for over 250 years. [3] Despite its long history, the exact contours of the concept have remained elusive. [4] A healthy academic debate over the precise definition of fiduciary exists, [5] but the following definition is an adequate starting point:

A fiduciary relation[ship] exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation. [6]

A. History of the Fiduciary Concept

One of the principal reasons for the fiduciary concept's perplexity is the concept's obscure genesis in the English courts of equity. [7] Indeed, cases from the late 18th century were based on the broad general principle "that if a confidence is reposed, and that confidence is abused, a court of equity shall give relief." [8]

The law of equity developed and the word "trust" came to have a specific "modern technical meaning." [9] Unfortunately, other relationships in which mere "confidence was reposed" were then left without a name. [10] Courts eventually recognized that certain relationships were similar to trusts, but did not meet the specific requirements for trust establishment. [11] These "almost−a−trust" relationships came to be known as fiduciary relationships.

The fiduciary concept is now firmly planted in the landscape of American law. [12] The number of relationships in which it arises is numerous, and a full catalog of fiduciary relationships would be a large volume. [13] Among the more established fiduciary relationships are the doctor−patient, [14] attorney−client, [15] and the principal−agent [16] relationships. Whether the investment banker−client relationship is fiduciary is the cutting edge of fiduciary jurisprudence. [17]

B. Terminology

Terminology in fiduciary law is a morass of conflicting and vague definitions. To ease discussion, the following terminology will be used throughout this thesis. A *fiduciary* or *fiduciary party* is the person or entity that is obligated to act for the benefit of another. In the corporate fiduciary relationship, fiduciary parties include all corporate directors, and certain non−director officers and shareholders. This group is also referred to in this thesis as *management*.

A *beneficiary* or *beneficiary party* is for whom the fiduciary is obligated to act. Beneficiaries in the corporate fiduciary relationship include all shareholders of the corporation while the corporation is solvent. The addition of creditors as beneficiary parties while the corporation is insolvent is a central topic of this thesis.

A fiduciary and a beneficiary are the parties to a *fiduciary relationship*. The particular fiduciary relationship examined in this thesis is the corporate fiduciary relationship. That is, the relationship between corporate directors, officers and controlling shareholders − *the fiduciary parties*, and shareholders and at certain times creditors − *the beneficiary parties*. The relationship between *fiduciary parties* and *beneficiary parties* arising in the corporate context will be referred to as *corporate fiduciary − solvent* when the corporation is solvent, and *corporate fiduciary − insolvent* when the corporation is insolvent. [18]

Each fiduciary relationship, and therefore its obligation, is made up of constituent *fiduciary duties*. Relevant duties in the corporate fiduciary relationship include the duty of care, the duty of loyalty and the duty of good faith. [19] The combination and requirements of these duties depend on the circumstances of the particular fiduciary relationship. Whatever the amalgamation of these duties, together they form a *fiduciary obligation*. A transgression of fiduciary obligation is usually referred to as a breach of fiduciary duty. This is imprecise. When a fiduciary falls short of the prescribed standard, it is more accurately termed a breach of fiduciary obligation or a breach of the fiduciary relationship. Because there are types of fiduciary duty, the duties of care, loyalty, good faith, candor, etc., when a fiduciary duty is breached, it is more precise to refer to the specific duty breached. If referring to breach of a specific fiduciary duty, the duty of loyalty for example, it is then appropriate to speak of a breach of fiduciary duty.

In analyzing any fiduciary relationship, it is helpful to distinguish the *existence* of a fiduciary relationship from the determination of the contours of the fiduciary obligation. [20] Only after it is established that a relationship is fiduciary, can it be determined if a breach of a fiduciary obligation has occurred.

One other term in fiduciary law is problematic. [21] *Trustee* can mean many different things depending on the particular fiduciary relationship in which it arises. [22] Generally, the term refers to a strict, or if used comparatively, more strict, obligation; however, certain trustees owe no fiduciary obligation. [23]

II.The Corporate Fiduciary Relationship in a Solvent Corporation

Corporate law has a tremendous effect on the business and commerce of the United States. Attorneys generally ignore the historical development of this integral facet of American society, but the corporate concept has a fascinating history. [24] Corporate law addresses the many issues that arise in the scope of a corporation's interaction with other members of society, and its agents. One of the central issues of corporate law is ensuring managerial accountability to absentee owners. [25]

Corporate fiduciary law is also among the most refined in all law. [26] State, not federal law governs the corporate fiduciary relationship. [27] The development and sophistication is also due to the common law development and the application of the Delaware General Corporation Law in Delaware's Court of Chancery [28] and Supreme Court. [29] Over 40% of corporations listed on the New York Stock Exchange and over 50% of Fortune 500 companies are incorporated in Delaware. [30] Delaware's dominant influence and the decisions in which courts defer to its corporate law developments are legion. [31] This section surveys the fiduciary obligation of a corporation's directors and officers in a solvent corporation. As discussed below, the standards and procedures are well established and function in an equitable and predictable manner. This elaborate scheme and mechanism should not be jettisoned upon the corporation's financial distress.

A. The Relationship is Fiduciary

The relationship between a corporation's officers, directors and controlling shareholders on the one hand, and stockholders of the corporation on the other, has consistently been held to be fiduciary in nature. [32] Indeed, it is rather strange to think of the relationship in any other way.

There are at least two justifications for the relationship being fiduciary. One relies upon the representational role of the directors. [33] Most of the shareholders' decisionmaking authority is vested in the board of directors through the corporation's articles of incorporation and state corporation codes. [34] Shareholders do retain control over certain issues affecting fundamental changes in the corporation. [35] The representational facet of the director/officer justifies the fiduciary obligation owed to the corporation and its shareholders.

The circumstances of modern corporate governance require representational, rather than direct governance. Shareholders in corporations of any size can not, and would not want to make the detailed daily decisions made by a corporation's management and directors. [36] It would be inefficient for them to do so. A benefit of stockholder status is that an owner relinquishes control of capital to experts. These experts, corporate directors and officers, use their knowledge and skill to make business decisions that maximize shareholders' return on investment.

A second justification for the fiduciary obligation of corporate officers and directors relies on trust law. Shareholders entrust assets to directors and officers for them to manage for their benefit. Thus, directors and officers owe a fiduciary obligation to shareholders because property has been entrusted to the corporate fiduciaries to be managed for the shareholders' benefit. [37]

B. Who is a Corporate Fiduciary?

Who are the parties to the corporate fiduciary relationship? Generally, the board of directors has the sole duty to manage the business affairs of the corporation. [38] The responsibility undertaken by the board of directors is *not* managing the corporation for the board's collective personal benefit, but for the benefit of the corporation. [39] Because of the power entrusted and the representational role of directors and officers, all corporate fiduciaries are fiduciary parties to the corporate fiduciary relationship.

In certain circumstances, non−director corporate officers are fiduciary parties to the corporate fiduciary relationship. [40] All corporate officers, as employees, are agents of the corporation, and are parties to a principal−agent relationship between the officer and the corporation.

Some shareholders are fiduciary parties to the corporate fiduciary relationship as well. [41] If a shareholder has a controlling interest in the corporation, [42] the shareholder owes a fiduciary obligation to minority shareholders. [43] Controlling shareholders owe a fiduciary obligation to minority shareholders, but also have the right to act in their own self−interest when they are acting solely in their capacity as shareholders. [44] It is rare that a controlling shareholder is not also a corporate director or high−ranking officer. [45] There is little emphasis in this thesis on the unique problems presented by controlling shareholders as fiduciary parties. [46]

These three groups, directors, officers and majority or controlling shareholders, are the fiduciary parties in the corporate fiduciary relationship. [47]

C. Who are the Beneficiaries?

As any veteran of the Corporations law school class knows it is black letter, hornbook, bedrock and well−settled law that director or officer owes a fiduciary obligation to the corporation and the shareholders. Until the 1930's it was generally thought that the exclusive beneficiary of the fiduciary relationship was the corporation alone. [48] This conceptualization of the corporate fiduciary relationship has been turned 180 degrees. The exclusive beneficiary now is generally thought to be the shareholders of the corporation, rather than the corporation itself. [49] Some commentators attribute this development to the enactment of the shareholder−focused federal securities law, [50] while others attribute it to the influence of economics. [51]

Perhaps the old−timers had it right, the change has not simplified corporate law. Among the issues raised if shareholders are considered the exclusive beneficiaries of management's fiduciary obligation include: (1) conflicts in modern large corporations with many subsidiaries, [52] (2) the anomalous situation in which the alleged beneficiary of a fiduciary relationship does not usually have standing to enforce the fiduciary obligation, [53] and (3) conflicts among sub−groups of shareholders. Preferred shareholders and convertible debenture holders can be an especially troublesome sub−group of shareholders. [54] In one sense they are shareholders in that they own or have the option to purchase an equitable ownership interest in the corporation. But in another sense they are creditors of the corporation. [55] Preferred shareholders are generally considered to be included among the beneficiaries to the corporate fiduciary relationship. [56]

The analysis is aided by focusing on the specific grounds of the claim of a preferred shareholder.

Whether or not a given claim asserted by preferred stockholders is governed by contract or fiduciary principles depends on whether the dispute arises from rights and obligations created by contract or from "a right or obligation that is not by virtue of a preference but is shared equally with the common [stockholders]". [57]

The general rule is that rights created by the corporate charter provision which govern the preferred stock are contractual, and no fiduciary protection extends to these rights, [58] thus traditional breach of contract analysis is appropriate. If a preferred stockholder's complaint is shared by all shareholders, fiduciary principals are implicated.

Numerous courts have announced the general rule that creditors are not beneficiary parties to the corporate fiduciary relationship while the corporation is solvent. [59] The reasoning underlying the exclusion of creditors from the corporate fiduciary relationship is relatively straightforward. Creditors have no ownership interest in a debtor−corporation's assets while the corporation remains solvent. [60] They have contractual rights. Though creditors are not beneficiary parties to the corporate fiduciary relationship in solvent corporations, a board of directors may consider the interests of creditors and other stakeholders in certain circumstances. [61] Many states have also enacted "other constituency statutes" that allow boards of directors to specifically consider other non−shareholders in making corporate decisions. [62] Some prominent corporate law decisions impose liability on corporate fiduciaries when they favor creditors in a way that harms the corporation's stockholders. [63]

Despite the majority of case law, a blanket statement that a fiduciary obligation is not owed to creditors is inadvisable. Even if solvent, certain entities labeled "debt" on a corporation's balance sheet may later be determined by a court to be "equity". Creditors come in many different forms. [64] Courts do not examine the capital structure of corporations with the exactitude of an accountant, but with the inherent flexibility of a court of equity. [65] Further, as discussed extensively in this thesis, when a corporation becomes insolvent its directors and officers owe a fiduciary obligation to its creditors.

D. Shareholder Standing to Sue and the Derivative Suit

A unique aspect of the corporate fiduciary relationship, when compared to other fiduciary relationships is that though shareholders are generally thought to be beneficiary parties to the corporate fiduciary relationship, they usually may not directly enforce the fiduciary obligation. [66] In most cases, a derivative suit in the name of the corporation must be utilized to enforce management's fiduciary obligation.

In a derivative action, one or more shareholders of a corporation, perceiving that the corporation has received an injury that the management of the corporation has failed to redress, sues on behalf of the corporation. [67] Thus, a derivative action is the equivalent of a suit by the shareholders to compel the corporation to sue, and it is also a suit by the corporation, asserted by the shareholders on its behalf, against those liable to the corporation. [68] The Federal Rules of Civil Procedure include a provision for shareholder derivative suits, [69] as do the Delaware Rules of Chancery. [70]

A suit is derivative if it must be prosecuted in the name of the corporation itself, rather than individual shareholders. Whether a complaint states a derivative claim or a non−derivative claim, however, is determined "from the body of the complaint rather than from the label employed" by plaintiff's counsel. [71] The law of the state of incorporation governs the issue unless pre−empted by some federal policy. [72]

The distinction, though articulated in many opinions, remains a difficult one to implement. [73] The distinction is addressed in a prominent treatise:

Generally speaking, a wrong to the incorporated group as a whole that depletes or destroys corporate assets and reduces the value of the corporation's stock gives rise to a derivative action; a breach of an individual shareholder's "membership contract" or some other interference with the right that traditionally are viewed as part of an individual's ownership of stock such as the right to vote or an allegation that a particular transaction will unfairly affect minority shareholders gives rise to a direct, non−derivative action by the injured shareholder or shareholders. [74]

Thus, the essential factor in the derivative versus non−derivative inquiry is whether the injury complained of was suffered by particular shareholders. If the injury is common to all shareholders, the suit will be derivative and must be brought in the name of the corporation.

Delaware, and most other jurisdictions, require a shareholder to make a pre−suit demand on the corporation's board of directors. [75] The demand must explain the basis for the shareholder's claim. [76] The board must then decide whether or not to pursue the claim. Demand is excused where the demand would be futile. [77]

Even if a shareholder complies with the demand requirements and has a valid cause of action, a corporation's board of directors may establish a litigation subcommittee, made up of uninterested directors, that decides whether prosecution of the suit is in the best interest of the corporation. [78]

E. The Business Judgment Rule

The business judgment rule, contrary to popular belief, is a standard of judicial review of corporate fiduciary conduct not a standard of conduct. [79] The rule is a rebuttable evidentiary presumption that business decisions are made by disinterested and independent directors [80] on an informed basis and with a good faith belief that the decision is in the best interest of the corporation and its shareholders. [81] The presumption protects any decision that "can be attributed to any rational business purpose." [82] "Courts give deference to directors' decisions reached by a proper process, and do not apply an objective reasonableness test in such a case to examine the wisdom of the decision itself." [83] They also defer to the business judgment "however controversial, unpopular, or even wrong [the director or officer's] decision turns out to be." [84] Courts struggle with the proper amount of deference to director and officer decisionmaking. The business judgment rule has two components: 1) protection of directors from personal liability and 2) protection of the integrity of the business decision. [85]

If corporate fiduciaries are sued with respect to a business decision, the court will examine the decision only to the extent necessary to determine whether the plaintiff has alleged sufficient facts to overcome the presumption. [86] If the plaintiff is unable to rebut the presumption, then the court will not examine the merits underlying the decision and will not second−guess the board's decision. [87] If the plaintiff does rebut the business judgment rule's presumption, then the director/officer will have the burden to show that the transaction/act/decision was entirely or intrinsically fair to the corporation. [88] While it may appear that the shifting of burdens and presumptions involve a complicated multi−stage trial, in a breach of fiduciary obligation trial, each party presents all their relevant evidence. The presumptions and burdens are merely used to structure the judicial analysis of the evidence.

The business judgment rule has been justified on five different grounds. [89] First, it encourages individuals to be directors who would otherwise decline because of the fear of individual liability. [90] Second, it encourages directors to engage in ventures that, though risky, may have the potential for enormous profit. [91] Third, it limits court involvement in complex corporate decisions that they are generally ill equipped to make. [92] Fourth, the business judgment rule ensures that directors rather than shareholders manage corporations. [93] Finally, it recognizes that shareholders may always remove directors when their decisionmaking skills are thought to be inadequate. [94]

F. Duty of Care

While the business judgment rule presumes that corporate fiduciaries act properly, if a plaintiff is able to rebut it, and has alleged that the director/officer has been grossly negligent, the duty of care is implicated. The role of the fiduciary duty of care appears to be among the more controversial issues in corporate law. [95] In its simplest and therefore vaguest terms, the duty of care requires directors to exercise the care that a person in a like position would exercise under similar circumstances. [96] The general standard of conduct is that of an ordinary and prudent person. [97] The duty of care has two aspects, the corporate fiduciary's oversight capacity and his or her decisional capacity.

"In the oversight setting, directors are responsible for monitoring the corporation's business." [98] "The duty of care requires that management act in an informed and considered manner, meaning that prior to making a business decision, the directors must have informed themselves of 'all material information reasonably available to them.'" [99]

The paradigm case of director liability for breach of the fiduciary duty of care in the oversight context, is *Francis v. United Jersey Bank*. [100] In *Francis*, Lillian Pritchard, an elderly woman, inherited 48% of the stock of a reinsurance brokerage corporation. [101] Ms. Pritchard and her two sons were the corporation's three directors. [102] Despite Ms. Pritchard's seat on the board of directors, the sons operated the business without any oversight or involvement by Ms. Pritchard. [103] After the sons diverted from the corporation more than $10 million to themselves, Ms. Pritchard's bankruptcy estate was held personally liable for the illegally diverted funds based on her breach of the duty of care. [104] *Francis*, and its egregious facts, is typical of the cases in which directors are held liable for breach of the fiduciary duty of care. [105]

The second aspect of the duty of care is the decisional component. "In the decisional setting, directors collectively consider whether to authorize a particular course of action, activity or transaction." [106] It is a duty to act with a reasonable amount of attention and skill. Because of the business judgment rule's presumption, directors will not be held liable for every mistaken judgment.

The most (in)famous case of director liability for breach of the fiduciary duty of loyalty in a decisional setting is *Smith v. Van Gorkom*. [107] *Van Gorkom* involved the directors of the Trans Union Corporation and a cash out tender offer merger. [108] The Delaware Supreme Court held that the board, which included several prominent businessmen, was grossly negligent in approving a cash out of all shareholders. [109] *Smith v. Van Gorkom* is widely cited for the standard of conduct for corporate fiduciaries in breach of the duty of care cases. [110]

In the wake of *Smith v. Van Gorkom* and the subsequent "corporate director liability crisis," many states enacted "charter option statutes." Such statutes allow corporations to include a provision in their articles of incorporation eliminating a director/officer's personal liability for monetary damages that may result from a breach of the duty of care owed to shareholders. Delaware's provision, section 102(b)(7), was the model for other states' statutes. Delaware courts have generally enforced such charter provisions. [111]

G. Duty of Loyalty

Corporate fiduciaries are not free to deal with corporate assets as if they are the board member's personal property. Corporate fiduciaries are obligated to exercise their decisionmaking in a manner consistent with their duty of loyalty to the corporation and its shareholders. [112] The duty of loyalty generally prohibits self−aggrandizing acts by corporate fiduciaries. [113] Courts and commentators struggle to define the fiduciary duty of loyalty. [114]

Specific acts and transactions implicating the duty of loyalty include: self dealing transactions, [115] excessive compensation, [116] corporate waste, [117] personal use of corporate assets, [118] use of corporate funds to perpetuate control, [119] corporate opportunities [120] and fiduciary obligations in bankruptcy. [121] The fiduciary obligation of candor is generally conceived as an adjunct of the duty of loyalty. [122]

"In the nineteenth century, common law courts were in substantial agreement that transactions between a corporation and one or more of its directors were void or voidable simply because a conflict of interest existed." [123] The complexity and interconnection of American business made such a rule impractical, and corporate law adjusted accordingly. [124]

Delaware has a specific provision in its corporate law for "interested director transactions." [125] Section 144 is a safe harbor for transactions between a corporation and a director/officer of the corporation. Section 144 allows transaction between a corporation and its directors or officers if the material facts of the transaction are disclosed to uninterested directors or a committee thereof, and such directors or committee ratifies the transaction. [126] Alternatively, a self−interested transaction may be ratified by shareholder vote ratifying the transaction. [127] If a director either appears on both sides of the transaction or has any personal interest in the transaction that is not equally shared by the stockholders, the director has self−interest. [128] The self−interest must be sufficiently material to form the basis of a breach of the fiduciary duty of loyalty. [129] In other words, the self−interest must represent a significant financial interest to the particular director. If a director/officer complies with section 144, the business judgment rule may re−apply. [130]

Demonstrating that the transaction is entirely or intrinsically fair to the corporation is another method for directors and officers to avoid breach of fiduciary obligation liability. [131] It applies whenever the business judgment rule's presumption is rebutted. [132] In general, a transaction can be considered fair if it "would have commended itself to an independent corporation." [133] The defendant director or officer has the burden of proving the transaction's fairness. [134]

Fairness has two components: fair dealing and fair price. [135] Fair dealing includes issues of when the transaction was timed, how it was initiated, structured, negotiated and disclosed to the directors, and how director and/or stockholder approval was obtained. [136] Fair price relates to the economic considerations of the proposed transaction, including all relevant factors: assets, market value, earnings, future prospects and any other elements that affect the intrinsic or inherent value of a company's stock. [137] The interested director is under a continuing duty of complete candor. [138]

H. Debtor−Creditor Relationship Versus Corporation−Equityholder Relationship

The debtor−creditor relationship is different than the corporation−equityholder relationship. [139] Because (1) shareholders elect directors, (2) directors hire corporate officers, and (3) directors and officers are often themselves shareholders, the interests of the two groups converge to a large extent. On the other hand, the debtor−creditor relationship is generally thought to be not one of trust or reliance. [140] Creditors are contractual parties with a corporation. Generally, creditors engage in a relationship with a corporation on equal footing, with each party attempting to get the best deal possible. [141] However, the debtor−creditor relationship does include "fiduciary−esque" elements. The commercial standard of good faith is an implied term in many contracts. [142]

Certain aspects of law and economics scholarship blur the distinction between the relationships. Economists view the corporation as a nexus of contractual relationships. [143] According to the law and economics view, the shareholder contributes capital to the corporation, relying on the corporation's asset aggregation in order to receive a return on its investment. Similarly, a creditor invests capital or credit with a corporation in the hopes that the corporation's management will give a return on the original investment at a pre−determined future date along with a contractually established premium. Employees and others contribute various other forms of capital in the expectation that it will be economically beneficial. [144]

Whatever the merits of this thinking, the return on "investment" is the fundamental difference between the two relationships. Creditors expect to recoup their initial contribution, and a competitively established premium as established by the contract between the corporation and creditor. [145] If the debtor−corporation recognizes tremendous profits, the creditor's return is limited to the repayment terms of the contract. If the corporation loses money, the creditor is still entitled to repayment as established by contract. [146] Thus, creditors are considered "fixed claimants." In a solvent corporation, fixed claimants include all bondholders, trade creditors, tort creditors, taxing authorities, employees and other parties with claims against the future earnings of the corporation.

Assuming the corporation remains solvent, the value of fixed claims not vary with the magnitude of solvency. The fact that a corporation is tremendously solvent or only marginally so, does not alter the value of fixed claimants' claims. The amount of the claim is independent of the financial success of the corporation. As a corporation varies between phenomenal success and stable financial health, the creditors' claims remain fixed. A creditor has capped its risk by constraining the potential repayment amount.

This is not the case in the shareholder−corporation relationship. Shareholders are not fixed claimants. They are the residual claimants or residual owners of the corporation. [147] There is no contractually or competitively established upside−limit on the return on its investment. [148] If the corporation does phenomenally, the shareholder sees appreciation in the value of its investment, i.e. the shares are worth more. This unlimited upside is tempered by the risk that the investment may prove worthless. If the corporation becomes insolvent and dissolves, shareholders are legally entitled to nothing. [149]

The nature of residual claims is such that the group holding such claims is the primary beneficiary of successful business operations and bears most of the risk of poor performance. [150] They have the most to lose when a corporation fails, in that they are the last group paid when the corporation's assets are liquidated. [151] The dollar that is won or lost because of good or bad decisionmaking accrues to, or is owed by, the residual owner. [152]

A solvent corporation's shareholders are also the optimal monitoring class. [153] Because shareholders claim the residual earnings of the company, they hold the correct set of economic incentives to monitor management to ensure that it makes decisions that will maximize the value of the business. [154]

"[S]hareholders of a solvent corporation, in contrast to its creditors, have an equitable interest in the property of the corporation in that they have a residual interest in the assets that would be distributed upon the corporation's dissolution." [155] Since creditors do not benefit directly from any increases in the value of corporate assets, [156] creditors of a solvent corporation have no equitable interest in the corporate property and thus are not owed any fiduciary obligation by the corporation's fiduciaries. [157] For fiduciary obligation purposes, the fixed claim *versus* open−ended claim is the essential difference between the debtor−creditor and corporation−equityholder relationships.

III.What is the Justification for the Addition of Creditors as Beneficiary Parties to the Insolvent Corporate Fiduciary Relationship?

Insolvency is a most important and material fact, not only with individuals but with corporations; and with the latter, as with the former, the mere fact of its existence may change radically and materially its rights and obligations. [158]

As the discussion above regarding the fiduciary obligation of directors and officers in solvent corporations makes clear, corporate creditors are generally not beneficiaries of the corporate fiduciary relationship. [159] But, as *McDonald v. Williams* exemplifies, when the corporation is insolvent, the general rule does not apply. [160] What is the justification for this radical alteration of one of the most fundamental legal relationships? Surely, radical change to the corporate fiduciary relationship is not simply due to Supreme Court fiat!

This section explores *why* insolvency alters the corporate fiduciary relationship. It begins by exploring the thorny issue of when the alteration occurs, then examines the existing justifications for the alteration of the traditional *corporate fiduciary − solvent* relationship into *corporate fiduciary − insolvent*. Finally, relying upon the contingent property interest of creditors, this section proposes a logical justification for the existence of a fiduciary obligation to creditors.

A. When are Creditors Added as Beneficiaries?

Among the issues raised by *corporate fiduciary − insolvent* is exactly *when* a fiduciary obligation is owed to creditors. The simple answer is that it occurs within the period (or some portion of the period), after a corporation is in financial distress and thereafter until a corporation returns to solvency or files a bankruptcy petition. [161]

In earlier years, it was generally assumed that there was no fiduciary duty to creditors until some statutory insolvency proceeding was initiated. [162] Such a proceeding could include receivership, an assignment for the benefit of creditors or bankruptcy. The bright line that such an event offers is attractive, but is not doctrinally consistent, nor do the problematic issues dealt with in this thesis occur exclusively within statutory proceedings. The justification for the inclusion of creditors in the corporate fiduciary relationship occurs independently of the institution of statutory proceedings. [163]

Admitting that the trigger of a fiduciary obligation to creditors is insolvency in fact, rather than the initiation of statutory proceedings, does not resolve the issue. Determining the moment of insolvency with precision has plagued corporate and bankruptcy law for decades, and has been called a "'guess compounded by an estimate.'" [164]

The dictionary definition of the word insolvency is the moment or state of being when an entity is "unable or having ceased to pay debts as they fall due in the usual course of business; having liabilities in excess of a reasonable market value of assets held." [165] Similarly Black's Law Dictionary defines insolvency as "[t]he condition of a person or business that is insolvent; inability or lack of means to pay debts. Such a relative condition of a person's or entity's assets and liabilities that the former, if all made immediately available, would not be sufficient to discharge the latter." [166]

Insolvency does more than alter the fiduciary obligation of a corporation's officers and directors. [167] Insolvency also restricts corporations from paying dividends, [168] and implicates some of the Bankruptcy Code's avoidance provisions. [169]

There are numerous mechanisms for determining insolvency. Alternatives include equitable insolvency, [170] "balance sheet insolvency," [171] the Bankruptcy Code's definition, [172] the Uniform Fraudulent Conveyance Act's definition, [173] the Uniform Fraudulent Transfer Act's definition, [174] and various state law definitions. [175] Whichever test is used, in hindsight, it is possible that a corporation was actually insolvent when the challenged transaction took place. [176] Valuation of contingent liabilities can be particularly troubling. [177]

It is impossible to confidently predict which insolvency calculation mechanism a court will use in a creditor's suit for breach of fiduciary duty, [178] however, recent Delaware court opinions favor "equitable insolvency" as the triggering event for purposes of fiduciary obligation. [179] Commentators generally ignore the practical difficulties in actually proving a corporation is insolvent. [180]

The *Credit Lyonnais* [181] decision by Chancellor Allen considerably complicated the traditional analysis of "when" a fiduciary obligation is owed to creditors. *Credit Lyonnais* involved a complicated "leveraged buyout case that failed to meet its sponsors' expectations." [182] Though, oft−quoted, the fiduciary obligation portion of the opinion can be considered dicta. [183] *Credit Lyonnais* stands for the proposition that when a corporation is in severe financial distress, a corporate fiduciary owes his or her fiduciary obligation to the corporate enterprise rather than shareholders or any single constituency. Chancellor Allen's trigger for alteration of the traditional fiduciary model was when the corporation is "in the vicinity of insolvency." [184] The seminal quote from the opinion reads:

In these circumstances where the company was in bankruptcy until May 28 and even thereafter the directors labored in the shadow of that prospect, [management] w[as] appropriately mindful of the potential differing interests between the corporation and its 98% shareholder. At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue [sic] risk bearers, but owes its duty to the corporate enterprise.

[…M]anagement was not disloyal in not immediately facilitating whatever asset sales were in the financial best interest of the controlling stockholder. In managing the business affairs of MGM, [management] owed their supervening loyalty to MGM, the corporate entity. It was not disloyal for them to consider carefully the corporation's interest in the [various] proposed transactions. This I conclude they did. [The majority shareholder] had gotten himself into a corner. He needed to liquidate assets to raise capital. [Management] could reasonably suspect that he might be inclined to accept fire−sale prices. But the MGM 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. [185]

How the above quote is understood to impose a direct fiduciary obligation between a corporate fiduciary and the creditors of a corporation "in the vicinity of insolvency" is unclear. [186] Chancellor Allen specifically held that corporate fiduciaries are not "the exclusive agent of residu[al] risk bearers." [187] Though a bit cryptic, it seems that Chancellor Allen was simply stating that when management acts may affect the "legal value" [188] of claims against the corporation, a corporate fiduciary must consider the interest of the corporation itself rather than simply maximizing shareholder value, hardly a unique proposition. [189]

A novel proposal, here made, for a trigger of the corporate fiduciary obligation being extended to creditors is that a fiduciary obligation is owed to creditors when *any act, decision or transaction threatens the legal value of a creditor's claim against the corporation.* The insolvency or "vicinity of insolvency" formulations are inadequate. [190] This is because the justification for alteration of the corporate fiduciary mechanism occurs before a corporation is insolvent:

[F]irms are *always* in the vicinity of insolvency because all it takes for any firm, no matter how solvent, to become insolvent is to lose a sufficiently risky bet. One can construct for any firm, no matter how solvent (so long as it has debt and limited liability), a bet sufficiently risky that it would increase the value of its shares, while it decreased the total value of the company − a bet, that is, that would be socially inefficient for the firm to make. [191]

If such a trigger were used, situations in which a corporate fiduciary would need to consider creditors as beneficiaries would include instances in which:

1) The corporation is insolvent;

2) The corporation is in the "vicinity of insolvency;" and

3) The corporation would enter the "vicinity of insolvency" as a direct result of an act, decision or transaction by the director/officer.

This would serve as an initial trigger to determine the *existence* of a fiduciary obligation to creditors.

When the corporation is insolvent [192] the justification for the existence of a fiduciary obligation to creditors is relatively clear. In such circumstances, the directors and officers are operating a corporation whose equitable owners are not shareholders but creditors. The results of director and officer decisions will affect the legal value of creditor's claims.

The second and third situations are more problematic. Both cases involve at least technically solvent corporations. Therefore, shareholders undeniably retain an interest in the corporation, but perhaps not the identical interest that shareholders have in financially healthy corporations. The "vicinity of insolvency" concept is only relevant if certain decisions that are taken when the corporation is solvent are also subject to creditors' fiduciary protection. [193] A director/officer act is no less harmful to creditors when taken while the corporation is healthy, but the corporation is made insolvent by the decision, than when a similar decision is made when the corporation is very nearly insolvent. These decisions are similar to those identified by constructive fraudulent transfer law. [194] A balance must be struck between (A) fostering entrepreneurial innovation and allowing threatened businesses the freedom to evolve and develop new initiatives, and (B) accountability to creditors when overly risky business decisions prove to be unsuccessful, and the value of creditor's claims are reduced. This trigger for fiduciary obligation to creditors is an attempt to balance each.

A second trigger could be utilized to determine the scope of the fiduciary obligation to creditors. As discussed below, if the corporation intends to continue to operate the business, the traditional *corporate fiduciary − solvent* fiduciary obligation should be duplicated post−insolvency as much as possible. However, *if the corporation were winding down or liquidating, the corporate fiduciary should be subject to a heightened "trustee−like" standard.* [195] A director/officer's decision to liquidate or not should be entitled to business judgment protection, like any other business decision. Thus, unless the corporation is ceasing to exist, the level of a corporation's insolvency is irrelevant to the scope of the corporate fiduciary analysis. [196]

This proposed dual trigger mechanism would alleviate the trouble of a precise solvency/insolvency calculation. Though important to many commentators when attempting to establish a unified scheme of fiduciary duty, [197] the precise level of solvency does not seem to be material. Once it is established that a director or officer's decision may have an effect on the "legal value" of a creditor's claim, creditors become beneficiary parties to the corporate fiduciary relationship. It is this contingent property interest in the assets of the corporation that is the basis for of the fiduciary relationship's adaptation to account for the corporation's insolvency. This contingent property interest is explored in Part III (C) below.

B. Existing Rationales for a Fiduciary Obligation to Creditors

The addition of creditors to the corporate fiduciary relationship can be viewed as an adaptation of the corporate fiduciary relationship to account for the corporation's insolvency. [198] Adapting the traditional fiduciary mechanism is the task, rather than using a corporation's insolvency to manufacture an entirely new and different fiduciary mechanism. Though the existence of a fiduciary obligation to creditors when a corporation is insolvent is nearly universally recognized, a rationale or justification for insolvency's alteration of the corporate fiduciary relationship is, with a few exceptions, ignored. The focus of much of the commentary is the content of the fiduciary obligation rather than the justification for the insolvency alteration.

The fundamental question to be answered is: what is it about insolvency that renders creditors, traditionally not owed a fiduciary obligation by a corporation's directors and officers, similar to shareholders? In other words, why does insolvency make a promissory note look like a stock certificate?

