
January 1994

Directors' Duties to Corporate Creditors: Delaware and the Insolvency Exception

Alan W. Tompkins

Recommended Citation

Alan W. Tompkins, Comment, *Directors' Duties to Corporate Creditors: Delaware and the Insolvency Exception*, 47 SMU L. REV. 165 (1994)
<https://scholar.smu.edu/smulr/vol47/iss1/12>

This Comment is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

DIRECTORS' DUTIES TO CORPORATE CREDITORS: DELAWARE AND THE INSOLVENCY EXCEPTION

Alan W. Tompkins

TABLE OF CONTENTS

INTRODUCTION	165
I. THE HISTORICAL FRAMEWORK	168
A. FIDUCIARY DUTIES OWED BY DELAWARE DIRECTORS...	168
B. DEVELOPMENT OF THE TRUST FUND DOCTRINE AND THE INSOLVENCY EXCEPTION	171
II. TROUBLING RECENT DEVELOPMENTS FROM THE CHANCERY COURT.....	176
A. <i>CREDIT LYONNAIS V. PATHE COMMUNICATIONS CORP.</i>	176
B. <i>GEYER V. INGERSOLL PUBLICATIONS CO.</i>	180
III. IMPLICATIONS OF THE RECENT DECISIONS	182
A. AN UNNECESSARY AND DUPLICATIVE TORT THEORY	183
B. DUTIES TO ONE OR DUTIES TO ALL?	184
C. APPLICATION OF THE BUSINESS JUDGMENT RULE TO DECISIONS CAUSING CONFLICT BETWEEN STOCKHOLDERS AND CREDITORS	187
D. DEVELOPMENT OF A MEANINGFUL DEFINITION OF INSOLVENCY	190
CONCLUSION	195

INTRODUCTION

TO say that Delaware corporation law has a significant impact on national commerce and industry would be an understatement. Delaware corporations have been the preferred choice of business entity for major companies operating in this country for several decades.¹ Data indicates that such corporations are the choice of more than 40% of all New York Stock Exchange companies, more than 50% of all Fortune 500 companies, and more than 80% of all companies that have reincorporated during

1. See William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 664 (1974) (noting that Delaware took the lead in corporation and trust law from New Jersey in 1913 and never lost it).

the last twenty-five years.² Delaware's dominance in the market for corporate charters has been attributed to three main elements. The first is a corporation statute which is regularly amended to make corporate changes easier to implement.³ The second is a set of jurisdictional rules designed to permit the exercise of personal jurisdiction over important defendants, such as foreign directors.⁴ The third is the Delaware court system, which provides for efficient resolution of corporate litigation.⁵ The Court of Chancery hears corporate law cases and has no jurisdiction over criminal or tort cases.⁶ Appeals to the Delaware Supreme Court can be made and decided quickly—sometimes overnight, when necessary.⁷ By virtue of the size and number of companies incorporated in the state, as well as the cumulative corporate law expertise of its courts, Delaware has a "profound impact" on the development of corporation law in other states.⁸ Judges, lawyers, and scholars pay close attention to Delaware decisions since innovations borne there often migrate to the laws of other jurisdictions.⁹

Because of its popularity as a state of incorporation, many commentators have asserted that Delaware has sold out the interests of stockholders in favor of management to attract the tax revenue related to corporate charters from other states.¹⁰ Regardless of whether such assertions are correct, one

2. Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 887 (1990); Leo Herzel & Laura D. Richman, *Delaware's Preeminence by Design*, Foreword to R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS F-1 (2d ed. Supp. 1991).

3. Herzel & Richman, *supra* note 2, at F-8. In a recent article, Mr. Andrew Turezyn of the Delaware office of Skadden, Arps stated that "Delaware's General Corporation Law was again amended in 1990 in several important respects, maintaining the statute's place as the most modern corporate statute in the country." Andrew J. Turezyn, *1990 Developments in Delaware Corporation Law*, 17 DEL. J. CORP. L. 65, 113 (1992).

4. Herzel & Richman, *supra* note 2, at F-8; see DEL. CODE ANN. tit. 10, § 3114(a) (Supp. 1990) (declaring that a nonresident of Delaware who accepts a position as director of a Delaware corporation is deemed to have consented to the appointment of the agent of such corporation as his agent for service of process in civil actions).

5. Herzel & Richman, *supra* note 2, at F-8.

6. *Id.* at F-9. Andrew Turezyn, a member of the Delaware bar, states that the cases decided in 1990 demonstrate that "the Delaware Court of Chancery continues as the preeminent trial court for the prompt and fair adjudication of corporate control cases and other corporate issues. No other trial court in the United States has the expertise in corporate law possessed by the Delaware Court of Chancery." Turezyn, *supra* note 3, at 113. Chancellor Allen of the Delaware Court of Chancery notes that the court has contributed importantly to the national welfare through its contribution to the development of the Delaware corporation law, which serves "in large part as the nation's corporation law." William T. Allen, *A Bicentennial Toast to the Delaware Court of Chancery 1792-1992*, 48 BUS. LAW. 363, 364 (1992).

7. Herzel & Richman, *supra* note 2, at F-9.

8. See Cary, *supra* note 1, at 671.

9. See *id.* (noting that Delaware case law is constantly cited in other jurisdictions); see also Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 866-67 (1969) (citing David H. Jackman of the Delaware Corporation Law Revision Committee for his view that Delaware should not adopt the Model Business Corporation Act since most other states copy Delaware laws, and the state should continue to be a leader, not a follower).

10. For examples of articles critical of the Delaware corporate law, see Cary, *supra* note 1 (arguing that Delaware is both the sponsor and victim of a system contributing to the deterioration of corporate standards; the state leads the race to the bottom); William E. Kirk III, *A Case Study in Legislative Opportunism: How Delaware Used the Federal-State System to Attain*

thing is clear—the Delaware Court of Chancery has recently taken steps toward reducing the protections afforded stockholders and management by the law of fiduciary duty. It seems ironic that in a time of corporate consolidation the Court of Chancery would author two opinions that will almost certainly serve as deterrents against the choice of Delaware as a state of incorporation, but this is precisely what has occurred.

The group that will benefit most from the recent decisions, *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*¹¹ and *Geyer v. Ingersoll Publications Co.*,¹² are the creditors of those solvent corporations that face the prospect of insolvency. This is a result of the expansion of an established principle known as the trust fund doctrine¹³ or the insolvency exception,¹⁴ which causes the directors of an insolvent corporation to owe fiduciary duties to creditors.¹⁵ Although the principle is expressed in different terms, its impact on directors is identical. The trust fund doctrine posits that as against stockholders, the assets of an insolvent corporation will be treated as a trust for the benefit of creditors, and fiduciary duties will be imposed.¹⁶ The insolvency exception provides that absent circumstances such as fraud, insolvency, or the violation of a statute, directors do not owe fiduciary duties to creditors.¹⁷ By implication, therefore, the board of an insolvent corporation is held to owe fiduciary duties to corporate creditors; the result is the same as that achieved under the trust fund doctrine.

Corporate Pre-Eminence, 10 DEL. J. CORP. L. 233 (1985) (commenting on the conscious opportunism of the Delaware legislature in aggressively pursuing the business of corporate charters for the state's economic benefit); Marc I. Steinberg, *Nightmare on Main Street: The Paramount Picture Horror Show*, 16 DEL. J. CORP. L. 1, 2 (1991) (arguing that although certain recent cases indicate that the law of fiduciary duty is vigilant, "laxity all too often prevails"). Examples of articles favorable to, or at least not critical of, the Delaware corporation law include David A. Drexler, *Federalism and Corporate Law: A Misguided Missile*, 3 SEC. REG. L.J. 374, 375 (1976) (arguing that Prof. Cary's preconceptions regarding the Delaware corporation statute and case law amount to "yellow journalism on the law review circuit," see Cary, *supra* note 1); Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984) (arguing that the increased discretion allowed corporate management under the Delaware corporation statute has proven beneficial to shareholders); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 945 (1982) (claiming that the arguments that posit that the Delaware corporation statute fails to provide adequate protection to shareholders are unsupported by theoretical or empirical evidence). A more exhaustive list of articles discussing both the Delaware statute and arguments for and against federal intervention in the state corporation chartering process appears in Alva, *supra* note 2, at 885 n.1, 887 n.10.

11. C. A. No. 12150, 1991 Del. Ch. LEXIS 215 (Dec. 30, 1991).

12. C. A. No. 12406, 1992 Del. Ch. LEXIS 132 (June 18, 1992).

13. See *Asmussen v. Quaker City Corp.*, 156 A. 180, 181 (Del. Ch. 1931); *Pennsylvania Co. for Ins. on Lives & Granting Annuities v. South Broad St. Theatre Co.*, 174 A. 112, 116 (Del. Ch. 1934) (holding that under the trust fund theory, the capital assets of an insolvent corporation constitute a trust fund for creditors).

14. See *Simons v. Cogan*, 549 A.2d 300, 302-03 (Del. 1988).

15. See *Bovay v. H.M. Byllesby & Co.*, 38 A.2d 808, 813 (Del. 1944) (holding that insolvency of corporation creates a trust for the benefit of creditors). See generally Lewis U. Davis, Jr. et al., *Corporate Reorganization in the 1990s: Guiding Directors of Troubled Corporations Through Uncertain Territory*, 47 BUS. LAW. 1 (1990) (citing recent cases from various jurisdictions that utilize the insolvency exception).

16. *Asmussen*, 156 A. at 181.

17. *Simons*, 549 A.2d at 302-03.

In *Credit Lyonnais* the court held that when a corporation is operating "in the vicinity of insolvency,"¹⁸ the board owes its duty to the corporate enterprise, consisting of creditors and shareholders,¹⁹ and does not function solely as the agent of shareholders. This extension of duties to cover creditors when the corporation is operating *in the vicinity of insolvency* plainly expands the notion that such duties are owed *only when the corporation is insolvent* and creates a dilemma for boards attempting to determine precisely when such duties may be owed. In *Geyer* the court was called upon to determine whether duties arise "when insolvency exists in fact, or when a party institutes statutory proceedings (e.g., bankruptcy proceedings)."²⁰ It concluded that duties arise upon the *fact* of insolvency²¹ and relied in part on an imprecise definition of insolvency, which may, in retrospect, be manipulated to classify many presently-viable corporations as insolvent. Thus, a perilous situation has been created for the boards of financially troubled companies that may not be insolvent at the time a particular decision is made but which may later be held to be insolvent to justify the imposition of fiduciary duties for the benefit of creditors. These cases blur the point at which fiduciary duties to creditors will arise and may cause those duties to arise earlier than in the past.