The much maligned trust fund doctrine, which states that under certain circumstances and conditions, a corporation's assets will be deemed a trust fund, or *res*, held in trust by corporate fiduciaries for the benefit of creditors, [199] does not include a justification for its existence. The economics−based rationale, to be discussed, does attempt to explain why creditors ought to be beneficiaries of the corporate fiduciary relationship post−insolvency, but its weaknesses outweigh its strengths. [200]

A strange case demonstrating the importance of establishing a rationale for the adaptation of the corporate fiduciary mechanism is presented by *In re Ben Franklin Retail Stores*. [201] Bankruptcy Judge Barliant recited the factual background of the case:

The Debtors are all Delaware corporations formerly in the wholesale and retail variety and craft business. They are a holding company (Ben Franklin Retail Stores, Inc.) and its operating subsidiaries that either owned and operated, or franchised and supplied, Ben Franklin and similar stores around the country. The Defendants were the Debtors' officers and directors…. They are accused of wrongfully prolonging the Debtors' corporate lives beyond the point of insolvency by misrepresenting the true value of the Debtors' accounts receivable. Specifically, they "refreshed" or redated the due dates of millions of dollars of receivables to make it appear that they were current when, in fact, they were seriously past due. As a result, receivables that should have been written down were recorded at full value. Based on that overvaluation, the Defendants induced creditors to lend money and supply inventory and other value to the Debtors, even after the Debtors were insolvent. Creditors were harmed because the Debtors sank deeper into insolvency as their liabilities grew.

The Debtors filed for chapter 11 bankruptcy relief on July 26, 1996, but the attempted reorganization failed and the Debtors converted their cases to chapter 7 on June 24, 1997. After the conversion, certain unsecured creditors assigned their claims against the Defendants to the chapter 7 Trustee. The Trustee, as assignee of those claims, alleges that the Defendants are liable for the losses suffered by creditors on two theories. First, the Defendants, as officers and directors of the Debtors while the Debtors were "in the vicinity of insolvency," owed fiduciary duties of care to creditors. The Defendants breached those duties by redating the receivables, misrepresenting the Debtors' financial condition and prolonging the Debtors' corporate lives beyond insolvency. Second, that conduct constituted negligence. [202]

It appears that at all times relevant the debtors Ben Franklin Stores was insolvent. [203] Therefore, in applying Delaware law, Ben Franklin's directors and officers owed a fiduciary obligation to creditors, and Bankruptcy Judge Barliant so found. [204] Bankruptcy Judge Barliant then discussed the constituent duties of the fiduciary obligation. He held that:

[C]reditors have a right to expect that directors will not divert, dissipate or unduly risk assets necessary to satisfy their claims. That is the appropriate scope of a duty that exists only to protect the contractual and priority rights of creditors. [205]

Such a formulation generates numerous problems. [206] First, if the obligation is merely to maintain the "contractual and priority of creditor's claims," it adds nothing to existing law when a debtor−corporation subsequently files for bankruptcy. Acts by corporate fiduciaries that would alter creditor rights would be actionable under the Bankruptcy Code's avoidance powers. [207]

Second, it is inconsistent with existing fundamental corporate law, and would represent a wholesale alteration of the corporate fiduciary relationship. As discussed throughout this thesis, such a fundamental alteration "re−invents the wheel" and need not be undertaken.

Third, Bankruptcy Judge Barliant failed to recognize that by fraudulently prolonging the debtor's life, the defendant directors *were* "altering the contractual and priority rights of creditors." By incurring unnecessary debt, the unsecured creditor's right to a payment from the chapter 7 liquidation is reduced because those new lenders will then share in the dividend from the bankruptcy. In *Ben Franklin*, the fraudulently incurred loans were secured loans, thus altering the priority rights of existing creditors, by essentially creating priming liens.

Bankruptcy Judge Barliant then held that because the loans fraudulently incurred were not misused, they breached no fiduciary obligation to the creditors. [208] He then holds that the trustee−plaintiff did not allege "that the Defendants did not use the corporate assets in an informed, *good faith* effort to maximize the corporation's long−term wealth creating capacity." [209] He does not clarify how fraudulently incurring loans is a good faith exercise of the director/officer obligation. [210] As Bankruptcy Judge Barliant recognizes later in his opinion, "[T]he duty could … be violated by causing the corporation to incur unnecessary debt to or for the benefit of shareholders." [211] It seems to the author that subjecting assets to unwarranted claims is a method of diverting them from legitimate corporate uses. By reducing the value of all claims, creditors and shareholders alike, the existing contractual and priority rights of creditors is not maintained. [212]

On appeal, District Judge Hibbler complicated the matter. [213] Judge Hibbler, hearing the appeal of unsecured and secured creditors, failed to recognize the "self dealing element" of the case. This is so because the defendants were paid agents of the corporation receiving a salary, as well as likely shareholders of the corporation. By fraudulently prolonging the life of the corporation, the defendants thereby extended themselves in management. Not only is this classic entrenchment, forbidden by corporate law, [214] it also enabled shareholders to receive the benefit of the fraudulently obtained loans provided by co−beneficiary creditors. [215]

Ben Franklin presents an egregious case of fraudulent conduct. The fraudulent incurring of loans while a corporation is insolvent is, of course, fraud. Fraud is inconsistent with any formulation of fiduciary obligation, and the defendant directors should have been held liable for their breach of fiduciary obligation. If *Ben Franklin* had relied on a rationale for its alteration of the corporate fiduciary mechanism, it may have reached the correct result.

1. Absolute Priority Rule

The most fundamental justification for the existence of a fiduciary obligation of an insolvent corporation's directors and officers to creditors is the absolute priority rule. The absolute priority rule can generally be described as a mechanism that provides that all senior creditors will be paid in full before any payment to junior creditor claims, and all junior creditor claims will be paid in full before any payment to shareholders. [216] "It represents the general principle that creditors, in the order of their non−bankruptcy priorities, are to be satisfied in full from the debtor's assets before the debtor may retain *any* interest in those assets." [217]

Pursuant to the absolute priority rule, creditors are the actual equity owners of an *insolvent* corporation. [218] The absolute priority rule, strictly applied, ignoring the variable of time, and using balance sheet insolvency exclusively, would replace shareholders with creditors as the owners of the corporation. This is so because there are insufficient assets with which to pay all creditors. Shareholders have lost their interest in the corporation. They will not receive anything if the corporation is liquidated. The shareholders are eliminated from consideration and creditors become the focus of the corporation's management.

The absolute priority rule is the foundation upon which chapter 7 liquidation proceedings are based. [219] It is also applied in chapter 11 bankruptcy, in the form of the best interests of creditors test. [220] The absolute priority rule attempts to implement the pre−insolvency expectations of creditors of the corporation. It also offers a framework, or worst−case scenario, to guide a troubled corporation's negotiation out of financial distress. [221] However, the absolute priority rule assumes that there is no future to the corporation. [222] The potential future appreciation in the corporation is not taken into account in the absolute priority rule analysis.

When a corporation is merely insolvent, it may, or may *not*, be doomed to liquidation. [223] It may be attempting to effectuate a workout or turnaround, while continuing operations, paying creditors, and attempting to turn a corner and restore shareholder value. A strict imposition of the absolute priority rule would immediately foreclose all claimants with lower priority claims than those that would receive partial payment through liquidation. The absolute priority rule, when applied to a non−liquidating corporation, inappropriately ignores the fact that some businesses go through cycles of financial distress and will no doubt return to financial health in the future. It also does not account for the concept of "springing insolvency," in which a corporation may be insolvent today, but not tomorrow. [224]

A fine example of this concept is the *Federal Water Service* recapitalization [225] discussed by Professor Dodd in his 1942 article, *Fair and Equitable Recapitalizations*. [226] *Federal Water* presented, for the approval of the Securities and Exchanges Commission, a recapitalization in which the Class A common shareholders were given 5% of the common stock of the recapitalized company and the preferred shareholders were given the other 95%. [227] The various series of preferred shares were entitled to large accrued dividends, and the book value of the assets was substantially less than the liquidation preferences of the preferred shares. [228] The corporate net income for the period 1935 − 1940 was substantially less than each year's annual preferred dividend, but the net income substantially exceeded the dividend in 1939 and 1940. [229] Estimated earnings for 1941 indicated an increase over 1940. [230] The Commission had to approve the recapitalization as being "fair and equitable." These terms were in the Public Utility Holding Company Act, [231] but were also the basis for Justice Douglas' implementation of the absolute priority rule under the Bankruptcy Act. [232] Professor Dodd summarizes the Commission's majority holding:

Under these circumstances it would have been difficult to justify a finding that the present value of the assets, measured on a prospective−earning basis, would exceed the amount of the preferred shareholders' liquidation claims, for which reason Commissioner Healy [the dissenter] insisted that the class A shareholders had no equity which entitled them to share in the reorganization. The majority of the Commission took a different view. They pointed out that the preferred shares had *no right to receive their dissolution preference except in the event of dissolution or liquidation, that they had no right to compel liquidation, and that the present proceeding was not one "where liquidation was in the atmosphere."* They concluded "that *the Class A has a reasonable expectation of receiving earnings at some future time,* and that this expectation cannot be dismissed as negligible," and they therefore held that though the value of the Class A shares was conjectural, it was sufficient to justify the approval of a plan which gave the holders 5% of the new common shares. The result, as the majority admitted, was *to give the preferred shareholders securities worth less than the amount of their liquidation preferences while at the same time permitting junior shareholders to participate.* [233]

While a bit obscure and though it was the Securities and Exchange Commission's opinion rather than that of a court, the reasoning in *Federal Water* should be applicable to the insolvent corporation. Shareholders may retain a sufficiently valuable interest in future earnings. Immediately foreclosing all shareholders' interest in all insolvent corporations would be an inequitable and irrational response to the corporate governance of the insolvent corporation.

An additional reason the absolute priority rule should not apply in the insolvent, non−bankruptcy debtor corporation, is that the liquidation is purely hypothetical. In an insolvent corporation, there is no immediate requirement of liquidation. Such troubled corporations generally attempt to work out of the financial distress of the corporation. Similar to the purpose and justification for the entire elaborate federal bankruptcy scheme, a business ought to have an opportunity to reorganize and capture the excess of liquidation value that may be realized by reorganization in or out of bankruptcy.

Applying the absolute priority rule to a corporation that is merely illiquid, or equitably insolvent, makes very little sense. Shareholders may retain a significant interest in such a corporation. An *ipso facto* termination of their interest, at least as a beneficiary party to the corporate fiduciary relationship, is nonsensical.

2. Economics−based Rationale

An additional, more specific justification for creditors as beneficiary parties to the corporate fiduciary relationship exists. It is based on agency theory, a branch of economics that focuses on the various costs that are imposed on a contributor of capital to a corporation when the contributor is not in control of the corporation. [234]

Shareholders, as residual claimants, in solvent corporations are distinct from fixed claimants. [235] Some commentators believe that the traditional powers of shareholders are altered by the corporation's insolvency. [236] Assuming the "balance sheet" test for insolvency, an insolvent corporation's liabilities exceed its assets. [237]

Whatever is received from the corporation's liquidation would be distributed to creditors pursuant to their state law established priorities. [238] Since the value received from the sale is by definition less than the liabilities of the corporation, some creditors will not be paid in full. Thus, pursuant to the absolute priority rule, shareholders would receive nothing. Therefore these commentators postulate that upon insolvency, shareholders cease to be the residual owners of the corporation.

Shareholders would receive nothing from the corporation's liquidation, and therefore their motivations are perverted. Insolvency exacerbates the adversarial relationship between a debtor and creditor. [239] Assuming they are economically rational, they would favor riskier investments that promise higher, though more speculative, returns. [240] According to the residual owner analysis, this change in shareholder motivation is the basis for the alteration of the beneficiary party of the corporate fiduciary relationship. Shareholders act in their own best interest, and in an insolvent corporation, that interest is too perverted to justify the maintenance of them as beneficiaries of the corporate fiduciary relationship.

Creditors of an insolvent corporation then become similar to shareholders in a solvent corporation. [241] The dollar that is "won or lost because of good or bad negotiating" accrues to or is owed by, these partial−payment−residual owners. [242] This is the group whose investment is on the line, or whose money is at risk.

The residual owner concept is *academically* compelling. [243] Residual owners can rightfully claim that they are the "true owners" of the corporation, and it is for their benefit that the insolvent corporation ought to be operated. They are the true beneficiary party of the *corporate fiduciary − insolvent* relationship. [244] Unfortunately, as is perhaps obvious, tremendous practical problems with the concept exist.

Unfortunately, creditors are not all alike. Assuming all claims priority can be established, in an insolvent corporation, there is, without doubt, *some group of creditors* who will not be paid in full. This is not true for *all creditors*. Over secured creditors, for example, are, or ought to be, indifferent to the level of solvency of the debtor corporation. At all times their rights in collateral are sufficient to repay the debtor's obligation. Thus, to determine the "true residual owners," further examination must be undertaken. [245]

Assuming the exact level of insolvency can be determined, it would be possible to identify the sub−group of creditors who are the true residual owners. If the corporation becomes more insolvent, their claim value is reduced, while if it approaches solvency, their claim value increases.

Creditors are a varied group of entities linked, perhaps, only by their relationship with a particular debtor. There is as much variety of risk aversion, interest in working with a debtor, and time investment horizon as exists in the general population. [246] Additionally, simply because multiple creditors are in a class together, there may be tremendous intra−class conflicts similar to the inter−class conflict.

Theoretically, if the residual owner concept is combined with the absolute priority rule or some state law priority scheme, the optimum residual owner class can be found. [247] Unfortunately, if found today, they may not be the optimum class tomorrow. [248] As a corporation's level of insolvency varies, its residual owners may change. These residual owners are different than a solvent corporation's shareholders in that if the corporation becomes less insolvent, this group of residual owners would then have their claims paid in full. They are still fixed claimants, they are not entitled to a premium when the corporation is insolvent any more than they are when the corporation is solvent. Therefore, as the level of solvency changes, the identity of the residual owners may also change. Is a director/officer to wake up every morning and calculate the exact solvency of the corporation, then, based on the corporation's state priority scheme, identify the exact residual owner, then operate the business for that class' benefit that day, only to wake up the next day, and engage in a similar exercise? [249] In a corporation with a capital structure of any complexity, such a proposal is plainly unworkable.

A second problem is that the other traditional powers of shareholders do not devolve upon the creditors upon insolvency. Such powers include the power to elect and remove directors as well as the power to ratify self−interested director transactions [250] and other powers. [251] Certainly, these other powers should logically devolve upon residual owners along with beneficiary status in the corporate fiduciary relationship. Perhaps, these are powers that residual owner model proponents believe should devolve upon creditors.

Third, the residual owner analysis utterly fails when a court utilizes the equitable insolvency mechanism for determining when creditors become beneficiary parties to the corporate fiduciary relationship. A corporation may be equitably insolvent, thus not paying its debts as they come due. [252] This does not mean that creditors have any equitable interest in the corporation. If an equitably insolvent corporation were liquidated, creditors may be paid in full, with a potential return to shareholders. In such cases, creditors should not be beneficiary parties to the corporate fiduciary relationship.

Additionally, if the residual owner rationale were employed, pre−insolvency equity, as well as all creditors not receiving any payment, would be excluded from the beneficiary class. [253] They would no longer be beneficiary parties to the fiduciary relationship. Such a myopic result is doctrinally insufficient and presents significant practical problems. While informative and useful in certain circumstances, the residual owner concept is not flexible enough to be used in the day to day management of a troubled corporation. [254]

A. A Proposed Justification for Creditors−as−Beneficiaries of the Insolvent Corporate Fiduciary Relationship

The absolute priority rule, while an effective and equitable mechanism in bankruptcy proceedings, does not aid the analysis of fiduciary obligation in a merely insolvent corporation. [255] The residual owner concept requires corporate fiduciaries to operate the insolvent corporation for the benefit of certain creditors who are its residual owners. [256] While academically and doctrinally appealing, it suffers from significant weaknesses and limitations. [257]

The possibility that a corporation may not fully satisfy its obligations to creditors is the basis for their addition as beneficiary parties to the corporate fiduciary relationship. Creditors of an insolvent corporation have an interest in the corporation, and therefore fiduciary protection is extended to all of the insolvent corporation's creditors. While creditors always have an investment at risk when it enters into a debtor−creditor relationship, their legal right to repayment is threatened by a corporation's insolvency. The right to repayment consists of a contractually established creditor's claim against a debtor. [258] The amount to be realized is the claim's "legal value". While the market value of a creditor's claim may fluctuate with the fortunes of the debtor corporation, particularly if the creditor's claim is publicly traded, a claim's legal value remains unaltered. [259] The protections of the fiduciary relationship are extended to creditors when the corporate fiduciary makes a decision that affects the legal value of a creditor's claim. [260]

Corporate fiduciaries must be permitted to resolve the business problems of the troubled corporation. Imposing additional obligations of identifying residual owners, or determining the precise moment of insolvency distracts directors and officers from the task at hand, returning the corporation to profitability. This is a prospect that all stakeholders, creditors and shareholders alike, agree is the proper goal.

When a corporation is insolvent it is reasonable to extend the fiduciary obligation to creditors. Directors and officers are using creditor's investments to operate the corporation. They are clearly affecting the legal value of creditor's claims. There are also acts, decisions and transactions undertaken by directors and officers when a corporation is solvent that ought to implicate creditor fiduciary protection. [261] The corporation's level of solvency is indicia that the legal value of creditor's claims may be reduced, but is not sufficiently comprehensive.

While largely academically unsatisfying, [262] this is the essence of any justification or rationale explaining a fiduciary obligation to creditors. The justification for creditors−as−beneficiaries need not be any more specific than the *existence of the possibility that the legal value of creditor's claims may be reduced*. Though perhaps vague, the justification is sufficiently concrete to form the foundation of *corporate fiduciary − insolvent*. Other rationales or more specific amendments to the corporate fiduciary relationship create more problems than they solve.

With a justification for the adaptation of the corporate fiduciary relationship proposed, the details and requirements of the fiduciary obligation can be established. Corporate fiduciaries are experienced with operating a corporation for absentee owners. Insolvency does not alter this fundamental aspect of the corporate fiduciary relationship. Maintaining the traditional corporate law fiduciary mechanism adds predictability and reduces transaction costs to the troubled corporation. Once directors and officers understand that the beneficiary class is altered, they should be free to implement a business plan with as little disturbance and distraction as possible.

I.A PROPOSED MODEL FOR THE FIDUCIARY OBLIGATION OF DIRECTORS AND OFFICERS OF INSOLVENT CORPORATION

No one suggests that while a corporation is insolvent, directors and officers are altogether free from fiduciary obligation. [263] Such a proposal makes as little sense in a financially troubled corporation as in a healthy corporation. There is near unanimity among courts and commentators that upon insolvency, some kind of fiduciary relationship exists between an insolvent corporation's management and its creditors. [264]

While nearly uniform in result, courts take many different paths to reach it. This thesis has identified a justification for creditors−as−beneficiaries of an insolvent corporation's management's fiduciary obligation. This thesis has also proposed that the trigger for the adaptation of the corporate fiduciary mechanism be based on creditors' contingent property interest in the corporation. Together they form the doctrinal foundation for the practical problem addressed by this section: what does a director/officer do when the corporation for which he or she serves becomes financially distressed?

This section proposes a model for the fiduciary obligation of directors and officers of financially troubled corporations. It is based on the traditional, solvent corporation's fiduciary mechanism, but is altered to account for the corporation's insolvency. The familiar elements of a director/officer's fiduciary obligation while the corporation is solvent are modified to account for the additional beneficiaries.

Directors continue to serve the corporation until they resign or are removed. Officers continue employment with the insolvent corporation. [265] Though obvious, this aspect of the corporation's transformation from solvency to insolvency is generally ignored. There exists a rich and well−developed case law on the fiduciary relationship of corporate fiduciaries in solvent corporations. [266] The fiduciary relationship in solvent and insolvent corporations is nearly identical, and therefore crafting an entirely new fiduciary obligation is unnecessary. [267]

The proposed model proceeds in a similar method as the preceding examination of the traditional solvent corporation's fiduciary system. First, the fiduciary and beneficiary parties are identified. It then evaluates the alterations insolvency has on the constituent duties for the *corporate fiduciary − insolvent* relationship.

A. Identification of the Fiduciary and Beneficiary Parties to the Corporate Fiduciary − Insolvent Relationship

The identity of the fiduciary party, or who owes the duty, in a corporate fiduciary relationship is not dependent on the level of solvency of a corporation. The level of a corporation's solvency does not alter the discretion and decisionmaking power of corporate management. The level of a corporation's solvency does not alter the entrustment, or the representational justifications for the corporate director/officer's fiduciary obligation. Corporate law and the corporation's articles or charter establish these powers and obligations. [268] Financial distress does not create new, or terminate existing, fiduciary parties. Therefore, this facet of the corporate fiduciary relationship passes through insolvency without change.

The beneficiary parties to the corporate fiduciary relationship are radically altered by the corporation's insolvency. While the corporation remains solvent, the corporate director/officer owes a fiduciary obligation to the corporation and its shareholders. [269] Though there are some thorny issues regarding the beneficiaries of the corporate fiduciary relationship, courts are able to resolve these issues in relatively straightforward terms. [270]

Insolvency and certain financial distress alter this fiduciary mechanism. [271] When a corporate officer or director takes action that may affect the legal value of creditors' claims, creditors become beneficiaries of the corporate fiduciary relationship. [272] Shareholders are no longer the exclusive "residual risk bearers". Creditors are transformed from fixed claimants into residual claimants. [273]

Unfortunately, creditors are a varied group, and interests among the group generally conflict. [274] Creditors' interests also generally conflict with shareholders' interests. However, certain groups of obligees may or may not qualify as beneficiary parties. [275] The value and status of these claims may affect the insolvency calculation and the beneficiaries' identify. Yet, these issues are largely unaddressed by courts and commentators in the context of a corporation's management's fiduciary obligation.

One proposed mechanism for determining the beneficiaries of the corporate fiduciary relationship is to determine who would have standing to bring a suit to enforce the obligation, and then simply require management to advance this group's interest in managing the corporation. [276] While attractive in that it may simplify the determination of the beneficiary, the mechanism does not account for certain aspects of the relationship. The fiduciary obligation, particularly the duty of loyalty, represents a standard of conduct. Any deviation from this standard is a breach of the corporate fiduciary's obligation, regardless of whether any entity has standing to sue to enforce a breach of fiduciary duty. There are certain management acts that are a breach of fiduciary obligation for which there may be no eligible plaintiff. Standing is not a part of the standard. It is a limitation on the fiduciary enforcement mechanism, that may, or may not, be present when a corporate fiduciary breaches his fiduciary obligation. Identifying who would have standing to sue also implicates all the practical problems inherent in identifying residual owners, discussed above. [277]

A thorny issue in identifying the universe of those to whom a corporation's management owes an obligation, is whether pre−insolvency beneficiary parties, the corporation and its shareholders, are excluded from the beneficiary class post−insolvency. Some courts and commentators believe that at the moment of insolvency, there is a shift of fiduciary obligation and creditors become the exclusive beneficiaries. [278] The "shift" spoken of is in the beneficiary of the fiduciary obligation, not a "shift" of the fiduciary obligation itself. The proper conceptualization is that creditors are added as members of the beneficiary class. [279] There is no shift of beneficiary; it is more properly considered an expansion of the beneficiary class. [280]

It is inappropriate to remove the corporation or its shareholders as beneficiary parties if the corporation is continuing business. This is so because:

1. Directors and Officers Continue to Owe a Fiduciary Obligation to the Corporation

It is axiomatic that a corporate fiduciary owes a fiduciary obligation to the corporation for which he serves, regardless of whether the corporation is solvent or insolvent. The maintenance of the corporation as beneficiary is aided by maintaining shareholders as beneficiaries to the corporate fiduciary relationship.

2. Shareholders' May Retain a Valuable Claim to the Future Appreciation in the Corporation's Value

As discussed above, and demonstrated by the *Federal Water* recapitalization, shareholders may retain a valuable interest in the future earnings and appreciation in the value of a corporation's assets. [281] This aspect is particularly evident if an examining court mistakenly uses equitable insolvency for the trigger of fiduciary obligation to creditors.

3. If the Corporation Subsequently Becomes a Bankruptcy Debtor, Corporate Fiduciaries Would Then "Re−Owe" a Fiduciary Obligation to Shareholders

If insolvency extinguishes shareholder beneficiary status, what happens if the corporation subsequently files for bankruptcy? Supreme Court case law holds that a debtor in possession owes a fiduciary obligation to all parties in interest in the bankruptcy case. [283] Does a bankruptcy petition re−instate beneficiary status to shareholders? Surely, the problems engendered by a gap in which shareholders are not beneficiaries of the corporate fiduciary relationship justify their maintenance as beneficiaries of management's fiduciary obligation.

4. Shareholders May Retain Important Powers, Including the Power to Remove Directors, and Ratify Self−Interested Corporate Fiduciary Transactions

Even if insolvent, shareholders likely retain the right to elect directors. [284] They also may retain the right to ratify certain self−interested corporate fiduciary transactions. [285] While a troubling and conflicted area of the law, these vital shareholder rights do not appear to be extinguished by a corporation's insolvency.

5. Even in Bankruptcy, Courts are Reluctant to Completely Foreclose Shareholder Interests

Finally, bankruptcy courts do not extinguish shareholder interests unless a corporation is clearly and demonstrably insolvent. [286] Non−bankruptcy courts should be even less inclined to do so. [287]

6. Maintaining Shareholders as Beneficiaries Makes Clear that Run of the Mill Breaches of the Fiduciary Duty of Loyalty are Forbidden

Most directors and officers understand that they are forbidden from embezzling from the corporation for which they serve. If shareholders are eliminated as beneficiaries, they may be more likely to engage in self−aggrandizing transactions with the corporation. Shareholder's derivative suits seeking to avoid such transactions are relatively established. Additional monitors of the distressed corporation's directors and officers merely adds accountability to the process.

The issues raised by commentators when director/officers owe a fiduciary obligation to conflicting beneficiaries in an insolvent corporation are well overstated. The conflict is no different than in a financially healthy corporation. As discussed above, this thinking may stem from an attorney's fear of a conflict of interest when representing multiple clients. [288] Directors and officers in debtor in possession corporations present similar conflicts of interest. [289] Directors and officers have experience in dealing with conflicting beneficiaries. There is as much diversity of interest among shareholders of a publicly traded corporation as exists in a financially troubled corporation. [290] While director/officer acts taken while the corporation is in financial distress may have greater repercussions, and certainly are subject to greater scrutiny, the fundamental conflict among beneficiaries is no different than in a financially healthy corporation.

B. The Standard of Conduct for Directors and Officers in Corporate Fiduciary − Insolvent

It is essential that corporate fiduciaries recognize that when the corporation for which they serve is in financial distress, or would be made so by an act, decision or transaction, they are no longer the "agent of the residual risk bearers." Potentially ruinous personal liability may result if director/officers neglect their obligation, or engage in overly risky transactions. [291] If nothing else, a director/officer must recognize that acts taken during financial distress will not only be important to the eventual success or failure of the corporation, but also will be the focus of intense judicial scrutiny. A fiduciary party to *corporate fiduciary − insolvent* had better be prepared for a thoroughly detailed *ex post* examination of his or her acts during the period of financial distress.

A second general notion of the change that occurs when a corporation nears insolvency is that a director/officer ought to start thinking more conservatively. [292] While the entrepreneurial spirit may have led the director/officer to success in the past, wild ideas and crazy schemes to rescue the sinking ship are significantly more risky than the risk borne by a start−up company. [293]

One argument often made is that the directors and officers ought to simply maximize the value of the corporation. [294] This, it is argued, would be in the creditors' best interest, as well as the shareholders'. Such a siren's song is deceptively simple. Though perhaps appropriate in smaller cases, [295] if an insolvent corporation has a capital structure of any complexity, there may be a tremendous disagreement over the meaning of "value maximization." To an underwater shareholder, value maximization means pursuit of the riskiest, though potentially most rewarding, endeavor. A one in a thousand chance of a complete turnaround is better than an immediate liquidation in which a shareholder will receive nothing. Value maximization to a vulture fund investor, who purchases a troubled corporation's bonds at a steep discount, may favor immediate liquidation of the corporation's assets, enabling the vulture investor to re−invest in another opportunity. Perhaps a complex index could be established, accounting for all beneficiaries' risk preference and time investment horizon could be utilized to determine a course of action that is optimal. Unfortunately, such an index is beyond the scope of this thesis, and is likely impossible to formulate.

While the vague concept of value maximization may aid a director/officer in choosing among alternatives, it is an inadequate foundation upon which to base a fiduciary enforcement mechanism. As perhaps is obvious at this point, there are no easy answers presented by *corporate fiduciary − insolvent*.

A second standard proposed is that a director or officer in an insolvent corporation should merely maintain the priority and contract rights of creditors. [296] While usually not clearly stated, such a standard stems from courts' fear that creditors may control debtor corporations or that creditors may improperly interject themselves into corporate governance. [297] While troubling in certain cases, if creditors are beneficiaries of a fiduciary obligation, there must be some thought about creditor's interest when the corporation is insolvent. Further, existing lender liability law ought to limit creditor control over corporate decisionmaking. [298]

1. Corporate Fiduciary − Insolvent's Duty of Care

Duty of care analysis is basically focused on corporate director/officer negligence. The corporation's solvency does not alter the standard of gross negligence. [299] While insolvency alters the beneficiary of the fiduciary obligation, to date there has not been an inference that the standard of care owed to creditors is any greater than that owed to shareholders − that of an ordinarily prudent person in similar circumstances. [300]

The non−effect insolvency has on traditional duty of care analysis is demonstrated by slightly altering the facts of the famous Delaware case, *Smith v. Van Gorkom*. [301] If *Smith v. Van Gorkom* had occurred when TransUnion was in financial difficulty, the Delaware Supreme Court's holding would not be altered. The board's ignorance and lack of proper diligence in considering the merger offer are unaffected by the solvency of the corporation.

The applicability of the business judgment rule when a corporation is insolvent, a major component of the traditional corporate fiduciary scheme, is an unsettled issue among courts and commentators. [302] If courts apply trust law principles, then directors and officers do not enjoy the business judgment rule's presumption that business decisions are made by disinterested and independent directors on an informed basis and with a good faith belief that the decision is in the best interest of the corporation and its shareholders. [303] Examining courts will directly proceed to an examination of the merits of the challenged corporate fiduciary act. [304] If courts apply traditional corporate law principals, the business judgment rule will apply, and a plaintiff will need to rebut the presumption.

Courts have applied trust law principles to insolvent corporate fiduciary law pursuant to the trust fund doctrine. While long in tooth, the trust fund doctrine is a less than venerated standard of conduct. [305] The doctrine is commonly attributed to Justice Story's 1824 United States Appellate Court opinion of *Wood v. Dummer*, [306] written while riding circuit in the state of Maine. [307] The doctrine has evolved over the past 175 years, and has spawned several Supreme Court and state court opinions. [308]

The trust fund doctrine states that under certain circumstances and conditions, a corporation's assets will be deemed a trust fund, or *res*, held in trust by corporate fiduciaries for the benefit of creditors. [309] Such 'circumstances and conditions' include the insolvency or dissolution of the corporation. Thus, according to the majority rule, no trust exists while the corporation remains solvent. [310] The trust springs into effect upon the insolvency or dissolution of the corporation. Often these two triggering events are not distinguished, which leads to confusion in the cases and commentary.

Most of the cases in which the trust fund doctrine has been applied involve self−dealing and clear instances of breach of a fiduciary relationship. [311] Typically, corporate fiduciaries prefer themselves to the detriment of creditors and other non−corporate fiduciary shareholders. Such cases are relatively straightforward, regardless of the legal justification. Unfortunately, these cases are rife with strong hyperbole and dicta that subsequent courts mistakenly recycle in the far more difficult cases. [312]

The result is that the trust fund doctrine is hopelessly inconsistent and lacks any semblance of doctrinal foundation. [313] It is unclear if the trust fund doctrine applies to solvent or only insolvent corporations, or if it applies only when a corporation is being dissolved. [314] It is unclear whether the trust fund doctrine subjects corporate fiduciaries to personal liability or merely avoids transactions that violate the doctrine and recaptures the dissipated assets. [315] It is unclear what the nature of the "trust" is, i.e., whether it is a true trust, an equitable lien, or a constructive trust. [316]

The business judgment rule should apply in the *corporate fiduciary − insolvent* relationship as long as the corporation is merely insolvent and not liquidating or winding down. This is so "because this is a course courts are familiar with, and because after−the−fact judicial second guessing of board decisions in the troubled and/or insolvent corporation context is no more productive an endeavor than judicial second−guessing of board decisions under ordinary circumstances." [317]

While the fact of insolvency is important, it does not *ipso facto* terminate the corporation's life. In such circumstances, tremendously important and difficult business judgment takes place. Such decisions are very different than those traditionally made by traditional trustees. Courts are no better positioned to second−guess the troubled corporation's management decisions then the healthy corporation.

The appropriateness of the business judgment rule's applicability to the *corporate fiduciary − insolvent* relationship can be demonstrated by a case in which a director/officer is not a shareholder or corporate creditor. [318] Assuming no undue influence, and a competent decision, such an outside and independent director/officer would surely be entitled to a presumption that his or her decisions were in the good faith pursuit of valid business judgment. [319]

A principal issue in which the business judgment rule's applicability may be material is the determination of the financial health of the corporation. More specifically, should a director/officer be entitled to rely on the business judgment rule's presumption when he or she determines whether a fiduciary obligation to creditors exists? In the majority of case law, it is clear that a corporation is insolvent. However, in close cases, the "trigger determination" should be accorded the same deference as any other business decision of a director/officer, and the business judgment rule's presumption should apply. [320]

While the applicability of the business judgment rule may be controversial, [321] the business judgment rule is not nearly as significant in *corporate fiduciary − insolvent* as in *corporate fiduciary − solvent*. If a director or officer is a creditor or shareholder of the corporation, it would generally rebut the business judgment rule. Directors often are shareholders of the corporation for which they serve. [322] Both inside and outside directors are encouraged to be stockholders of the corporation for which they serve. Directors occasionally are also creditors of the corporation. [323]

Once creditors are beneficiaries, there are two distinct classes of beneficiaries, creditors and shareholders. If a director or officer is a member of either group, a director/officer has self−interest, rebutting the business judgment rule's presumption. It is similar to a corporate fiduciary who is on "both sides" of a transaction in a solvent corporation. Under *corporate fiduciary − solvent* analysis, such an interest would rebut the business judgment rule, and a court would proceed to examine the substantive merits of the transaction or decision, applying the entire fairness standard. [324]

When a director/officer is a shareholder or creditor, and that status represents a material interest, [325] the defendant director/officer in a breach of fiduciary obligation suit would then have the burden of proving entire/intrinsic fairness.

[326] However, the business judgment rule *would still technically apply*. [327]

The single instance in which a heightened fiduciary obligation is appropriate is the case in which a corporation has decided to fold its tents, and dissolve. [328] During the winding up process, outside of bankruptcy, a corporation's fiduciaries lack the court supervision and oversight of the Bankruptcy Court. In these cases, and these cases alone, the trust fund doctrine, with all of its warts, may be appropriate.

A classic example of the proper application of the trust fund doctrine is the majority opinion in *New York Credit Men's Adjustment Bureau, Inc. v. Weiss*. [329] In *New York Credit*, the defendant directors purchased a wholesale electrical business. [330] In the first post−purchase year, "the business of the corporation fell off sharply." [331] The defendants had several available courses of action, including soliciting additional loan capital, dissolution under New York law or the commencement of federal bankruptcy proceedings. [332] Spurning these options, the defendants chose to conduct a public auction. [333] They advertised the sale in two newspapers and sent out 1,000 postcards targeted at parties potentially interested in purchasing electrical supplies. [334] The sale netted over $19,000; however, the assets sold had a value on the corporation's balance sheet of over $73,000. [335] The corporation owed at least $52,000 to its creditors at the time of the sale. [336]

The majority opinion quoted language from Fletcher's regarding the trust fund doctrine. [337] It went on to hold that because creditors had not been notified of the sale, the defendants would have the burden of "showing that their action in selling the inventory at public auction resulted in obtaining full value under the circumstances, and did not occasion an improper or improvident depletion of the trust." [338] It affirmed the lower court's determination that the defendants are "obligated to account and respond in damages for the amount, if any, by which less than full value was realized upon the sale." [339]

New York Credit Men's is a curious case. For whatever reason, the directors decided to sell the assets of the corporation without specific notice to creditors. What is important about the case is that the debtor corporation was ceasing to do business, outside state dissolution proceedings and bankruptcy. It is also vital that the decision challenged by the creditors was the sale of all of the assets of the corporation. Subsequent courts have ignored this crucial fact. In the particular circumstances of *New York Credit Men's*, the opinion has merit. When a corporation has decided to cease operations, and attempts to sell all of its assets outside the supervision of state court dissolution proceeding, or the bankruptcy court, the trust fund analysis may be warranted. However, this reasoning has been extended to cases in which the corporation is attempting to continue in business. [340]

When a corporation is attempting to negotiate a workout and is evaluating alternatives, its management should not be limited to those opportunities that are consistent with the obligations of an exclusive trustee relationship between the corporation's management and its creditors. Such a standard removes from consideration alternatives that may benefit all creditors and shareholders alike.

2. Corporate Fiduciary − Insolvent's Duty of Loyalty

The duty of loyalty is not a static concept, but should be considered dynamic and open−ended so that it may reach new and evolving situations. [341] A corporation in financial distress is just such an instance in which courts ought to use the flexibility of the duty of loyalty analysis. Insolvency does not alter the framework of the duty of loyalty analysis.

The corporate fiduciary's duty of loyalty analysis ought to be considered a default rule. There are many similar, but far more developed, doctrines in corporate and bankruptcy law that render the *corporate fiduciary − insolvent*'s duty of loyalty analysis superfluous in many cases. [342] Such similar doctrines include fraudulent transfer law. [343] It, like traditional corporate fiduciary law, is well defined and thoroughly developed. The Bankruptcy Code contains other avoidance powers including its preference [344] and strong−arm [345] provisions, which may overlap with creditor actions for breach of the fiduciary duty of loyalty.

Suits for breach of the fiduciary duty of loyalty must also be distinguished from cases that present breach of contract, including the commercial standard of good faith. [346] *Creditor* suits for breach of the fiduciary duty of loyalty must also be distinguished from *shareholder* suits. Shareholder suits remove most of the more mundane breaches of the duty of loyalty in which a director or officer embezzles corporate assets, in whatever form. An additional limitation is temporal; this doctrine is applied to breaches of the fiduciary duty of loyalty while the corporation is insolvent, but before any statutory insolvency proceeding has been initiated. [347]

What remains unaddressed by these other areas of law are acts, transactions and decisions made by directors and officers, while a fiduciary obligation is owed to creditors, but before a bankruptcy petition is filed, that involve the director/officer's material self interest, and that cause injury to creditors. Whatever the frequency with which such cases occur, they very rarely produce published opinions. [348]

Thus assuming the business judgment rule is rebutted, a reviewing court would apply the entire/intrinsic fairness standard. Unfortunately, most of the entire fairness cases arise in the context of a merger. The general principles that form the entire fairness analysis are applicable to financially distressed corporations. The emphasis would be on the fair process element rather than the fair price element, because there is usually no price to evaluate.

Fair process in the financially distressed corporation can be compared to a hypothetical independent board. The key inquiry is whether a complained of act, decision or transaction would have recommended itself to an independent board. [349] It is essentially a vague inquiry in to the reasonableness of the transaction. If a reviewing court finds that the complained of act was reasonable under the circumstances, it should defer to the decision of the director/officer. When a corporation becomes financially distressed, there is risk that the legal value of creditor's claims will be reduced and shareholders will not receive any return on their investment. The proposed model attempts to fashion a model that encourages directors and officers to creatively and vigorously pursue a workout, while ensuring that directors and officers are held accountable for their unreasonable acts that reduce the value of claims against the corporation.

The prospect of corporate fiduciaries acting for the benefit of certain beneficiaries has been addressed above. [350] It is a far safer course for directors and officers (as well as conceptually consistent) to view their fiduciary obligation to the corporation alone, rather than adding the additional identification of other beneficiary parties to the corporate fiduciary relationship.

As proposed, both shareholders and creditors are beneficiary parties to the *corporate fiduciary − insolvent* relationship. Because of the conflict between the beneficiaries, decisions must occasionally be made that favor either one beneficiary class or the other. To the extent possible, corporate fiduciaries ought to consider each of the beneficiary classes equal. Corporate fiduciaries ought to resolve conflicts among the beneficiaries in the good faith pursuit of maximizing the value of the claims on the corporation. [351] Generally, this pursuit will mean that creditors are given primacy over the claims of shareholders.

Some scholars and practitioners create trouble for themselves by thinking that duty of loyalty cases are easily identified, and that thorough analysis of these issues is not needed. [352] An instance in which this conflict was not presented to the court, was the recent United States Supreme Court decision, *Bank of America v. 203 North LaSalle Street Partnership*. [353] *203 N. LaSalle* was framed for the court as a new value case, but it raises interesting fiduciary issues. [354]

C. Creditor Standing to Sue for Breach of Fiduciary Obligation

A rationale and standard of *corporate fiduciary − insolvent* has been proposed. But the proposed standard is academic unless there is an enforcement mechanism. Commentators have recognized that the enforcement of fiduciary obligations by creditor lawsuit can be an inadequate protection for creditors. [355] However, the director/officer fear of lawsuit and its attendant liability do serve as a deterrent to negligent and self−dealing conduct. Fiduciary principles command loyalty, care and good faith. However, the practical difficulties of enforcing a fiduciary obligation should not be under valued.

Courts utilize the derivative suit when a shareholder−plaintiff alleges a breach of fiduciary obligation by a director/officer in a solvent corporation. [356] The rationale for the shareholder derivative suit, that the damage caused by a breach of fiduciary obligation is truly borne by the corporation, is equally applicable when a director/officer is a defendant in a breach of fiduciary obligation suit by a creditor or shareholder.

Consistent with one of the major themes of this thesis, the standing rules for creditor or shareholder suits for breach of fiduciary obligation should be similar to those in the *corporate fiduciary − solvent* relationship. Currently, the terms of the civil rules limit derivative suits to plaintiff−shareholders, though it seems plausible that if the rule's drafters had considered it, they would have included creditors, to the extent that they are beneficiaries of the corporate fiduciary relationship.

Cases that have addressed the issue in the context of creditors suing directors and/or officers in solvent corporations have not foreclosed the possibility of "beneficial owners" having sufficient standing to sue to enforce the fiduciary obligation. [357] Creditors are precisely such equitable owners of the corporation, after the fiduciary obligation to creditors has been triggered.

A creditor should not have more rights than the shareholder. The creditor is partially "replacing" the shareholder as a beneficiary party. A creditor of an insolvent corporation does not own the corporation anymore than a solvent corporation's shareholders. [358]

Just as a shareholder needs to prove that it was a shareholder at the time of the breach, a creditor would need to demonstrate it was among the beneficiaries of the fiduciary obligation at the time of the breach of fiduciary duty. [359] The insolvency "creates" the fiduciary obligation to creditors.

If there are individualized injuries to a particular plaintiff, then perhaps a creditor could maintain an individual suit. [360] Whether a claim is general or particular is a question of state law. [361]

If the corporation does eventually file for bankruptcy protection, the standing issue is partially alleviated. While the Bankruptcy Code's automatic stay [362] will preclude suits by individual creditors and shareholders, the bankruptcy estate will have standing to sue the corporation's directors and officers for breach of fiduciary obligation. [363] Unless a creditor has a particularized claim, these causes of action become property of the estate because at all times, the corporation (now debtor) will continue to be a beneficiary party to the corporate fiduciary relationship. [364]

CONCLUSION

It is hoped that this analysis aids directors, officers and their advisors, when the corporation for which they serve is in financial distress. The justification for a fiduciary obligation to creditors is based on the contingent property interest of creditors and the threat to the "legal value" of their claims. The fiduciary obligation for the *corporate fiduciary − insolvent* relationship should be modeled on the *corporate fiduciary − solvent* relationship, including the fiduciary duties of care, loyalty and good faith, the business judgment rule as altered, and the derivative suit requirement.

FOOTNOTES:

[*] The term corporate fiduciary – insolvent utilizes the natural science's binomial nomenclature in which a species is identified and distinguished according to its traits and properties. See generally, Deborah A. DeMott, Fiduciary Obligation under Intellectual Siege: Contemporary Challenges to the Duty to be Loyal, 30 Osgoode Hall L.J. 471 (1992) (Discussing a taxonomic approach to fiduciary relationships); Ernst Mayr, E.Gorton Linsley and Robert L. Unsinger, Methods and Principles of Systematic Zoology (1953) (Discussing the history and benefits of binomial nomenclature); Ernst Mayr, Principles of Systematic Zoology, (1969) (same).

Corporate Fiduciary – insolvent is the particular species of fiduciary in which a director or officer serves in an insolvent corporation. It is the temporal period during which a corporation is financially unhealthy and before the corporation is a debtor in bankruptcy. Corporate fiduciary – insolvent should be distinguished from the fiduciary relationship in which a corporation is a fiduciary or trustee to an indenture or similar situation.

Most law students have been exposed to the relationship, though perhaps not directly. Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981) discussed infra at note 100−105, is the first fiduciary obligation case in the most widely used corporate law textbook. William L. Cary & Melvin Eisenberg, Cases and Materials on Corporations 1014 (7th ed. 1995 & Supp. 1997). Back To Text

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[1] See, e.g., Norwood P. Beveridge, Jr., Does a Corporation's Board Owe a Fiduciary Duty to Its Creditors?, 25 St. Mary's L.J. 589 (1994) (claiming directors owe no duty of care to creditors and examining Trust Fund Doctrine's role); Royce de R. Barondes, Fiduciary Duties of Officers and Directors of Distressed Corporations, 7 Geo. Mason L. Rev. 45 (1998) (arguing against utilizing "over investment theory" of finance to analyze Federal Bankruptcy Law Problems); Stephen H. Case, Fiduciary Duty of Corporate Directors and Officers, Resolution of Conflicts Between Creditors and Shareholders, and Removal of Directors by Dissident Shareholders in Chapter 11 Cases, The 1988 Williamsburg Conference on Bankruptcy, 391 (ALI−ABA Invitational Conference 1988); Richard M. Cieri et al., The Fiduciary Duties of Directors of Financially Troubled Companies, 3 J. Bankr. L. & Prac. 405 (1993) (discussing directors' fiduciary obligations during insolvency prior to filing for bankruptcy); Peter F. Coogan et al., Panel Discussion: The Problems of the Sinking Ship, 31 Bus. Law. 1371 (1976) [hereinafter, Coogan et al., Panel Discussion](discussing directors' fiduciary obligations during insolvency); Lewis U. Davis et al., Corporate Reorganization in the 1990's: Guiding Directors of Troubled Corporations Through Uncertain Territory, 47 Bus. Law. 1 (1991) (observing result of federal bankruptcy law superseding state corporate law when companies file for bankruptcy); Vladimir Jelisavcic, Comment, Corporate Law – A Safe Harbor Proposal to Define the Limits of Directors' Fiduciary Duty to Creditors in the "Vicinity of Insolvency:" Credit Lyonnais v. Pathe, 1992 J. Corp. L. 145 (1992) (criticizing how decision exposes directors to creditor liability thereby effecting directors' exercise of business judgement); Laura Lin, Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors, 46 Vand. L. Rev. 1485 (1993) (noting how creditors and shareholders have conflicting interests when corporations struggle and determining obligations of each); Stephen R. McDonnell, Geyer v. Ingersoll Publications Co.: Insolvency Shifts Directors' Burden Form Shareholders to Creditors, 19 Del. J. Corp. L. 177 (1994) (exploring impact of decision on corporate governance in Delaware); Harvey R. Miller, Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations, 23 Seton Hall L. Rev. 1467 (1993) (claiming board of directors should be able to negotiate for some consideration to stockholders when planning reorganization, despite corporation's "patent insolvency"); Robert B. Millner, What Does it Mean for Directors of Financially Troubled Corporations to Have Fiduciary Duties to Creditors?, 9 J. Bankr. L. & Prac. 201 (1999) (discussing directorial duty scope and nature in Corporate law); Robert C. Morris, Directors' Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais, 19 Iowa J. Corp. L. 61 (1993); Joseph Jude Norton, Relationship of Shareholders to Corporate Creditors Upon Dissolution: Nature and Implications of the "Trust Fund" Doctrine of Corporate Assets, 30 Bus. Law. 1061 (1975) (utilizing trust fund theory of corporate assets to discuss relationship between corporations, shareholders, and creditors upon dissolution); 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 (1996) (examining management's temptation to serve creditors' interests before serving those of shareholders' immediately prior to filing for bankruptcy); Mike Roberts, The Conundrum of Directors' Duties in Nearly Insolvent Corporations, 23 Mem. St. U. L. Rev. 273 (1993) (examining fiduciary obligations of corporate directors during passage from solvency to insolvency); Steven L. Schwarcz, Rethinking a Corporation's Obligation to Creditors, 17 Cardozo L. Rev. 647 (1996) (claiming only after determining whether debtors generally have obligations to creditors can it be determined if corporations also have similar obligations); Ann E. Conaway Stilson, Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors, 20 Del. J. Corp. L. 1 (1995) (discussing directors' fiduciary obligations to creditors); Gregory V. Varallo & Jesse A. Finkelstein, Fiduciary Obligations of Directors of the Financially Troubled Company, 48 Bus. Law. 239 (1992) (following corporate governance law development in financially−troubled companies while focusing on Delaware). Back To Text

[2] The encounter between insolvency and conventional fiduciary analysis is similar to the alternative dimension Superman visits in which he is confronted with his evil twin Bizarro. Back To Text

[3] See Robert Cooter & Bradley J. Freedman, The Fiduciary Relationship: Its Economic Character and Legal Consequences, 66 N.Y.U. L. Rev. 1045, 1045 (1991). See generally, Council on Ethical and Judicial Affairs, American Medical Association, Code of Medical Ethics 116 (1996−1997 ed.) (claiming fiduciary relationship of doctor−patient is ancient). See, e.g,, Susan M. Gilles, Promises Betrayed: Breach of Confidence as a Remedy for Invasions of Privacy, 43 Buff. L. Rev. 1, 41 n.169 (1995) (explaining scope of fiduciary theory). Back To Text

[4] See 36A C.J.S. Fiduciary § 381 (1987) ("A general definition of the word which is sufficiently comprehensive to embrace all cases cannot well be given."); Cooter & Freeman, supra note 3, at 1046 (claiming the nature of fiduciary relationships is "a source of confusion and dispute"); Deborah M. DeMott, Beyond Metaphor: An Analysis of Fiduciary Obligation, 1988 Duke L.J. 879, 879 (1988) (calling fiduciary duties "one of the most eluvise concepts in Anglo−American law"). Back To Text

[5] Compare Austin W. Scott, The Fiduciary Principle, 37 Cal. L. Rev. 539, 540 (1949) ("Who is a fiduciary? A fiduciary is a person who undertakes to act in the interest of another person. It is immaterial whether the undertaking is in the form of a contract. It is immaterial that the undertaking is gratuitous."), with J.C. Shepherd, Towards a Unified Concept of Fiduciary Relationships, 97 L.Q L. Rev. 51, 75 (1981) (collecting theories and definitions, as well as proposing definition: "A fiduciary relationship exists whenever any person receives a power of any type on condition that he also receive with it a duty to utilise that power in the best interests of another, and the recipient of the power uses that power."); see also 36A C.J.S. Fiduciary § 381 (1987):

[Fiduciary] connotes the idea of trust or confidence, contemplates good faith, rather than legal obligation, as the basis of the transaction, refers to the integrity, the fidelity, of the party trusted, rather than his credit or ability, and has been held to apply to all persons who occupy a position of peculiar confidence towards others, and to include those informal relations which exist whenever one party trusts and relies on another, as well as technical fiduciary relations. Back To Text

[6] Restatement (Second) Of Trusts § 2 (1979). Back To Text

[7] See generally L.S. Sealy, Fiduciary Relationships, 1962 Cambridge L.J. 69 (1962) (reviewing history of fiduciary duties while also purporting to classify certain fiduciary relationships). See, e.g., Bishop of Woodhouse v. Meredith, 1 Jac. & W. 204, 213 (1820) (describing English roots of fiduciary duties); Winchester v. Knight, 1 P.Wms. 406, 407 (1717) (same). Back To Text

[8] See Sealy, supra note 7, at 70 (quoting Lord Thurlow in Gartside v. Isherwood, 1 Broc.C.C. 558, 560, (1788), referring to Filmer v. Gott, 4 Bro.P.C. 230 (1742)). Back To Text

[9] Id. at 71. Back To Text

[10] See id.; see also Cholmondeley v. Clinton, 4 Bli. 1, 96 (1821) (expressing concern over the various meanings of trust); York Buildings Co. v. McKenzie, 8 Bro. P.C. 42, 64 (1795) (debating calling such situations "trusts"). Back To Text

[11] See Sealy, supra note 7. See generally Cholmondeley, 4 Bli. at 96; York Buildings Co., 8 Bro.P.C. at 64 (discussing problems of modern specific meaning). Back To Text

[12] An academic holy war exists over whether the fiduciary concept can be explained purely in terms of contract, or whether fiduciary relationship represents something more. Compare Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary Duties: A Response to Anti−Contractarians, 65 Wash. L. Rev. 1, 4 (1990) (explaining fiduciary concept exclusively by reference to contract); Frank H. Easterbrook & Daniel R. Fischel, Contract and Fiduciary Duty, 36 J. L. & Econ. 425, 426−27 (1993) (same) [hereinafter Easterbrook & Fischel, Contract and Fiduciary Duty]; and John H. Langbein, The Contractarian Basis of the Law of Trusts, 105 Yale L.J. 625, 628 (1995) (same), with Victor Brudney,

Contract and Fiduciary Duty in Corporate Law, 38 B.C. L. Rev. 595, 598−600 (1997) [hereinafter Brudney, Contract and Fiduciary Duty in Corporate Law] (arguing that fiduciary concept cannot be explained by contract); Kenneth B. Davis, Judicial Review of Fiduciary Decision−Making: Some Theoretical Perspectives, 80 Nw. U. L. Rev. 1, 2−3 (1985) (same); Scott FitzGibbon, Fiduciary Relationships Are Not Contracts, 82 Marq. L. Rev. 303, 305 (1999) (same); Deborah A. DeMott, Fiduciary Obligation Under Intellectual Siege: Contemporary Challenges to the Duty to be Loyal, 30 Osgoode Hall L. J. 471, 472 (1992) (same); Alison Grey Anderson, Conflicts of Interest: Efficiency, Fairness and Corporate Structure, 25 UCLA L. Rev. 738, 739 (1978) (same); Tamar Frankel, Fiduciary Duties as Default Rules, 74 Or. L. Rev. 1209, 1209 (1995) (same); Tamar Frankel, Fiduciary Law, 71 Cal. L. Rev. 795 (1983) [hereinafter Frankel, Fiduciary Law] (same); Lawrence E. Mitchell, The Fairness Rights of Corporate Bondholders, 65 N.Y.U. L. Rev. 1165, 1170−71 (1993) [hereinafter Mitchell, Fairness Rights] (same); Ernest J. Weinrib, The Fiduciary Obligation, 25 U. Toronto L.J. 1, 12 (1975) (same). Back To Text

[13] See Brudney, Contract and Fiduciary Duty in Corporate Law, supra note 12, at 595 ("The concept 'fiduciary' in Anglo−American law has evolved to embrace a wide range of relationships…. [I]t has been extended to the relationships between a variety of professionals and their clients and further to the world of commerce."); Easterbrook & Fischel, Contract and Fiduciary Duty, supra note 12, at 425 ("The many agency relations that fall under the 'fiduciary banner' are so diverse that a single rule could not cover all without wreaking havoc."); Frankel, Fiduciary Law, supra note 12, at 802 ("I submit that we are witnessing the emergence of a society predominantly based on fiduciary relations."). Back To Text

[14] See, e.g., Moore v. Regents of the Univ. of Cal., 51 Cal.3d 120, 128−31 (1990) (describing how doctors breach fiduciary obligations owed to patients by either failure to "disclose facts material to the patient's consent or, alternatively . . . performance of medical procedures without having first obtained the patient's informed consent"); Planned Parenthood v. Verniero, 41 F. Supp.2d 478, 487 (D. N.J. 1998) (referring to "close fiduciary relationship between doctor and patient"). But see Wadsworth v. ABC Ins. Co., 732 So.2d 56, 56 (La. Ct. App. 1998) (holding "it is possible to have a doctor/patient relationship were there is no fiduciary relationship," when doctor and patient in question had a 7−year long "consensual sexual relationship," that resulted in patient suing doctor for having sex with her despite his knowledge of her weakened condition created by her recent car accident). Back To Text

[15] See Millbank, Tweed, Hadley & McCloy v. Boon, 13 F.3d 537, 543 (2d Cir. 1994) (holding "[t]here is even more compelling reason to apply a prophylactic rule to remove incentive to breach when the fiduciary relationship is that of an attorney and former client because of the attorney's unique position of trust and confidence."); see also Stephen Gillers, Regulation of Lawyers: Problems of Law and Ethics, 67−69 (5th ed. 1998) (advocating three reasons to impose fiduciary obligations on attorneys in client relationships. First, clients "depend on the attorney's integrity, fairness, superior knowledge and judgement." Also attorneys "may have acquired information about a client that gives the attorney unfair advantage in negotiations between them." Last, it might be hard for clients to "change attorneys," because of economic or psychological dependence.). See, e.g., Shaw v. Manufacturers Hanover Trust Co., 68 N.Y.2d 172, 176 (1986) (holding because of fiduciary relationship between attorneys and clients, fee agreements must be made very clear to clients). Back To Text

[16] See, e.g., Rangen, Inc. v. Sterling, Nelson & Sons Inc., 351 F.2d 851, 859 (9th Cir. 1965), cert. denied, 383 U.S. 936 (1966) (referring to fiduciary relationships between buyers, or principals, and agents); Starkman v. Seroussi, 377 F.Supp. 518, 518 (S.D.N.Y. 1974) (acknowledging fiduciary relationships between stockbrokers, as agents, and clients, as principals); Seidman & Seidman v. Schwartz, 665 S.W. 2d 214, 216 (Tex. App. 1984) (holding partnership could sue partner for breach of fiduciary duty). Back To Text

[17] See Southmark Co. v. Lybrand (In re Southmark Corp.), 163 F.3d 925, 930 (5th Cir. 1999) (examining fiduciary duty of investment company to clients). See generally M. Brett Haire, The Fiduciary Responsibilities of Investment Bankers in Change−of−Control Transactions: In re Daisy Systems Corp., 55 Bus. Law. 883 (2000) (discussing Bear Stearns & Co. v. Daisy Sys. Corp. (In re Daisy Sys. Corp.), 97 F.3d 1171,1175−79 (9th Cir. 1996) which holds that "exclusive financial advisors" have a fiduciary duty to client companies). Back To Text

[18] The corporate fiduciary relationship is limited temporally and geographically. It is different then it was thirty years ago. There is also tremendous diversity in state law, as well as outside the United States. For other nations' treatment

of the corporate fiduciary − insolvent relationship. See generally Davis Thomson, Directors, Creditors and Insolvency: A Fiduciary Duty or a Duty Not to Oppress?, 58 U.T. Fac. L. Rev. 31 (2000) (comparing Canadian, British, Australian, and New Zealand law); Ian F. Fletcher, The Law Of Insolvency, 517–535 (1990) (examining Great Britain's law); International Liability of Corporate Directors (1993) (discussing law in Denmark, Luxembourg, Netherlands, Norway and Switzerland). Back To Text

[19] See, e.g., Harris Trust & Sav. Bank v. Salomon, Smith Barney, Inc., 120 S.Ct. 2180, 2185 (2000) (examining ERISA's impact on fiduciary's "general duty of loyalty"); Great Rivers Coop. v. Farmland Indus., 198 F.3d 685, 705 (8th Cir. 1999) (holding "fiduciary's duties encompass both a duty of care and a duty of loyalty"); Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) (holding "directors who knowingly disseminate false information that results in corporate injury or damage for individual stockholders violate their fiduciary duty and may be held accountable in a manner appropriate to the circumstances"). Back To Text

[20] Bankruptcy courts have created an enormous body of case law on the existence of fiduciary obligation in the context of the Bankruptcy Code's non−dischargeable provision for debts incurred "for fraud or defalcation while acting in a fiduciary capacity…." 11 U.S.C. § 523(a)(4) (1994 & Supp. 1998). See, e.g., Davis v. Aetna Acceptance Co., 293 U.S. 328, 333 (1934) (holding "a factor does not act in a fiduciary capacity."); Berres v. Bruning (In re Bruning), 143 B.R. 253, 253 (D. Colo. 1992) (holding "common law fiduciary relationship[s] arise between director[s] and an insolvent corporation's creditors at the moment of insolvency"); Miramar Resources, Inc. v. Schultz (In re Schultz), 208 B.R. 723, 723 (Bankr. M.D. Fla. 1997) (exploring differences between fiduciary duties under corporate law principles as opposed to those who act in fiduciary capacity created by law). Back To Text

[21] "A commonly used word – seemingly specific and concrete when used in everyday speech – may mask troubling ambiguities that upon close examination are seen to derive not simply from casual use but from more fundamental epistemological problems." Katz v. Oak Indus., Inc., 508 A.2d 873, 875 (Del. Ch. 1986) (referring to the word "coercion"). Back To Text

[22] Black's defines trustee as a:

person holding property in trust. The person appointed, or required by law, to execute a trust. One in whom an estate, interest, or power is vested, under an express or implied agreement to administer or exercise it for the benefit or to the use of another. One who holds legal title to property "in trust" for the benefit of another person (beneficiary) and who must carry out specific duties with regard to the property. The trustee owes a fiduciary duty to the beneficiary.

Black's Law Dictionary, 1514 (6th Ed. 1990). Back To Text

[23] Indenture trustees are the prime example. See Robert Dean Ellis, Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights, 24 J. Corp. L. 295, 311 n. 95 (1999) ("[C]ourts have long abandoned any broad notion of fiduciary duties beyond the scope of the negotiated contractual arrangements between the indenture trustee and the beneficiary."); see also Martin Riger, The Indenture as Bargained Contract: The Persistence of Myth, 16 J. Corp. L. 211 (1991) (discussing bond holders indenture problems). Back To Text

[24] See generally Adolph A. Berle, Jr., Studies in the Law of Corporate Finance 1−25 (1928). Professor Berle traces the history of the corporation from Roman law, where a corporation was called a "university," (including famous University of Vestal Virgins), the English contribution (including South Sea Co., of South Sea bubble fame) to the Napoleonic Code and modern corporate law. See Larry D. Soderquist et al., Corporate Law and Practice 1−6 (2d ed. 1999); Lawrence M. Friedman, A History of American Law, 450−54 (1973) (examining Corporate history and structure). Back To Text

[25] See Mitchell, supra note 12, at 1171 (citing Kenneth E. Scott, Corporation Law and the American Law Institute Corporate Governance Project, 35 Stanford L. Rev., 927, n.1 (1983)). This thesis focuses on larger corporations, particularly those in which identity of ownership diverges from identity of management. See infra note 36. Back To Text

[26] However, there are areas of corporate law that remain ill defined. See Varallo & Finkelstein, supra note 2, at 239 ("Perhaps no area of corporate governance has received less attention than the law pertaining to governance of the troubled company."). Back To Text

[27] Curiale v. Reissman, 798 F.Supp. 141, 144 (S.D.N.Y. 1992) (finding no federal subject matter jurisdiction for claim of breach of fiduciary duty of bank directors by FDIC); see also McDermott, Inc. v. Lewis, 531 A.2d 206, 214−15 (Del. 1987); E. Norman Veasey, The Defining Tension in Corporate Governance in America, 52 Bus. Law. 393, 393 (1997) [hereinafter Veasey, Defining Tension] ("[T]he 'genius of American corporate law' is its state−oriented federalism and its flexible self−governance, it is the independent directors and corporate counselors who have to make the system work.) (citing Roberta Romano, The Genius Of American Corporate Law (1993)). But see Roberts, supra note 1, at 275−79 (noting development of federalized standard of director conduct in certain circumstances). Back To Text

[28] While Delaware's Court of Chancery is generally thought to be a court of equity, it may be more properly considered a state trial court of limited jurisdiction. For an interesting discussion of the bankruptcy court as a court of equity, see Marcia S. Krieger, The Bankruptcy Court Is a Court of Equity: What Does That Mean?, 50 S.C. L. Rev. 275 (1999) . Back To Text

[29] See DeMott, supra note 4, at 879 (claiming fiduciary obligation developed "through a jurisprudence of analogy rather than principle"); Craig W. Palm & Mark A. Kearney, A Primer on the Basics of Directors' Duties In Delaware: The Rules of the Game (Part I), 40 Vill. L. Rev. 1297, 1302 (1995) (explaining how dissatisfied shareholders can bring suit in court); see also Edward S. Rock, Saints and Sinners: How Does Delaware Law Work?, 44 UCLA L. Rev. 1009, 1015 (1997) (seeking to "conceptualize Delaware fiduciary duty law in process terms."). Back To Text

[30] See Veasey, Defining Tension, supra note 28, at 401. Back To Text

[31] See generally William H. Rehnquist, The Prominence of the Delaware Court of Chancery in the State−Federal Joint Venture of Providing Justice, 48 Bus. Law. 351 (1992); E. Norman Veasey, The National Court of Excellence, 48 Bus. Law. 357 (1992); Dennis J. Block et al., The Business Judgment Rule, Fiduciary Duties Of Corporate Directors, (5th Ed. 1998) 3−4, n. 14 [hereinafter The Business Judgment Rule]; The prominence of the Delaware courts has also been the source of scholarly criticism and support. Compare William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663 (1974), with Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. L. Stud. 251 (1979). Back To Text

[32] See Federal Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982) ("Directors hold a place of trust and by accepting the trust are obliged to execute it with fidelity, not for their own benefit, but for the common benefit of the stockholders of the corporation.") (citing Koehler v. Black River Falls Iron Co., 67 U.S. (2 Back) 715, 720, 17 L.Ed. 339 (1862)); see also Securities and Exch. Comm. v. Chenery Corp., 318 U.S. 80, 85, 63 S.Ct. 454, 458, 87 L.Ed. 626, 632 (1943) (agreeing officers and directors who manage holding company in process of reorganization under Public Utility Holding Company Act of 1935 are in positions of trust, rejecting relaxed view of fiduciary obligations, insisting on their scrupulous observance); Ashman v. Miller, 101 F.2d 85, 90−91 (6th Cir. 1939) (noting director of corporation maintains fiduciary relationship to it and its stockholders in that his/her position is one of trust, frequently denominated trustee and thereby held accountable in equity); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) (noting fiduciary duties of care and loyalty owed to corporations and their shareholders by board of directors extends to board conduct in sale of corporate control) (citing Smith v. Van Gorkom, 488 A.2d 858, 872−873 (Del. 1985)); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986) (noting ultimate responsibility for managing affairs of corporation falls on its board of directors, and in furthering this duty, directors owe fiduciary duties of care and loyalty to corporations and its shareholders); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) (same); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1959) (asserting while technically not trustees, corporate officers and directors stand in fiduciary relation to corporation and its stockholders). Back To Text

[33] See Victor Brudney, Fiduciary Ideology in Transactions Affecting Corporate Control, 65 Mich. L. Rev. 259, 260 (1966):

[T]he fiduciary responsibility of an officer or director attaches as a concomitant of his selection by the stockholders to represent them in managing their investment. Because the power over their investment thus delegated to him is representational, the duties he owes and the restrictions to which he is subject in his dealings with respect to their "property" are rooted in the law of agency and the law of trusts, which govern comparable representational relationships.

Id.