This Comment will examine how the Delaware Court of Chancery has recently endeavored to broaden the scope of the trust fund doctrine and the insolvency exception, as well as the effect that such a change may have on boards of directors. Part I reviews the historical development of Delaware fiduciary duty law and the trust fund doctrine. Part II summarizes the recent chancery court decisions noted above, and Part III explores the implications of those decisions.

I. THE HISTORICAL FRAMEWORK

A. FIDUCIARY DUTIES OWED BY DELAWARE DIRECTORS

To understand the impact of the trust fund doctrine, it is essential to understand the fiduciary duties traditionally owed by the board of directors to the corporation and its stockholders. The applicable law is that of the state of incorporation, which generally determines the rules that govern the internal affairs of the corporation.²² Such internal affairs include the legal relationships between shareholders and directors. In particular, state law determines the duties of directors as well as how they may be found liable for a breach of those duties.²³ The Delaware Supreme Court has held that fidu-

18. 1991 Del. Ch. LEXIS at *108.

19. *Id.* at *108 n.55.

20. 1992 Del. Ch. LEXIS at *7.

21. *Id.* at *8.

22. RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 296-310 (1971); *First Nat'l City Bank v. Banco Para el Comercio Exterior de Cuba*, 462 U.S. 611, 621 (1983).

23. Willis L. M. Reese & Edmund M. Kaufman, *The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit*, 58 COLUM. L. REV. 1118, 1124-25 (1958); see also *Armstrong v. Pomerance*, 423 A.2d 174, 177 (Del. 1980) (holding that Delaware has a significant interest in overseeing those owing fiduciary duties to shareholders of

ciary duties arise when either a property right or an equitable interest exists to support such duties.²⁴ The obvious example of an equitable interest is stock ownership.²⁵ Similarly, fiduciary duties arise as a result of property rights in a trust relationship, such as when a corporation dissolves. In that circumstance, corporate assets are held in trust for the benefit of both stockholders and creditors, and fiduciary duties are consequently imposed on the board of directors for the benefit of both interests.²⁶

Under the Delaware statute, the board of directors is ultimately responsible for management of the business and affairs of the corporation unless its certificate of incorporation provides otherwise.²⁷ In the discharge of its managerial responsibilities, the board owes an unyielding fiduciary duty to the corporation and its shareholders.²⁸ The fiduciary duty owed by directors includes a duty of care as well as a duty of loyalty.²⁹ Regarding the duty of care, directors have an obligation to inform themselves, prior to making a business decision, of all material information available to them.³⁰ Once fully informed, directors must then act with requisite care in the discharge of their duties.³¹ With respect to the duty of loyalty, directors can neither stand on both sides of a transaction nor expect to derive personal benefit from it in the sense of self-dealing (as opposed to any benefit which may be derived by the corporation or shareholders generally).³²

The principle that the board is responsible for managing the affairs of the corporation has given rise to the business judgment rule as a form of legal protection for board decisions.³³ The rule exists to protect and promote the

Delaware corporations, and that the state has the power to establish the rights and responsibilities of those who manage its domestic corporations).

24. *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988).

25. *Id.*

26. *Gans v. MDR Liquidating Corp.*, C. A. No. 9630, 1990 Del. Ch. LEXIS 3, at *24 (Jan. 10, 1990).

27. DEL. CODE ANN. tit. 8, § 141(a) (1990); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

28. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *see also* *Davis et al.*, *supra* note 15, at 2-3 (summarizing general fiduciary duties of directors of solvent corporations).

29. *Aronson*, 473 A.2d at 812.

30. *Id.*

31. *Id.*

32. *Id.* The Supreme Court of Delaware described the responsibilities of corporate management in compelling terms in *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939):

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, . . . 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 . . . 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 to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self interest.

Id. at 510.

33. ERNEST L. FOLK III ET AL., *FOLK ON DELAWARE CORPORATION LAW* § 141.22 (3d

full and free exercise of the managerial power granted to directors.³⁴ Absent an abuse of discretion, the board's judgment will be respected by the courts.³⁵ The chancery court articulated the rationale for respecting the collective business judgment of a corporate board in the following terms:

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.³⁶

The business judgment rule will not provide protection for an unintelligent or unadvised judgment.³⁷ In determining whether a decision will be protected by the rule, the applicable standard of care is predicated upon concepts of gross negligence.³⁸ When a board's decision is challenged, the burden is on the challenging party to establish the facts necessary to rebut the presumption.³⁹ If the business judgment rule applies to a board's decision, there is a "presumption that in making a business decision the directors . . . 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."⁴⁰ The effect of the presumption, when applied by a court, is that the court will not substitute its own judgment for that of the board unless a breach of fiduciary duty is involved.⁴¹

The business judgment rule has also been described as a substantive rule of

ed. 1991). The Delaware Supreme Court acknowledged one commentator's views of a difference between the business judgment rule and business judgment doctrine as follows:

One eminent corporate commentator has drawn a distinction between the business judgment rule, which insulates directors and management from personal liability for their business decisions, and the business judgment doctrine, which protects the decision itself from attack. The principles upon which the rule and doctrine operate are identical, while the object of their protection are different.

Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 n.10 (Del. 1986) (citing Hinsey, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 611-13 (1984)). The Court notes that although it has not referred to such a distinction in specific terms, in appropriate cases a reference to the rule "may be understood to embrace the concept of the doctrine." *Id.* But see Krishnan Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 DEL. J. CORP. L. 505, 506 n.4 (1985) (asserting that the distinction between rule and doctrine is not a part of existing law).

34. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

35. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

36. *Solash v. Telex Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608, at 97,727 (Del. Ch. Jan. 19, 1988), quoted in *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 780 (Del. Ch. 1988).

37. *Van Gorkom*, 488 A.2d at 872.

38. *Aronson*, 473 A.2d at 812.

39. *Id.*

40. *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173, 180 (Del. 1986) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

41. *Citron v. Fairchild Camera & Instrument Corp.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,915, at 90,104 (Del. Ch. May 19, 1988), *aff'd*, 569 A.2d 53 (Del. 1989).

law.⁴² As such, it provides that there is no liability for an injury or loss to the corporation arising from corporate action when the directors, in authorizing the action, proceeded in good faith and with appropriate care.⁴³ Thus, where independent board action is challenged and the presumption in favor of the board is not overcome, the substantive aspect of the rule mandates the outcome of the litigation.⁴⁴

B. DEVELOPMENT OF THE TRUST FUND DOCTRINE AND THE INSOLVENCY EXCEPTION

The trust fund doctrine, and its resulting imposition of fiduciary duties for the benefit of creditors, appears to have first arisen in Delaware with the establishment of the state's receivership statute.⁴⁵ In *Mackenzie Oil Co. v. Omar Oil & Gas Co.*⁴⁶ the chancery court was called upon to interpret the statute, which permitted the creditor of an insolvent corporation to petition the court for appointment of a receiver to oversee the administration of corporate assets.⁴⁷ The chancellor concluded that the statute was intended to do "something more than to create simply an equitable remedy. . . . [I]t creates a substantive right of a clearly equitable nature."⁴⁸ Further, he found that the right created was such that "the assets of a corporation upon the event of insolvency may be regarded by creditors and stockholders as impressed with somewhat of the nature of a trust to be administered for their benefit."⁴⁹ The chancellor based his conclusion on the enactment of the receivership statute:

It is well settled that insolvency on the part of a corporation can have no effect as impressing upon corporate assets a trust which creditors may appeal to equity to take cognizance of and administer for their benefit. Accordingly, if the statute in question had never been enacted, the suggestion that insolvency converts corporate assets into a quasi trust for the benefit of creditors would find no countenance.⁵⁰

Continuing, he found that the receivership statute granted stockholders and creditors a right to assert an interest in corporate assets which had previously never existed:

When insolvency arises, it creates a right on the part of creditors and

42. *Id.*

43. *Id.*

44. *Id.*

45. Section 3883 of the Delaware Revised Code of 1915 provided, in pertinent part: Whenever a corporation shall be insolvent, the Chancellor, on the application and for the benefit of any creditor or stockholder thereof, may, at any time, in his discretion, appoint one or more persons to be receivers of and for such corporation, to take charge of the estate, effects, business and affairs thereof, and to collect the outstanding debts, claims, and property due and belonging to the company. . . .

MacKenzie Oil Co. v. Omar Oil & Gas Co., 120 A. 852, 853 (Del. Ch. 1923).

46. 120 A. 852 (Del. Ch. 1923).

47. *Id.* at 857.

48. *Id.* at 856.

49. *Id.* at 857.

50. *Id.* (citations omitted).

stockholders to be regarded as bearing a different relationship towards the corporate assets from that which had theretofore existed. . . . [I]n the absence of the statute, [neither] stockholders [nor] creditors [can] 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.⁵¹

The question of whether the trust fund doctrine operates to place all creditors of an insolvent corporation on an equal footing in terms of the distribution of assets was addressed in *Asmussen v. Quaker City Corp.*⁵² In *Asmussen* a creditor complained that he was excluded from payments made to certain other creditors after the assets of an insolvent corporation were liquidated. The complainant sought to establish liability on the part of the officers and directors through use of the doctrine for an allegedly improper distribution of corporate assets. In the decision, the chancellor articulated his understanding of the nature of the doctrine:

That all courts recognize a trust fund doctrine of some sort appears to be clear. . . . If an insolvent corporation should undertake to turn its assets over to stockholders, leaving creditors unpaid, I think no dissent can be found to the proposition that the law would condemn the effort. As against stockholders, it is universally conceded that the assets of an insolvent corporation will be regarded in such a case as "a trust fund for the benefit of creditors."⁵³

The court confirmed that the dicta of *Mackenzie Oil*⁵⁴ was "correctly expressive of the law,"⁵⁵ and relied upon the language in reaching the conclusion that the trust fund doctrine does not include a right for all creditors to be paid ratably from corporate assets outside the context of receivership proceedings.⁵⁶ The court held that until a corporation is placed into receivership, its assets would not be treated as a trust fund for the benefit of creditors "in the sense that one creditor has a right to be paid his debt *pari passu* with all other creditors similarly situated, and that, if he is not so paid, he may hold the directors accountable as for a breach of trust."⁵⁷

It is important to note that the language of *Asmussen* may have signalled a shift in the chancery court's thinking about the nature of the trust fund doctrine. In *Mackenzie Oil*, the court stated that the "right to assert an interest now exists where it did not exist before."⁵⁸ Read in context, it seems apparent that the *Mackenzie Oil* court considered the newly-created interest to be the right to petition the court for a receiver under the receivership statute. However, the language of *Asmussen* quoted above⁵⁹ implies that a court of

51. *Id.*

52. 156 A. 180 (Del. Ch. 1931).