Christopher W. Frost, Running the Asylum: Governance Problems In Bankruptcy Reorganizations, 34 Ariz. L. Rev. 89, 101 (1992) [hereinafter Frost, Running the Asylum] (recognizing representational basis for director/officer fiduciary obligation); Christopher W. Frost, The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations, 72 Am. Bankr. L.J. 103, 103−04 (1998) [hereinafter Frost, Corporate Governance] (same); Frank H. Easterbrook & Daniel R. Fischel, Corporate Control Transactions, 91 Yale L.J. 698, 700 (1982) (same). Back To Text

[34] See Del. Code Ann. tit. 8, § 141(a) (1974 & Supp. 1999) (stating business and affairs of every corporation will be managed by or under direction of board of directors); Rev. Model Bus. Corp. Act § 8.01(b) (stating all corporate powers shall be exercised by, and business and affairs of corporation managed under direction of its board of directors). See generally William L. Cary & Melvin Eisenberg, Cases and Materials on Corporations 254−86 (7th Ed. 1995 & Supp. 1997). Back To Text

[35] Such fundamental changes include mergers, Del. Code Ann. tit. 8, § 251(b)(c) (1974 & Supp. 1999) (stating after board of directors of each corporation adopts resolution approving agreement of merger, agreement will be submitted to stockholders of each constituent corporation at annual meeting for purpose of acting on agreement); Rev. Model Bus. Corp. Act § 11.02 (b)(2) (stating foreign or domestic corporation may be party to merger if merger is permitted by laws under which corporation is organized); and the sale of substantially all of the corporation's assets, Rev. Model Bus. Corp. Act § 12.02 (stating that sale, lease, exchange or other disposition of assets must have approval of corporation's shareholders if disposition would leave corporation without significant continuing business activity); Del. Code Ann. tit. 8, § 271(a) (1974 & Supp. 1999) (stating that every corporation may at any meeting of its board of directors sell, lease, or exchange all or substantially all of its property and assests as its board of directors deems for best interest of corporation, when authorized by resolution adopted by holders of majority of outstanding stock of corporation entitled to vote thereon); and changes to the articles of incorporation, Del. Code Ann. tit. 8, § 109(a) (1974 & Supp. 1999) (stating after coporation has received any payment for its stock, power to adopt, repeal, amend by−laws will be in stockholders entitled to vote); Rev. Model Bus. Corp. Act § 10.03(b) (stating after adopting proposed amendment, board of directors must submit amendment to shareholders for their approval). Back To Text

[36] See Allison Grey Anderson, Conflicts of Interest: Efficiency, Fairness and Corporate Structure, 25 UCLA L. Rev. 738, 774 (1978):

[In publicly held corporations,] to obtain the efficiencies from economies of scale, large amounts of capital must be aggregated, usually from many individuals. Since the transaction costs of shareholder management would be prohibitive, centralized management is a necessity for the publicly held corporation. Centralized management produces additional efficiency gains because of economies of scale in the use of information and experienced judgment, and because it economizes on negotiating and bargaining costs.

See also Harold Demsetz, Toward a Theory of Property Rights, 57 Am. Econ. Rev., Papers and Proceedings of the Seventy−ninth Annual Meeting of the American Economic Association 347, 358 (1967) (noting if all owners of publicly held corporations participate in each decision that needs to be made, scale of economics of operating company will be overcome by high negotiating costs as opposed to small management group allowing for effective control to be concentrated in managements hands, reducing negotiation costs); Park McGinty, Ethical Ann. Corporate Law Symposium: Limited Liability Companies: The Limited Liability Company: Opportunity for Selective Securities Law Deregulation, 64 U. Cin. L. Rev. 369, 382 (1996) (noting centralized management allows directors to oversee corporation's executive officers, imposing broad fiduciary duties that run to all shareholders, separating ownership from control, and allowing corporate shareholders to rely completely on others for their profit). Back To Text

[37] See Steven R. Gross et al., Collier Business Workout Guide, ¶ 3.02, 3−5 (1999) [hereinafter Collier Business Workout Guide] (noting foundation of corporate law is that business and affairs of corporation are managed by directors of its board who owe fiduciary duties to shareholders in that property has been entrusted to directors to be managed for shareholders' benefit); see also Simons v. Cogan, 542 A.2d 785, 790 (Del. Ch. 1987) (same), aff'd, 549 A.2d 300 (Del. 1988); Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988) (noting before fiduciary relationship arises, there must be existing property right or equitable interest, such as stock ownership). This is true in public corporations, or in any corporation in which the identity of management is distinct from the owners of the corporation. Professors Berle and Means first recognized this concept in 1932 in their book The Modern Corporation and Private Property. Shareholders as beneficiaries is a relatively new development in corporate law, and despite the frequency with which it is repeated, shareholders probably should not be considered direct beneficiaries of the corporate fiduciary relationship. See infra Part II (D) (noting requirement of derivative suit is major limitation on conception that shareholders are direct beneficiaries to corporate fiduciary relationship). Back To Text

[38] See supra note 36. Back To Text

[39] See Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1959):

Public policy … has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or enable it to make in the reasonable and lawful exercise of its powers.

Id. (noting that corporate officers are not permitted to use their positions of trust to enhance their own interests). Despite the derivative suit requirement, shareholders are also considered beneficiary parties of the corporate fiduciary relationship. See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) ("[In managing the business and affairs of a corporation], directors are charged with an unyielding fiduciary duty to protect the interests of the corporation, and to act in the best interest of the shareholders."); Levine v. Smith, 591 A.2d 194, 200 (Del. 1991) ("The directors exercise of their managerial power in all its aspects is tempered by fundamental fiduciary obligations owed to by the directors to the corporation and its shareholders.") (internal quotes omitted); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (asserting board of directors has duty to protect corporate enterprise, including stockholders, "from harm reasonably perceived, irrespective of its source"). Back To Text

[40] See Radol v. Thomas, 772 F.2d 244, 256 (6th Cir. 1985) (instructing officers and directors of a corporation have fiduciary relationship to corporation and its stockholders). Back To Text

[41] See Sinclair Oil v. Levien, 280 A.2d 717, 719 (Del. 1971) (asserting when company is substantial shareholder of its subsidiary company in that former nominates all members of latter's board of directors, then shareholding company is not independent of its subsidiary, thus owing it fiduciary duties); Sealy Mattress Co. v. Sealy, Inc., 532 A.2d 1324, 1333 (Del. Ch. 1987) (confirming for prospective merger, where target corporation's parent corporation and directors, who are employees of and are controlled by parent's majority stockholder, stand on both sides of proposed merger and determined its terms, parent company then has burden of establishing entire fairness of merger). See generally Weinberger v. UOP Inc., 457 A.2d 701, 710 (Del. 1982) . Back To Text

[42] See The Business Judgment Rule, supra note 31, at 344 ("Control may be the result of either (1) ownership of the unrestricted power to vote more than 50% of the corporation's outstanding voting securities, or (2) actual control over a majority of the corporation's board of directors."); see also Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) (noting under Delaware law, if shareholder owns majority interest in corporation, then owes fiduciary duty); Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1113 (Del. 1994) (same); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 70 (Del. 1989) (asserting shareholder owning only 50% of corporations stock owes no fiduciary duties to corporation). But see In re Tri−Star Pictures, Inc., Litigation, 634 A.2d 319, 328 (Del. 1993) (asserting even when not majority shareholder, company that dictates destiny of another owes fiduciary duty). Back To Text

[43] See The Business Judgment Rule, supra note 31, at 342−499. Back To Text

[44] See The Business Judgment Rule, supra note 31, at 349 (noting majority shareholders did breach fiduciary duty to minority shareholders by selling substantially all of subsidiaries assets, but were entitled to pursue there own interests with their own shares) (citing Thorpe v. CERBCO, Inc., 676 A.2d 436, 444 (Del. 1996); see also Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996) (stating board of directors needs only to justify its actions when its primary purpose is "to interfere with or impede exercise of the shareholder franchise, and the shareholders are not given a full and fair opportunity to vote"); Stroud v. Grace, 606 A.2d 75, 83 (Del. 1992) (noting controlling shareholders may vote in favor of transaction provided that they do not violate fiduciary duty); Bershad v. Curtiss−Wright Corp., 535 A.2d 840, 845 (Del. 1987) (asserting stockholders in Delaware have right to control shares in their own interest, limited only by fiduciary duties to other stockholders). Within this fiduciary obligation is the duty to demonstrate intrinsic fairness to the corporation when a controlling shareholder stands on both sides of a transaction. See supra note 42; see also Alpert v. 28 Williams St. Corp., 473 N.E.2d 19, 24 (N.Y. 1984) (noting as long as fair to minority shareholders, majority shareholders may exclude formers' interests concerning merger without violating latters' fiduciary duties). For a more thorough discussion of entire fairness see infra Part II (G). Back To Text

[45] See Lippi v. City Bank, 955 F.2d 599, 613 (9th Cir. 1991) (recognizing two controlling shareholders as corporate directors). See generally Crosby v. Beam, 548 N.E.2d 217 (Ohio 1989) (same); Sinclair Oil v. Levien, 280 A.2d 717 (Del. 1971). The major exception is when the controlling shareholder is itself a corporation or other entity. This occurs most often in transactions involving a parent−subsidiary relationship. The focus of this thesis is on individual liability of corporate fiduciaries; thus a thorough discussion of this issue is left for another day. Back To Text

[46] The fiduciary obligation of a controlling shareholder is also a bit different than that of a director or officer. See infra Part I (comparing different fiduciary relationships). Controlling shareholders may also be creditors of the corporation. The interrelationship of the two roles was addressed in Odyssey Partners, L.P. v. Fleming Cos., 1996 Del. Ch. LEXIS 91, 1996 WL 422377 (Del. Ch. Apr. 21, 1995) (noting ceditor, even if also controlling stockholder, may still exercise his/her creditors rights) aff'd 672 A.2d 35 (Del. 1996); see also Solomon v. Pathe Communs. Corp., CIV.A.12563, 1995 Del. Ch. LEXIS 46, at *16 (Del. Ch. Apr. 21, 1995) ("A controlling shareholder is not required to give up legal rights that it clearly possesses; this is certainly so when those legal rights arise in a non−stockholder capacity."). Back To Text

[47] Despite the argument's cleverness, the corporation itself is not a fiduciary party to the corporate fiduciary relationship. A corporation owes no fiduciary obligation to its shareholders. See Radol v. Thomas, 772 F.2d 244, 258 (6th Cir. 1985) ("Liability for breach of the director's fiduciary obligation could not possibly run against the corporation itself, for this would create the absurdity of satisfying the shareholders' claims against the directors from the corporation, which is owned by the shareholders."); see also Jordan v. Global Natural Resources, Inc., 564 F.Supp. 59, 68 (S.D. Ohio 1983) (concluding "a corporation as an entity has no fiduciary duty to its shareholders as a matter of law"). But see Marbury Management, Inc. v Kohn, 699 F.2d 704, 711−15 (2d. Cir. 1980) (allowing corporation to be held vicariously liable to third parties for acts by directors of corporation within their authority). The distinction between this corporation, (not a fiduciary party to the corporate fiduciary relationship) and a corporation that is a controlling shareholder, (thereby owing a fiduciary obligation to minority shareholders) is another troubling conflict in corporate fiduciary law. Back To Text

[48] In 1932, Professor Dodd wrote:

That directors are fiduciaries for their corporation is indisputable. That many of the powers, such as the power of declaring or passing dividends and the power of issuing new stock, may affect the individual interests of stockholders rather than the corporate enterprise as a whole is obvious and has led to a growing tendency to treat directors as fiduciaries for stockholders as well as for the corporate entity.

E. Merrick Dodd, Jr., For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145, 1147 (1932) (noting directors as fiduciaries will prevent corporate managers from putting profits from stockholders into their own pockets). See generally Adolph Berle, For Whom Corporate Managers Are Trustees, 45 Harv. L. Rev. 1365 (1932) (same). Back To Text

[49] See Thomas A. Smith, The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty, 98 Mich. L. Rev. 214, 214 (1999) ("Now the orthodox view among corporate law scholars is that the corporate fiduciary duty is a norm that requires firm managers to 'maximize shareholder value.'"); Schwarcz, supra note 1, at 649 ("Traditionally viewed, a corporation's obligation, or at least that of the directors, is solely to its shareholders."); David S. Ruder, Duty of Loyalty – A Law Professor's Status Report, 40 Bus. Law. 1383, 1384 (1985) ("[T]he development of fiduciary principles in the corporate field has historically been based upon the proposition that corporate managers owe their primary responsibilities to the owners of the corporation – the shareholders.") .

None of these articles accounts for Professor Dodd's statement, or traces the history of the corporation as a beneficiary of the corporate fiduciary relationship. This current of thought has led some to argue that directors and officers do not owe the corporation itself any fiduciary obligation. Rima Fawal Hartman, Situation−Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals, 50 Wash. & Lee L. Rev. 1761, 1768, 1779 (1993). Back To Text

[50] See Mitchell, Fairness Rights, supra note 12, at 1173 n. 21 (noting traditional view of management's fiduciary duties was that they were owed only to corporation and not stockholders); see also Bawden v. Taylor, 98 N.E. 941, 942 (Ill. 1912) (stating "an officer has no control over the shares of the individual stockholder and is not a trustee for such stockholder with respect to his stock"); Goodwin v. Agassiz, 186 N.E. 659, 660−61 (Mass. 1933) (same). The direct influence of federal securities law on state fiduciary law is perhaps questionable, but securities law's focus on disclosure to investors may have been a contributing factor to the shareholder focus of corporate fiduciary law. Back To Text

[51] See Lawrence E. Mitchell, A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes, 70 Texas L. Rev. 579, 586 (1992) (noting lessening of distinction between interests of broader corporation and its stockholders); Smith, supra note 49, at 214 ("To economically oriented corporate law professors, distinguishing between directors' fiduciary duty to shareholders and a duty to the corporation itself smacks of reification – treating the fictional corporate entity as if it were a real thing."); Donald E. Schwartz, Objective and Conduct of the Corporation, Defining the Corporate Objective: Section 2.01 of the ALI's Principles, 52 Geo. Wash. L. Rev. 511, 512 (1984) (noting according to ALI § 2.01, "a corporation 'should have' as its objective an economic orientation that promotes wealth enhancing activities"). Back To Text

[52] If a corporate parent owns all the equity of a subsidiary, under the "shareholder primacy norm," the subsidiary's board of directors ought to operate the subsidiary for the exclusive benefit of the parent, including, inter alia, providing goods or services at a discount. See generally Eric J. Gouvin, Resolving the Subsidiary Director's Dilemma, 47 Hastings L.J. 287 (1996) (noting often, subsidiary board of directors is not able to act in manner beneficial to subsidiary because it must do as parent corporation demands); Richard Posner, The Rights of Creditors of Affiliated Corporations, 43 U. Chi. L. Rev. 499, 509 (1976) (recognizing conflict between maximizing creditor protection and corporate freedom, concluding efficient corporation law mediates between these goals in order to raise money for investments); see also Kieran J. Fallon, Source of Strength or Source of Weakness?: A Critique of the "Source − of − Strength" Doctrine in Banking Reform, 66 N.Y.U. L. Rev. 1334, 1383 (1991) (illustrating methods by which parent corporations take advantage of subsidiaries). Back To Text

[53] In most circumstances, a shareholder−beneficiary must bring a derivative suit on behalf of the corporation. See infra Part II (D) (discussing requirements of derivative suit); see also infra notes 65−66. Back To Text

[54] See generally Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 593 (Del. 1986) (stating "preferences and limitations associated with preferred stock exist only by virtue of an express provision (contractual in nature) creating such rights or limitations. But absent negotiated provision conferring rights on preference stock, it does not follow that no rights exist"); Dalton v. American Inv. Co., 490 A.2d 574, 586 (Del. Ch. 1985), aff'd, 501 A.2d 1238 (Del. 1985) (discussing whether preferred shareholders may vote upon proposed amendment which threatens to alter their preferences even if not entitled to vote under certificate of incorporation); Lawrence E. Mitchell, The Puzzling Paradox of Preferred Stock (And Why We Should Care About It), 51 Bus. Law. 443, 444 (1996) (noting preferred stockholder's position in "corporate firmament" is most vulnerable of financial participants in that courts only apply fiduciary standards in evaluating preferred stockholders rights when their equitable stake in corporation is threatened

by corporate contol transactions or controlling stockholder). Back To Text

[55] Jackson Nat'l Life Ins. Co. v. Kennedy, 741 A.2d 377, 363 (Del. Ch. 1999) ("The rights of preferred stockholders are, in certain respects, both equitable and contractual. The relationship between a corporation and its preferred stockholders is 'primarily … contractual in nature,' involving rights and obligations created contractually by the certificate of designation") (citing HB Korenvaes Investments, L.P. v. Marriott Corp., No. CIV.A.12922, 1993 Del. Ch. LEXIS 90, at *16 (Del. Ch. June 9, 1993); see also Jedwab, 509 A.2d at 593 (noting provisions associated with limitations and preferences of perfererred stockholders are "contractual in nature"); Rothschild Intern. Corp. v. Liggett Group, 474 A.2d 133, 136 (Del. 1984) ("Preferential rights are contractual in nature and therefore are governed by the express provisions of a company's certificate of incorporation."). But see HB Korenvaes Investments, L.P., 1993 Del Ch. LEXIS 90, at *15 (stating "the holder of preferred stock is not a creditor of the corporation. Such a creditor has no legal right to annual payments of interest, as long term creditors will have . . . ."). Back To Text

[56] See Moore Bus. Form, Inc. v. Cordant Holdings Corp., No. CIV.A.13911, 1995 Del. Ch. LEXIS 134, at *15−16 (Del. Ch. Nov. 2, 1995) ("A corporation's directors are fiduciaries for the preferred stockholders, whose interests they have a duty to safeguard, consistent with the fiduciary duties owed by those directors to [the corporation's] other shareholders and to [the corporation] itself.") (citing Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1062 (De. Ch. 1987)). See also Mitchell, supra note 54, at 445 (noting that preferred stockholders are seen as having ownership interest in corporation, entitling them to have corporate officers and directors work in their favor). Back To Text

[57] Jedwab v. MGM Grand Hotels, Inc, 509 A.2d 584, 594 (Del. Ch. 1986). Back To Text

[58] See Baron v. Allied Artists Pictures Corp., 337 A.2d 653, 657, 660 (Del. Ch. 1975) (noting it is well estalished that preferred shareholders' rights are contractual and that corporations board of directors has fiduciary duty to ensure that preferred dividends are brought up to date in timely fashion); see also Jedwab v. MGM Grand Hotels, Inc., 509 A.2d at 594. See generally Petroleum Rights Corp. v. Midland Royalty Corp., 167 A. 835 (Del. 1933). Back To Text

[59] See, e.g., Lorenz v. CSX Corp., 1 F.3d 1406, 1417 (3d Cir. 1993) (noting corporation has no duty to act for benefit of its creditors, or to refrain from acting in manner converse to their interests); Broad v. Rockwell Int'l. Corp., 642 F.2d 929, 958−59 (5th Cir. 1981) (noting corporation does not breach fiduciary duty to creditor when fully complying with its obligations under indenture); C−T of Va., Inc. v. Barrett, 124 B.R. 689, 692−693 (W.D. Va. 1990) (noting when corporation announces leveraged buyout, it signals that corporation is for sale, turning directors' duties to gaining highest possible price for their shareholders, without extending such duties to interests of current or future creditors); Metropolitan Sec. v. Occidental Petroleum Corp., 705 F.Supp. 134, 139 (S.D.N.Y. 1989) (noting creditor lacks standing to pursue cause of action under § 14(e) of Williams Act in that standing is granted only to class of securities holders to whom tender offer is made); Hartford Fire Ins. Co. v. Federated Dep't Stores, Inc., 723 F.Supp. 976, 991 (S.D.N.Y. 1989) (same); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F.Supp. 1504, 1519, 1524 (S.D.N.Y. 1989) (noting that creditors are not entitled to benefits not bargained for in indenture); Simons v. Cogan, 549 A.2d 300, 303 (Del. 1988) (stating "a convertible debenture represents a contractual entitlement to the repayment of a debt and does not represent an equitable interest in the in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties."); Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del.Ch. 1986) (noting it is director's job to maximize interests of corporate stockholders and they may sometimes do so at expense of others without constituting breach of duty); but see Pittsburgh Terminal Corp. v. Baltimore & O.R.R., 680 F.2d 933, 941 (3d Cir.) (stating although no Maryland case has addressed issue, court "would be very much surprised if Maryland or any other state would today hold that no [fiduciary] obligations were owed [to convertible bondholders] by an issuer of such securities and its directors"). Back To Text

[60] See generally NPF WL, Inc. v. Sotka, No. 99 C 7966, 2000 U.S. Dist. LEXIS 6547, at *24 (N.D. Ill. May 10, 2000) (asserting "[i]t is well settled that 'so long as a corporation remains solvent…its directors owe no duties or obligations to others,'") (citing Beach v. Miller, 130 Ill. 162, 170 (1889)); In re Reuscher 169 B.R. 398, 402 (S.D. Ill. 1994) (stating under ordinary circumstances, while corporation remains solvent, officer/director has no fiduciary relationship with corporation's creditors); G. Eric Brunstad, Jr. & Mike Sigal, Competitive Choice Theory and the Unresolved Doctrines of Classification and Unfair Discrimination in Business Reorganizations Under the Bankruptcy Code, 55

Bus. Law. 1, 53 (1999) ("So long as a firm remains solvent (and therefore able to pay all claims in full), creditors generally have no cause to complain about a firm's particular investment choices (within certain limits) because the firm's gains or losses will not destroy the creditors' ability to receive full payment"). Back To Text

[61] See generally Charles R.T. O'Kelley and Robert B. Thompson, Corporations and Other Business Associations, Cases and Materials, 266 (3d ed. 1999) [hereinafter O'Kelley & Thompson, Corporations and Other Business Associations] ("Directors may consider the interests of other constituencies if there is 'some rationally related benefit accruing to the stockholders,' (citing Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985)) or if so doing 'bears some reasonable relation to general shareholder interests.'" (citing Mills Acquisition Co. v. Macmillan, Inc. (Del. 1985))); ABA Committee on Corporate Laws, Other Constituency Statutes: Potential for Confusion, 45 Bus. Law. 2253 (1990) (hereinafter Other Constituency Statutes) (stating "[t]here have been some cases in which courts have appeared to recognize the proposition that corporations have responsibilities that go beyond shareholder and embrace creditors, employees, communities and other constituencies." [citing Universal Leaf Tobacco Co. v. Congoleum Corp., 554 F.2d 1283 (4th Cir. 1977); Herald Co. v. Seawall, 472 F.2d 1081 (10th Cir. 1972); Boyertown Burial Casket Co. v. Amedco, 407 F. Supp. 811 (E.D. Pa. 1976); Elco Corp. v. Microdot Inc., 360 F. Supp 741 (D. Del. 1973); Abramson v. Nytronics, Inc., 312 F. Supp 519 (S.D.N.Y. 1970)]; Amp Inc. v. Allied Signal Inc., No. CIV.A. 98−4405, 1998 U.S. Dist. LEXIS 15617, at *12 (E.D. Pa. Oct. 8, 1998) (stating board of directors may use discretion in considering others' interests, including creditors). Back To Text

[62] For a discussion of the trouble such statutes may cause, see Other Constituency Statutes at 3368 Back To Text

[63] See Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182−83 (Del. 1985):

A board of directors may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders… such concern for non−stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.

Compare Dodge v. Ford Motor Co., 170 N.W. 668, 682 (Mich. 1919) (stating "[t]he discretion of the directors will not be interfered with by courts unless there has been bad faith, wilful neglect, or abuse of discretion."), with Shlensky v. Wrigley, 237 N.E.2d 776, 779 (Ill. 1968) (stating "[i]n a purely business corporation . . . the authority of the directors in the conduct of the business of the corporation must be regarded as absolute when they act within the law, and the court is without authority to substitute its judgment for that of the directors.") (citing Helfman v. American Light and Traction Co., 187 A. 540, 550 (N.J. Ch. 1936)). Back To Text

[64] A curious case is presented by utility cooperatives. In Wabash Valley Power Ass'n. v. Michigan, 903 F.2d 445, 448 (7th Cir. 1990), a non−profit power generation−and−transmission utility had customers in three midwestern states. As a co−op, Wabash's owners were its electricity−consuming customers. Wabash also had significant bondholder−creditors. This structure is similar to a corporation in which the exclusive customers of the corporation are also its shareholders. The owners felt rates should remain low and creditors thought rates should be high, thus a conflict. Judge Easterbrook, noting that the co−op may need to be operated for the benefit of the bondholders resolved the issue of for whose benefit the rate should be set. "This suit serves the interest of Wabash's members at the expense of the interest of Wabash's creditors." Wabash, 903 F.2d at 451. Back To Text

[65] See Varallo & Finkelstein, supra note 1, at 244 n.18. ("The line separating the obligations to debt holders under the implied common law covenant from fiduciary duties owed equity holders is not fully defined, but clearly does exist."). The Internal Revenue Code similarly examines the function of a class of debt or equity, rather than a simple reliance on the form a corporation chooses. Certain classes of preferred stock are considered debt for tax purposes. See generally In re Kallmeyer, 242 B.R. 492, 495 (9th Cir. B.A.P. 1999) (asserting director of insolvent corporation, that has ceased doing business, becomes trustee for corporations creditors); Credit Agricole Indosuez v. Rossiyskiy Kredit Bank, N.Y.S.2d 26, 31 (N.Y. 2000) (stating "trust fund doctrine," where remaining corporate assets of insolvent corporation are held in trust for general creditors, should not be used by general creditors to get preliminary injunctions prior to money judgments being obtained). Back To Text

[66] See Veasey, Defining Tension, supra note 27, at 395−6; see also Gordon v. Fundamental Investors, Inc., 362 F. Supp. 41, 44 (S.D.N.Y. 1973) (stating "we can assume that there may well be standing to sue directly in the case of a merger which results in the dilution of the shareholder's interest."); Delahoussaye v. Newhard, 785 S.W.2d 609, 612 (Mo. Ct. App. 1990) (opining "however, 'ordinarily an action based on acts relating to the capital stock as an entirety is a corporate cause of action and cannot be sued for by a shareholder merely as an individual.'") (citing Gieselmann v. Stegeman, 443 S.W.2d 127, 131 (Mo. 1969)). Back To Text

[67] See Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 96 (1991) (observing "[d]evised as a suit in equity, the purpose of the derivative action was to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'") (citing Cohen v. Beneficial Loan Corp., 337 U.S. 541, 548 (1949)); Ross v. Bernhard, 396 U.S. 531, 534 (1970) (stating derivative suits enforce corporate causes of action against officers, directors, and third parties); James W. Moore, 5 Moore's Federal Practice, 23.1−8 (3d ed. 1999). Back To Text

[68] See 5 Moore's Federal Practice, 23.1−8, (citing Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984)). Back To Text

[69] See Fed. R. Civ. P. 23.1; Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 529 (1984) (stating "the term 'derivative action,' which defines the scope of Rule 23.1, has long been understood to apply only to those actions in which the right claimed by the shareholder is one the corporation could itself have enforced in court"); Lynam v. Livingston, 257 F. Supp. 520, 524 (D. Del. 1966) (stating in stockholder's derivative suit, cause of action does not belong to stockholder but to corporation) Back To Text

[70] See Del. Ct. Ch. R. 23.1; Leung v. Schuler, C.A. No. 17089, 2000 Del. Ch. LEXIS 41, at *23 (Del. Ch. Feb. 29, 2000) (stating that Delaware's Chancery Court Rule 23.1 does require plaintiff to plead particularized facts) (citing Aronson, 473 A.2d at 814); In re Fuqua Indus., Inc. Shareholder Litig., 752 A.2d 126, 127 (Del. Ch. 1999) (stating representative plaintiff must not hold interests antagonistic to class). Back To Text

[71] See 5 Moore's Federal Practice, 23.1−10; The Business Judgment Rule, supra note 31, at 1411 (citing In re Sunrise Sec. Litig., 916 F.2d 874, 882 (3d Cir. 1990)); see also Kramer v. Western Pac. Indus., Inc., 546 A.2d 348, 352 (Del. 1988) ("Whether a cause of action is individual or derivative must be determined from the 'nature of the wrong alleged' and the relief, if any, which could result if plaintiff were to prevail."); Lipton v. News Int'l, PLC, 514 A.2d 1075, 1078 (Del. 1986) (stating in determining whether complaint is derivative nature of alleged wrongs prevail over plaintiff's designation). Back To Text

[72] Kamen, 500 U.S. at 108−109 (holding because statute being enforced was substantive, law of incorporation state prevails); Strougo v. Scudder, Stevens & Clark, Inc., 964 F. Supp. 783, 790 (S.D.N.Y. 1997); King v. Douglas, 973 F. Supp. 707, 723 (S.D. Texas 1996); The Business Judgment Rule, supra note 31, at 1412 (citing In Re Sunrise, 916 F.2d at 879. Back To Text

[73] See The Business Judgment Rule, supra note 31, at 1412. Back To Text

[74] The Business Judgment Rule, supra note 31, at 1413; see also Reifsnyder v. Pittsburgh Outdoor Adver. Co., 173 A.2d 319, 322 (Pa. 1961) (holding suit was direct and not derivative); William L. Cary & Melvin Eisenberg, Cases and Materials on Corporations, 1014 (7th ed. 1995 & Supp. 1997). Back To Text

[75] See O'Kelley & Thompson, Corporations and Other Business Associations, supra note 62, at 397. Back To Text

[76] See id. Back To Text

[77] See id. Back To Text

[78] See The Business Judgment Rule, supra note 31, at 1689−1800. Back To Text

[79] See Veasey, supra note 28, at 403. ("The defining tension in corporate governance today is the tension between deference to directors' decisions and the scope of judicial review."); The Business Judgment Rule, supra note 31, at 4.

The business judgment rule's presumption is a fundamental aspect of the corporate fiduciary relationship, and is a significant departure from the historic trustee relationship. Common law trustees, or testamentary trustees do not enjoy business judgment protection. Trustees are held to a higher standard that commands more conservative conduct and decisionmaking. Similarly, requiring a shareholder to maintain a derivative rather than a direct suit to enforce the fiduciary obligation is a significant departure from the historic trustee fiduciary obligation. Back To Text

[80] The applicability of the business judgment rule to non−director officers is a question rarely considered by courts. See The Business Judgment Rule, supra note 31, at 98. It is generally assumed that such officers do enjoy business judgment rule protection. See, e.g., Galef v. Alexander, 615 F.2d 51, 57 n.13 (2d Cir. 1980) (asserting business judgment rule generally applies to both decisions of executive officers and those of directors); In re Southeast Banking Corp., 827 F. Supp. 742, 748 (S.D. Fla. 1993) (stating Florida arguably applies business judgment rule to officers); Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971) (stating decisions of executive officers might fall within rule and probably did in case at hand). Back To Text

[81] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.") (citing Kaplan v. Centex Corp., 284 A.2d 119, 124); Robinson v. Pittsburgh Oil Refining Corp., 126 A.2d 46 (Del. Ch. 1924)); Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996) (stating business judgment rule presumes that "the Board acted independently, with due care, in good faith and in the honest belief that its actions were in the stockholders' best interests"); The Business Judgment Rule, supra note 31, at 21. Back To Text

[82] Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (stating board of directors enjoys presumption of sound business judgment); See generally Meyerson v. El Paso Natural Gas Co., 246 A.2d 789, 794 (1967) (asserting business judgment should not be interfered with absent "gross and palpable overreaching"). Back To Text

[83] Brazen v. Bell Atl. Corp., 695 A.2d 43, 46 (Del. 1997). See generally Paramount Communication Inc. v QVC Network Inc., 637 A.2d 34, 42 (Del. 1993) ("Under normal circumstances, neither the courts nor the stockholders should interfere with the managerial decisions of the directors. The business judgment rule embodies the deference to which such decisions are entitled. . . Nevertheless, there are rare situations . . . [where the business judgment rule does not apply and] a court subjects the directors' conduct to enhanced scrutiny to ensure that it is reasonable."). Back To Text

[84] Grobow v. Perot, 526 A.2d 914, 928 (Del. Ch. 1987). Back To Text

[85] See The Business Judgment Rule, supra note 31, at 6. The second aspect is the only substantive element of the business judgment rule. Upholding the decision is substantive protection to directors' decisions. The first element, though procedural rather than substantive, is generally thought to be more important. Back To Text

[86] See The Business Judgment Rule, supra note 31, at 5; see also Spiegel v. Buntrock, 571 A.2d 767, 774 (Del. 1990) (stating "[t]he burden is on the party challenging the decision to establish facts rebutting th[is] presumption") (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. Supr. 1984)). Chancellor Allen has explained the business judgment rule:

Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second−guess such decisions when they appear to have been made in good faith. Thus, for example, a good faith decision by a disinterested board cannot be the source of director liability even if the process by which the decision was made was arguably negligent. In order to prevent second−guessing on what might be close questions concerning the appropriateness of the process by which a business decision was made, the law has set a high standard. Only if the process is grossly negligent may liability for damage resulting from a good faith decision be found.

Solash v. Telex Corp., Fed. Sec. L. Rep. (CCH) ¶ 93,608 (Del. Ch. 1988). Back To Text

[87] See The Business Judgment Rule, supra note 31, at 5. Back To Text

[88] See infra Part II (G) (discussing entire fairness in detail). Back To Text

[89] Judicial deference to the business judgment rule is more generally defended on the grounds that courts wish to allow corporations to make their own decisions. See Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983).

[A]fter the fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.

Id. Back To Text

[90] See The Business Judgment Rule, supra note 31, at 12. Back To Text

[91] See id. Back To Text

[92] See id. at 15. (citations omitted). Back To Text

[93] See id. at 17. Back To Text

[94] See id. at 18. Back To Text

[95] See O'Kelley & Thompson, supra note 61, at 271 ("One of the most controversial issues in American corporate law is the role of the fiduciary duty of care in ensuring that a corporation's directors carry out their managerial responsibilities with reasonable care and diligence."). Back To Text

[96] See Meyers v. Moody, 693 F.2d 1196, 1209 (5th Cir. 1982) (stating Texas law imposes on corporate officers and directors to exercise "that degree of care which a person of ordinary prudence would exercise under the same or similar circumstances"); The Business Judgment Rule, supra note 31, at 109; Brudney, Contract and Fiduciary Duty in Corporate Law, supra note 12, at 597 n. 9:

The [duty of care] require[s] some level of attentiveness, some process for (and actual) acquisition or possession of relevant information, some reasoned deliberation in performing services, and exercise of some conscious (but virtually unrestricted) judgment about acceptable levels of return per unit of risk or other measure of enhancing stockholder well−being.