53. *Id.* at 181.

54. *See supra* text accompanying note 51.

55. *Asmussen*, 156 A. at 183.

56. *Id.*

57. *Id.*

58. *Mackenzie Oil*, 120 A. at 857.

59. Specifically, "[i]f an insolvent corporation should undertake to turn its assets over to stockholders, leaving creditors unpaid . . . the law would condemn the effort. . . . [T]he assets of an insolvent corporation will be regarded in such a case as 'a trust fund for the benefit of creditors.'" *Asmussen*, 156 A. at 181.

equity will treat the assets of an insolvent corporation as a trust fund for the benefit of creditors *even without* the commencement of receivership proceedings. Although such an implication may not have been intended by the court at the time, this interpretation has certainly found favor with the court of chancery in recent years.⁶⁰

In *Asmussen* the court noted that it had not been called upon to decide the question of whether a director who was also a creditor could prefer himself over other creditors in the payment of claims.⁶¹ Three years later, the chancery court was presented the opportunity to answer precisely that question. The complainant in *Pennsylvania Co. For Insurances on Lives & Granting Annuities v. South Broad St. Theatre Co.*⁶² was the trustee of a bond issue secured by a mortgage on the South Broad Street Theatre. While under the threat of foreclosure by the complainant (the first mortgagee), the theater company made a substantial repayment of principal to the second mortgagee. At the time of the payment, the theater company was indirectly controlled by an individual who also controlled the entity holding the second mortgage on the property. Further, the theater company was insolvent. The court held that the trust fund doctrine applied to the case, that the creditors should share the payment in proportion to their respective indebtedness, and that the second mortgagee's possession of the funds was subject to a trust for the benefit of the complainant.⁶³ In doing so, the court advanced the proposition that a majority of courts believed the trust fund doctrine to be the foundation of a rule which forbade director-creditors from enjoying a preference over other creditors in the circumstance of insolvency.⁶⁴ The court's rationale for applying the rule was as follows:

Let the theory under the rule be phrased as it may, analysis in the end will resolve all the reasons underlying the rule into one simple proposition that it is . . . but "merely applied common honesty" that a director of an insolvent corporation should not be allowed as it sinks to take advantage of his position by rushing ahead to a place in the life boat, if I may use the figure, ahead of his fellow passengers.⁶⁵

60. See *infra* text accompanying notes 89-122.

61. *Asmussen*, 156 A. at 183. A point of clarification on *Asmussen* is in order. It is apparent from the text, and was so assumed by the court in *Pennsylvania Co. for Ins. on Lives & Granting Annuities v. South Broad St. Theatre Co.*, 174 A. 112 (Del. Ch. 1934), that the court in *Asmussen* inadvertently used the words "director-debtors" when intending to use "director-creditors." The passage in question is the following: "Whether director-debtors or others who are similarly circumstanced in point of advantage are to be excepted from those who may be favored by payment in full, is a question which I do not pass upon, it not being presented by the case." *Asmussen*, 156 A. at 183. The misstatement is evident when it is considered that a debtor is one who owes and (usually) pays, not one who is "favored by payment." *Id.*

62. 174 A. 112 (Del. Ch. 1934).

63. *Id.* at 116-17.

64. *Id.* at 116.

65. *Id.* The court attributed the source of the trust fund doctrine to the basic principle that "men should act in honesty and fairness." *Id.* Further, the court traced the origin of the doctrine to the early nineteenth century:

So far as I am informed, the so-called trust fund doctrine received its first pronounced recognition in a case before Mr. Justice Story when on circuit in 1824. . . . He referred in his opinion to the earlier case of *Vose v. Grant*, 15 Mass. 505, as recognizing the doctrine. The Massachusetts case is the earliest

In *Bovay v. H.M. Byllesby & Co.*⁶⁶ the Supreme Court of Delaware addressed the application of the trust fund doctrine to the case of the Vicksburg Bridge & Terminal Co., which was rendered insolvent by the fraudulent actions of its directors. Byllesby & Co., an investment firm involved in raising funds for the bridge-building venture through the sale of securities, controlled a majority of the nine-member board of directors of Vicksburg Bridge. The Byllesby-appointed directors were held to be "in complete control of the bankrupt [bridge corporation],"⁶⁷ in the "position of fiduciaries, and, as such, under a duty to exercise the utmost good faith in their transactions with the bankrupt."⁶⁸ The court found that as a result of unlawful payments to Byllesby & Co., as well as the "enormous profit exacted in the sale of securities,"⁶⁹ the bridge corporation "was rendered insolvent at the very inception of its business life, and financially incapable of completing the bridge in final and permanent form."⁷⁰ The court acknowledged application of the trust fund doctrine in noting that "[a]n insolvent corporation is civilly dead in the sense that its property may be administered in equity as a trust for the benefit of creditors."⁷¹ Continuing, the court stated that "[t]he fact which creates the trust is the insolvency, and when that fact is established, the trust arises, and the legality of the acts thereafter performed will be decided by very different principles than in the case of solvency."⁷² This language is troubling in that it implies that the trust fund doctrine will be applied upon the establishment of insolvency,⁷³ but is plainly set in the context of fraudulent conduct by the directors.⁷⁴ The important question thereby raised is whether the trust fund doctrine should apply at the time of insolvency when *outside* the context of fraud by directors. The court provided little guidance when it wrote that its language was "to be interpreted in the light of the situations presented,"⁷⁵ and offered the following text:

Clearly, it was not meant that directors of a corporation are trustees, in a strict and technical sense, in all of their relations with the corporation, its stockholders, and creditors; but, as clearly, it was implied that they should be treated as such when they have *unlawfully profited through*

one in this country at least which has come under my observation as supporting the doctrine. That case may be called the spring to which the doctrine traces its source.

Id. (citations omitted).

66. 38 A.2d 808 (Del. 1944).

67. *Id.* at 813.

68. *Id.*

69. *Id.* at 811.

70. *Id.*

71. *Id.* at 813.

72. *Id.*

73. *Id.*

74. This point is made by the court in stating that the nature of this suit "is one brought for the benefit of creditors to recover large sums of money unlawfully and fraudulently diverted from a trust fund . . . in violation of the fiduciary relationship. It is a suit to execute a trust, and to undo a fraud." *Id.* at 814.

75. *Id.* at 813.

breach of duty, and at the expense of the corporation.⁷⁶

In 1974, the opportunity arose for the chancery court to decide whether directors owed a fiduciary duty to the holders of convertible debentures in *Harff v. Kerkorian*.⁷⁷ The plaintiffs were holders of the 5% subordinated convertible debentures of Metro-Goldwyn-Mayer, Inc. (MGM) who contended that a 1973 cash dividend (the first since 1969) was declared improvidently and primarily for the benefit of Mr. Kerkorian, a director and the controlling stockholder of MGM.⁷⁸ The plaintiffs alleged that the declarations of the cash dividends depleted the capital of MGM and endangered its future prospects.⁷⁹ In reaching its decision that no duties were owed, the court noted that “[d]ebenture holders are not stockholders and their rights are determined by their contracts. . . . A holder of a convertible bond does not become a stockholder, by his contract, in equity any more than at law.”⁸⁰ The most significant language of *Harff* was the articulation of the three conditions subsequently relied upon by Delaware courts to trigger the trust fund doctrine—fraud, insolvency, or violation of a statute.⁸¹ The court stated that:

unless there are special circumstances which affect the rights of the debenture holders as creditors of the corporation, e.g., fraud, insolvency, or a violation of a statute, the rights of the debenture holders are confined to the terms of the Indenture Agreement pursuant to which the debentures were issued.⁸²

The chancery court found that since the plaintiffs did not allege insolvency or violation of a statute and did not specifically allege the existence of fraud in their class action claim, none of the three conditions giving rise to fiduciary duties were present.⁸³ The supreme court later reversed the chancery court’s finding, holding that a claim of fraud had been clearly sounded in the complaint.⁸⁴

The question of whether fiduciary duties were owed to the holders of convertible debentures was not explicitly addressed by the Delaware Supreme Court in its reversal of *Harff*. When the question later arose in *Simons v. Cogan*,⁸⁵ however, the court stated that it did not differ with the substantive analysis articulated by the chancery court in *Harff*.⁸⁶ The supreme court permitted the convertible debenture holders in *Harff* to proceed with their litigation alleging a breach of fiduciary duty by directors because they had brought themselves within the fraud exception, not the insolvency excep-

76. *Id.* at 813-14 (emphasis added).

77. 324 A.2d 215 (Del. Ch. 1974), *rev'd in part*, 347 A.2d 133 (Del. 1975).

78. *Id.* at 217.

79. *Id.*

80. *Id.* at 219.

81. *Id.* at 222.

82. *Id.*

83. *Id.*

84. *Harff*, 347 A.2d at 134.

85. 549 A.2d 300 (Del. 1988).

86. *Id.* at 303.

tion.⁸⁷ The court stated that "a convertible debenture represents a contractual entitlement to the repayment of a debt and does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties."⁸⁸ From this language, it is clear that the Delaware Supreme Court did not intend to extend the protections of fiduciary duty law to corporate creditors *outside the context of fraud*, but rather intended that creditors rely on their contract with the corporation for protection.

II. TROUBLING RECENT DEVELOPMENTS FROM THE CHANCERY COURT

A. *CREDIT LYONNAIS BANK V. PATHE COMMUNICATIONS CORPORATION*

*Credit Lyonnais*⁸⁹ is the story of a leveraged buyout gone bad. The deal was the highly-priced and highly-leveraged acquisition of MGM/UA Communications by Pathe Communications Corp. (PCC), an entity controlled by Giancarlo Parretti. In March, 1990, Parretti signed an agreement with Kirk Kerkorian, the owner of MGM/UA, for PCC's cash purchase of all the stock of MGM. Parretti and PCC managed to raise the \$1.33 billion needed to close the acquisition through a series of complex financing transactions, and did so on November 1, 1990. Cash provided by Credit Lyonnais Bank Nederland, N.V. (CLBN) and its parent played a central part in the financing. Upon closing of the acquisition, Parretti installed himself as chairman and chief executive officer of MGM.

Unfortunately, the company was financially out of control within a matter of weeks. Having borrowed heavily, licensed away most of its films, factored the receivables resulting from the licensing contracts, and used all the cash to pay part of the acquisition price, MGM was immediately short of cash and cash-producing assets. The situation was accentuated by the fact that, prior to the acquisition, Parretti had directed the company to conserve cash by slowing payments to creditors. As a result, the company accumulated \$20 million in unpaid trade bills. By the end of March, 1991, the problem was so severe that certain MGM vendors filed a Chapter 7 proceeding against the company in the United States Bankruptcy Court in Los Angeles.

In order to help MGM to escape bankruptcy, Parretti and CLBN negotiated a series of agreements. These agreements provided, among other things, for a change in MGM's corporate governance structure and \$145 million in additional financing. The corporate governance agreement provided CLBN with the authority to remove Parretti and other directors of MGM from office upon a breach of the agreement. Parretti signed the agreements on April 15. Shortly thereafter, MGM's creditors dismissed their bankruptcy proceeding.

87. *Id.*

88. *Id.*

89. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, C. A. No. 12150, 1991 Del. Ch. LEXIS 215 (Dec. 30, 1991).

The situation continued to deteriorate. During an audit by Peat Marwick in mid-May, it was discovered that a major film licensing contract which had provided \$130 million in funds for the acquisition of MGM was subject to a "put" arrangement. This arrangement would obligate MGM to reimburse the licensee more than \$100 million immediately upon exercise. Neither MGM nor PCC had disclosed the existence of the arrangement to CLBN during the bank loan negotiations. On May 28, the put was purportedly exercised by the licensee.

In addition to its financial woes, the company was embroiled in a bitter struggle for managerial control. As part of the April agreements between Parretti and the bank, a new management team was installed in order to strengthen financial management and ensure a lasting recovery. However, from the beginning, Parretti barely masked his intention to control and dominate the management of the company. His actions were so severe that on June 17, CLBN concluded that Parretti had failed to comply with the corporate governance agreement in both form and substance. As a result, CLBN took action to have the MGM shares transferred into its own name and executed documents necessary to remove Parretti and his associates from the board of MGM. CLBN and MGM then brought suit under Delaware General Corporation Law section 225 to determine the persons who constituted the lawfully elected board of directors of the company.

In the proceedings, Parretti complained that the management team was committed to preventing him from regaining control of MGM because they realized that if he regained control, they would be fired. Parretti claimed that the team breached its duty to PCC, the 98.5% shareholder of MGM, in part by failing to facilitate the sale of certain assets which might have helped Parretti regain control. In the decision, Chancellor Allen noted that Parretti had gotten himself into a corner, and the management team could have reasonably suspected that he would be inclined to accept fire-sale prices for the assets in question.⁹⁰ In holding that there was no breach of fiduciary duty by the executive committee of the MGM's board, Allen stated that "where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the [stockholders], but owes its duty to the corporate enterprise."⁹¹ Allen noted that in evaluating the sale transactions, the executive committee "had an obligation to the community of interest that sustained the corporation [i.e., both stockholders and creditors], to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."⁹² To support his rationale, Chancellor Allen offered footnote 55—the clearest and most troubling indication of his intention to extend the duties of directors to cover the creditors of solvent corporations.⁹³

90. *Id.* at *109.

91. *Id.* at *108.

92. *Id.* at *109.

93. So that the reader may fully appreciate the implications of Allen's footnote, it is presented in its entirety below:

The possibility of insolvency can do curious things to incentives, exposing credi-

In the footnote, Allen presented a hypothetical situation in which the directors of a solvent corporation owe a duty to the corporation's creditors. His reasoning, while technically only dicta, stands in stark contrast to the position he took five years earlier in *Katz v. Oak Industries*,⁹⁴ a case which has been characterized as expressly denying creditors the possibility of extra-contractual rights.⁹⁵ The plaintiff in *Katz* was the holder of long-term debt securities issued by Oak Industries, Inc. (Oak), a Delaware corporation. Through a class action, *Katz* sought to enjoin consummation of an exchange offer made by Oak to holders of various classes of its long-term debt. The offer was an "integral part of a series of transactions that together would

tors to risks of opportunistic behavior and creating complexities for directors. Consider, for example, a solvent corporation having a single asset, a judgment for \$51 million against a solvent debtor. The judgment is on appeal and thus subject to modification or reversal. Assume that the only liabilities of the company are to bondholders in the amount of \$12 million. Assume that the array of probable outcomes of the appeal is as follows:

		<u>Expected Value</u>
25% chance of affirmance	(\$ 51mm)	\$ 12.75
70% chance of modification	(\$ 4mm)	2.80
5% chance of reversal	(\$ 0mm)	<u>0.00</u>
Expected Value of Judgment on Appeal		\$ 15.55

Thus, the best evaluation is that the current value of the equity is \$3.55 million. (\$15.55 million expected value of judgment on appeal - \$12 million liability to bondholders). Now assume an offer to settle at \$12.5 million (also consider one at \$17.5 million). By what standard do the directors of the company evaluate the fairness of these offers? The creditors of this solvent company would be in favor of accepting either a \$12.5 million offer or a \$17.5 million offer. In either event they will avoid the 75% risk of insolvency and default. The stockholders, however, will plainly be opposed to acceptance of a \$12.5 million settlement (under which they get practically nothing). More importantly, they very well may be opposed to acceptance of the \$17.5 million offer under which the residual value of the corporation would increase from \$3.5 to \$5.5 million. This is so because the litigation alternative, with its 25% probability of a \$39 million outcome to them (\$51 million - \$12 million [=] \$39 million) has an expected value to the residual risk bearer of \$9.75 million (\$39 million x 25% chance of affirmance), substantially greater than the \$5.5 million available to them in the settlement. While in fact the stockholders' preference would reflect their appetite for risk, it is possible (and with diversified shareholders likely) that shareholders would prefer rejection of both settlement offers.

But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than \$15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

Id. at *108 n.55.

94. 508 A.2d 873 (Del. Ch. 1986).

95. See Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1217 (1990).

effect a major reorganization and recapitalization of Oak."⁹⁶ Oak Industries was not in good financial condition and could reasonably have been called a corporation "operating in the vicinity of insolvency."⁹⁷ In his review of the facts, Allen noted that even "a casual review of Oak's financial results over the last several years shows it unmistakably to be a company in deep trouble Unless Oak can be made profitable within some reasonably short time it will not continue as an operating company. Oak's board of directors . . . has authorized steps to buy the company time."⁹⁸

Allen decided that Oak's exchange offer was not a "coercive device,"⁹⁹ the "purpose and effect of [which was] to benefit Oak's common stockholders at the expense of the [h]olders of its debt."¹⁰⁰ In reaching his decision, however, Allen stated that it is the "obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders; that they may sometimes do so 'at the expense' of others . . . does not for that reason constitute a breach of duty."¹⁰¹ He reasoned that "corporate restructurings designed to maximize shareholder values may in some instances have the effect of requiring bondholders to bear greater risk of loss and thus in effect transfer economic value from bondholders to stockholders."¹⁰² Most important of all, Allen stated that "if courts are to provide protection against such enhanced risk, they will require either legislative direction . . . or the negotiation of indenture provisions designed to afford such protection."¹⁰³

Two respected Delaware practitioners recently commented that Allen's differing positions in *Katz* and *Credit Lyonnais* are not necessarily inconsistent but rather represent a "further evolution" of the law of fiduciary duty.¹⁰⁴ Although their proposition is plausible, it is difficult to isolate the key facts which distinguish the two situations. Both involved corporations lacking equity capital and experiencing resultant financial difficulties, albeit for different reasons. Likewise, both involved situations in which stockholders either did or would likely have experienced a transfer of wealth from creditors.¹⁰⁵ In *Oak* the board took actions that benefitted stockholders at the expense of creditors; Allen held that either the legislature or the initial negotiation of contract terms had to provide a basis for the protection of

96. *Katz*, 508 A.2d at 875.

97. *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at *108.

98. *Katz*, 508 A.2d at 875-76.

99. *Id.*

100. *Id.* at 879.

101. *Id.*

102. *Id.*

103. *Id.*

104. Gregory V. Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239, 242 n.12 (1992).

105. The wealth transfer in *Katz* has been described as consisting of "a significant downgrading of the priority of the debtholders' investments and thus their value." Mitchell, *supra* note 95, at 1216. In *Credit Lyonnais* majority stockholder Parretti apparently sought to sell assets at fire sale prices in order to raise cash, which would likely have decreased the security and collateral of certain creditors. See *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at *109.

creditors.¹⁰⁶ Thus, his views were consistent with Delaware precedent and traditional notions of the relationship between the corporation, its stockholders, and its creditors.¹⁰⁷ In *Credit Lyonnais* the directors *refused* to take actions which would have benefitted the majority stockholder at the expense of creditors; Allen embraced their lack of action as prudent and consistent with maximizing the long-term wealth-creating capacity of the corporation, despite the duties owed to shareholders under Delaware law.¹⁰⁸ Although one factor affecting the outcome of *Credit Lyonnais* may have been Allen's sincere doubts about the credibility of MGM's majority stockholder Parretti,¹⁰⁹ it seems more reasonable to conclude that he has adopted a more liberal view of the board's responsibilities toward corporate creditors in recent years.¹¹⁰

B. *GEYER V. INGERSOLL PUBLICATIONS CO.*

Less than six months after *Credit Lyonnais*, the chancery court decided *Geyer v. Ingersoll Publications Co.*¹¹¹ Thomas P. Geyer filed suit against Ingersoll Publications Company (IPCO) and Ralph Ingersoll II alleging breach of fiduciary duties, fraudulent conveyances, and the right to a judgment on a promissory note made by IPCO. According to Geyer's complaint, he and Ingersoll were principals in a partnership involved in the business of managing newspapers in the late 1970's and early 1980's. At some point, they replaced the partnership structure with a corporate structure, causing the formation of IPCO. Both Geyer and Ingersoll received shares of IPCO in return for their interests in the partnership and became

106. *Katz*, 508 A.2d at 879.