Harvey R. Miller, Corporate Governance, supra note 1, at 1474−75 n. 24 (citing Meyers v. Moody, 693 F.2d 1196, 1209 (5th Cir. 1982) which states " '[d]ue care' is that degree of care which a person of ordinary prudence would exercise under the same or similar circumstances"); Michael H. Ubelaker, Director Liability Under the Business Judgment Rule: Fact or Fiction?, 35 SW. L.J. 775, 787 (1981) (discussing standard of care as referring to prudent businessman rather than merely prudent man). Back To Text

[97] See Graham v. Allis−Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) (stating "directors of a corporation…are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances"); see also Bowerman v. Hamner, 250 U.S. 504, 512 (1919); Gamble v. Brown, 29 F.2d 366, 370 (1928) (both discussing standard of care applied to directors of corporation in managing corporate affairs). Back To Text

[98] O'Kelley & Thompson, supra note 61, at 272. See James L. Griffith, Jr., Director Oversight Liability: Twenty−First Century Standards and Legislative Controls on Liability, 20 Del. J. Corp. L. 653, 665 (1995) (discussing generally director's duty of oversight); E. Norman Veasey & Julie M.S. Seitz, The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge, 63 Tex. L. Rev. 1483, 1501 (1985) (discussing oversight as second principal function of board). Back To Text

[99] Richard M. Cieri et al., The Fiduciary Duties of Directors of Troubled Companies, 3 J. Bankr. L & Prac. 405, 406 (1993) (quoting Aronson v Lewis, 473 A.2d at 812 (Del. 1984)). See Cede & Co. v. Technicolor, Inc., Consol. Nos. 336 & 337, 1993 Del. LEXIS 398, at *68−74 (Del. Oct. 22, 1993) (discussing directors' breach of duty of care and gross negligence when they made uninformed decision to sell company for too low per−share sale price). Back To Text

[100] 432 A.2d 814, 817 (N.J. 1981) (holding "[director] negligent in not noticing and trying to prevent misappropriation of funds by corporation in an implied trust"). Back To Text

[101] See id. at 817−18. Back To Text

[102] See id. Back To Text

[103] See id. Back To Text

[104] See id. at 829 (stating "by virtue of her office, Mrs. Pritchard had the power to prevent the losses sustained by the clients of [the corporation]. With power comes responsibility. She had a duty to deter the depredation of the other insiders, her sons. She breached that duty and caused plaintiffs to sustain damages"). Back To Text

[105] It is quite rare that directors are held to have breached the fiduciary duty of loyalty. See The Business Judgment Rule, supra note 31, at 167−72. See generally Joseph W. Bishop. Jr., Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 Yale L.J. 1078 (1968) (discussing consequences of corporate directors' and officers' breach of duty to not enrich themselves at corporation's expense and of gross negligence in management of corporation's affairs). Back To Text

[106] O'Kelley & Thompson, Corporations and Other Business Associations, supra note 61, at 273, 285−310. Back To Text

[107] 488 A.2d 858 (Del. 1985). Back To Text

[108] See id. at 864. Back To Text

[109] See id. Back To Text

[110] See, e.g., Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000) (contending Disney directors on old board did not avail themselves of all material information reasonably offered in approving Ovitz' 1995 contract, thereby violating fiduciary duty of care); Quickturn Design Sys. v. Shapiro, 721 A.2d 1281, 1292 (Del. 1998) (holding Delayed Redemption Provision was void under 8 Del. C. § 141(a), which bestows any newly elected board full power to manage and direct business affairs of Delaware corporation); Malone v. Bribcat, 722 A.2d 5, 11 (Del. 1998) (stating directors' fiduciary duties consist of duty to deal with stockholders honestly). Back To Text

[111] See Ann E. Conway Stilson, Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors, 20 Del. J. Corp. L. 1, 97 (1995) (stating Delaware's § 102(b)(7) was adopted in order to eliminate director's personal liability). See, e.g., Arnold v. Society for Savings Bancorp., Inc., 650 A.2d 1270, 1286 (Del. Supr. 1993) (finding breach of duty of disclosure, but directors not liable because of Delaware's § 102(b)(7)); In re Rego Co., 623 A.2d 92, 94 (Del.Ch. 1992) (stating Delaware among other jurisdictions have shielded directors or shareholders of dissolved corporations from personal liability for corporate obligations). Back To Text

[112] See Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599 (1921) (stating transactions between corporations where boards have common members may require proof of entire fairness); Edelman v. Fruehauf Corp., 798 F.2d 882, 886 (6th Cir. 1986) (holding under Michigan law transaction between corporation and one of its fiduciaries must be "fair and reasonable" or ratified by disinterested shareholders or directors after full disclosure); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361−62 (Del. 1993) (holding duty of loyalty requires best interest of corporation take precedence over interest possessed by fiduciary); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1264 (Del. 1989) (requiring intrinsic fairness of deal where director's loyalties were divided and there was lack of independent director oversight); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (noting where directors are interested in transaction and no disinterested approval exists business judgment rule inapplicable in determining demand futility in derivative suit); Pogostin v. Rice, 480 A.2d 619, 623−24 (Del. 1984) (stating bare allegations of director participation in wrongdoing to not establish demand futility); Lewis v. Fuqua, 502 A.2d 962, 966 (Del. Ch. 1985) (discussing importance of disinterest of director participating on litigation committee). Back To Text

[113] See Guth v. Loft, 5 A.2d 503, 510 (Del. 1939):

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests…A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty…The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self interest.

See also Ledbetter v. First State Bank & Trust Co., 85 F.3d 1537, 1540 (11th Cir. 1996) (discussing primary duty bestowed on fiduciary as being undivided loyalty to beneficiary); Benedict v. Amaducci, 92 Civ. 5239, 1993 U.S. Dist. LEXIS 3556, at *14 (S.D.N.Y. March 22, 1993) (asserting corporate fiduciaries must never place themselves in position whereby personal interests will come in conflict with interest of beneficiary). Back To Text

[114] See, e.g. Brudney, supra note 12, at 599 n.9:

The obligation of loyalty is to serve the interests of the beneficiary rather than those of the fiduciary. In its most demanding form, it requires the fiduciary to serve solely the beneficiary's interests and to refrain from any kind of behavior (in performing services or in dealing with the beneficiary or the property in its control) from which the fiduciary may gain in excess of specified compensation−−even if such behavior imposes no cost on the beneficiaries or, indeed, if the failure to engage in such behavior causes a loss to them.

See also Ledbetter, 85 F.3d at 1540 (discussing primary duty conferred upon fiduciaries being their undivided loyalty to beneficiary). Back To Text

[115] See, e.g., Del. Code Ann. tit. 8, § 144 (1994 & Supp. 1999) (establishing conditions for validating contract with interested directors); N.Y. Bus. Corp. Law § 713 (McKinney 1986) (same); Remillard Brick Co. v. Remillard−Dandini Co., 241 P.2d 66, 74 (Cal. 1952) (applying duty of loyalty analysis to invalidate contract with interested directors); Globe Woolen Co. v. Utica Gas & Elec., 121 N.E. 378, 380 (N.Y. 1918) (same). Back To Text

[116] See, e.g., Rogers v. Hill, 289 U.S. 582, 591 (1933) (applying duty of loyalty analysis to claim of excessive management compensation); McPhall v. L.S. Starrett Co., 257 F.2d 388 (1st Cir. 1958) (asserting options to buy stock given to employees without receiving any consideration in return was violation of duty of loyalty); In re Estate of Lerch, 159 A.2d 506, 512−13 (Pa. 1960) (stating no breach of duty of loyalty where corporate trustee loaned money through its commercial department to corporation in which trustee held minority stock interest). Back To Text

[117] See, e.g., Delta Star, Inc. v. Patton, 76 F. Supp. 2d 617, 634 (W.D. Pa. 1999) (explaining corporate waste as exchange of corporate assets for consideration so excessively diminutive as to be placed beyond range reasonable person might be willing to accept); Lewis v. Vogelstein, 699 A.2d 327, 338 (Del. 1997) (same); Michaelson v. Duncan, 407 A.2d 211, 217 (Del. 1979) (applying duty of loyalty analysis to claim of corporate waste). Back To Text

[118] See, e.g., Lincoln Stores v. Grant, 34 N.E. 2d 704, 707 (Mass. 1941) (holding use of corporate assets by interested directors was breach of duty of loyalty); Diamond v. Oreamuro, 248 N.E.2d 910, 913−14 (N.Y. 1969) (holding officers liable to corporation for profits derived from use of corporate information); Delta Star, Inc., 76 F. Supp. 2d at 617 (same). Back To Text

[119] Accord, Crane Co. v. Harsco Corp., 511 F. Supp. 294, 305 (Dist. Del. 1981) (noting general rule use of corporate funds to perpetuate control of corporation is improper); American Gen. Corp. v. Unitrin, Inc., No. 13699, 1994 Del. Ch. LEXIS 144, at *14 (Del. Ch. Aug. 26, 1994) (finding misuse of corporate funds to perpetuate control created irreparable injury); Victor Brudney, Fiduciary Ideology in the Transactions Affecting Corporate Control, 65 Mich. L. Rev. 259, 263−72 (1966) (discussing purchase by corporation of its own stock elicits issues of economic abuse of corporation). Back To Text

[120] See, e.g., Irving Trust Co. v. Deutsch, 73 F.2d 121, 123 (2d Cir. 1934), cert. denied, 294 U.S. 708 (1935) (applying duty of loyalty analysis to misappropriation of corporate opportunity); Guth v. Loft, 5 A.2d 503, 510 (Del. 1939) (same); Klinicki v. Lundgren, 695 P.2d 906, 910−11 (Ore. 1985) (same). Back To Text

[121] See In re Bennett, 989 F.2d 779, 789−90 (5th Cir. 1993) (discussing duty of loyalty and fiduciary obligation in context of partnership bankruptcy); Maynard, Maynard & Woodcon v. Holder, No. 2:97−CU−477−J, 1998 U.S. Dist. 17637, at *10 (N.D. Tex. Oct. 28, 1998) (defining, in tandem, fiduciary obligation and duty of loyalty of officers and directors); David S. Ruder, Duty of Loyalty – A Law Professor's Status Report, 40 Bus. Law. 1383, 1386−87 (1985); Mitchell, supra note 12, at 1194−95. Back To Text

[122] See Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992) (stating "duty of candor" is proposition that directors of Delaware corporations are under fiduciary duty to disclose fully and fairly all material information); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1283 (Del. 1989) (stating duty of candor is basic doctrine of fair dealing); Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (stating fair dealing is duty of candor); Marciano v. Nakash, 535 A.2d 400, 406−07 (Del. Super. 1987) (same). Back To Text

[123] O'Kelley & Thompson, Corporations and Other Business Associations, supra note 61, at 358−59. See Brown v. Scott County Tobacco Warehouses, Inc., 5 Va. Cir. 75, 75 (1983) (stating corporation cannot purchase its own stock where no retained earnings or capital surplus exists); Rodman Ward Jr. et al., Folk on the Delaware General Corporation Law, § 144 (4th ed. 2000) [hereinafter Folk on the Delaware General Corporation Law] ("It is a long−established principle of Delaware law that . . . the fiduciary relationship between directors and the corporation imposes fundamental limitations on the extent to which a director may benefit from dealings with the corporation he serves") (citing Marciano v. Nakash, 535 A.2d 400, 403 (Del. 1987) and Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939)). Compare Norwood P Beveridge, Jr., The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self−Interested Director Transaction, 41 DePaul L. Rev. 655 (1992) with, Harold Marsh, Jr., Are Directors Trustees?, 22 Bus. Law. 35 (1966). Back To Text

[124] See Wardell v. Union Pac. R.R., 103 U.S. 651, 658 (1880) (asserting directors cannot in same situation act for themselves and for corporation); European & North Am. Ry. Co. v. Poor, 59 Me. 277 (1871) (asserting acts done by directors should be for interests of cestuis que trust); O'Kelley & Thompson, Corporations and Other Business Associations, supra note 61, at 358. Back To Text

[125] Accord Del. Code Ann. tit. 8, § 144 (1974 & Supp. 1999) (removing term "interested director" from confusion surrounding it when terms are met and prevents invalidation of agreement "solely" because such director or officer is involved); Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976) (stating Del. Gen. Corp. Law § 144 does not offer immunity to directors who act unfairly); Marciano v. Nakash, 535 A.2d 400 (Del. 1987); Folk on the Delaware General Corporation Law, supra note 123, at § 144. Back To Text

[126] See supra note 125; Del. Code Ann. tit. 8, § 144(a)(1) (1974 & Supp. 1999). Back To Text

[127] Del. Code Ann. tit. 8, § 144(a)(2) (1974 & Supp. 1999). For cases dealing with ratification in non−self−interested director transactions, see Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1997) (concerning ratification of officer and

director compensation); In re Santa Fe Pac. Corp. Shareholders Litig., 669 A.2d 59, 68 n. 5 (Del. 1995) (stating majority of completely well−versed stockholders may ratify action of interested directors); Smith v. Van Gorkom, 488 A.2d 858, 890 (Del. 1985) ("where a majority of fully informed stockholders ratify action of even interested directors, an attack on the ratified transaction normally must fail"). Back To Text

[128] See Packer v. Yampol, C.A. No. 8432, 1986 Del. Ch. LEXIS 413, at * 41 (Del. Ch. Apr. 18, 1986) (asserting improved probability of directors' continual presence by virtue of business deal counteracts element of director disinterest); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) (asserting directors' breach of fiduciary duty involves self−dealing); Folk on the Delaware General Corporation Law, supra note 123, at § 144.5 ("In general, directorial interest exist when ever a director either (a) appears on both sides of the transaction or (b) has any personal financial interest in the transaction that is not equally shared by the stockholders."). Back To Text

[129] See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) (stating directors are charged with uncompromising fiduciary duty to look after interests of corporation and to perform in best interests of shareholders); Emergency Patient Servs. v. Crisp, 602 S.W.2d 26, 27 (Mo. App. 1980) (asserting director occupies fiduciary relation with corporation and stockholders and may not personally profit by virtue of association at expense of corporation and stockholders); Ramacciotti v. Joe Simpkins, Inc., 427 S.W.2d 425, 431 (Mo. 1968) (same). Back To Text

[130] See Folk on the Delaware General Corporation Law, supra note 123, at § 144.2 (noting possible conflict between Cede & Co. 634 A.2d at 351 and more recent Delaware Chancery Court opinion, Cooke v. Oolie, C.A. No. 11134, 1997 Del. Ch. LEXIS 92 (Del. Ch. June 23, 1997)). Back To Text

[131] See Del. Code Ann. tit. 8, § 144(a)(3) (1974 & Supp. 1999). Thus, a self−interested director/officer has three options to choose from when seeking to engage in a self−interested transaction. He or she may: (1) acquire disinterested board or committee approval, (2) acquire stockholder vote ratifying the transaction, or (3) demonstrate the transaction's intrinsic fairness to the corporation. For cases discussing entire fairness. See Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) (stating that directors are required to demonstrate inherent fairness of bargain); Marciano v. Nakash, 535 A.2d 400, 404 (Del. 1987) (stating that intrinsic fairness test furnishes substantive standard against which evidential burden of interested directors is applied); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 940 (Del. 1985) (same); Sterling v. Mayflower Hotel, 93 A.2d 107, 114 (Del. 1952) (stating same). Back To Text

[132] See, e.g., Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988) (stating fairness becomes an issue only if presumption of business judgment rule is defeated); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (noting it is presumption that in making a business decision directors of corporations acted in best interests of company); Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971) (noting when persons who control transaction are on both sides, presumption and deference to sound business judgment is no longer present). Back To Text

[133] See International Radio Tel. Co. v. Atlantic Communications Co., 290 F. 698, 702 (2d Cir. 1923) (noting fair way to question validity of proposition is whether it would have commended itself to an independent corporation); Johnston v. Greene, 121 A.2d 919, 925 (Del. 1956) (commenting on fair way to determine director's actions); Folk on the Delaware General Corporation Law, supra note 123, at § 144.9 n. 90. Back To Text

[134] Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) ("[D]irectors are required to demonstrate both their utmost good faith and the most scrupulous inherent fairness of transactions in which they possess a financial, business or other personal interest which does not devolve upon the corporation or all stockholders generally."); Weinberger v. UOP, 457 A.2d 701, 710 (Del. 1983) (stating burden must be sufficient to pass test of careful scrutiny by courts); David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 431 (Del. Ch. 1968) (stating that party who stands upon both sides of proposed merger has burden of proof to show that transaction is fair after careful scrutiny by court). Back To Text

[135] See Weinberger, 457 A.2d at 710; see also Kahn v. Lynch Communication Sys., 669 A.2d 79, 84 (Del. 1995) (applying fair price component); Stauffacher v. Checota, No. 87−1925, 1989 Wisc. App. LEXIS 306, at *14 (Wis. Ct. App. March 9, 1989) (commenting entire fairness doctrine is focal point against which merger transaction can be measured). Back To Text

[136] See Bastian v. Bourns, Inc., 256 A.2d 680, 681 (1969) (stating interests of stockholders should be dealt with in entirely fair manner); Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 58 (1952) (noting directors must use utmost good faith); Folk on the Delaware General Corporation Law, supra note 123, at § 144.9. Back To Text

[137] See Folk on the Delaware General Corporation Law, supra note 123, at § 144.9. Back To Text

[138] See In re Tri−Star Pictures, Inc. Litig., Consol., No. 9477, 1992 Del. Ch. LEXIS 30, at *30 (Del. Ch. Feb. 21, 1992) (concluding where compensatory damages are bought in claim for breach of duty of candor, individual damage to plaintiffs is essential element of that claim). See generally In re Brae Corp., No. 11348, 1991 Del. Ch. LEXIS 87, at *6 (Del. Ch. May 14, 1991) (stating in order for breach of duty of candor to have occurred there must have been fact omitted which would have been significant to deliberations of reasonable shareholder); see also Sims v. Tezak, 296 Ill. App. 3d 503, 507 (1998) (stating Delaware courts have imposed upon corporate directors fiduciary duty to disclose fully and fairly all material information within board's control when it seeks shareholder actions). Back To Text

[139] See Mann Constr. Co. v Comm'r, No. 27187−96, 1999 Tax Ct. Memo LEXIS 220, at *20 (T.C. June 3, 1999) (stating whether a bonafide debtor−creditor relationship exists depends on all facts and circumstances); People v. Peoples Bank & Trust Co., 268 Ill. App. 39, 43 (1932) (noting anyone who holds money of another is debtor but debtor in such sense is not alone sufficient to create relationship of debtor−creditor). Back To Text

[140] See Schwarcz, supra note 1, at 655 n.8:

A debtor−creditor relationship is qualitatively different from the traditional examples of fiduciary relationships. Even in a landlord−tenant relationship, which is perhaps the closest fiduciary analogy, the landlord entrusts real property (by analogy money) to a tenant (debtor) pursuant to a lease (loan agreement). The tenant is in possession of, and must care and eventually return, the actual property leased. However in the case of a loan, the money loaned becomes solely the debtor's property, and can be used by the debtor without restriction. There is no entrusting of property rights.

See also Mans v. Peoples Bank of Imboden, 340 Ark. 518, 525 (2000) (emphasizing for fiduciary relationship to exist, factual underpinnings are necessary to establish relationship of trust); Country Corner Food & Drug Inc. v. First State Bank & Trust Co., 332 Ark. 645, 654 (1998) (stating same). Back To Text

[141] Professor Brudney identifies a key distinction between contract and fiduciary principles:

[C]orporate fiduciary obligations start from the exclusive benefit principle, [the principle that a fiduciary must act exclusively for the benefit of the beneficiary] and the question is how far from that starting point the fiduciary may be permitted to go in appropriating benefits for itself. Claims of bad faith or unconscionability [in contract] start from the premise that the party charged was entitled to seek all the advantages the contract might permit, and the question is how to limit the benefits he or she may appropriate at the expense of the other party.

Brudney, supra note 12, at 631−32. See also International Radio Tel. Co. v. Atlantic Communication Co., 290 F. 698, 702 (2d Cir. 1923) (stating "[a] fair way to determine the [validity of a traffic contract] is to consider whether the proposition submitted would have commended itself to an independent corporation."). Back To Text

[142] See Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 WL 277613, at *24 (Del.Ch. Dec. 30, 1991) ("while contracting parties are not fiduciaries for each other, there are outer limits to the self−seeking actions they may take under contract. Where one party's actions are such as to deprive the other of a material aspect of the bargain for which he contracted, the first party will be found to have violated that elemental obligation of all contracting parties to deal with each other in good faith and to deal fairly with each other with respect to the subject matter of the contract."); see also Robert S. Summers, The General Duty of Good Faith – Its Recognition and Conceptualization, 67 Cornell L. Rev. 810 (1982); Robert Charles Clark, The Duties of the Corporate Debtor to Its Creditors, 90 Harv. L. Rev. 505 (1977); Robert S. Summers, "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 Va. L. Rev. 195 (1968); Schwarcz, supra note 1, at 651−65 (discussing thoroughly sources of corporation debtor's obligation to its creditors).

The presence or absence of a fiduciary obligation to creditors is most evident in transactions in which the market value of a corporation's bonds plummet while its shareholders receive a premium. See, e.g., Metropolitan Life Insurance Co. v. RJR Nabisco, Inc., 716 F.Supp. 1504 (S.D.N.Y. 1989); HB Korenvaes Investments v. Marriott Corp., No. 12922, 1993 WL 257422 (Del. Ch. July 1, 1993). See generally, Barry J. Benzig, Getting What You Bargained For: The Contractual Nature of A Preferred Shareholder's Rights – Korenvaes, L.P. v. Marriott Corp., 19 Del. J. Corp. L. 517 (1994); Nancy W. Graml, Bondholder Rights in Leveraged Buyouts in the Aftermath of Metropolitan Life Insurance Co. v. RJR Nabisco, Inc., 29 Am. Bus. L. J. 1 (1991); William T. Allen, Independent Directors In MBO Transactions: Are They Fact or Fantasy?, 45 Bus. Law. 2055 (1990). Back To Text

[143] Frank Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J. L. Econ. 395, 401 (1983) [hereinafter Easterbrook & Fischel, Voting] ("From an economic perspective, a corporation is just a name for a great web of contractual arrangements.") (citing Michael Jensen & William Meckling, Theory of the Firm: Management Behavior, Agency Costs and Ownership Structure, 3 J. Financial Econ. 305 (1976)); see also Frank H. Easterbrook and Daniel R. Fischel, The Economic Structure of Corporate Law (1991); Laura Lin, supra note 1, at 1488 ("Both shareholders and creditors are suppliers of capital; each contributes funds to the corporation in exchange for claims on cash flows generated by the entity's operations."). Back To Text

[144] A fundamental criticism of such a conceptualization is that it ignores the fact that shareholders own the corporation. This is most evident in a close corporation. The majority of commentary focuses on large publicly held corporations, but does not account for the anomalous situation of the close corporation. If it could be determined that some other entity had perfect monitoring and economically efficient decisionmaking capabilities, and would operate the corporation at optimal rationality and efficiency, would the close corporation be required to be operated as this entity commanded? Back To Text

[145] Lin, supra note 1, at 1488 ("Creditors have fixed claims against the corporation that entitle them to receive a pre−determined rate of interest and repayment of their principal at a specified maturity rate."); Frost, supra note 33, at 106 ("Creditors trade a claim to the business' upside potential for a fixed, priority claim on the assets and the income stream"). There is a general belief that bondholders' return on investment is strictly set by contract. This is not exactly correct. There is a free flowing market in corporate bonds similar to the stock exchanges. A director/officer's act or decision can have just as catastrophic of an effect on a bond's trading price as a share of stock. This bond market has arisen without the traditional fiduciary protection stockholders enjoy. Perhaps bondholders should be left to their peril, but the existence of the market, and the catastrophic effect certain director/officer acts make on that market should be recognized.

The counter argument is that although the market value of publicly traded debt is directly related to the value of the corporate assets, this benefit to creditors is incidental to their legal rights. Collier Business Workout Guide, supra note 37, at 3−8. For a thorough discussion of this distinction, see infra Part III (A) (proposing a trigger for a fiduciary obligation to creditors).

Once a large corporation files for bankruptcy, there is generally an active and variable market in creditor claims on the debtor. See generally Chaim Fortgang & Thomas M. Mayer, Trading Claims and Taking Control of Corporations in Chapter 11, 12 Cardozo L. Rev. 1 (1990). Back To Text

[146] For example, if the corporation discovers a cure for cancer and the world is willing to pay billions for it, the creditor who washes the windows of the corporate headquarters is not entitled to an increased claim. If the corporation wastes a significant amount of money on a new product that does not sell well, the window washer creditor is not required to reduce his claim. See generally Wells Fargo Asia Ltd. v. Citibank, N.A., 936 F.2d 723, 726 (2d Cir. 1991) (stating it is important that justified expectations of parties to contract be protected); Olwine v. Torrens, 236 Pa. Super. 51, 54 (1975) (noting as a class, debtors gain during periods of inflation and creditors lose). Back To Text

[147] Assuming solvency, shareholders are the only non−fixed claimant. See Lin, Shift of Fiduciary Duty, supra note 1, at 1488 ("[s]hareholders … receive rights to participate in the profits of the corporation in the form of dividends, as may be declared from time to time at the board's discretion, and to share in the firm's residual assets upon corporate dissolution."). Back To Text

[148] The downside limit is the shareholder's initial investment because of limited liability. Back To Text

[149] Easterbrook & Fischel, supra note 143 at 403:

As the residual claimants, the shareholders are the residual claimants to the firm's income. Bondholders have fixed claims, and employees generally negotiate compensation schedules in advance of performance. The gains and losses from abnormally good or bad performance are the lot of the shareholders, whose claims stand last in line.

Id.

The author finds this a curious justification. Though perhaps plausible and logically consistent, the entire history of corporate law has been based on the premise that shareholders are the ultimate holders of the voting power. They own the corporation. The fact that it is economically efficient is perhaps, merely coincidental. See Smith v. Bath Loan & Bldg. Ass'n, 126 Me. 59, 63 (Sup. Ct. 1927) (stating insolvency abrogates provisions of contract between association and its shareholders); Cook v. Emmet Bldg. Ass'n, 90 Md. 284, 288 (1899) (holding shareholders who gave notice of withdrawal when association was insolvent but before it had been judicially declared so were not entitled to priority of creditors). Back To Text

[150] See Easterbrook & Fischel, Voting, supra note 143, at 403:

The shareholders are the group with the appropriate incentives (collective choice problems aside) to make discretionary decisions… Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion. Back To Text

[151] Id. Back To Text

[152] Id. Back To Text

[153] See Douglas G. Baird & Thomas H. Jackson, Bargaining After the Fall and the Contours of the Absolute Priority Rule, 55 U. Chi. L. Rev. 738, 761 (1988) [hereinafter Baird & Jackson, Absolute Priority Rule]; see also G. Eric Brunstad & Mike Sigal, Competitive Choice Theory and the Unresolved Doctrines of Classification and Unfair Discrimination in Business Reorganizations Under the Bankruptcy Code, 55 Bus. Law. 1, 50 (1999) ("[E]quity holders of a financially healthy firm typically have both something to gain and something to lose from any decision over the disposition of the firm and its assets (i.e., if the firm invests its assets poorly, they will suffer both an erosion of their interests and foregone opportunity costs). As a result equity holders generally possess incentives to make value−maximizing decisions, or at least compel their agents to do so."). Back To Text

[154] See Easterbrook & Fischel, supra note 143, at 403. Back To Text

[155] Collier Business Workout Guide, supra note 37, ¶ 3.02[1][a], at 3−5. See generally Scott F. Norberg, Debtor Incentives, Agency Costs, and Voting Theory in Chapter 11, 46 U. Kan. L. Rev. 507, 514 (1998) (stating shareholders are residual owners and therefore, their rights to firm's cash flow and assets are subject to creditors). See, e.g., Del. Code Ann. tit. 8, § 281 (1991 & Supp. 1998) (setting forth procedure for payment and distribution of assets to claimants and shareholders upon corporation's dissolution). Delaware corporate law requires all "claims or obligations [pursuant to Del. Code Ann. tit. 8, § 280 (1974 & Supp. 1999)] . . . be paid in full and any such provision for payment . . . be made in full if there are sufficient assets. . . . Any remaining assets shall be distributed to the stockholders of the dissolved corporation." Title 8, § 281. Back To Text

[156] Creditors do enjoy a slight benefit from the additional security a successful venture offers by increasing the available assets for the creditor's claims. See Easterbrook & Fischel, Voting, supra note 143, at 403 (recognizing possibility creditors could "receive…a tiny benefit (in increased security) from the undertaking of a new project"). Back To Text

[157] "[A] mere expectancy interest does not create a fiduciary relationship. Before a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist." Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988); see also Anadarko Petroleum Corp. v. Panhandle East. Corp., 545 A.2d 1171, 1176 (Del. 1988) (finding fiduciary duty exists for beneficial owners of stock by distinguishing equitable ownership from legal ownership); Hart v. Hanson, 14 N.D. 570, 575 (N.D. 1905) (finding assumption that directors of banking corporation owe some duty individually to each creditor is erroneous). "Creditors of the corporation are utter strangers to the obligations of the directors to the corporation." Id. See generally Collier Business Workout Guide, supra note 37, ¶ 3.02[2], at 3−7 to 3−8 (noting directors of corporation owe no fiduciary duty to creditors who lack equitable interest). Back To Text

[158] McDonald v. Williams, 174 U.S. 397, 404 (1899) (Peckham, J.). Back To Text

[159] See supra Part II (C) (asserting general rule that creditors are not beneficiaries of corporate fiduciary relationship as long as corporation is solvent). Back To Text

[160] See, e.g., Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. Ch. 1992) (asserting fiduciary duties to creditors arise when there is insolvency); Harff v. Kerkorian, 324 A.2d 215, 222 (Del. Ch. 1974) (contending insolvency is a special circumstance affecting the rights of creditors), rev'd in part on other grounds, 347 A.2d 133 (Del. 1975); Schwarcz, supra note 1, at 667−68 (suggesting director's fiduciary obligation be extended to creditors of insolvent corporation). Back To Text

[161] The fiduciary obligation of a chapter 11 debtor in possession's directors and officers is distinct from the obligation of an insolvent corporation's management. That fiduciary relationship, corporate fiduciary – bankruptcy debtor in possession in the nomenclature of this thesis, has different contours. "The filing of a petition under chapter 11 of the Bankruptcy Code is a bright line. Once it is crossed, the allegiance, goals, and fiduciary duties of corporate directors is transformed." Richard M. Cieri et al., Breaking Up Is Hard to Do: Avoiding the Solvency−Related Pitfalls in Spinoff Transactions, 54 Bus. Law. 533, 551−52 (1999) [hereinafter Cieri, Breaking Up Is Hard To Do]. For additional commentary focusing on this particular fiduciary relationship, see generally Martin J. Bienenstock, Conflicts Between Management and the Debtor in Possession's Fiduciary Duties, 61 U. Cin. L. Rev. 543 (1992) (discussing whether fiduciary duties exist between management and creditors); Daniel B. Bogart, Liability of Directors of Chapter 11 Debtors in Possession: "Don't Look Back – Something May Be Gaining On You", 68 Am. Bankr. L.J. 155, 180 (1994) (discussing changes in corporate governance following chapter 11 filing); C.R. Bowles, Jr. & Nancy B. Rapoport, Has the DIP's Attorney Become the Ultimate Creditors' Lawyer in Bankruptcy Reorganization Cases?, 5 Am. Bankr. Inst. L. Rev. 47, 53−54 (1997) (stating filing of bankruptcy petition creates fiduciary duty to creditors); Clark, supra note 142, at 536 (observing in context of equitable subordination that there is a "duty to provide a 'reasonable' amount of net worth for the benefit of persons who might be injured by their tortious activities"); Dennis F. Dunne, The Revlon Duties and the Sale of Companies in Chapter 11, 52 Bus. Law. 1333 (1997) (discussing Revlon duties in relation to chapter 11 cases); Frost, Corporate Governance, supra note 33, at 113 (recognizing fiduciary duties arise in bankruptcy scheme but considers governance structure of chapter 11 "a less than satisfactory substitute for the contract and market controls that are eliminated by the filing of a bankruptcy petition"); Frost, Running the Asylum, supra note 33, at 110−11 (stating fiduciary duties are extended to creditors, similar to fiduciary duties that are owed to shareholders); Michael A. Gerber, The Election of Directors and Chapter 11 – The Second Circuit Tells Stockholders to Walk Softly and Carry a Big Lever, 53 Brook. L. Rev. 295, 342 (1987) (noting ability of trustees and debtor in possessions to void certain transfers helps maximize bankruptcy estate and therefore, is in keeping with fiduciary obligations to creditors); Regina Stango Kelbon et al., Conflicts, the Appointment of "Professionals," and Fiduciary Duties of Major Parties in Chapter 11, 8 Bankr. Dev. J. 349, 423−35 (1991) (discussing fiduciary responsibilities in bankruptcy); Jeffrey C. Krause, Whose Lawyer Are You: Fiduciary Obligations of Debtor and Debtor−in−possession and Counsel, 31 Beverly Hills B.A. J. 37 (1997) (concerning fiduciary duty of debtor in possession and its attorney to creditors); Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. Pa. L. Rev. 669, 707−11 (1993) [hereinafter LoPucki & Whitford, Corporate Governance] (addressing issue of creditor and shareholder conflicts regarding fiduciary obligations); Miller, supra note 1, at 1479 (raising question of when does corporation become insolvent for purposes of director's fiduciary obligations to creditors); Raymond T. Nimmer & Richard B. Feinberg, Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity, 6 Bankr. Dev. J. 1, 2 (1989) (stating one aspect of debtor in possession involves fiduciary duties); John T. Roache, The Fiduciary Obligations of a Debtor In Possession, 1993 U.