107. The traditional ownership model posits that a corporation is owned by its stockholders, and bondholders are merely contract claimants. Mitchell, *supra* note 95, at 1174; *see also* Mann v. Oppenheimer & Co., 517 A.2d 1056, 1061 (Del. 1986) (stating that the rights of debenture holders are controlled by the terms of the indenture under which the securities are issued); Prudential-Bache v. Franz Mfg. Co., 531 A.2d 953, 955 (Del. Super. Ct. 1987) (holding that "[c]reditors' rights arise from contract and do not, by themselves, implicate the fiduciary duties officers [and directors] owe their corporations and shareholders").

108. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (stating that in the discharge of its managerial responsibilities, the board of directors owes an unyielding fiduciary duty to the corporation and its shareholders).

109. Chancellor Allen's disbelief of Giancarlo Parretti is evident throughout the opinion. "Although Parretti implied at trial and asserted in the counterclaim that he was not assisted . . . I find this not to be the case." *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at *38 n.24. "I reject Parretti's testimony and instead accept that of Gille[.]" *Id.* at *39. "Mr. Parretti claims he was unaware of the existence of the Put. I do not accept this testimony as truthful." *Id.* at *90.

110. The *Credit Lyonnais* decision has recently received a considerable amount of attention from commentators. In addition to Varallo & Finkelstein, *supra* note 104, *see* Martin J. Bienenstock, *Conflicts Between Management and the Debtor in Possession's Fiduciary Duties*, 61 U. CIN. L. REV. 543, 555 (1992) (arguing convincingly that Chancellor Allen's reasoning in n.55 is seriously flawed); Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1843 n.68 (1992) (noting that standards as to when an enterprise is insolvent so as to trigger management's fiduciary obligations to creditors has become problematic in practice); Lynn M. Lopucki & William C. Whitford, *Corporate Governance in the Bankruptcy of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 768 n.319 (1993).

111. C. A. No. 12406, 1992 Del. Ch. LEXIS 132 (June 18, 1992).

employees of the corporation. Ingersoll became the president, chairman of the board, and controlling shareholder of IPCO. In addition to his dealings with IPCO, Ralph Ingersoll, together with E. M. Warburg, Pincus & Co. (Warburg), a New York investment banking firm, assembled an international publishing empire in the late 1980s. After a dispute in 1990, Ingersoll and Warburg divided their empire, with Ingersoll retaining ownership of foreign newspapers and Warburg retaining ownership of domestic newspapers.

In the fall of 1988, IPCO purchased Geyer's shares in return for a note in the principal amount of \$2 million. The note obligated IPCO to make monthly payments of principal and interest in increasing amounts, with a balloon payment of nearly \$1 million due on October 15, 1991. Geyer claimed that IPCO failed to make the payment due on June 15, 1991, as well as all payments due after that date. In his complaint, Geyer claimed that Ingersoll caused IPCO to surrender certain valuable assets to third parties so that he could personally benefit. Geyer cited two examples of such conduct in his complaint. First, he alleged that Ingersoll caused IPCO to cancel a management agreement with Goodson Newspapers (worth approximately \$50 million) in return for Goodson's agreement to sell one of its properties, the New Haven Register, to Ingersoll and Warburg. Second, Geyer alleged that when Ingersoll and Warburg divided their publishing empire, Ingersoll caused IPCO to cancel its management agreements with domestic newspapers in return for his receiving the foreign media properties owned by he and Warburg.

Ingersoll, a nonresident of Delaware, moved for dismissal of Geyer's complaint arguing that the chancery court lacked personal jurisdiction over him, and therefore existed no statutory authorization for service of process. Geyer purportedly served Ingersoll pursuant to DEL. CODE ANN. tit. 10, section 3114 (Supp. 1990), which provides that a nonresident of Delaware who accepts a position as director of a Delaware corporation is deemed to have consented to the appointment of the corporation as his agent for service of process in any action against the director for a violation of his duty in such capacity. Ingersoll contended that Geyer lost his status as a shareholder (and became a creditor) upon his sale of shares back to IPCO, and that no duty was owed to Geyer absent fraud, insolvency, or the violation of a statute. Ingersoll reasoned that for the insolvency exception to apply, some sort of statutory proceedings (e.g., bankruptcy) must have begun rather than insolvency merely existing in fact. Geyer responded that directors owe fiduciary duties to creditors *no later* than when insolvency exists in fact. Since IPCO was insolvent, Ingersoll owed a fiduciary duty to Geyer. Therefore, Geyer argued that service of process was authorized under the Delaware nonresident director statute.

The key to determining the personal jurisdiction issue was at what point insolvency arises so as to create a fiduciary duty to creditors: when insolvency exists in fact or when a party institutes statutory proceedings. Importantly, Vice Chancellor Chandler stated that despite language in another chancery court case (authored by Chancellor Allen) holding that the terms

of section 3114 should be construed liberally,¹¹² he would not use different interpretive guidelines for determining the existence of fiduciary duties for personal jurisdiction purposes than for purposes of actually imposing liability.¹¹³ In his words, "either the fiduciary duty existed or did not exist no matter why its existence is an issue."¹¹⁴

In concluding that insolvency occurs upon insolvency in fact, not upon a statutory filing, Chandler relied upon two factors—the first of which was his understanding that Delaware case law required such a conclusion. He based his analysis on *Bovay v. H.M. Byllesby & Co.*¹¹⁵ and the later cases citing it,¹¹⁶ with emphasis on the following language of *Bovay*: "the fact which creates the trust [for the benefit of creditors] is the insolvency, and when that fact is established, the trust arises, and the legality of acts thereafter performed will be decided by very different principles than in the case of solvency."¹¹⁷ Chandler also cited *Asmussen*¹¹⁸ for the proposition that insolvency occurs upon insolvency in fact, and based his argument on the failure of *Asmussen* to affirmatively state that the institution of statutory proceedings is necessary for the condemnation of a board's act of turning corporate assets over to stockholders while leaving creditors unpaid.¹¹⁹ Further, Chandler cited *Credit Lyonnais* for the proposition that it is "efficient and fair to cause the insolvency exception to arise at the moment of insolvency in fact rather than waiting for the institution of statutory proceedings."¹²⁰

The second factor Chandler relied upon for his conclusion was the purported "ordinary meaning"¹²¹ of the word insolvency. "An entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business. That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held."¹²² As discussed below, however, the ordinary meaning of insolvency can be quite difficult to establish.

III. IMPLICATIONS OF THE RECENT DECISIONS

Each of the following subsections examines a major issue arising from the recent chancery court cases and discusses the possible impact on corporate directors and boards.

112. See *Hoover Indus., Inc. v. Chase*, C. A. No. 9276, 1988 Del. Ch. LEXIS 98, at *8 (July 13, 1988).

113. *Geyer*, 1992 Del. Ch. LEXIS 132, at *7 n.1.

114. *Id.*

115. 38 A.2d 808 (Del. 1944); see *supra* text accompanying note 68.

116. See *Kidde Indus., Inc. v. Weaver Corp.*, 593 A.2d 563 (Del. Ch. 1991); *Gans v. MDR Liquidating Corp.*, C. A. No. 9630, 1990 Del. Ch. LEXIS 3 (Jan. 10, 1991).

117. *Geyer*, 1992 Del. Ch. LEXIS 132, at *8 (quoting *Bovay*, 38 A.2d at 813).

118. *Asmussen v. Quaker City Corp.*, 156 A. 180 (Del. Ch. 1931); see *supra* text accompanying note 52.

119. *Geyer*, 1992 Del. Ch. LEXIS 132, at *11-12.

120. *Id.* at *14.

121. *Id.* at *13.

122. *Id.* (citations omitted) (quoting WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 626 (1988)).

A. AN UNNECESSARY AND DUPLICATIVE TORT THEORY

Holding directors accountable for owing fiduciary duties to creditors when a corporation is solvent is unnecessary and unjustified. It is well settled that directors owe such duties to creditors once the corporation becomes insolvent, but prior to that point, creditors' interests are adequately protected by several other means—receivership statutes, fraudulent conveyance statutes, the federal bankruptcy code, the law of contract and, most importantly, their ability to choose those entities to which they will lend money.

Under Delaware law, creditors or stockholders who are concerned about fraud or the mismanagement of an insolvent corporation may apply to the chancery court for appointment of a receiver to take charge of the corporation's assets and business affairs.¹²³ Precedent also exists for the appointment of a receiver for a solvent corporation, in certain limited circumstances.¹²⁴ The Delaware fraudulent conveyance statutes provide that where a transaction is fraudulent as to a creditor, that creditor may have the transaction set aside or annulled to the extent necessary to satisfy his claim.¹²⁵ Remedies are available to creditors regardless of whether the corporation was solvent,¹²⁶ insolvent,¹²⁷ or rendered insolvent as a result of the fraudulent transaction.¹²⁸

Creditors' remedies are not limited to state statutes. The federal bankruptcy code provides a remedy to the creditors of a bankrupt debtor for fraudulent transactions.¹²⁹ A bankruptcy trustee may avoid any transfer of an interest in property of, or obligation incurred by, the debtor within one year before the filing of a bankruptcy petition if it is shown that the transaction was made with intent to hinder or defraud creditors or if the debtor received less than reasonable value in the exchange.¹³⁰ In addition, creditors are fully capable of negotiating the terms of their contract with the debtor at the outset. Banks and other financial institutions routinely include extensive provisions regarding the events which will constitute a default in their loan agreements, and such provisions operate to accelerate the maturity of the obligation and make legal remedies available when the corporation drops below a pre-determined level of financial health.¹³¹ Similarly, purchasers of publicly-traded debt instruments are able to review the documents represent-

123. DEL. CODE ANN. tit. 8, § 291 (1974).

124. See *Vale v. Atlantic Coast & Inland Corp.*, 99 A.2d 396, 400 (Del. Ch. 1953) (noting that the court's power to appoint a receiver for a solvent corporation will be exercised with great restraint); *Drob v. National Memorial Park*, 41 A.2d 589, 597 (Del. Ch. 1945) (recognizing that courts of equity have the inherent right to appoint a receiver for a solvent corporation when fraud and gross mismanagement cause an imminent danger of loss).

125. DEL. CODE ANN. tit. 6, § 1309(a)(1) (1974).

126. *Id.* §§ 1305-07.

127. *Id.* § 1304.

128. *Id.*

129. 11 U.S.C. § 548 (1988 & Supp. III 1991).

130. 11 U.S.C. § 548(a) (1988).

131. See generally JOSEPH J. NORTON, *COMMERCIAL LOAN DOCUMENTATION GUIDE* § 1.06 (Joseph J. Norton et al. eds., 1991) (noting that a typical commercial loan agreement contains provisions such that a lender can pursue various remedies, including acceleration and collection actions, upon default by the borrower).

ing their contract with the corporation, as well as the corporation's financial statements, at the time of investment. If the contract terms do not provide for adequate protection of their interests in the event of insolvency, the purchaser is free to choose a different debt obligation which is more to its liking.

In sum, creditors have extensive and adequate protections available without the imposition of additional common law fiduciary duty requirements on corporate directors. For example, if the directors of MGM/UA had begun to dispose of assets in an imprudent or fraudulent manner which endangered the interests of Credit Lyonnais Bank, the bank could have availed itself of the protective covenants almost certainly contained in its loan agreement with MGM/UA. Further, the bank could have made use of the fraudulent conveyance statutes or the federal bankruptcy code, if necessary. Similarly, the chancery court could have obtained the result desired by the plaintiff in *Geyer*, personal jurisdiction over the defendant director, through the use of a traditional fraud approach rather than by resort to the amorphous insolvency doctrine. *Geyer* alleged fraudulent conveyances by Ralph Ingersoll and IPCO, and the court found that *Geyer* had "sufficiently allege[d] specific facts to support his claim that IPCO did not receive fair consideration in the transaction."¹³² Yet rather than rely on the language of *Harff*, which causes fiduciary duties to arise upon a showing of fraud,¹³³ the court used the insolvency exception to achieve the desired result. Admittedly, *Geyer* cited the insolvency exception in order to obtain jurisdiction over defendant Ralph Ingersoll, but the court's disregard of the fraud allegations for personal jurisdiction purposes illustrates the apparent intent of the chancery court to wade into the insolvency morass upon any reasonable opportunity.

B. DUTIES TO ONE OR DUTIES TO ALL?

Prior to *Credit Lyonnais*, directors of solvent corporations owed fiduciary duties to only one group of interests—the corporation and its owners. Chancellor Allen posited that when a solvent corporation is operating in the vicinity of insolvency, directors owe fiduciary duties to the corporation and the community of interests which sustain it.¹³⁴ Under existing law, there are two such interest groups which are generally recognized—stockholders and creditors.¹³⁵ But as Allen pointed out, the interests of these two groups are often in fundamental conflict in the context of the troubled corporation. One can easily see that directors put in the position of owing unyielding fiduciary duties to two competing interest groups will have great difficulty in performing their managerial decision-making functions. As shown in note

132. *Geyer v. Ingersoll Publications Co.*, C. A. No. 12406, 1992 Del. Ch. LEXIS 132, at *23.

133. *Harff v. Kerkorian*, 324 A.2d 215, 221-22 (Del. Ch. 1974) (providing that absent fraud, insolvency, or the violation of a statute, the rights of creditors are confined to the terms of their contract with the debtor), *rev'd in part*, 347 A.2d 133 (Del. 1975).

134. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, C.A. No. 12150, 1991 Del. Ch. LEXIS 215, at *108 (Dec. 30, 1991).

135. Although Allen includes employees among the community of interests which may sustain a troubled corporation, this group may appropriately be included within the category of creditors. *Id.* at *109 n.55.

55 of *Credit Lyonnais*, a strategy which maximizes the value of stockholders' interests may well result in a loss of principal by creditors, and a strategy which assures creditors of a full recovery may deprive stockholders of the maximum possible return.¹³⁶ This example highlights one of the major uncertainties in the language of *Credit Lyonnais*—whether Allen intended to hold directors accountable for acting in the best interest of multiple conflicting constituencies, or in the best interest of the corporate entity alone.

Although such a distinction may appear to be academic and without effect, it is not. As noted above, the interests of stockholders and creditors are often in conflict when a corporation is operating in the vicinity of insolvency. If directors are held to concurrently owe duties to stockholders and creditors in such a situation, many decisions made by the board could violate the duties owed to one group or the other, giving rise to a cause of action by the disappointed group. Surely, Chancellor Allen did not intend such a result.

An alternative approach is to assume that directors owe a duty *only to the corporation*, and not to any particular interest group. This theory also poses problems since directors must choose between managing the corporation in a more or less entrepreneurial manner. For example, if directors place more emphasis on the security of creditor interests, they will take fewer risks in order to preserve the assets available for repayment of obligations. But if they place greater emphasis on the desire to expand the corporation's asset base and profitability, they will put more assets at risk in order to achieve this objective. Given that we operate in a risk-oriented, capitalistic society, it seems unlikely that Allen would seek to hold directors of solvent corporations to the same standard as the officers who manage a bank trust department; however, this is precisely what his opinion suggests.

The view that directors owe their duty only to the corporation, and not to any particular constituency, has been considered and developed by Professor Lawrence Mitchell, among others.¹³⁷ His work has contributed to an examination of the roles of directors, stockholders, and creditors, and a review of his views may be helpful in understanding the reasoning behind Chancellor Allen's note in *Credit Lyonnais*.¹³⁸ Mitchell has characterized the "bond doctrine"¹³⁹ as the theory that the rights of bondholders are determined by

136. *Id.*

137. See Mitchell, *supra* note 95; see also Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205 (1988) (claiming that recent leveraged buyouts, takeovers, and recapitalizations have resulted in stockholders getting rich at the expense of bondholders; urging in response that courts declare that directors have a fiduciary duty to deal fairly with all investors, including bondholders, and that the Securities and Exchange Commission adopt a disclosure rule requiring public companies to state whether a restructuring transaction is fair or unfair to every class of the company's security holders). Professor Mitchell notes that Morey McDaniel is "[t]he primary contemporary proponent of fiduciary duty for bondholders," but points out that McDaniel's work "overstates the extent to which courts have provided fiduciary rights for bondholders." Mitchell, *supra* note 95, at 1169 n.11.

138. Readers should note that Professor Mitchell's arguments for the fiduciary protection of bondholders are made in the context of publicly-traded corporations *outside the context of insolvency*. See Mitchell, *supra* note 95, at 1166 n.3. The inclusion of his arguments in this paper are intended only as an aid to developing the issues presented herein.

139. *Id.* at 1175.

the terms of indenture agreements under which the securities are issued, and that beyond those contractual duties, the corporation owes no additional duties to its bondholders.¹⁴⁰ He argues that the bond doctrine is "an obsolete piece of jurisprudence developed in an era more fixed on legal formalities, to the exclusion of real human relationships, than our own."¹⁴¹ His proposed solution involves a development of legal doctrines governing both the "vertical relationship"¹⁴² between bondholders and corporate management, as well as the "horizontal relationships . . . among the various contributors of corporate capital."¹⁴³ As to the relationship between bondholders (or creditors) and corporate management (directors), Mitchell points out that although the duty of loyalty is generally enforceable only by a corporation's stockholders, recovery for the breach of such duty is by the corporation.¹⁴⁴ In support of the idea that directors should (or do) owe fiduciary duties to bondholders, he argues that this result "reflects the belief that the duty is owed to the corporation and that the breach of the duty produces injury to it. The value of any such recovery thus indirectly compensates anyone who has a financial interest in the corporation."¹⁴⁵ Mitchell surmises that "there appears to be no good reason to deny the extension of management's duty of loyalty to bondholders and every good reason to do so."¹⁴⁶

As to the duty of care, Professor Mitchell convincingly argues that "the duty of care exists to encourage [corporate management] to serve their corporation prudently and attentively. Surely the [observance of the duty of care] is equally the concern of the bondholder as the stockholder."¹⁴⁷ Mitchell notes that the risk to both stockholders and bondholders is the diminution of corporate assets, resulting in an increased likelihood of bond default and the reduction of residual wealth,¹⁴⁸ but points out that persons who invest in either of the two types of securities do so with differing degrees of risk tolerance.¹⁴⁹ Mitchell articulates the argument advanced by some commentators that if the duty of care is extended to bondholders, that group will be more inclined than stockholders to challenge those entrepreneurial decisions of the board which turn out badly. As a result, management innovation and risk taking will be chilled.¹⁵⁰ He concludes that the argument is wrong,¹⁵¹ arguing that sufficiently educated courts understand the risk pref-

140. *Id.* Mitchell attributes the "classic statement of the traditional view of bondholders' rights" to the Delaware Supreme Court in *Mann v. Oppenheimer & Co.*, 517 A.2d 1056, 1061 (Del. 1986). Additional cases cited as espousing the traditional view include *Simons v. Cogan*, 549 A.2d 300, 303-04 (Del. 1988), and *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524 (S.D.N.Y. 1989).

141. Mitchell, *supra* note 95, at 1222.

142. *Id.* at 1170.

143. *Id.* at 1171.

144. *Id.* at 1192.

145. *Id.*

146. *Id.* at 1199.

147. *Id.* at 1206.

148. *Id.* at 1206-07.

149. *Id.* at 1207.

150. *Id.*

151. *Id.*

erences of stockholders and bondholders, there is no good reason that courts cannot make reasonable judgments, based on the circumstances surrounding a questioned transaction, and extend to bondholders the fiduciary protections traditionally provided to stockholders.¹⁵²

Professor Mitchell's suggestions are reasonable and possess a certain appeal; however, quite unappealing consequences could result if his views are adopted by courts without a substantial effort to achieve conformity among the related theories of fiduciary duty law. As discussed herein, questions exist as to how and whether the business judgment rule will be adapted to the context of bondholder fiduciary duty claims, and fiduciary duties should not be extended until a coherent framework is developed for use in understanding their implications. As appealing as Professor Mitchell's views may be, neither his views nor a coherent framework was developed in the *Credit Lyonnais* opinion in a form which can be effectively used as precedent.