Ill. L. Rev. 133 (1993) (discussing fiduciary obligations regarding debtor in possession and creditors); Erica M. Ryland, Bracing For the "Failure Boom": Should a Revlon Auction Duty Arise in Chapter 11?, 90 Colum. L. Rev. 2255, 2259 (1990) (noting managers and debtor in possessions have trustee duties for all claimants); David A. Skeel, Jr., Rethinking the Line Between Corporate Law and Corporate Bankruptcy, 72 Tex. L. Rev. 471, 500 (1994) (discussing effect of bankruptcy on derivative suit litigations); E. Allan Tiller, Personal Liability of Trustees and Receivers in Bankruptcy, 53 Am. Bankr. L.J. 75 (1979) (discussing liability of trustees when fiduciary duties are breached); J. Ronald Trost, Corporate Bankruptcy Reorganizations: For the Benefit of Creditors or Stockholders?, 21 UCLA L. Rev. 540, 543 (1973) (discussing Justice Douglas' use of independent trustees and absolute priority rule in order to keep management from gaining distinct advantages). Back To Text

[162] Compare Mackenzie Oil Co. v. Omar Oil & Gas Co., 120 A. 852, 857 (Del. Ch. 1923) (finding trust's imposition of recently enacted receivership statute to be basis for creditor's recognized interest in corporation's assets).

When insolvency arises, it creates a right on the part of creditors and stockholders to be regarded as bearing a different relationship towards the corporate assets from that which had theretofore existed. The proprietary right over the assets is solely in the corporation acting through its officers; stockholders cannot manage or control the assets; neither can creditors. Nor, in the absence of the [Delaware receivership] statute, can either stockholders or creditors assert any litigable interest in the assets because of insolvency alone. . . . A right to assert an interest now exists where it did not exist before.

Id. (emphasis added), with Asmussen v. Quaker City Co., 156 A. 180, 183 (Del. Ch. 1931) (unwilling to extend obligations to creditors "[u]ntil recourse has been had [pursuant] to . . . [the] receivership statute . . . . [Consequently,] equity will not treat the assets of an insolvent corporation as a trust fund for the benefit of creditors"). See, e.g., Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 184 (1942) ("When the equity owners are excluded and the old creditors become stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority."). Back To Text

[163] See infra Part III (C) (proposing justification for fiduciary obligation to creditors based on their contingent property interest in corporation). Back To Text

[164] H.R. Rep. No. 95−595, at 222 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6181. See also Peter F. Coogan, Confirmation of a Plan Under the Bankruptcy Code, 32 Case W. Res. L. Rev. 301, 313−14 (1982) (noting "make−believe characteristics" of estimated future earnings for purposes of valuation and insolvency).

Unfortunately, there is little guidance in the case law on how insolvency should be determined, i.e. whether directors should consider the entity insolvent when it is unable to meet debts as they come due or when the fair value of liabilities exceeds the fair value of corporate assets. Moreover, as some commentators have pointed out, the approach to valuing corporate assets and liabilities is unclear. Should the enterprise be valued on a going concern or on a liquidating basis? If directors choose a going concern basis, does there come a time when a liquidating methodology becomes appropriate?

Varallo & Finkelstein, Fiduciary Obligations, supra note 1, at 245 n.20. See, e.g., Davis, et al, supra note 1, at 4 n.13 (illustrating significant difference in calculations from four months prior to bankruptcy filing and eight months after filing). Back To Text

[165] Webster's Third New International Dictionary 1170 (3d ed. 1993). Back To Text

[166] Black's Law Dictionary 797 (6th ed. 1990). Back To Text

[167] For an extensive discussion of insolvency as it effects spinoff transactions, see Cieri, Breaking Up Is Hard to Do, supra note 162, at 557−68. See generally Clark, supra note 142 (surveying various obligations, contractual and otherwise, of corporate debtor to its creditors). Back To Text

[168] See generally Frost, Running the Asylum, supra note 33, at 110 & 110 n.121 (observing dividend restriction by citing to Del. Code Ann. tit. 8, § 170 (1974 & Supp. 1998)); Rao et al., supra note 1, at 73−74 (1996) ("Dividend restriction statutes ensure that an adequate capital level is available to meet the claims of creditors by restricting the ability of shareholders to withdraw capital in the form of dividends or redemptions when the firm is at or near insolvency."); William T. Vukovich, Civil Remedies in Bankruptcy for Corporate Fraud, 6 Am. Bankr. Inst. L. Rev. 439, 444−45 (1998) (discussing prohibition of dividend payments through use of fraudulent conveyance law or state corporate law when corporate insolvency is implicated and resulting liability if such dividends were made). Back To Text

[169] See 11 U.S.C. § 542 (1994) (regarding turnover of property to estate); 11 U.S.C. § 544 (covering trustee as lien creditor and successor for certain types of creditors and purchasers); 11 U.S.C. § 547(discussing preferences); 11 U.S.C. § 548 (1994) (dealing with fraudulent transfers and obligations); 11 U.S.C. § 551 (preserving avoided transfers for benefit of estate); 11 U.S.C. § 552 (1994) (concerning postpetition effect of security interest). Back To Text

[170] "Equitable insolvency is defined as the inability to pay one's debts as they mature irrespective of balance sheet reporting of asset values in excess of reported liabilities." Miller, supra note 1, at 1480 n.57. "Equitable insolvency is the inability to pay debts as they become due. By way of example, a debtor may be asset rich and cash poor. His assets may be sufficiently illiquid so as to deny him the opportunity to convert sufficient of these assets to cash quickly enough to pay his debts as they become due." Coogan, Bermant & Glatt, Panel Discussion, supra note 1, at 1373. Back To Text

[171] "Bankruptcy or balance sheet insolvency is defined as balance sheet negative net worth, i.e., the book value of assets is less than reported liabilities." Miller, supra note 1, at 1480 n.58.

[I]nsolvency in the bankruptcy sense, means that the debtor's liabilities are greater than the fair market value of his assets. The bankruptcy test goes beyond the balance sheet. You may look at a balance sheet which shows substantial solvency when, as a matter of fact, many of the assets may be reflected at values far greater than their true worth. You may see a balance sheet which indicates significant insolvency with certain assets reflected at depreciated book and other assets subject to significant reserves. As a matter of reality, these assets may have a fair market value greatly in excess of balance sheet figures.

Coogan, Bermant & Glatt, Panel Discussion, supra note 1, at 1373−74; see N.Y. Debt. & Cred. Law § 271 (McKinney 1990) (asserting debtor is insolvent when its fair salable value of assets is less than existing debts). Back To Text

[172] The Bankruptcy Code defines insolvency as:

(A)…financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of –

i. property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and
ii. property that may be exempted from property of the estate under § 522 of this title…

11 U.S.C. § 101(32). Back To Text

[173] Unif. Fraudulent Conveyance Act § 2(1), 7A U.L.A. 442 (1999) ("A person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."). Back To Text

[174] "[I]f the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation," and presumes that the debtor "who is generally not paying his [or her] debts as they become due" is insolvent. Unif. Fraudulent Transfer Act § 2(a), (b), 7A U.L.A. 648 (1999). Back To Text

[175] See, e.g., Del. Code Ann. tit. 6, § 1302 (1999) (adopting Uniform Fraudulent Transfer Act's insolvency definition); N.Y. Debt. & Cred. Law § 271 (McKinney 1990) ("A debtor is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."); 12 Pa. Cons. Stat. Ann. § 5102 (West 1999) (stating debtor, as general rule, means one who "is insolvent if, at fair valuation, the sum of the debtor's debts is greater than all of the debtor's assets); Tex. Bus. & Com. Code Ann. § 1.201(23) (West 1994) (stating "[a] person is 'insolvent' who either has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due or is insolvent within the meaning of the federal bankruptcy law"). Back To Text

[176] See Cieri, Breaking Up Is Hard to Do, supra note 161, at 560 (indicating hindsight generally reveals some corporations to be insolvent when transaction occurred). But see Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L., Inc. (In re R.M.L., Inc.), 92 F.3d 139, 155 (3d Cir. 1996) (recognizing "[t]he use of hindsight to evaluate a debtor's financial condition for purposes of the Code's 'insolvency' element has been criticized by courts and commentators alike"). Back To Text

[177] See In re R.M.L., Inc., 92 F.3d at 155−56 (agreeing with bankruptcy court that method used to valuate contingent liability was not accurate since it had "effect of grossly overstating its financial condition"); In re Xonics Photochemical, Inc., 841 F.2d 198, 200 (7th Cir. 1988) (recognizing difficulty of valuating contingent liabilities since, "[b]y definition, a contingent liability is not certain −− and often is highly unlikely −− ever to become an actual liability"); see also Cieri, Breaking Up Is Hard to Do, supra note 161, at 562−67 (analyzing factors for contingent liability in context of insolvency). An additional problem is created by fixed future obligations of a corporation. For example, a corporation may be contractually obligated to purchase supplies from a trade creditor. A balance sheet, or "snap shot" examination of a corporation's finance may not fully account for these future obligations. Time, therefore, is an element largely ignored in calculating a corporation's solvency. Back To Text

[178] See Collier Business Workout Guide, supra note 37, at 3−14. Back To Text

[179] See LaSalle Nat'l Bank v. Perelman, 82 F. Supp.2d 279, 290−93 (D. Del. 2000) (finding corporate directors do not owe creditors duties beyond any existing contractual agreement, unless there exists a special circumstance such as insolvency); Geyer v. Ingersoll Publications Co., 621 A.2d 784, 789 (Del.Ch. 1992) (contending if fiduciary duties are created upon insolvency, then directors may choose a course of action that serves whole corporate enterprise). The court in Geyer recognized the fact that directors normally do not owe creditors fiduciary duties unless there is insolvency. See id. at 787; see also Odyssey Partners, L.P. v. Fleming Cos., 735 A.2d 386, 417 (Del. Ch. 1999) (same). Back To Text

[180] For examples of commentary and case law utilizing hypotheticals, in which the value of alternatives is readily quantifiable, see Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 WL 277613, at *1155 n.55 (Del. Ch. 1991); Royce De R. Barondes, Fiduciary Duties of Officers and Directors of Distressed Corporations, 7 Geo. Mason L. Rev. 45 (1998); Lin, supra note 1; Schwarcz, supra note 1. If a director/officer should ever find him/herself in such a situation, these cases and articles will be very helpful. Back To Text

[181] Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications, No. 12150, 1991 WL 277613 (Del.Ch. Dec. 30, 1991). Back To Text

[182] See Credit Lyonnais, 1991 WL 277613 at *1,2. The case involved extensive discovery, including 29 depositions, and a 15−day bench trial. Id. at *1. The facts, though incredibly complex, have been recited in numerous articles. They are largely irrelevant to essential fiduciary obligation aspect of the case. Back To Text

[183] Judge Posner's definition of dicta is instructive: "A statement in a judicial opinion that could have been deleted without seriously impairing the analytical foundations of the holding – that being peripheral, may not have received the full and careful consideration of the court that uttered it." Sarnoff v. American Home Prods., 798 F.2d 1075, 1084 (7th Cir. 1986); see also Black's Law Dictionary 313 (abridged 6th ed. 1991) (defining dicta as opinions of judge which do not embody resolution or determination of specific case before court). Back To Text

[184] Credit Lyonnais, 1991 WL 277613 at * 33. Back To Text

[185] Credit Lyonnais, 1991 WL 277613 at *33. Back To Text

[186] Chancellor Allen summarized his Credit Lyonnais decision in a subsequent case:

where 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.'

Equity−Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 n. 2 (Del. Ch. 1997); see also Royce De R. Barondes, Fiduciary Duties of Officers and Directors of Distressed Corporations, 7 Geo. Mason L. Rev. 45, 69−70 (1998) (stating Chancellor's summary suggests Credit Lyonnais does not create duty creditors can enforce affirmatively). But see 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) (stating board of directors of corporations operating in vicinity of insolvency owes duty to corporate enterprise); Miramar Resources, Inc. v. Schultz (In re Schultz), 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997) (reading Credit Lyonnais decision, perhaps incorrectly, finding direct fiduciary obligation to creditors). Back To Text

[187] Credit Lyonnais, 1991 277613 at *34. See infra, Part III (B)(2) (reasoning proponents of economics−based justification discussed below would not agree. The "residual risk bearers" are shareholders in a solvent corporation, and creditors, or certain creditors, in insolvent corporation. The model relies on the fact that residual owners, whoever they are, are ideal group whose interest should be maximized.) Back To Text

[188] "Legal value" is a term of art used here to distinguish claims of creditors against an insolvent corporation for claims of creditors whose claims may be incidentally reduced by director and officer decisions. For a more thorough explanation, see infra Part III (C) (proposing justification for fiduciary obligation to creditors). Back To Text

[189] See In re Insulfoams, 184 B.R. 694, 707 (Bankr. W.D. Pa. 1995) (claiming fiduciary duty obligates corporate officers to devote themselves toward promoting interests of corporation); In re Jackson, 141 B.R. 909, 917 (N.D. Tex. 1992) (quoting Faour v. Faour, 789 S.W. 2d. 620 (Tex. App.–Texarkana 1990), writ denied, (noting corporate officers and directors have fiduciary duty to corporation and none to the individual shareholders). Back To Text

[190] See Mediators v. Manney, 93 Civ. 2304, 1996 U.S. Dist. LEXIS 14402, at *12 (S.D.N.Y. 1996) (observing unfairness of discharging claim filed after company is insolvent but prior to declaring bankruptcy); see also infra, Part III (B)(2) (supporting "novel proposition" may more accurately reflect reality. The perversion motivations of an insolvent corporation's shareholder likely occurs much earlier than insolvency. It would seem that the "perversion" begins to occur at the point in time that the shareholder's interest is worth less than what such shareholder paid for it. At this point, the shares can be considered underwater, as to that shareholder. That particular "underwater shareholder" would then favor riskier investments. By the time the corporation is insolvent, and presumably all shareholders' motivations are perverted, the only change is that the perversion is unanimous. The "perverted motivations" of day traders, or those that hold shares for very short periods, are likely similar to underwater shareholders). Back To Text

[191] Smith, supra note 49, at 215. Back To Text

[192] See 5 Collier On Bankruptcy § 545 LH (Lawrence P. King et al. eds., 15th ed. Rev. 2000) (defining insolvency as if entity's debts are greater than its assets, at fair valuation, exclusive of property exempted or fraudulently transferred); see also Black's Law Dictionary 547 (abridged 6th ed. 1991) (defined as under bankruptcy law, condition of person or firm that is unable to pay debts as they fall due, or in usual course of trade or business). See Smith, supra note 49, at 215 (noting this thesis continually refers to alteration of traditional corporate fiduciary relationship as being "upon insolvency"). Back To Text

[193] See Koch v. Farmer Union, 831 F.2d 1339, 1342 (7th Cir. 1986) (asserting trustee has duty to creditor and may be held liable for breach of this duty); see also Continental Air Lines v. Hillblom, 61 B.R. 758, 783 (S.D. Tex. 1986) (expanding idea that use of funds outside ordinary course of business constitutes breach of fiduciary duty); Credit Lyonnais N.V. v. Pathe Communications Corp., No. 12150, 1991 WL 277613 at *34 (Del. Ch. Dec. 30, 1991) (noting if "vicinity of insolvency" concept is merely focused on proximity of corporation to insolvency, better, more definite test can certainly be established. For example, act taken while value of corporation's assets' are within 5% of its liabilities would be more certain test, however such test does not address true concern of Credit Lyonnais). Back To Text

[194] See 11 U.S.C. § 548(a)(1)(B)(1994) ("The trustee may avoid any transfer of an interest of the debtor . . . if debtor voluntarily or involuntarily . . . received less than a reasonable equivalent value in exchange for such transfer . . . was insolvent on the date that such a transfer was made."**)**; see also In re Healthco Int'l, 195 B.R. 971, 981 (Bankr. D. Mass. 1996) (affirming laws regarding fraudulent transfer which are made with intent to hinder, delay or defraud co−creditors). See generally Jack F. Williams, The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guarantees: Fraudulent Transfer Law as a Fuzzy System, 15 Cardozo L. Rev. 1403 (1994). Back To Text

[195] See 11 U.S.C. § 704 (1994) ("The trustee's principal duty is to collect and reduce to money property of estate for which he serves…with the best interest of parties in interest . . . the trustee must oppose the discharge of the debtor, which is for the benefit of general unsecured creditors whom the trustee represents"); see also Sherr v. Winkler, 552 F.2d 1367, 1374 (10th Cir. 1977) (noting trustee must exercise due diligence and must treat all parties fairly or risk negligence action); infra Part IV (B)(1) (discussing duty of care in insolvent corporations). Back To Text

[196] See In re Molded Acoustical Prods., 18 F. 3d 217, 226 (3d Cir. 1993) (noting even pre−petition, if debtor/creditor have settled, transfer might be seen as against industry norm); In re Hoffman Ass'n, 194 B.R. 943, 955 (Bankr. D. S.C. 1995) (noting companies are required to continue their normal practices and can not favor one creditor over another). It is also essential, for practical reasons, that fiduciary obligation is not altered with every minor change in financial fortune. Any model that proposes frequent and detailed monitoring of a complex corporation's solvency is fraught with difficulty. If a director or officer is commanded to determine daily the level of insolvency of the corporation, the director/officer will either not do it, or continue to operate the corporation as if it were solvent. If the director/officer is conscientious about his or her obligation, he will spend more time calculating for whose benefit he is operating the business rather than on the merits of the business problems of the corporation. Back To Text

[197] See In re Martin, 154 B.R. 490, 492 (Bankr. C.D. Ill. 1993) (noting courts are split on meaning of fiduciary duty); see also Schwarcz, supra note 1, at 677 (proposing unified theory in which corporate fiduciary's obligation would be altered by corporation's level of insolvency: "The more insolvent the corporation is or would become, the more the fiduciary obligation shifts from shareholders to creditors, in a continuum."). See generally Varallo & Finkelstein, supra note 1, at 240 (distinguishing between duties owed by director of "nearly insolvent" corporation and clearly insolvent corporation: "We start with the hypothesis … that the duties owed by a board of a troubled company and the constituencies to which the board owes its duties shift depending upon the relative financial health of the corporation."). Back To Text

[198] See In re Reuscher, 169 B.R. 398, 403 (S.D. Ill. 1994) (noting officer and director of corporation must assume fiduciary obligation to creditors when company becomes insolvent); see also New York Credit Men's Adjustment Bureau v. Weiss, 305 N.Y. 1, 7 (1953) (noting when insolvency is approaching, officers and directors become trustees for creditors and are obligated to protect them). Because it is a corporate fiduciary relationship, rather than a testamentary trustee (or any other type of fiduciary relationship), it seems perfectly logical to implement the corporate law analysis to the corporate director/officer, regardless of solvency. But see Case, supra note 1, at 391 (comparing fiduciary obligation of director/officer in insolvent or bankruptcy debtor corporation with fiduciary obligation of testamentary trustee with conflicting beneficiaries). Back To Text

[199] See American Nat'l Bank of Austin v. Mortgage Am., (In re Mortgage Am.), 714 F.2d 1266, 1268−69 (5th Cir. 1983) ("In the days before Erie Railroad v. Tompkins, the federal courts concluded that both shareholders and creditors had an interest in the 'trust', which necessarily meant that both had standing to bring the action.") (citing

Hollins v. Brierfield Coal & Iron Co., 150 U.S. 371, 383); see also Meikle v. Export Lumber, 67 F.2d 301, 306 (9th Cir. 1933) (affirming trust fund, asset of corporation, is held by corporation for benefit of creditors). See generally Norton, supra note 1. Back To Text

[200] See Ben Franklin Retail Stores v. Kendig, No. 97C7934, 2000 U.S. Dist. LEXIS 276, at *12 (N.D. Ill. Jan. 11, 2000) (noting directors owe loyalty to shareholders until corporation is insolvent and then to creditors); CST v. Mark, 520 A.2d 469, 472 (Pa. 1987) (noting director's duty to interests of corporation); see also infra Part III (B)(2) (discussing the economics−based rationale). Back To Text

[201] See Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.), 225 B.R. 646 (Bankr. N.D. Ill. 1998), aff'd in part and rev'd in part sub nom, Jackson Nat'l Life Ins. Co. v. Kendig (In re Ben Franklin Retail Stores, Inc.), 1999 U.S. Dist. LEXIS 16645 (N.D. Ill. Oct. 25, 1999), remanded sub nom, Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.), No. 99C6042, 2000 U.S. Dist. LEXIS 276 (N.D. Ill. Jan. 11, 2000). The procedural history of Ben Franklin is particularly tortured, generating at least two reported opinions and several unreported opinions. Substantially contemporaneous with the unsecured creditor's suit, secured creditors brought a similar suit, not discussed in the bankruptcy court's reported opinion. At some point, these two cases were administratively consolidated when both sets of plaintiffs appealed to the District Court for the Northern District of Illinois. On October 20, 1999, District Judge Hibbler issued opinion dismissing the trustee's objections to Bankruptcy Judge Barliant's findings of fact and conclusions of law in the unsecured creditor suit. Subsequently, Judge Hibbler issued a "clarification" addressing issues raised by both the secured and unsecured creditors. The case then returned to the "friendly confines," not of Wrigley Field, but of Bankruptcy Judge Barliant's courtroom. There are currently motions pending to allow amendment of the original complaint. See id. Back To Text

[202] In re Ben Franklin Retail Stores, Inc., 225 B.R. at 649. Back To Text

[203] See id. at 649−53 (noting there is no discussion in any of the Ben Franklin opinions of debtor's solvency or insolvency. It would seem that if the defendants could have shown that the corporation was solvent at the time, it would be a complete affirmative defense to an action for breach of a fiduciary obligation owed to creditors). Back To Text

[204] See id. at 652−53 (stating directors of solvent corporations owe duty to shareholders not creditors) (citing Geyer v. Ingersoll Publications, 621 A.2d 784 (Del. Ch. 1992). Back To Text

[205] Id. at 655. Back To Text

[206] See St. James Capital Corp. v. Pallet Recycling Ass'n, 589 N.W.2d 511, 514 (Minn. App. 1999) (observing formulations have been used in other cases); see also Farmers Co−Op. Ass'n of Bertha v. Kotz, 223 N.W.2d 576, 578 (Minn. 1946) (noting debtors might give one creditor preference over others); Grager v. Hansen, 206 N.W. 440, 441 (Minn. 1925) (stating bankruptcy law gives four months prior to filing provision to justify preferable treatment). Back To Text

[207] 11 U.S.C. §§ 542, 544, 547−51 (1994) ("Individual creditor does not have standing to exercise bankruptcy trustees 'recovery and avoidance' power…); see also Lin, supra note 1, at 1512−13 (affirming directors duty upon insolvency). Back To Text

[208] See Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998). Back To Text

[209] Id. at 656 (citing Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications, No. 12150, 1991 WL 277613, at *34 (Del.Ch. Dec. 30, 1991). Back To Text

[210] See Fischer v. Campbell, 101 F. 156, 158 (5th Cir. 1900) (observing if conveyance was made in good faith and not to hinder or defraud creditors, it will not be set aside as fraudulent); see also Ben Franklin Retail Stores, Inc., 225 B.R. at 656 (noting it is unclear under Bankruptcy Judge Barliant's formulation of the fiduciary obligation to creditors,

whether director/officer is obligated to fraudulently incur additional capital to prolong corporation's life) (emphasis added); First Nat'l Bank of Chicago v. Trebein, 52 N.E. 834, 837 (Ohio 1898) (supporting conveyance with intention to hinder and delay creditors is deemed fraudulent). Back To Text

[211] Ben Franklin Retail Stores, Inc., 225 B.R. at 656; see also Warren v. King, 108 U.S. 389, 396 (1883) (holding no part of corporation's property can be used to reimburse shareholders until all debt has been paid). Back To Text

[212] This is true only if the additional loans were unsecured. If they were secured, the fraudulent loans were an alteration of the priority scheme. See United States v. Key, 397 U.S. 322, 325−26 (1970) (asserting statutes have been set up to protect value of the creditors' claims); see also Case v. Los Angeles Lumber Prods., 308 U.S. 106, 123−24 (1939) (holding plan to pay creditors must be fair and equitable). Back To Text

[213] See Jackson Nat'l Life Ins. Co. v. Kendig (In re Ben Franklin Retail Stores, Inc.), No. 97C6043, 1999 U.S. Dist. LEXIS 16645, at *22 (N.D. Ill. Oct. 25, 1999) (noting issues raised by corporate director's fiduciary obligation to lender, as creditor of insolvent corporation, was not addressed in Judge Barliant's opinion). Back To Text

[214] See United States v. Shaid, 730 F.2d 225, 230 (5th Cir. 1984) (noting reason for prolonging life of corporation is to delay legal actions); see also Schact v. Brown, 711 F.2d 1343, 1351 (7th Cir. 1983) (noting artificially prolonging life of company worsens its insolvency and losses); Comeau v. Rupp, 810 F. Supp. 1127, 1140 (D. Kan. 1992) (stating fraudulently prolonging life of insolvent corporation does not benefit corporation). Back To Text

[215] See In re Ben Franklin Retail Stores, Inc., 1999 U. S. Dist. LEXIS 16645, at *6 (referring to District Judge Hibbler's opinion that does not state whether defendants were shareholders. If they were, as seems likely, they would have indirectly benefited from the fraudulently obtained loans as shareholders. This is a classic case of a bad faith resolution of a conflict among beneficiaries). See generally Case, supra note 1. Back To Text

[216] See Bruce A. Markell, Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations, 44 Stan. L. Rev. 69, 70 (1991) (noting absolute priority rule permits creditors' rights to supersede rights of equity owners); Walter J. Blum & Stanley A. Kaplan, The Absolute Priority Doctrine in Corporate Reorganizations, 41 U. Chi. L. Rev. 651, 652 (1974) (stating under absolute priority rule, senior classes of investors must be compensated in full before junior investors may participate in reorganization). Justice Douglas is generally considered the father of the absolute priority rule. See David A. Skeel, Jr., Vern Countryman and the Path of Progressive (and Populist) Bankruptcy Scholarship, 113 Harv. L. Rev. 1075, 1092 (2000) (maintaining, as part of his progressive approach to bankruptcy, Douglas would require absolute priority rule to be applied before reorganization could be approved); see also Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific R.R. Co., 318 U.S. 523, 565−66 (1942) (Justice Douglas stating: "[i]t is sufficient that each security holder in the order of his priority receives from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered."). He was also the principal author of the Securities and Exchange Commission report on bankruptcy. See Securities and Exchange Commission, Report on the Study and Investigation of the Work, Activities and Functions of Protective and Reorganization Committees (1936−39). Back To Text

[217] Frost, supra note 161, at 541; see also 11 U.S.C. § 1129(b)(2)(B)(ii) (1994) (requiring all senior claims be fulfilled before any junior claims are fulfilled); In re Drimmel & Unruh, 135 B.R. 410, 412 (Bankr. D. Kan. 1991) (stating absolute priority rule grants unsecured creditors priority over equity interests until unsecured claims are paid). Back To Text

[218] See Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 183−84 (1942) (holding upon exclusion of stockholders from reorganization plan, creditors essentially become new stockholders). This proposition relies upon the exclusive use of the "balance sheet" formulation of insolvency. See supra Part III (A) (identifying various mechanisms for determining insolvency). If a corporation is merely "equitably insolvent" creditors may not have any equitable interest in the assets of the corporation, and could be paid in full in the course of a liquidation. See Stilson, supra note 1, at 85 (stating when corporation is insolvent, liquidation will permit senior creditors to be paid completely). Therefore the recent Delaware opinions utilizing "equitable insolvency" as the trigger of a fiduciary obligation to creditors are not relying on the absolute priority rule. See supra Part III (A) (noting recent trend in

Delaware case law favoring equitable insolvency as trigger of fiduciary obligation). Back To Text

[219] See 11 U.S.C. § 726 (1994) (stating property of estate must first be used to satisfy claims of creditors and only reverts to debtor after such claims have been satisfied); see also David Gray Carlson & Jack F. Williams, The Truth about the New Value Exception to Bankruptcy's Absolute Priority Rule, 21 Cardozo L. Rev. 1303, 1318 (2000) (discussing application of absolute priority rule and new value exception in chapter 7 liquidations); George H. Singer, Supreme Court Clarifies "New Value Exception" to Absolute Priority Rule − or Does It?, 18 Am. Bankr. L.J. 1, 32 (1999) (maintaining absolute priority rule is applied in chapter 7 cases in sense that right to receive distribution is not available until all debts are satisfied). Back To Text

[220] See 11 U.S.C. § 1129(a)(7) (1994) (requiring prior to approval of chapter 11 bankruptcy, court must confirm claims of each impaired class will be satisfied); see also Bank of Am. Nat'l Trust and Savings Ass'n v. 203 North Lasalle St. Partnership, 526 U.S. 434, 441 (1998) (requiring best interests of creditors test be met before reorganization plan is approved); Gary E. Klausner et al., Chapter 11−−The Bank of Last Resort, 45 Bus. Law. 261, 277 (1989) (noting best interests of creditors test requires court, before approving suggested reorganization plan, to conclude that under such plan creditors will receive same as or more than creditors would receive in event of straight liquidation). It should be noted that there is very little "absolute" about the absolute priority rule in chapter 11. See 11 U.S.C. § 506(c) (allowing trustee to surcharge secured creditor's collateral, thus reducing its claim, while maintaining lower priority creditor's rights); Singer, supra note 219, at 32 (maintaining absolute priority rule is not truly absolute in chapter 11 cases because creditors often surrender value to equity owners, even though equity owners would have no rights upon reorganization). Back To Text

[221] See Markell, supra note 216, at 86 (asserting debtors fulfill their absolute priority rule obligations when they distribute securities to creditors that are roughly equivalent to creditors pre−bankruptcy claims); see also Thomas H. Jackson, Bankruptcy, Non−Bankruptcy Entitlements, and the Creditors' Bargain, 91 Yale L.J. 857, 857 (1982) (maintaining main purpose of bankruptcy proceedings is to allocate debtors' assets amongst those holding claims against debtor's property). The negotiating leverage the absolute priority rule affords to debtors can not be ignored. See Richard Broude, Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative, 39 Bus. Law. 441, 442 (1984) (stating under absolute priority rule debtor could threaten to switch to straight liquidation bankruptcy, which would severely limit potential recovery of creditors). Back To Text

[222] See Ralph A. Peeples, Staying In: Chapter 11, Close Corporations and the Absolute Priority Rule, 63 Am. Bankr. L.J. 5, 74 (1989) (maintaining absolute priority rule may prevent efficient reorganizations of debtor corporations, and thus frustrate one purpose of bankruptcy proceedings). Even when used in a chapter 11 reorganization, the requirement of the best interest of creditors test is to ensure that creditors would not receive a better return with the immediate cessation of the business, and liquidating the corporation's assets. See Linda J. Rusch, Gerrymandering the Classification Issue in Chapter Eleven, 63 U. Colo. L. Rev. 163, 170 (1992) (stating court must determine creditors will receive more under suggested reorganization plan than they would under straight liquidation before approving such reorganization plan); see also supra note 220 and accompanying text (describing requirements of best interests of creditors test). Back To Text

[223] See Sanford Fork & Tool Co. v. Howe, Brown & Co., 157 U.S. 312 (1895), where the Supreme Court enforced a lien in favor of the directors of a corporation. The Court stated:

[F]or here the corporation was a going concern, and intending to continue in business, and the mortgage was given with a view of enabling it to so continue, and to prevent creditors whose debts were maturing from invoking the aid of the courts to put a stop thereto. Can it be that if, at any given time in the history of a corporation engaged in business, the market value of its property is in fact less than the amount of its indebtedness, the directors, no matter what they believe as to such value, or what their expectations as to the success of the business, act at their own peril in taking to themselves indemnity for the further use of their credit in behalf of the corporation? Is it a duty resting upon them to immediately stop business, and close up the affairs of the corporation? Surely a doctrine like that would stand in the way of the development of almost any new enterprise. It is a familiar fact that in the early days of any manufacturing establishment, and before its business has become fully developed, the value of the plant is less than the amount of money which it has cost; and, if the directors cannot indemnify themselves for the continued use of their personal credit for the benefit of the corporation, many such enterprises must stop in their very beginning.

Id. at 318−19; see also Harvey R. Miller, Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations, 23 Seton Hall L. Rev. 1467, 1468 (1993) (discussing potential for corporation which appears to be insolvent to be rehabilitated under chapter 11); David A. Skeel, Jr., The Law and Finance of Bank and Insurance Insolvency Regulation, 76 Texas L. Rev. 723, 732 (1998) (noting in cases of insolvent insurance companies, state insurance commissioner has option of either initiating liquidation or reorganization). Back To Text

[224] See Susan Jensen−Conklin, Financial Reporting by Chapter 11 Debtors: An Introduction to Statement of Position 90−7, 66 Am. Bankr. L.J. 1, 51 n.205 (1992) (maintaining chapter 11 is designed to give financially distressed company opportunity to rehabilitate itself). But see Marshall E. Tracht, Insider Guaranties in Bankruptcy: A Framework for Analysis, 54 U. Miami L. Rev. 497, 530 (2000) (claiming bankruptcy proceedings allow financially distressed company to ward off inevitable collapse at great cost to creditors). The absolute priority rule, if applied to non−liquidating insolvent corporations, would also raise the problem of re−instating shareholders as beneficiaries of the corporate fiduciary relationship after a bankruptcy petition is filed. See infra Part IV (A) (arguing shareholders should continue as beneficiaries post−insolvency). Back To Text

[225] In re Federal Water Serv. Corp., Public Utility Holding Company Act Release No. 35,3023, 10 S.E.C. 194 (Sept. 25, 1941); In re Federal Water Service Corp., Public Utility Holding Company Act Release No. 35,2635, 8 S.E.C. 893 (March 24, 1941). Back To Text

[226] E. Merrick Dodd, Jr., Fair and Equitable Recapitalizations, 55 Harvard L. Rev. 780, 793−96 (1942) (analyzing Federal Water and maintaining absolute priority standard is less stringent in cases or reclassifications as opposed to reorganizations); see also SEC v. Chenery Corp, 318 U.S. 80, 84−5 (1942) (affirming SEC's holding in Federal Water and providing factual background information). Back To Text

[227] See Dodd, supra note 226, at 794. See Release No. 35,3023, supra note 225, at 2; see also Chenery Corp., 318 U.S. at 84 (1942) (noting in fourth proposed reorganization plan filed by Federal Water provision was made for all but 5.3% of common stock to be reallocated to the preferred shareholders). Back To Text

[228] See Dodd, supra note 226, at 794 (observing Federal Water preferred shareholders were entitled to dividends of $7.00, $6.50, $6.00 and $4.00 and liquidation preferences were worth substantially more than shares' book value). Back To Text

[229] Id. (noting although corporate net income for 1935 – 1940 was less than each year's preferred dividend, consolidated net income exceeded dividend requirements in 1936, 1937, 1939 and 1940). Back To Text

[230] Id. (stating in addition to consolidated net income exceeding dividend requirements in 1936, 1937, 1939 and 1940, earnings in 1941 were estimated to be higher than earnings in 1940). An essential fact of the Federal Water recapitalization was that it was a public utility that could set its own rates, and therefore its future financial projections were extremely reliable. Back To Text

[231] Public Utility Holding Company Act § 11(e), 15 U.S.C. § 79k(e) (Supp. 1939) (requiring in order for divestment plans to be approved by SEC, such plans must be "fair and equitable" to those who will be affected by them). See John D. Ayer, Rethinking Absolute Priority After Ahlers, 87 Mich. L. Rev. 963, 975 (1989) (noting fair and equitable requirement in Public Utility Holding Company Act has been interpreted by Court to mean that absolute priority rule should be applied); Chauncey H. Hand & G. Clark Cummings, Consensual Securities Modification, 63 Harvard L. Rev. 957, 978 (1950) (maintaining fair and equitable requirement dictates application of absolute priority rule). Back To Text

[232] See Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 115−16 (1939) (holding in order for reorganization to be fair and equitable as required by Bankruptcy Act, claims of secured creditors must be fulfilled before claims of unsecured creditors, and claims of unsecured creditors must be fulfilled before claims of stockholders); see also Brian

A. Basil, The New Value Exception To Absolute Priority In Bankruptcy, 101 Com. L.J. 290, 291 (1996) (noting absolute priority rule was incorporated into Bankruptcy Act as part of fair and equitable requirement). Justice Douglas perhaps partially replied to his former fellow SEC Commissioners in Alabama Asphaltic: "[a] bondholder interest in a solvent company plainly is not the equivalent of a proprietary interest, even though upon default the bondholders could retake the property transferred. The mere possibility of a proprietary interest is, of course, not its equivalent." Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 184 (1942). Back To Text

[233] Dodd, supra note 226, at 794−95. (citations omitted) (emphasis added). Back To Text

[234] See supra note 36 (discussing separation of ownership and control); see also Manuel A. Utset, Towards a Bargaining Theory of the Firm, 80 Cornell L. Rev. 540, 551−52 (1995) (describing agency theory as process whereby shareholders relinquish control over corporation's day to day activities to managers). See generally William W. Bratton, Jr., Corporate Debt Relationships: Legal Theory in a Time of Restructuring, 1989 Duke L.J. 92, 126 (1989) (noting agency theory assumes certain costs related to fact that hired managers will tend to act in their own best interests). Back To Text

[235] See supra Part II (H) (discussing distinction between fixed and residual claimants); see also Kenneth B. Davis, Jr., The Status Of Defrauded Securityholders In Corporate Bankruptcy 1983 Duke L.J. 1, 16 (1983) (noting claims of shareholders are subordinate to claims of fixed creditors); Lin, supra note 1, at 1488 (maintaining shareholders must agree to surrender their claims in favor of claims of fixed creditors in exchange for right to earn portion of corporation's residual profits). Back To Text

[236] See Easterbrook & Fischel, supra note 143, at 404:

When the firm is insolvent, the bondholders and other creditors eventually acquire control, through provisions in bond indentures and other credit agreements or through operation of bankruptcy laws. When the firm is in distress, the shareholders' residual claim goes underwater, and they lose the appropriate incentives. Other groups, such as preferred shareholders or creditors, will receive the benefits of new decisions and projects until the claims are satisfied; the shareholders get only what is left over… [S]hareholders lose the controlling votes when their shares are under water; managers become answerable to other investors. They may choose to leave the managers in office, through "workout" agreements, but this does not obscure the fact that the discretionary power has passed. Because managers try to enhance their own reputations, we would expect them to be as faithful in the pursuit of creditors' interests as they one were in pursuit of shareholders' interests.

See also Barondes, supra note 1, at 49 (maintaining as corporations near insolvency, shareholders will be more likely to pursue risky investments because if corporation fails, loss will affect creditors and not shareholders); Philippe Aghion et al., Improving Bankruptcy Procedure, 72 Wash. U. L.Q. 849, 854 (1994) (asserting managers will act in their own self interests, and not necessarily on behalf of shareholders, as corporation nears bankruptcy). Back To Text

[237] See supra Part III (A) (discussing various mechanisms for determining insolvency); John C. McCoid II, The Occasion For Involuntary Bankruptcy, 61 Am. Bank. L.J. 195, 195 (1987) (defining balance sheet insolvency as state in which liabilities exceed assets); see also Karen E. Blaney, Note, What Do You Mean My Partnership Has Been Petitioned into Bankruptcy?, 19 Fordham Urb. L.J. 833, 839 (1992) (stating debtor is insolvent under balance sheet test when his total liabilities exceed his total assets). Back To Text

[238] Assuming for the moment, that the selected liquidation proceeding exactly imposes the "predicted" state law priorities. Back To Text

[239] Lin, supra note 1, at 1488−89 ("When the enterprise becomes insolvent in the sense that its liabilities exceed the value of its assets, the sources of conflict between shareholders and creditors include (1) the level of risk that management should undertake, (2) the race between the parties to recover their investments in the firm, (3) the incentives to liquidate versus keeping the firm intact as a going concern, and (4) the level of investment in new projects."). Back To Text

[240] See G. Eric Brunstad, Jr. & Mike Sigal, Competitive Choice Theory and the Broader Implications of the Supreme Court's Analysis in Bank of America v. 203 North LaSalle Street Partnership, 54 Bus. Law. 1475, 1524 ("As a general rule, the usual method of increasing investment return is through increased risk taking. Moreover, the deeper the firm's insolvency, the greater the equity holders' incentives to compel the firm to take additional risks because that may be the only way to recover their positions.") (citing Frank E. Easterbrook, Is Corporate Bankruptcy Efficient?, 27 J. Fin. Econ. 411, 415 (1990)); Lynn M. LoPucki & William C. Whitford, Corporate Governance, supra note 161, at 684 ("[W]hen a marginally solvent company engages in high risk investment, the risks are borne primarily by creditors while the benefits accrue primarily to shareholders…. [U]nder certain commonly occurring circumstances, the holders of junior interests will have reason to prefer that the company engage in high risk investments while the holders of senior claims have reason to prefer the opposite policy."). Back To Text

[241] See Schwarcz, supra note 1, at 666−67 (explaining in solvency, creditor receives repayment and shareholder receives equity once creditor is paid, but in insolvency creditor receives upside and shareholder does not); Charles W. Adams, New Capital for Bankruptcy Reorganizations: It's the Amount that Counts, 89 Nw. U.L. Rev. 411, 414 (1995) (noting until corporation becomes solvent again only creditor will receive gains); see also Charles W. Adams, An Economic Justification for Corporate Reorganizations, 20 Hofstra L. Rev. 117, 125 (1991) (observing once corporation is insolvent, creditor seeks to liquidate so he will be paid before other creditors while shareholder seeks high risk projects because any gain will go to him). Back To Text

[242] Baird & Jackson, supra note 153, at 761 (reasoning residual owner negotiates on behalf of firm because its incentives are at stake); id. at 775 (stating vesting control in the residual owner fixes the problem of reorganizing the company because of their possibility of gains or losses); LoPucki & Whitford, supra note 161, at 772 (asserting most often there are multiple claimants and it is unknown on how to apportion the control among them). Back To Text

[243] LoPucki & Whitford, supra note 161, at 772 ("We do not doubt that placing control of the reorganizing firm in the hands of parties who have both the risk of loss and the possibility of gain can be an effective way to promote wealth maximizing behavior."). But see Baird & Jackson, supra note 154, at 775 (observing many times there are many residual owners and not all are identified); LoPucki & Whitford, supra note 161, at 772 (opining there are problems in deciding how to distribute control among group of residual claimants). Back To Text

[244] Underlying the residual owner concept is the idea that a corporate director/officer must know to whom he is obligated. This compulsion stems, perhaps unrecognized, from attorneys' general conception as to whom they are obligated and the identity of their client. But see Daniel B. Bogart, Liability of Directors of Chapter 11 Debtors in Possession: "Don't Look Back – Something May Be Gaining on You", 68 Am. Bankr. L.J. 155, 158 (1994) (identifying residual owner does not help in determining a director's fiduciary obligation). Attorneys are generally sensitive to the problem of client identification and may transfer similar thinking to the problem of an insolvent corporation's directors and officers. The identification of the residual owner may not be as vital as who the client is in attorney representation. But see Baird & Jackson, supra note 153, at 775 (noting corporate reorganization should focus on residual owner). Back To Text

[245] The residual owner concept ignores the inherent conflict between creditors. This conflict can be just as divisive as that between creditors and shareholders. Because of the existence of this conflict, the residual owner concept must be used more specifically than simply saying creditors as a whole are the beneficiary party to the corporate fiduciary relationship. The implications of over−secured creditors as beneficiaries is not sufficiently explained in the literature. Back To Text

[246] G. Eric Brunstad, Jr. & Mike Sigal, Competitive Choice Theory and the Unresolved Doctrines of Classification and Unfair Discrimination in Business Reorganizations Under the Bankruptcy Code, 55 Bus. Law. 1, 58−59 (1999) (comparing different risk preferences and motivations of creditors by posing three hypothetical creditors: (1) secured creditor; (2) unsecured trade creditor; and (3) employee claimant for unpaid wages); see also Saul Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 Yale L.J. 49, 51−52 (1982) (listing two most important types of misbehavior by debtor as: (1) conversion; and (2) risk alteration). Back To Text

[247] Of course, in order to find the true residual owners, an absolute priority mechanism must be established as controlling. There is some variation between state absolute priority rule law and the absolute priority rule as appears in the Bankruptcy Code. Back To Text

[248] See Frost, supra note 33, at 112:

[Residual owner] analysis is deceptive in its simplicity. Although allowing the residual claimants to exercise control over the process should result in rational decisionmaking, the method can only work if one can readily identify this group. Such identification is no easy manner. The question calls for complex determinations of both asset values and the amount of liabilities that are the core problems of the reorganization process itself.

David Arthur Skeel, Jr., The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases, 78 Va. L. Rev. 461, 485 (1992) (noting residual owners are shareholders, but once corporation has become insolvent, residual owners are unsecured); LoPucki & Whitford, supra note 161, at 772 ("The primary problem – often unrecognized – is that there commonly be more than one class of claims or interests that qualify simultaneously as the residual owner of an insolvent firm. The prescription that control should lie with the residual owners does not tell us how control should be apportioned among those classes."). Back To Text

[249] Such a proposal has been made. See Jelisavic, supra note 1, at 170 (proposing "the vicinity of insolvency" be defined through use of Professor Edward Altman's Z−score analysis). See generally Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp., No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991) (expanding discussion by hypothetical of corporation approaching state of insolvency); David Thomas, Directors, Creditors and Insolvency: A Fiduciary Duty or a Duty Not to Oppress?, 58 U. Toronto Fac. L. Rev. 31, 33 (2000) (examining directors' duty to balance creditors' interests versus shareholders' interests when company is approaching insolvency). Back To Text

[250] See e.g., Del. Code Ann. tit. 8 § 144 (1974 & Supp. 1999). See also Olga N. Sirodoeva−Paxson, Judicial Removal of Directors: Denial of Directors' License to Steal or Shareholders' Freedom to Vote?, 50 Hastings L.J. 97, 101 (1998) (noting most statutes allow shareholder to remove directors with or without cause); Mary A. Jacobson, Note, Interested Director Transactions and the (Equivocal) Effects of Shareholder Ratification, 21 Del. J. Corp. L. 981, 982 (1996) (asserting "the legal effect of ratification is a confusing and unresolved issue in Delaware corporate law"); Williams v. Geier, 671 A.2d 1368, 1379 (Del. 1996) (noting court is not addressing ratification). Back To Text

[251] See Deborah A. De Mott, Down the Rabbit−Hole and Into the Nineties: Issues of Accountability in the Wake of Eighties−Style Transaction in Control, 61 Geo. Wash. L. Rev. 1130, 1133 (1993) (stating shareholders can approve and disapprove transactions that are approved by directors); Robert B. Thompson, Shareholders as Grown−Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No", 67 u. cin. l. rev. 999 (1999) (recognizing "[s]hareholders are gaining increasing judicial and administrative recognition that their governance rights include, not just passive responses to management, but also the right to initiate action and determine the corporation's agenda"); International Bhd. of Teamsters Gen. Fund v. Fleming Cos., 975 P.2d 907 (Okla. 1999) (stating generally shareholders' rights go further than those of board of directors, and shareholders plan may be voted on by shareholders). Back To Text

[252] See supra Part III (A) (discussing various insolvency mechanisms). Back To Text

[253] Federal Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d. 973, 976−77 (4th Cir. 1982), cert. denied, 461 U.S. 928 (recognizing fiduciary duty shifts from stockholder to creditor in insolvent corporation); Hovis v. Powers Constr. Co., Inc. (In re Hoffman Assocs., Inc.), 194 B.R. 943, 965 (Bankr. D. S.C. 1995) (stating court has power to reorder claims of creditors); Miller, supra note 1, at 1487 n.72 (explaining to allow debtor to remain in possession, there must be guarantee that debtor can be depended upon in its fiduciary responsibility). Back To Text

[254] Frost, supra note 33, at 115 (recognizing courts occasionally utilize residual owner concept when principal asset of insolvent or bankrupt corporation is lawsuit); see also In re Central Ice Cream, 836 F.2d 1068, 1069−70 (7th Cir. 1987) (utilizing facts similar to those presented as "hypothetical" in Credit Lyonnais at n. 55); In re Bowman, 181

B.R. 836, 841 (Bankr. D. Md. 1995) (opining courts must question whether debtor in possession can make reasonable decision to accept settlement or whether conflict of interest exists); In re Spielfogel, 211 B.R. 133, 145 (Bankr. E.D.N.Y. 1997) (stating "not only does Trustee have a fiduciary duty to Debtor in his capacity as residual claimant with respect to the proposed settlement, but he is disregarding that duty by not considering the Debtor's residuary interest in any settlement."). Back To Text

[255] See supra Part III (B)(1). Back To Text

[256] See supra Part III (B)(2). Back To Text

[257] Id. Back To Text

[258] Involuntary creditors may have a "judicially established" claim with a similar "legal value". But see Schwarcz, supra note 1, at 652 (observing contracts alone do not create fiduciary obligations between debtors and creditors). Back To Text

[259] See infra Part III (C) (discussing distinction between legal value and market value in context of leveraged buyouts that dramatically effect bond prices).

A special case in which the legal value of a creditor's claim is threatened, but not directly, is when a corporation is merely equitably insolvent. See infra Part III (C) (discussing various insolvency mechanisms). If a corporation is merely illiquid, a claim's legal value may be threatened due to the delay in payment. Such a case would be similar to the right to immediate payment presented in United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assoc., Ltd., 484 U.S. 365, (1988). In Timbers, the Supreme Court was faced with the issue of a partially secured creditor seeking interest on its claim while the bankruptcy case was proceeding. The creditor in Timbers argued that the bankruptcy case delayed the creditor from foreclosing on its collateral. A similar delay in payment could occur if a debtor−corporation is equitably insolvent, reducing the legal value of the creditor's claim. An over−secured creditor claim's legal value could be similarly reduced. Back To Text

[260] See infra Part III (C) (proposing trigger for fiduciary obligation to creditors). Back To Text

[261] See id. Back To Text

[262] See Grant Gilmore, The Age of Antiquarius: On Legal History in a Time of Troubles, 39 U. Chi. L. Rev. 475, 488 (1972):

Whether we [attorneys] look on ourselves as historians or problem solvers, as philosophers or as activists, let us do what we can to preserve our students from the simplistic beliefs that there can ever be easy answers to hard questions, that the correct course which we should follow can ever be known in advance, that the process of decision can ever be reduced to one of logical deduction from infallible premises. Back To Text

[263] But see Thomas G. Kelch, The Phantom Fiduciary: The Debtor in Possession in Chapter 11, 38 Wayne L. Rev. 1323 (1992) (proposing to jettison management's fiduciary duty of loyalty when corporation is debtor in possession in bankruptcy). Back To Text

[264] See, e.g., Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985) ("[T]he fiduciary duty of the trustee runs to shareholders as well as to creditors."); Sanford Fork & Tool Co. v. Howe, Brown & Co., 157 U.S. 312, 317 (1895) ("It is said that the directors of a corporation stand in a fiduciary relation to both the stockholder and the creditors."); Askanase v. Fatjo, 130 F.3d 657, 663 (5th Cir. 1997) ("[T]he trust fund doctrine…prohibits an insolvent corporation from paying money or distributing assets to its directors in preference to creditors."). See generally Pepper v. Litton, 308 U.S. 295 (1939); Alexander v. Hillman, 296 U.S. 222 (1935); MacDonald v. Williams 174 U.S. 397 (1899); Hollins v. Brierfield Coal & Iron Co., 150 U.S. 371 (1893); Graham v. Railroad Co., 102 U.S. 148 (1880); Sanger v. Upton, 91 U.S. 56 (1875); Sawyer v. Hoag, 84 U.S. 610 (1873); Railroad Co. v. Howard, 74 U.S. 392 (1868); Curran v. Arkansas, 56 U.S. 304 (1853); Mumma v. Potomac Co., 33 U.S. 380 (1834); Cooper v.

Parsky, 140 F.3d 433 (2d Cir. 1998); Ed Peters Jewelry Co. v. C & J Jewelry Co., 124 F.3d 252 (1st Cir. 1997); Mediators, Inc. v. Manney, 105 F.3d 822 (2d Cir. 1997); Unsecured Creditors Committee of Debtor STN Enterprises v. Noyes (In re STN Enterprises), 779 F2d. 901 (2d Cir. 1985); American Nat'l Bank v. Mortgage Am. Corp. (In re Mortgage Am. Corp.), 714 F.2d 1266 (5th Cir. 1983); Federal Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d. 973 (4th Cir. 1982), cert. denied, 461 U.S. 928 (1983); Clarkson Co. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981), cert. denied, 455 U.S. 990 (1982); Automatic Canteen Company of America v. Wharton, 358 F.2d. 587 (2d Cir. 1966); Bank Leumi−Le−Israel, B.M. Philadelphia Branch v. Sunbelt Industries, 485 F.Supp. 556 (S.D. Ga. 1980). Back To Text

[265] The corporate fiduciary's status as an officer or director is what is important. Maintenance of this status is the hook upon which the fiduciary obligation is hung. See Coogan et al., Panel Discussion, supra note 1, at 1387 (discussing importance and difficulties of retaining key directors and officers). Back To Text

[266] See supra, Part II. Back To Text

[267] An argument can be made that the fiduciary obligation of corporate fiduciary−insolvent is also similar to the relationship between a corporate fiduciary in a debtor−in−possession corporation, (corporate fiduciary – debtor in possession) as well as a post confirmation corporate officer (corporate fiduciary – post confirmation). Those relationships seem to principally derive from the corporate fiduciary – solvent and corporate fiduciary – insolvent relationships. Therefore, if corporate fiduciary – insolvent can be well−defined, subsequent analysis between it and the other scenarios mentioned may be in order. Back To Text

[268] See, e.g., Del. Code Ann. tit. 8 § 141 (1974 & Supp. 1998). Back To Text

[269] See supra Part II (C) (noting "shareholders−as−beneficiaries" is problematic misnomer). Back To Text

[270] See supra Part II (C) (discussing problem of preferred shareholders). Back To Text

[271] See supra Part III (A) (proposing trigger for alteration of traditional fiduciary mechanism). Back To Text

[272] See id. Back To Text

[273] See id. Back To Text

[274] See supra Part III (B)(2) (discussing conflicts among creditors). Back To Text

[275] Are future mass tort claimants accurately considered creditors, for whose benefit a corporation should be operated? This issue is a thorny one when the corporation is in bankruptcy and a plan is being negotiated. In the realm of corporate fiduciary−insolvent, these issues are unexplored. Consider the Johns−Manville case, in which on the eve of its bankruptcy petition, Johns−Manville was a defendant in several thousand asbestos suits. See generally GAF Corp. v. Johns−Manville Corp. et al. (In re Johns−Manville), 26 B.R. 405 (Bankr. S.D.N.Y. 1983). If all asbestos claimants were considered "creditors" under the state law in which Johns−Manville was incorporated, and Johns−Manville was considered insolvent, should not Johns−Manville have been operated for the benefit of creditors? If a residual owner analysis were used, should not it have been operated for the benefit of the asbestos claimants? Back To Text

[276] LoPucki & Whitford, Corporate Governance, supra note 161, at 706−07:

The law governing fiduciary duties of managers does not speak directly to the question of where management's loyalties should lie when the interests of creditors and shareholders are in conflict. But one might interpret it as so doing, by entertaining a questionable inference. The inference is that if a particular constituency is permitted to sue for breach of a fiduciary duty of loyalty or care, management has a duty to advance the interests of that constituency when they are in conflict with the interests of other constituencies.

Professors Lopucki and Whitford address the issue, but conclude that a fiduciary obligation to both creditors and shareholders is the better view. See id. at 709. Back To Text

[277] Recall the issues of "springing insolvency," the difficulty with precisely establishing that a corporation is insolvent, and the other problems discussed in Part II. Back To Text

[278] See, e.g., Federal Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d 973, 976−77 (4th Cir. 1982), cert. denied, 461 U.S. 928 (1983) ("[W]hen the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors."); Davis v. Woolf, 147 F.2d 629, 633 (4th Cir. 1945) ("when a corporation becomes insolvent, the … [corporate fiduciaries] … no longer represent the stockholders but by the fact of insolvency, become trustees for the creditors."). See generally Alexander v. Hillman, 296 U.S. 222 (1935); Manufacturers Trust Co. v. Becker (In re Calton Crescent, Inc.), 173 F.2d 944, 951−52 (2d Cir. 1949) (Hand, J., dissenting)

The books are full of declarations that an insolvent holds his property in trust for his creditors; and, when the insolvent is a corporation, whose directors were concededly fiduciaries as to shareholders, they become doubly fiduciaries of the creditors upon insolvency. The shareholders have then lost any interest in the assets, and the directors must be fiduciaries of the creditors, if they are to be fiduciaries at all.

Id. Hovis v. Powers Constr. Co. (In re Hoffman Assoc.), 194 B.R. 943, 964 (Bankr. D. S.C. 1995) ("[W]hen the debtor became insolvent, the fiduciary duty owed by [the director,] shifted from the stockholders to all of the creditors of the debtor.") (citing Federal Deposit Insurance Corp. v. Sea Pines, 692 F.2d 973, 976−77 (4th Cir 1982)). Back To Text

[279] LoPucki & Whitford, Corporate Governance, supra note 161, at 709 ("We conclude that the better view is that management "owes" fiduciary duties to both the creditors and the shareholders of an insolvent company, until their claims or interests are extinguished as part of the reorganization case.") (footnote omitted). Back To Text

[280] See Sanford Fork & Tool Co. v. Howe, Brown & Co., 157 U.S. 312, 317 (1895); Ed Peters Jewelry Co. v. C & J Jewelry Co., 124 F.2d 252, 276 (1st Cir. 1997) ("[T]he corporation's directors thereafter become trustees of "the creditors to whom the [company's] property … must go.") (citing Olney v. Conanicut Land Co., 18 A. 181 (R.I. 1889)); Butler v. Bantz (In re Howe Grain, Inc.) 209 B.R. 496, 499 (Bankr. D. Neb. 1997) (asserting creditors have enhanced rights after chapter 11 filing); Value Property Trust v. Zim Co., (In re Mortgage & Realty Trust), 195 B.R. 740, 750 (Bankr. C.D. Cal. 1996) (stating upon insolvency, corporate directors have expanded fiduciary duties which extend to creditors); Committee of the Creditors of Xonics Med. Sys. v. Haverty (In re Xonics), 99 B.R. 870, 872 (Bankr. N.D. Ill. 1989) ("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"). Back To Text

[281] See supra Part III (B)(1) (discussing inapplicability of absolute priority rule in merely insolvent corporations). Back To Text

[282] See supra Part III (A) (discussing various mechanisms for determining insolvency). Back To Text

[283] See, e.g., Pepper v. Litton, 308 U.S. 295, 307 (1939)

While normally [the] fiduciary obligation 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."

Id. (footnotes omitted, emphasis added). Back To Text

[284] See supra Part II. Back To Text

[285] See Del. Code Ann. tit. 8 § 144(3) (1974 & Supp. 1998); see also supra Part II (G) (discussing § 144 safe harbor provision). Back To Text

[286] Even if a corporation is clearly insolvent, bankruptcy plans of reorganization do not often extinguish shareholders without some payment even though, in violation of a strict application of the absolute priority rule. For empirical evidence, see 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, 195 (1990). Back To Text

[287] The reticence of the Delaware Supreme Court to extinguish the shareholder franchise is demonstrated by Saxon Indus., Inc. v. NKFW Partners, 488 A.2d 1298 (Del. 1985). Saxon involved a bankruptcy debtor corporation whose shareholders brought suit to compel an election of board of directors under Delaware state law. See Del. Code Ann. tit. 8 § 211(c) (1974 & Supp. 1998). The court held that despite a $200 million shareholder deficit, the amount Saxon was insolvent, "[s]ince Saxon remained in control of its affairs, insolvency did not divest the stockholders of their right to elect directors. Normal corporate governance therefore continues…[G]iven the strong Delaware policy behind the free exercise of a stockholder's right to elect directors, and the absence of that focus in the pending bankruptcy proceedings, the scales necessarily tip in favor of the former." Saxon, 488 A.2d at 1302−03. While a peculiar decision, it is indicative of the Delaware court's apprehension to foreclose shareholder rights. But see In re Emons Indus., Inc., 50 B.R. 692, 694 (Bankr. S.D.N.Y. 1985). In deciding whether an equity holder committee ought to be appointed in an insolvent debtor's chapter 11 case, Judge Abram observed, "[T]his court is of the view that generally no equity committee should be appointed when it appears that a debtor is hopelessly insolvent because neither the debtor nor the creditors should have to bear the expense of negotiating over terms of what is in essence a gift." Back To Text

[288] See supra note 244. Back To Text

[289] See generally Case, supra note 1, at 391 (discussing distinction between an "improper personal conflict" and the inevitable "conflict among beneficiaries"); see also In re Roberts, 75 B.R. 402, 410 (D. Utah 1987) ("The concurrent representation of the trustee and a creditor, irrespective of whether or not actual conflict of interest exists, is specifically prohibited . . ."); In re Thompson, 54 B.R. 311, 315 (N.D. Ohio 1985), aff'd, 77 B.R. 113 (1987) (discussing conflicting interest inherent in attorney representing bankruptcy estate as well as interested creditors). Back To Text

[290] A dramatic conflict of interest has been produced with the advent of day traders, persons and firms who are stockholders for mere moments. Day traders are stockholders, entitled to the same rights enjoyed by traditional long−term investors. Back To Text

[291] See Bayless Manning, Reflections and Practical Tips on Life in the Boardroom after Smith v. Van Gorkom, 41 Bus. Law. 1 (1985) (noting potential director liability from Van Gorkom case was $133 million). Back To Text

[292] Collier Business Workout Guide, supra note 37, at 3−9 (stating "the director role has changed from 'helmsman to guardian'") (citing In re Baldwin United Corp., 43 B.R. 443, 460 (S.D. Ohio 1984). Back To Text

[293] Collier Business Workout Guide, supra note 37, at 3−14 ("Instead of trying to act in the shareholders' interests by maximizing the value of the remaining assets, the directors must act conservatively in the creditors' interests by preserving for the creditors the value of the assets pending liquidation, at least when the company has no real chance of being revitalized."). Back To Text

[294] See, e.g., Lin, supra note 1, at 1524 (asserting director of insolvent corporation has duty to maximize its value); Rao et al., supra note 1,at 76 (explaining shareholders of financially troubled firms have nothing to lose by having directors involve corporation in high risk projects to attempt to create gains and benefit long term interests). Back To Text

[295] A paradigm case would be a single asset real estate entity that had a single mortgagee creditor. Unfortunately, such cases are rarely framed as fiduciary obligation cases. See infra note 354 (discussing fiduciary obligation implications of 203 N. LaSalle). Back To Text

[296] See Steinberg v. Kendig (In re Ben Franklin Retail Stores) 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998) ("On this theory, creditors have a right to expect that directors will not divert, dissipate or unduly risk assets necessary to satisfy

claims. That is the appropriate scope of a duty that exists only to protect the contractual and priority rights of creditors.") discussed supra Part III; see also Lin, supra note 1, at 1521 (supporting proposition that courts are defining director's duty to creditors as one protecting their contractual right of priority for repayment of debts). Back To Text

[297] See, e.g., St. James Capital Corp. v. Pallet Recycling Assocs., 589 N.W.2d 511, 517 (Minn. App. 1999) (explaining "creditors have the right to be repaid, it is equally true that they do not have the right, absent an agreement to the contrary to dictate what course of action the directors and officers of a corporation shall take in managing the company, or . . . to direct how the assets of the corporation shall be disposed of . . ."). Back To Text

[298] Indeed, the interaction of corporate fiduciary – insolvent law and lender liability may create problems and conflicting obligations and liability. Back To Text

[299] See supra, Part II. Back To Text

[300] Collier Business Workout Guide, supra note 37, at 3−10 (noting fiduciary duty of directors shifts to creditors upon insolvency); see also In re Ben Franklin Stores, 225 B.R. at 653 (creditors merely take place of shareholders, they do not receive additional protection or benefits). Back To Text

[301] 488 A.2d 858 (Del. 1985). Back To Text

[302] See Miller, supra note 1, at 1485 ("[T]he business judgment rule continues to be the standard for reviewing the conduct of directors of an insolvent corporation."); Rao, et al., supra note 1, at 67 ("[A]gents of a solvent firm are subject to suits brought by shareholders, the prospect of individual liability is faint, given the deference paid to agents' decisions under the business judgment rule. With the onset of financial distress, however, the latitude afforded the agent is diminished, and substantial operational or investment decisions must be weighed more carefully against potential legal liability."); Roberts, supra note 1, at 283 ("Thus, the business judgment rule remains a mandate even during bankruptcy proceedings."). But see Federal Deposit Ins. Corp. v. Sea Pines, 692 F.2d 973, 977 (4th Cir. 1982), cert denied, 461 U.S. 928 (1985) ("The law by the great weight of authority seems to be settled that when a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders, but by the fact of insolvency, become trustees for the creditors, and that they cannot by transfer of property or payment of cash prefer themselves or other creditors.") (emphasis added). Back To Text

[303] See supra Part II (E) (discussing business judgment rule in solvent corporations). Back To Text

[304] Id. Back To Text

[305] See American Nat'l Bank of Austin v. MortgageAmerica, (In re MortgageAmerica), 714 F.2d 1266, 1268 − 69 (5th Cir. 1983) ("Although 'corporate trust fund' doctrine is the theory that has been the most thoroughly studied by both courts and commentators, it is nonetheless often poorly understood… [S]ince [its creation, it] has become such a source of confusion that a leading commentator has introduced his forty−page treatment of the subject with the warning that "perhaps no concept has created as much confusion in the field of corporate law as has the 'trust fund doctrine.'") (citing Fletcher's Cyclopedia of the Law of Private Corporations § 7369 (rev. perm. Ed. 1981)); see also Beveridge, supra note 1, at 595 (declaring trust fund doctrine as "a fiction unsound in principle and vexing in business practice"). This thesis' author believes that the treatise to which the court refers has engendered a majority of the confusion. Back To Text

[306] 30 F. Cas. 435 (C.C.D. Me. 1824). Back To Text

[307] See generally McDonald v. Williams, 174 U.S. 397 (1899) (acknowledging existence of trust fund doctrine); Automatic Canteen Co. v. Wharton, 358 F.2d 587, 590 (2d Cir. 1966) (acknowledging right of creditor as beneficiary of trust fund formed by insolvent corporation); Weiss v. New York Credit Men's Ass'n., 110 N.E. 2d 397, 398 (N.Y. 1953) (acknowledging formation of trust fund); Beveridge, supra note 1, at 594 (tracing roots of trust fund doctrine to Justice Story's opinion in Wood v. Dummer); Hunt, The Trust Fund Theory and Some Substitutes For It, 12 Yale L.J. 63, 64 (1902) (analyzing Justice Story's application of trust fund doctrine.); Varallo & Finkelstein, Fiduciary

Obligations of Directors, supra note 1, at 245 ("The doctrine that corporate assets of an insolvent corporation are a trust fund for the benefit of corporate creditors has been traced to Justice Story's opinion in Wood v. Dummer."); Warren, Safeguarding the Creditors of Corporations, 36 Harv. L. Rev. 509, 544 (1923) (tracing origins of trust fund doctrine to Justice Story). Back To Text