C. APPLICATION OF THE BUSINESS JUDGMENT RULE TO DECISIONS CAUSING CONFLICT BETWEEN STOCKHOLDERS AND CREDITORS

If directors are to owe duties both to creditors and stockholders, their decision-making process could conceivably deprive them of the basic legal protection normally afforded corporate directors—the business judgment rule. In the situation outlined in note 55 of *Credit Lyonnais*,¹⁵³ Allen suggests that the board of directors may properly choose to accept a settlement offer of \$15.55 million, leaving stockholders with a recovery of \$3.5 million after payment of the \$12.0 million obligation to creditors. The facts plainly indicate that stockholders stand to gain far more (\$9.75 million, based on his expected value calculation) from an aggressive pursuit of the litigation than from settlement. Allen notes that a diversified group of stockholders will likely *prefer* rejection of the settlement offer, given their preferences regarding risk and return. Thus, the board will have chosen to accept a settlement which, based on an accepted model of decision theory, is demonstrably less beneficial to the stockholders than a known alternative. Assuming that the board makes this decision, an obvious question is raised as to whether it will be protected by the business judgment rule if (when?) sued by stockholders for a breach of fiduciary duty.

The chancery court has stated that Delaware corporation law does not “operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares.”¹⁵⁴ Thus, the fact that shareholders are opposed to a particular course of action will not make the business judgment rule unavailable to the directors. Therefore, an analysis of whether the protection of the rule is available to the board must begin with an examination of the elements necessary for its application.

152. *Id.* at 1212.

153. *See supra* note 93 and accompanying text.

154. *Paramount Communications, Inc. v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,284 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989).

Chancellor Allen has articulated the elements of the business judgment rule as follows:

The business judgment form of judicial review encompasses three elements: a threshold review of the objective financial interests of the board whose decision is under attack (*i.e.*, independence), a review of the board's subjective motivation (*i.e.*, good faith), and an objective review of the process by which it reached the decision under review (*i.e.*, due care). The first of these factors is, of course, a condition to the use of the business judgment form of review; if the board is financially interested in the transaction, the appropriate form of judicial review is to place upon the board the burden to establish the entire fairness of the transaction. Each of the second two elements of the rule reflects one of the two theoretically possible bases for director liability in a disinterested transaction. If each is satisfied (*i.e.*, plaintiff cannot show a *prima facie* case of, or, if such a case is made out, the balance of the evidence does not establish, bad faith or gross negligence), then there is, in my opinion, no basis to issue an injunction or to impose liability.¹⁵⁵

The third element, objective due care, is satisfied in this situation upon the assumption that the board acted with requisite care in considering all the material facts reasonably available to it, such as the probability of an affirmation or reduction of the judgment on appeal.

Satisfaction of the first and second elements, independence and good faith, may be more problematic. Regarding independence, the chancery court has noted that a substantial economic interest which compromises a director's duty of loyalty may be either direct or indirect.¹⁵⁶ Directors are obligated to eschew any conflict between duty and self-interest.¹⁵⁷ The Delaware Supreme Court has held that for a director's decision to be independent, the decision must be "based on the corporate merits of the subject before the board rather than extraneous considerations or influences."¹⁵⁸ The facts here give no indication that any member of the board had a *direct* financial interest in either the outcome of the litigation or the general welfare of the corporate creditors. It is clear, however, that the board was aware of the probability that an unsuccessful appeal could result in the eventual insolvency and bankruptcy of the firm. Given the trend toward litigation against the directors of bankrupt corporations, both individually and in their fiduciary capacities,¹⁵⁹ there is a possibility that the decision to pursue a strategy which was sub-optimal for shareholders may have been at least partially motivated by a desire to avoid potential litigation by creditors (grounded in the

155. *In re* RJR Nabisco, Inc. Shareholders Litig., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,709-10 (Del. Ch. Jan. 31, 1989) (citations omitted).

156. *Solash v. Telex Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608, at 97,727 (Del. Ch. Jan 19, 1988).

157. *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1345 (Del. 1987).

158. *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984).

159. See A. A. Sommer, Jr., *Directors Under Fire*, A.B.A.J., June 1992, at 94 (examining recent increase in shareholder actions against directors of public and private companies); Gretchen Morgenson, *What Did Pop Expect to Happen When He Gave the Kids his Credit Card?*, FORBES, Sept. 28, 1992, at 95 (reviewing the nature and extent of federal agency litigation against directors of insured federal financial institutions).

language of *Credit Lyonnais*). Further, the board may have explicitly considered the issue of whether the corporation, after insolvency, would have sufficient resources available to indemnify the directors for any personal financial loss resulting from stockholder or creditor suits. With this consideration likely resolved in the negative, a question can be raised as to whether the directors acted independently or with an indirect, substantial economic interest in accepting the settlement proposal. If it appears that the directors' interests in avoiding litigation with creditors amounted to an indirect economic interest in the decision, the first element necessary for the application of the rule—objective independence—would not be present.

Another question arises regarding the second element necessary for application of the rule—subjective good faith. Has the board acted in good faith, or with a subjective motivation to avoid potential litigation by the creditors? Allen set a high standard for subjective good faith by stating that when determining whether a director has acted in good faith for purposes of the second element, not only financial interests but any interest that might pull one from the path of propriety will be considered.¹⁶⁰ Further, when evaluating the applicability of the rule in the context of a selective stock repurchase, the Delaware Supreme Court stated that “[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protection of the business judgment rule may be conferred.”¹⁶¹ The court noted that for the rule to apply, “directors may not have acted solely or primarily out of a desire to perpetuate themselves in office.”¹⁶² A question is thereby raised as to whether the directors' interests in avoiding litigation with creditors could be likened to the desire to perpetuate their positions in office. Certainly, it is reasonable to assume that an interest in avoiding the burden of protracted litigation is a more compelling personal consideration than the loss of benefits connected with a directorship position.

Therefore, given the high standard for subjective good faith articulated by Allen, as well as the Delaware Supreme Court's cautious approach, it is possible that a prudent board could be denied the protection of the business judgment rule as a result of its effort to follow the language of *Credit Lyonnais* and act in the best interest of two competing constituencies. Of course, this result assumes that the directors openly discussed their individual concerns regarding the potential of fiduciary duty litigation by creditors, but it highlights the unenviable conflict that directors will face if they are held to concurrently owe duties to competing interest groups.

In the alternative, assume that the board chooses to attempt to maximize stockholder values through an aggressive pursuit of the litigation. Further

160. *In re* RJR Nabisco, Inc. Shareholders Litig., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,711 (Del. Ch. Jan. 31, 1989).

161. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

162. *Id.* at 955.

assume that Murphy's Law¹⁶³ is operative, and the judgment is reversed on appeal. The corporation has no other assets and defaults on its debt obligations. The creditors sue the board for breaching its fiduciary duty, prominently citing *Credit Lyonnais* as the authority for their cause of action. Will the business judgment rule apply to protect the board? It seems likely that the protection of the rule will be available, particularly since it was developed to defend against these types of claims by shareholders.¹⁶⁴ If the theory of *Credit Lyonnais* is that duties are owed to the corporation alone, there would appear to be no problem with the availability of the rule since the directors acted to maximize the corporation's value. If the directors acted with the objective of avoiding litigation, however, the result could be the same as that discussed in the preceding section.

D. DEVELOPMENT OF A MEANINGFUL DEFINITION OF INSOLVENCY

If directors are to be held accountable for owing fiduciary duties to corporate creditors once the condition of "insolvency in fact"¹⁶⁵ has arisen, it is only fair that such a condition be clearly identifiable in the ordinary course of business. Commentators examining the general nature of fiduciary duties recently highlighted this problem, noting that the "insolvency exception can result in director liability for conduct that a troubled company's directors may not perceive as erroneous. . . . [B]ecause a director may not be able to rely on the corporation's balance sheet as an indicator of solvency, the director will not know when he or she owes a fiduciary duty to creditors."¹⁶⁶ Even the chancery court has acknowledged the need for certainty in the determination of insolvency. In the context of a complaint requesting the appointment of a receiver for the assets of an allegedly insolvent corporation, the court wrote that "[i]nsolvency is a jurisdictional fact, proof of which must be clear and convincing and free of doubt. . . . If the court should entertain any serious doubt, a complaint asking for the appointment of a receiver should be denied."¹⁶⁷

In attempting to offer a meaningful definition of "insolvency in fact,"¹⁶⁸ Chandler described two different, and sometimes contradictory, corporate conditions. For convenience, the "unable to pay"¹⁶⁹ condition will be referred to as Definition 1, and "liabilities in excess of a reasonable market value of assets"¹⁷⁰ will be referred to as Definition 2. The Uniform Commercial Code defines insolvency as the condition which exists when an enterprise has ceased to pay its debts in the ordinary course of business, or when it cannot meet its financial obligations as they come due.¹⁷¹ This is consis-

163. Anything which possibly can go wrong, will go wrong.

164. See *supra* text accompanying notes 33-38.

165. Geyer v. Ingersoll Publications Co., No. 12406, 1992 Del. Ch. LEXIS 132, at *8 (Del. Ch. June 18, 1992).

166. Davis et al., *supra* note 15, at 3.

167. Banks v. Cristina Copper Mines, Inc., 99 A.2d 504, 506 (Del. Ch. 1953).

168. Geyer, 1992 Del. Ch. LEXIS 132, at *8.

169. *Id.* at *13.

170. *Id.*

171. U.C.C. § 1-201(23) (1990); see also EUGENE F. BRIGHAM, FINANCIAL MANAGE-

tent with Definition 1. However, Definition 2, given as an alternative to (or interpretation of) Definition 1, describes the general condition of negative net worth, and ignores the issue of the corporation's short-term financial liquidity.¹⁷² Liquidity is the measure of an enterprise's position with respect to cash and marketable securities, which reflects its ability to meet short term obligations as they come due.¹⁷³ Noted professors of accounting Robert Anthony and James Reece, in discussing various analytical tests of financial condition, distinguish between the concepts of liquidity and solvency as follows:

Liquidity refers to the company's ability to meet its current obligations. Thus, liquidity tests focus on the size and relationships of current liabilities and of current assets, which presumably will be converted into cash in order to pay the current liabilities. Solvency, on the other hand, pertains to the company's ability to meet the interest costs and repayment schedules associated with its long-term obligations.¹⁷⁴

It is entirely possible that a corporation may fit Definition 2, having total liabilities in excess of total assets, and yet have sufficient liquid assets available to pay its current obligations. Consider the following examples which illustrate the difficulty that directors may have in determining, with any degree of precision, when a corporation may be held to be insolvent under the alternative definitions offered by Chandler.