[308] See generally Alexander v. Hillman, 296 U.S. 222, 239 (1935) (placing trusts within jurisdiction of courts of equity); McDonald v. Williams, 174 U.S. 397, 404 (1898) (requiring creation of trust fund when corporation becomes insolvent); Hollins v. Brierfield Coal & Iron Co., 150 U.S. 371, 381 (1893) (authorizing court of equity to place assets of corporation in trust fund for benefit of creditors); Graham v. Railroad Co., 102 U.S. 148 (1880) (applying trust fund doctrine); Sanger v. Upton, 91 U.S. 56, 60−61 (1875) (recognizing stock of corporation put in fund for payment of debts); Sawyer v. Hoag, 84 U.S. 610, 620 (1873) (recognizing establishment of trust fund doctrine, stating "we think it well established that the capital stock of a corporation, especially its unpaid subscriptions is a trust fund for the benefit of the general creditors of the corporation"); Railroad Co. v. Howard, 74 U.S. 392, 409 (1868) (applying trust fund doctrine to hold creditors of railroad were entitled to proceeds of property held in trust for repayment of debts before stockholders were entitled to their share); Curran v. Arkansas, 56 U.S. 304, 308 (1853) (explaining trust fund doctrine); Mumma v. Potomac Co., 33 U.S. 281, 286 (1834) (utilizing trust fund doctrine); United States v. Rich Co., 437 F.2d 549 (9th Cir. 1970) (applying principles of trust fund doctrine); Snyder v. Nathan, 353 F.2d 3, 4 (7th Cir. 1965) (recognizing Supreme Court decisions which hold trust fund was established for payment of debts to creditors); Stewart v. United States, 327 F.2d 201, 202 (10th Cir. 1964) (discussing importance of trust fund upon insolvency of corporation); Updike v. United States, 8 F.2d 913, 917 (8th Cir. 1925) (extending trust fund doctrine to apply to dissolution of corporation); Lawrence v. Greenup, 97 F. 906, 909 (6th Cir. 1899) (authorizing courts of equity to place property of insolvent corporations in trust for payment to creditors then shareholders); Drew v. United States, 367 F.2d 828, 830 (Ct. Cl. 1966) (discussing applicability of trust fund); Plastic Contact Lens Co. v. Frontier of Northeast, Inc., 324 F. Supp. 213, 220 (W.D.N.Y. 1969) (holding applicable law authorizes formation of trust for benefit of creditors); King v. Coosa Valley Mineral Prod. Co., 215 So.2d 275 (Ala. 1968) (requiring formation of trust for creditors upon insolvency); Commons v. Shine, 35 Cal. App. 3d 141, 145 (1973) (bestowing fiduciary duty upon director to form trust for benefit of creditors); Bovay v. H.M. Byllesby & Co., 38 A.2d 808, 813 (Del. 1944) (noting insolvency is what creates trust fund); Asmussen v. Quaker City Corp., 156 A. 180 (Del. Ch. 1931) (recognizing trust fund doctrine); New York Credit Men's Adjustment Bureau v. Weiss, 110 N.E.2d 397, 400 (N.Y. 1953) (acknowledging trust fund doctrine); Tax Comm. v. McAfee, 462 P.2d 601 (Okla. 1970) (discussing distribution of dissolved corporation's assets); Wewoka Petroleum Corp. v. Gilmore, 319 P.2d 285, 288 (Okla. 1957) (holding general rule for dissolution of corporations is that corporate assets are trust for payment of all liabilities); see also Bankruptcy Review Commission Report at 254 (1970). Back To Text

[309] See American Nat'l Bank of Austin v. MortgageAmerica (In re MortgageAmerica), 714 F.2d 1266, 1268 – 69 (5th Cir. 1983) (noting "[i]n the days before Erie Railroad v. Tompkins, the federal courts concluded that both shareholders and creditors had an interest in the 'trust,' which necessarily meant that both had standing to bring the action") (Internal citation removed) (citing Hollins v. Brierfield Coal & Iron Co., 150 U.S. 371, 383 (1893); see also Norton, supra note 1 (discussing existence of trust fund only when corporation is insolvent). Back To Text

[310] See McDonald v. Williams, 174 U.S. 397, 400 (1899) (noting "[w]hen a corporation is solvent, the theory that its capital is a trust fund upon which there is any lien for the payment of its debts has in fact very little foundation. No general creditor has any lien upon the fund under such circumstances, and the right of the corporation to deal with its property is absolute, so long as it does not violate its charter or the law applicable to such corporation"); United States v. Armstrong, 26 F.2d 227, 230 (8th Cir. 1928) (inferring there is no foundation to application of trust fund to solvent corporations); Keith v. Kilmer, 261 F. 733, 738 (1st Cir. Mass. 1919) (asserting reference to trust fund deals solely to insolvent corporations not those which are solvent); Lawrence v. Greenup, 97 F. 906, 908 (6th Cir. 1899) (stating "[u]nder the decisions of the Courts of the United States, there is no solid foundation for the contention that the capital of a corporation which is solvent is a "trust fund" upon which there is any lien for the payment of corporate debt."). Back To Text

[311] These cases are generally categorized as "corporate looting" or "denuding". See, e.g., Burroughs v. Fields, 546 F.2d 215, 217 (7th Cir. 1976) (describing situation where corporate director/officer paid commission to himself when corporation was insolvent); Chemtall Inc. v. Citi−Chem, Inc., 992 F. Supp. 1390, 1404 (S.D. Ga. 1998) (diverting

corporate resources); Underwood v. Stafford, 155 S.E.2d 211 (Sup. Ct. N.C. 1967) (describing act of wrongful appropriation of assets). Back To Text

[312] See, e.g., Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (In re Buckhead Am. Corp.) 178 B.R. 956 (D. Del. 1994); Miramar Resources, Inc. v. Schultz (In re Schultz), 208 B.R. 723 (Bankr. M.D. Fla. 1997). Back To Text

[313] Compare Varallo & Finkelstein, Fiduciary Obligations of Directors, supra note 1, at 251 ("Since [Asmussen in 1931 and Bovay in 1944], the trust fund doctrine appears never again to have been analyzed in the Delaware courts."), with Jewel Recovery, L.P. v. Gordon, 196 B.R. 348, 354 (N.D. Tex. 1996) ("Delaware law recognizes that when a corporation becomes insolvent, the assets of the corporation become a trust for the benefit of the corporation's creditors."). Back To Text

[314] See, e.g., McDonald v. Williams, 174 U.S. 397, 401 (1899) (recognizing trust fund doctrine only applies when corporation is insolvent); Sawyer v. Hoag, 84 U.S. 610, 620 (1873) (determining capital stock of corporation is trust fund for payment of its debts); Automatic Canteen Co. of Am. v. Wharton, 358 F.2d. 587, 589 (2d Cir. 1966) (imposing constructive trust forbidding payment of dividends from insolvent corporation, while stating trust fund doctrine does not apply while corporation is solvent); Hunter v. Fort Worth Capital Corp., 620 S.W. 2d 547, 551 (Tex. 1981) (limiting trust fund doctrine to dissolved corporations); Vesser v. Robinson Hotel, Co., 266 N.W. 54 (Mich. 1936) (holding trust is imposed regardless of corporation's solvency or insolvency). Back To Text

[315] See, e.g., Bank Leumi−Le−Israel, B.M. v. Sunbelt Indus., 485 F.Supp. 556, 559 (S.D. Ga. 1980) (imposing fiduciary obligation on insolvent corporation's officer "in the nature of a trust"); Henry I. Siegel Co. v. Holliday, 663 S.W.2d 824, 826 (Sup. Ct. Texas 1984) (holding insolvent corporation's directors not personally liable, but merely allowing corporate creditors to follow corporate assets dissipated); Tigrett v. Pointer, 580 S.W. 2d. 375 (Texas App. 1978) (noting insolvent corporation's directors and officers have fiduciary obligation not to prefer certain creditors). Back To Text

[316] Norton, supra note 1, at 1068 (analyzing where trust fund doctrine fits in among various types of trusts). Back To Text

[317] The Business Judgment Rule, supra note 31, at 628. Back To Text

[318] If a turnaround manager or troubled corporation expert were retained by the corporation, surely he or she would be entitled to the business judgment rule presumption. For these professionals, business decisions that may effect the value of creditor claims are the norm. A director/officer in a distressed corporation would be well advised to retain such professionals. Back To Text

[319] Imposing a trustee−like obligation on such a professional is not consistent with established business practices. See Manufacturers Trust Co. v. Becker, 338 U.S. 304, 315 (1949) (noting corporate directors are not classed as express trustees). Back To Text

[320] How would a reviewing court handle an incorrect determination that the corporation was insolvent? (Thus, the corporation was solvent, but the corporate fiduciary, with excess caution, honestly and rationally believed that the corporation was insolvent). It seems incontrovertible that the court would defer to the decision, as long as it was the product of a rational decisionmaking process. Back To Text

[321] The major argument against the business judgment rule's applicability to an insolvent corporation's directors and officers is that the director was elected by shareholders, and therefore is beholden to shareholders. This contention is addressed presently. Back To Text

[322] See Brandt v. Hicks, Muse & Co. (In re Healthco Intern., Inc.), 208 B.R. 288, 303 (Mass. Dist. Ct. 1997) The court stated that:

[i]t is said stock ownership by a director is not a conflict of interest. Corporations encourage it so as to have a board whose personal interests are aligned with those of stockholders, the corporation's prime constituency. This is undoubtedly true as a general proposition. But it does not change the fact these directors had a personal interest in a corporate transaction…

Id. Back To Text

[323] In solvent corporations this can arise in a number of cases. A director can engage in transactions with the corporation directly. While perhaps forbidden in the early days of corporate law, such transactions are recognized in state law. Directors may also become creditors of the corporation through indemnity or contribution claims. Such dual status, corporate director/officer and creditor would also rebut the business judgment rule. Back To Text

[324] See supra Part II. Back To Text

[325] See Healthco, 208 B.R. at 303 (citing Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360−62 (Del. 1994)) (stating test of materiality is: "[w]ould the independence of judgement of a reasonable person in the director's position be affected by the financial interest in question?"); see also Kahn v. Roberts, 679 A.2d 460, 467−468 (Del. 1996) (finding no material information was withheld). Back To Text

[326] See supra Part II (G) (discussing rebuttal of business judgment rule in solvent corporation). Back To Text

[327] Simply because the business judgment rule's presumption is rebutted its original applicability is not affected. Back To Text

[328] See Doyle v. Gordon, 158 N.Y.S.2d 248, 259 (N.Y. Sup. Ct. 1954). The court states:

[t]here is a clear distinction between a payment made by a corporation, which, even though insolvent, has reasonable hopes that it will survive a temporary financial emergency and pay all creditors equally, and a payment where the corporate officers realize that the probabilities are that other creditors will not receive as favorable treatment.

Id. See also Coogan et al., Panel Discussion, supra note 1, at 1375−76. The panel discusses:

If there is an honest belief on the part of management that the debtor can be resuscitated, I believe that the directors have the duty to do their very best to preserve the debtor's viability and maximize the recovery to shareholders. I would become concerned about the trust fund doctrine and other creditor remedies in the situation where the debtor continues to operate notwithstanding the belief by its management that it is insolvent and has little or no chance of remaining viable (statement by Mr. Glatt). It doesn't seem to me to be much of a stretch of existing fraud laws of whatever variety you would care to choose, to say that a director, who knowingly permits his corporation to incur obligations when he is convinced, knows, or whatever degree of certainty, it will be unable to repay, will be held liable just the same as if he incurred that indebtedness by using a credit card on his way down to the bankruptcy court…It would not be a surprise to me to see a court find that a director who permits his corporation to do that, might be saddled with the corporation's debts (statement by Mr. Bermant).

Id. Back To Text

[329] 105 N.Y.S.2d 604 (1st Dep't 1951), aff'd, 110 N.E.2d 397 (N.Y. 1953). Back To Text

[330] 110 N.E.2d at 398. Back To Text

[331] See id. Back To Text

[332] See id. Back To Text

[333] See id. Back To Text

[334] See id. at 398−399. Back To Text

[335] See id. at 399. Back To Text

[336] See id. Back To Text

[337] The majority states:

[i]f the corporation was insolvent at the time it is clear that defendants, as officers and directors thereof, were to be considered as though trustees of the property for the corporate creditor−beneficiaries. See 3 FLETCHER'S CYCLOPEDIA CORPORATIONS, § 849. If the corporation was then technically solvent but insolvency was approaching and was then only a few days away, defendants, as officers and directors, were, in effect, trustees by statute for the creditors by virtue of § 60 of the General Corporation Law which obligated them to protect the trust res for the creditors and to account for waste in not obtaining full value for the res, if there was any waste by reason of their conduct.

Id. at 398. See also American Nat'l Bank of Austin v. MortageAmerica Corp. (In re MortgageAmerica Corp.), 714 F.2d 1266, 1270 (5th Cir. 1983) (defining trust fund doctrine as fund that holds corporation's assets for benefit of its stockholders and creditors); Wood v. Drummer, 30 F. Cas. 435, 437 (C.C.D.Me. 1824) (establishing trust fund doctrine). Back To Text

[338] New York Credit Men's Adjustment Bureau, Inc. v. Weiss, 110 N.E.2d at 400. Back To Text

[339] Id. at 400 (internal citations omitted). The case was remanded to the lower court to determine whether the creditors had suffered any actual damage, i.e., whether the sale proceeds were less than what a "real" sale would receive. Back To Text

[340] See, e.g., In re Shulz, 208 B.R. 723, 730 (Bankr. D. Fla. 1997) (positing fiduciary/trustee relationship arises at moment transaction involving depletion of corporate assets is considered by director of ongoing, but nearly insolvent company). But see In re Blanton, No. 88−137251k, 1989 Bankr. LEXIS 2451, at *33 (W.D. Tex. Oct. 5, 1989) (refusing to apply trust fund doctrine where corporation was insolvent, but continuing to do business). It is interesting to note that though the Weiss court claimed to be imposing trust concepts, it does not actually engage in a trust analysis; a testamentary trustee could not sell all of the assets of the trust regardless of beneficiaries' consent to the sale. See also Ayr Composition, Inc. v. Rosenberg, 619 A.2d 592, 595 (N.J. 1993) (asserting that directors of insolvent corporations have "quasi−trust" relationship with creditors). Back To Text

[341] See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 (Del. 1985) (holding silence of Delaware General Corporate Law as to sophisticated defensive tactics at issue is not to be construed as prohibition of such measures); Moran v. Household Int'l Inc., 500 A.2d 1346, 1351 (Del. 1985) (finding reasonable anti−takeover mechanism involving preferred share purchase rights plan); Morey W. McDaniel, Bondholders and Stockholders, 13 J. Corp. L. 205, 266 (1988) (discussing nature and extent of fiduciary duties owed to bondholders by corporate directors). Back To Text

[342] See 11 U.S.C. § 510(c) (1994) (permitting federal Bankruptcy Court, under doctrine of equitable subordination, to subordinate claims of one creditor to another); In re Richels, 163 B.R. 760, 763 (Bankr. E.D. Va. 1994) (holding chapter 7 trustee could pierce corporate veil to avoid prepetition transfer of substantial corporate assets by 50% shareholder where corporation was both "alter ego" of shareholder and device used to obscure fraud); see also Robert Charles Clark, The Duties of the Corporate Debtor to Its Creditors, 90 Harv. L. Rev. 505 (1977) (discussing interrelationship between various obligations of corporate debtor to its creditors). Back To Text

[343] 11 U.S.C. § 548(1994) (enabling trustee to avoid any transfer of interest of debtor within one year of filing petition made with intent to hinder, delay or defraud any entity to whom debtor was or, as result of transfer, became indebted); see also In re Sherman, 67 F.3d 1348, 1355 (8th Cir. 1995) (noting trustee need not establish actual harm in order to avoid transfer if evidence establishes debtor intended to hinder, delay or defraud creditors); In re Kannry & Morton,

Inc., 91 B.R. 93, 95 (Bankr. N.D. Cal. 1988) (stating purpose of trustee's power to avoid such transfers is to prevent debtor from reducing funds available for distribution to all creditors). Back To Text

[344] 11 U.S.C. § 547 (1994) (empowering trustee to avoid prepetition transfers resulting in preferential treatment of certain creditors); see also In re Chase & Sanborn Corp., 813 F.2d 1177, 1181 (11th Cir. 1987) (observing preferential transfer avoidance power assists in diminishing estate to detriment of some or all creditors); In re Kleckner, 93 B.R. 143, 149 (Bankr. N.D. Ill. 1988) (asserting fundamental inquiry is whether prepetion transfer depleted or diminished debtor's estate). Back To Text

[345] 11 U.S.C. § 544 (1994) (granting trustee or debtor−in−possession rights and powers of judicial lien creditor, execution creditor and bona fide purchaser of real property); see also Edward Pirsig Farms, Inc. v. Continental Ill. Nat'l Bank & Trust of Chicago (In re Pirsig Farms, Inc.), 46 B.R. 237, 241 (Bankr. D. Minn. 1985) (finding, as fiduciary to estate, trustee has duty and power to avoid all unperfected liens for benefit of estate and creditors); 5 Collier On Bankruptcy ¶ 544.01, at 1 (Lawrence P. King et al. Eds., 15th ed. Rev. 1997) (explaining avoiding powers exist to further goal of every insolvency statute, which is equal distribution of debtor's assets among its general non−priority creditors). Back To Text

[346] U.C.C. § 1−203 (1989) (noting "[e]very contract or duty within this Act imposes an obligation of good faith in its performance and enforcement."); see also Schwarcz, supra note 1, at 656−65 (suggesting commercial law obligation of good faith creates balance between expectations of bondholders and needs of shareholders that may obviate need for traditional fiduciary standards). A recent case of egregious conduct occurred in the Fruit of the Loom bankruptcy. William F. Farley, former CEO of Fruit of the Loom, Inc., found it necessary to purchase a Czech Soviet−era Mig fighter aircraft, which he stored at the corporate hangar while the corporation for which he served was nearing insolvency. See David Barboza, Taking the Starch Out of an American Icon, N.Y. Times, March 19, 2000, § 3, at 1. One does not need an elaborate and exotic conception of fiduciary obligation to find such conduct a breach of the fiduciary obligation of loyalty. Back To Text

[347] See In re Amdura Corp., 167 B.R. 640, 645 (Bankr. D. Colo. 1994) (concluding purposes of trust fund doctrine, and fiduciary obligations it creates, are satisfied once bankruptcy petition is filed); Bowers−Siemon Chems. Co., Inc. v. Bowers (In re Bowers−Siemon Chems. Co.), 139 B.R. 436, 450 (Bankr. N.D. Ill. 1992) (explaining trust fund doctrine developed as protection for creditors who were otherwise without remedy, and that, therefore, it is not available once bankruptcy petition is filed). If the breach occurred before the petition, and subsequently bankruptcy proceedings are commenced, any breach of the fiduciary duty of loyalty would be resolved under the proposed analysis. Thus, the court hearing the matter may be a bankruptcy court, but it would be applying the law of the state of incorporation, rather than bankruptcy law. See In re L.T. Roth Coal Co., Inc., 66 B.R. 753, 791 (Bankr. E.D. Ky. 1986) (noting core bankruptcy proceedings often involve adjudication of rights of parties as fixed by state law, i.e., whether unsecured creditor has rights superior to transferees of debtor's property). Back To Text

[348] See, e.g., Main, Inc. v. Blatstein, No. CIV. A. 98−5947, 1999 WL 424296, at *15 (E.D. Pa. June 23, 1999) (holding insolvent corporation's directors' fiduciary duties to creditors prevented them from using corporate assets for personal gain); Snyder Elec. Co. v. Fleming, 305 N.W. 2d 863, 869 (Minn. 1981) (observing corporate directors and officers, as fiduciaries, may not exploit their special position by collecting on corporate debts owed them ahead of other corporate creditors). But see Helm Fin. Corp. v. MNVA R.R., Inc., 212 F.3d 1076, 1082 (Minn. 2000) (finding no self−dealing, and, thus, no breach of fiduciary duty to creditors where debtor's directors distributed stock in corporate subsidiary to debtor's shareholders). The paradigm case would occur when a corporation is in the vicinity of insolvency, i.e., the corporation is within weeks of being both equitable and balance sheet insolvent. Management non−negligently and in good faith chooses a course of conduct that, while reasonable at the time, proves to be disastrous to the corporation, its stockholders and its creditors. If management had chosen to act exclusively for the benefit of the corporation's creditors, the disaster would have been mitigated.

Under the proposed model of corporate fiduciary – insolvent, such a decision by a corporation's directors and officers would not result in personal liability. Back To Text

[349] See International Radio Tel. Co. v. Atlantic Communications Co., 290 F. 698, 702 (2d Cir. 1923) (positing where disinterested board would not find contract unfair or unconscionable, courts should not invalidate agreement between controlling corporation and corporation it controls); Johnstone v. Greene, 121 A.2d 919, 925 (Del. 1956) (opining independent board of directors would not have deemed director's purchase of patents appropriation of corporate opportunity, and therefore, that no fiduciary duty had been breached); see also Kimble C. Cannon and Patrick J. Tangney, Protection of Minority Shareholder Rights under Delaware Law: Reinforcing Shareholders as Residual Claimants and Maximizing Long−Term Share Value by Restricting Directorial Discretion, 1995 Colum. Bus. L. Rev. 725 (noting goals of maximizing shareholder value and protecting actual and constructive minority shareholder interests are furthered when directorial discretion is curtailed). Back To Text

[350] See Revlon Inc. v. McAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1986) (holding concern for other corporate constituencies is proper only when some rationally related benefit to shareholders can be identified); Thomas A. Smith, Article, The Efficient Norm for Corporate Law: A Neo−Traditional Interpretation of Fiduciary Duty, 98 Mich. L. Rev. 214, 218 (1999) (arguing rational investors would prefer, and derive greater benefit from, corporate norm aimed at maximizing value of all financial claims against corporation); supra Part III (B)(2) (demonstrating problems with fiduciary model that solely advances interests of creditors) and Part IV (B) (demonstrating problems with fiduciary model that solely maximizes value of corporation). Back To Text

[351] See McDaniel, supra note 341, at 231, n.208 (describing as "investor coordination costs" those costs which result from resolving conflicts between various beneficiaries of corporation, and which inevitably detract from goal of maximizing value of all corporate claims); Stilson, Reexamining the Fiduciary Paradigm, supra note 1, at 121 (urging legislature to create statutory scheme which unambiguously sets forth relative priority of competing claims to corporate assets); Case, supra note 1 (suggesting because fiduciaries must, of necessity, resolve conflicts among corporate beneficiaries often to detriment of one or more such beneficiaries, liability for breach of fiduciary duty should be limited to instances in which fiduciary acted in self−interested manner). Back To Text

[352] See, e.g., Robert Cooter & Bradley J. Freedman, The Fiduciary Relationship: Its Economic Character and Legal Consequences, 66 N.Y.U. L. Rev. 1045, 1052 (1991) (linking difficulty in detecting fiduciary misconduct with limited information available to corporate principal regarding agent's actions); Rao et al, supra note 1, at 61 ("Violations of the duty of loyalty are relatively simple to detect and the resulting harm is often easily ascertained. As a result, the duty of loyalty is largely irrelevant to this article"). The article focused on the economic aspects of the insolvent corporation's fiduciary relationship, but such a misconception in a legal journal is dangerous. Back To Text

[353] 526 U.S. 434 (1999); see also David Gray Carlson and Jack F. Williams, The Truth About the New Value Exception to Bankruptcy's Absolute Priority Rule, 21 Cardozo L. Rev. 1303 (2000) (proposing LaSalle decision specifically, and "new value" exception generally, are of little consequence in majority of chapter 11 cases); Judith Greenstone Miller and John C. Murray, The "New Value" Exception: Myth or Reality after Bank of America National Trust & Savings Association v. 203 N. LaSalle Street Partnership?, 104 Com. L.J. 147 (1999) (discussing impact of Court's decision on future of "new value" exception to absolute priority rule). Back To Text

[354] In 203 N. LaSalle, the debtor was an Illinois limited partnership. 203 N. LaSalle, 190 B.R. 567, 573 (Bankr. N.D. Ill. 1995). While its relevance to corporate fiduciary law may not be immediately obvious, the limited partnership was insolvent, and as such, the general partners owed fiduciary duties to the creditors of the partnership based on similar principles as found in the corporation setting. It is the limited partnership's pass through tax status that is important. If the debtor was a Subchapter S corporation, the analysis would be the same. The debtor limited partnership owned 15 floors of office space in the central business district of Chicago. 203 N. LaSalle, 190 B.R. at 573. A non−recourse note in the principal amount of $92,582,000 encumbered the property. The debtor was unable to pay the note, and Bank of America commenced foreclosure action, and the debtor responded with a bankruptcy petition. The property was valued at $54,544,500, and Bank of America's claim was bifurcated pursuant to Bankruptcy Code § 506(a). Id. at 576.

The debtor proposed a plan in which its partners would contribute $6.125 million dollars to the reorganized entity in exchange for all the equity of the reorganized debtor. Id. at 577. Why in the world would otherwise rational business people contribute millions of dollars to a venture that had already lost significant money? Bankruptcy Judge Wedoff answered that question:

This plan, and indeed, the entire bankruptcy case, was filed by the debtor primarily to avoid the severe tax consequences to the debtor's partners of a foreclosure sale of the debtor's property. The principal of the general partner estimated the collective tax liability of the partners, in the event of foreclosure, at $20 million dollars.

Id. at 576.

This detail was also recognized by the Supreme Court: "The debtor's principal objective was to ensure that its general partners retained title to the property so as to avoid roughly $20 million in personal tax liabilities." Id.at 434. While the tax consequences of acts in bankruptcy are a shadowy mystery to most bankruptcy attorneys, it is enough to understand that the tax liability was the result of depreciation that the general partners took on the partnership's property in previous tax years. If the debtor partnership were to allow foreclosure, or if they allowed a non−partner entity to acquire any portion of the partnership equity, the partners would recognize significant depreciation recapture tax liability. That is the reason they were throwing good money after bad, not any altruistic or sentimental attachment to 15 floors of office building in the Windy City.

By proposing such a plan, the debtor, and it partners, hoped to avoid personal tax liability that would result from their partnership ownership interest. There was no benefit to the debtor partnership! The debtor partnership, as a pass through entity, is not a taxpayer, and therefore is indifferent to the tax liability of the partners. But what about the creditors? The debtor partnership, in proposing such a plan, clearly favored the partner beneficiary class to the complete exclusion of the creditor beneficiary class!

Before the bankruptcy petition was filed, state fiduciary law is still in place. Because the partnership was insolvent, the partnership, and more specifically its general partner, was in a fiduciary relationship with the creditors of the partnership. If the relationship existed, certainly the creditors interest should have been considered. By almost any formulation of the fiduciary relationship, the actions of the partnership were breaching the fiduciary duties of care and/or loyalty to the principal creditor, Bank of America. If Bank of America had filed a state court action or an adversary proceeding in the bankruptcy case, raising these issues, it is difficult to see how a court could find that the proposed plan, and perhaps even the filing of the bankruptcy petition was anything but a breach of fiduciary duty. Bank of America could then file a motion to lift the automatic stay, and the issue would not have reached the Supreme Court. Bank of America could certainly have used the prospect of enormous potential personal liability as negotiating leverage.

The Delaware Court of Chancery has held that corporate fiduciaries do not become self−interested, thus rebutting the business judgment rule, because they insist that a transaction be structured to maximize tax benefits to a corporation's principals. See Bodkin v. Mercantile Stores Co., 22 Del. J. Corp. L. 1156 (Del. Ch. 1996). But that is not the case in 203 N. LaSalle – the tax benefits would accrue to non−debtor principals while creditors are additional beneficiaries of the corporate fiduciary relationship. Back To Text

[355] See, e.g., In re Schipper, 109 B.R. 832, 835 (Bankr. N.D. Ill. 1989) (noting fiduciary duty of trustee and debtor−in−possession has not been addressed in detail by courts and remains undefined); John T. Roache, Note, The Fiduciary Obligations of a Debtor in Possession, 1993 U. Ill. Rev. 133, 165 (explaining while debtor−in−possession owes fiduciary duties to creditors, those obligations are ill−defined, and offer inadequate protection to estate's claimants); Carlos J. Cuevas, The Myth of Fiduciary Duties in Corporate Reorganization Cases, 73 Notre Dame L. Rev. 385 (1998) (describing practical difficulties of enforcing fiduciary obligation in troubled and bankrupt corporations). Back To Text

[356] See Note, When Should Courts Allow the Settlement of Duty of Loyalty Derivative Suits?, 109 Harv. L. Rev. 1084, 1095 (1996) (criticizing settlement approval mechanism for derivative suits as failing to deter fiduciary wrongdoing and encouraging meritless suits); supra Part II (D) (discussing shareholder derivative suit). See generally Reinier Kraakman et al., When are Shareholder Suits in Shareholder Interests?, 82 Geo. L.J. 1733 (1994) (arguing legal rules surrounding derivative litigation create distorted disincentives for bringing suit by not accurately reflecting value and cost of deterrence of fiduciary misconduct). Back To Text

[357] See, e.g., Harf v. Kerkorian, 324 A.2d 215, 222 (Del. Ch. 1974), aff'd, 347 A.2d 133 (Del. 1975) (affirming Chancery Court's dismissal of class action claim by debenture holders because they were not stockholders, but allowing class action claim, based on fraud, to proceed); Simons v. Cogan, 549 A.2d 300, 303 (Del. 1988) (determining convertible debenture is credit instrument which does not desolve upon its owner any equity interest which would give rise to fiduciary duties). But see Dale B. Tauke, Article, Should Bonds Have More Fun? A Reexamination of the Debate Over Corporate Bondholder Rights, 1989 Colum. Bus. L. Rev. 1, 54 (arguing extension of fiduciary rights would undermine risk allocation of bond contracts). Back To Text

[358] See Schwarcz, supra note 1, at 667 (observing creditors of insolvent corporation have repayment priority and right to participate in increase in value of debtor's assets, rights associated with ownership). It can be argued that the creditor's rights are actually much less than a shareholder in a solvent corporation. A creditor does not have the power to elect directors, or ratify self interested director suits. See In re Ben Franklin Stores, 225 B.R. 646, 652 (Bankr. N.D. Ill. 1998) (proposing creditors should not be disadvantaged by limitations on duties of fiduciaries they had no power to elect). Back To Text

[359] See supra Part III (A) (proposing trigger for fiduciary obligation to creditors). Back To Text

[360] See Kalb, Voorhis & Co. v. American Fin. Corp., 8 F.3d 130, 132 (2d Cir. 1993) (finding property of bankruptcy estate does not belong to any one creditor); In re Morpheus Lights, Inc., 228 B.R. 449, 453 (Bankr. N.D. Cal. 1998) (same); Solow v. Stone, 994 F. Supp. 173, 177 (S.D. N.Y. 1998) (holding since corporation defendant was chapter 11 debtor, suit by individual creditor could only be maintained if suit did not involve property of estate). Back To Text

[361] See In re Mediators, Inc., 105 F.3d 822, 825 (2d Cir. 1997) (determining state law controls whether individual or trustee may pursue claim against debtor); Morton v. National Bank (In re Morton), 866 F.2d 561, 563 (2d Cir. 1989) (observing Congress has left determination of property rights in bankruptcy estate to state law); St. Paul Fire and Marine Ins. Co. v. Pepsico, Inc., 884 F.2d 688, 695 (2d Cir. 1989) (concluding creditor had no particularized and direct injury under state law, and therefore, no standing to assert claim). Back To Text

[362] 11 U.S.C. § 362(1994) (providing filing of bankruptcy petition creates new estate and operates as stay prohibiting any creditor from attempting to continue to collect from debtor or debtor's property); see also United States v. Dos Cabezas Corp., 995 F.2d 1486, 1491 (9th Cir. 1993) (positing automatic stay provides debtor with breathing room from creditors who are prevented from pursuing, to detriment of all creditors, their own claims); In re Porter, 42 B.R. 61, 63 (Bankr. S.D. Tex. 1984) (finding automatic stay serves dual purpose of providing fresh start to debtor while ensuring creditors access to equitable share of debtor's estate). Back To Text

[363] American Nat’l Bank of Austin v. MortgageAmerica Corp. (In re MortgageAmerica Corp.), 714 F.2d 1266, 1275 (5th Cir. 1983) (holding "strong arm" provision of Bankruptcy Code allows trustee to step into shoes of creditor to assert any claim for benefit of all creditors); Delgado Oil Co., Inc., v. Torres, 785 F.2d 857, 861 (10th Cir. 1986) ("However skillfully pleaded, the instant common law action [by a creditor seeking to enforce a fiduciary obligation] is preempted by the bankruptcy case.").

The trustee or debtor in possession may not bring actions that are not property of the estate, or belong exclusively to an individual creditor. See Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 431 (1972) (finding trustee in reorganization was not proper party to bring suit on behalf of all debenture holders). However, in the fiduciary obligation context, the corporation is at all times a beneficiary of its management's fiduciary obligation. Back To Text

[364] See MortgageAmerica Corp., 714 F.2d at 1276:

This somewhat anomalous situation – where a cause of action assertable by creditors actually belongs to the corporation – is best understood through the analogy to the typical shareholders' action against a corporation's officers and directors. Like most jurisdictions, Texas has established such a right of action, which can be brought either directly by the corporation or, if the corporation refuses to act, by a shareholder derivative action. Despite the fact that the action under normal circumstances is frequently not brought by the corporation itself, the courts have uniformly held that, upon bankruptcy, it passes to the trustee, who is then charged with prosecuting it for the benefit of all creditors and shareholders.

See also Mitchell Excavators, Inc. v. Mitchell, 734 F.2d 129, 131 (2d Cir. 1984) (affirming lower court's dismissal of shareholder's post−petition derivative action on grounds that once petition was filed, claim was only enforcible by trustee); In re General Dev. Corp., 179 B.R. 335, 338 (Bankr. S.D. Fla. 1995) (asserting trustee was proper party to bring derivative suit upon filing of bankruptcy petition). Back To Text