EXAMPLE 1

Maple Industries, Inc. (Maple), a Delaware corporation, was purchased by investors in a leveraged buyout transaction approximately two years ago. Its balance sheet on January 1, 1993, in summary form, is as follows (amounts in millions):

MENT THEORY AND PRACTICE 862 (1982) (defining insolvency as the firm's inability to meet its maturing debt obligations).

172. Other authorities have noted the distinctions between insolvency, illiquidity, and conditions of negative net worth. Black's Law Dictionary offers several definitions of insolvency, one of which is as follows: "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." BLACK'S LAW DICTIONARY 797 (6th ed. 1990). Prof. Higgins defines solvency as the "state of being able to pay debts as they come due," but defines insolvency as the "condition of having debts greater than the realizable value of one's assets." ROBERT C. HIGGINS, ANALYSIS FOR FINANCIAL MANAGEMENT 240, 246 (1984).

173. ROBERT N. ANTHONY & JAMES S. REECE, ACCOUNTING: TEXT AND CASES 423 (1983).

174. *Id.*

	<u>Book Value¹⁷⁵</u>	<u>Market Value</u>
Cash and Marketable Securities	\$ 4.0	\$ 4.0
Other Assets	16.0	10.0 ¹⁷⁶
Total Assets	<u>\$ 20.0</u>	<u>\$ 14.0</u>
Liabilities	\$ 16.0	\$ 16.0
Shareholder's Equity	4.0	(2.0)
Total Liabilities and Equity	<u>\$ 20.0</u>	<u>\$ 14.0</u>

Assume that Maple's \$16.0 million in liabilities consists of a bank note with interest payable annually (at 8% per annum) and principal due at the end of three years (on 12/31/95). Annual interest costs amount to \$1.28 million per year. Based on the present balance sheet and the assumption that its business operates without substantial losses, Maple clearly has sufficient cash and marketable securities to meet its obligations for at least three years. Under Definition 1, there is no question of solvency because Maple has not defaulted (and may not default for at least three years) on any obligation due its creditors. Although the total market value of its assets is presently less than the total of its liabilities, there is a real possibility that the market value of the assets will appreciate (over the next three years) so that its obligations can be repaid and shareholders can receive a return of (and perhaps on) their investments.

If Maple should default on any part of its bank note obligation prior to full repayment, however, Definition 2 could be applied to conclude that the corporation was insolvent as of January 1, 1993. As a result, the court could impose a retroactive duty on Maple's directors for the benefit of its creditors. Under this scenario, each act of the board of directors from January 1, 1993 until the date of default could be scrutinized in light of a fiduciary responsibility owed to the creditors. Such acts could include actual negotiations with the creditors for a more favorable interest rate or repayment terms, as well as any possible sale of assets (potentially at a discount to fair market value) which might have provided funds for the payment of debt obligations and the avoidance of default.

EXAMPLE 2.

The summary balance sheet of Ash Industries, Inc. (Ash), a Delaware corporation, is as follows (amounts in millions):

175. Book value is the amount at which an asset or liability is recorded in the accounting records of the corporation. ROBERT K. ESKEW & DANIEL L. JENSEN, *FINANCIAL ACCOUNTING* 339 (1989).

176. Examples of similar differences between the book and market value of corporate assets are evident from the history of numerous companies involved in the United States banking, savings and loan, oil, natural gas, and real estate industries over the past ten years.

	Book Value	Market Value
Cash and Marketable Securities	\$ 4.0	\$ 4.0
Other Assets	16.0	11.0
Total Assets	<u>\$ 20.0</u>	<u>\$ 15.0</u>
Liabilities	\$ 12.0	\$ 12.0
Shareholder's Equity	8.0	3.0
Total Liabilities and Equity	<u>\$ 20.0</u>	<u>\$ 15.0</u>

Assume that Ash's liabilities consist of (1) a \$6.0 million short-term bank note, due in the immediate future, and (2) a \$6.0 million bond obligation, secured by the Other Assets, due in five years. The Other Assets have declined in value, and are not readily available for sale or refinancing, except at a substantial loss. Although Ash has assets with a market value 25% greater than its liabilities, due to poor financial management, market conditions, or other difficulties, it will probably not be able to pay its bank note when due.¹⁷⁷ Therefore, the entity will be insolvent under Definition 1 but not under Definition 2. Fortunately, this situation is somewhat less troublesome from a legal perspective because, regardless of the reason, the corporation will have crossed the line of default upon its failure to pay the bank note when due, and contract remedies will likely be available to the creditor.

The challenge presented is to develop a standard for determining when the condition of insolvency has arisen (and hence, when duties are owed to creditors) in terms which are equally as objective and predictable for courts as for officers and directors. Three options are apparent. First, a "bright line" test, such as the institution of insolvency proceedings, could be applied. This was the test urged by Mr. Ingersoll in *Geyer*—the same test appropriately rejected on the basis of Delaware precedent.¹⁷⁸ Second, one of the alternative definitions articulated by Webster's Dictionary or Black's Law Dictionary could be chosen. Third, the two alternative definitions articulated by Chandler could be refined to create a single, two-part standard. Under this option, a key question becomes how (or whether) these sometimes contradictory definitions can be reconciled in order to create a logical, predictable standard.

A useful standard can be developed through a refinement of the alternative definitions. The general definition of insolvency offered by Chandler is closely related to the concept of default in contract law. Definition 1, which

177. "Commercial bankers frequently observe that a company may have a satisfactory level of net income [or net worth] yet be illiquid—that is, short of cash to meet claims as they come due." JEROME B. COHEN ET AL., *INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT* 422 (5th ed. 1987). "[I]f a company has good prospective earning power, it may be illiquid today but not necessarily over the lifetime of its long-term obligations. . . . [H]owever, if illiquidity causes a company to be denied short-term credit, its long-term obligations will be jeopardized." *Id.*

178. *Geyer v. Ingersoll Publications Co.*, No. 12406, 1992 Del. Ch. LEXIS 132, at *8-12 (Del. Ch. June 16, 1992).

specifies that "an entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business,"¹⁷⁹ is analogous to the condition of an uncured default or the failure of performance on a credit obligation. The key distinction between default and this definition of insolvency is the issue of timing, in the sense that an entity may become insolvent long before it actually defaults on any obligation. Definition 2, providing that "an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held,"¹⁸⁰ may be conceptually likened to the prospect of a future default.

In this manner, the two definitions offered by Chandler and Webster's Dictionary can be characterized as tests which indicate either (a) an actual, uncured default or (b) a likely prospective default by a corporation with respect to its long-term credit obligations. No help is available on the concept of default from the Uniform Commercial Code, which does not define the term but instead leaves the contracting parties free to negotiate the conditions which will constitute nonperformance. There is however, a useful framework offered by an unlikely source—the Uniform Consumer Credit Code (UCCC). The UCCC permits the default provisions of a consumer credit agreement to be enforced only when either (1) the borrower has failed to make a payment when due,¹⁸¹ or (2) the likelihood of payment, performance, or realization of collateral is significantly impaired.¹⁸² The burden for establishing the prospect of a significant impairment is on the creditor.¹⁸³

This model provision for dealing with defaults on consumer credit obligations offers a starting point for the development of a meaningful corporate law standard for determining when directors should owe fiduciary duties to creditors. Subsection (1) can be adapted to address the primary concern of all creditors—that the borrower avoid uncured defaults. Such defaults include the failure to make payment when due and, in sophisticated credit arrangements, the failure to meet and maintain the financial covenants and warranties which are a part of the agreement. A violation of this section should operate to create *per se* fiduciary duties for the benefit of creditors.

Subsection (2) could similarly be developed into a more useful articulation of the notion that an entity is insolvent when its liabilities exceed its assets. Such a standard could provide that a corporation is insolvent when both (a) the fair market value of its assets are less than the fair market value of its

179. *Id.* at *13.

180. *Id.*

181. UNIFORM COMMERCIAL CREDIT CODE § 5-109(1) (1974).

182. *Id.* § 5-109(2).

183. *Id.* The second comment following § 5-109 emphasizes that the creditor bears the responsibility for proving the possibility of nonperformance as a result of insolvency of the borrower:

A second type of default relates to behavior of the consumer which endangers the prospect of a continuing relationship. It may be insolvency, illegal activity, or an impending removal of assets from the jurisdiction. There must, however, be circumstances present which significantly impair the relationship. The burden of proof is on the creditor to justify his action on a claim of default of this type.

Id. § 5-109, cmt. 2.

liabilities,¹⁸⁴ and (b) the prospect of payment, performance, or realization of a creditor's collateral is significantly impaired. As with the UCCC, it seems reasonable for creditors to bear the burden of establishing both points under subsection (2).

CONCLUSION

The issues of whether the directors of a corporation facing the prospect of insolvency owe duties to corporate creditors, as well as how such a condition may be determined, are troubling and in need of clarification. One means of doing so rests with the Delaware legislature. The Delaware General Corporation Law could be amended to provide a clear, useful standard for determining the condition of corporate insolvency. Similarly, an amendment could provide language specifying whether directors will owe duties to corporate creditors upon the fact of insolvency or upon the existence of some other financial condition or event. Such an amendment is easily justified since the present uncertainty in the law will almost certainly deter promoters and others from choosing Delaware as a state of incorporation.

A second means of clarification rests with the Supreme Court of Delaware. When the question of directors' duties to creditors next arises, the court should take the opportunity to restate the long-settled notions of fiduciary duty and resolve the troubling issues raised by *Credit Lyonnais*. Until the issues are clarified, the directors of troubled corporations can only hope that the courts of other states (as well as the remaining members of the Delaware Court of Chancery) do not adopt the views expressed in *Credit Lyonnais*.

184. The credit obligations of many Delaware corporations are publicly traded and, as a result, their market values may fluctuate significantly. The inclusion of the fair market value standard for liabilities acknowledges the fact that many of these obligations can be repurchased in the open market at a discount.

Articles

