ABOLITION OF THE CORPORATE DUTY TO CREDITORS

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The corporation’s core objective is to further the interests of shareholders. But one judicially crafted exception has long existed. In many jurisdictions around the world, financial distress mandates a shift to a duty to creditors. In May 2007, the Delaware Supreme Court announced a modern law of duty shifting.

This Article’s prescription and reasoning break with existing law and critiques. We urge abolition of the doctrines. The result would be a duty to creditors arising upon a formal bankruptcy filing. This legal step, not “insolvency” or another financial metric, would be determinative.

Our reasoning is structural. First, the doctrines conflict with the corporate governance structure, one consisting of two alternative systems: the corporate governance system rooted in state law and the bankruptcy corporate governance system rooted in federal law. The mechanisms of the normal system promote the largely unitary interests of shareholders while those of the bankruptcy system primarily protect the disparate interests of creditors. By imposing creditor-oriented goals on corporations subject to the shareholder-oriented governance system, duty shifting mismatches ends and means.

Second, the doctrines misconceive the structure of shareholder ownership rights. Using a myopic residual claimant analysis, they ignore call option-like economic rights as well as voting and other “embedded rights” inherent in the concept of shareholder. Moreover, duty shifting imposes a unique duty on corporate debtors, depriving shareholders of property without justification, disclosure, or legal process.

Following the abolition of duty shifting, the task at hand will be to determine the optimal transition between the two governance systems.

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INTRODUCTION

In a society based on private property, the core objective of a corporation would seem uncomplicated. The corporation is owned by shareholders and, like other property, exists to further the owners’ interests. This objective should animate every material corporate decision.

For nearly two centuries, one judicially crafted exception has existed near the intersection of corporate and bankruptcy law. When a corporation reaches some stage of financial distress, but has not made a federal bankruptcy filing, the duty of directors shifts from a focus on the interests of shareholders to those of creditors.1

Until two decades ago, the exception languished in a backwater. Since its resuscitation in a sweeping new form in an opinion carrying a patina of social science, the exception has attracted enormous attention in the academy and in the real world. This is hardly surprising. These state law “duty shifting doctrines” mandate that the corporation’s current financial condition, without more, alters the corporation’s very reason for being. Similar duty shifting doctrines are found in other countries.2

1. For succinctness, we discuss primarily the most important duty shifting doctrine, although much of our discussion also applies to other doctrines. Specifically, we focus on the doctrine associated with the traditional “trust fund” analysis and its modern extensions. We do not discuss, for instance, “deeper insolveny,” wherein recovery is sought from officers, directors, and others for prolonging the life of an insolvent corporation. See, e.g., Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349 (3d Cir. 2001) (stating that “deeper insolveny” may give rise to a cognizable injury” under Pennsylvania law). The deeper insolveny doctrine appears to be falling of its own weight. In a characteristically thoughtful and witty decision, Vice Chancellor Leo Strine held in August 2006 that “Delaware law does not recognize [deeper insolveny] as a cause of action, because catchy though the term may be, it does not express a coherent concept.” Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 174 (Del. Ch. 2006). Other judges are skeptical as well. See, e.g., Seitz v. Detweiler, Hershey & Assocs. (In re CitX Corp.), 448 F.3d 672, 678 (3d Cir. 2006) (holding that deeper insolveny is not an independent cause of action); Official Comm. of Unsecured Creditors v. Rural Tel. Fin. Corp. (In re VarTec Telecom, Inc.), 335 B.R. 631, 646 (Bankr. N.D. Tex. 2005) (holding that Texas does not recognize tort of “deeper insolveny”).

2. As to related doctrines (and statutes) in other common law jurisdictions, see generally Caron Bélanger, Ernst & Young Inc. v. Wise (In re Peoples Dep’t Stores Inc.), 2004) 3 S.C.R. 461, 481–86 (Can.) (discussing “best interests of the corporation” under
Existing critiques of these doctrines are narrow in scope and incremental in reasoning. They focus on the current variants of the doctrine and sometimes proffer modifications. They tend to be grounded on practical considerations such as the doctrines’ ambiguity and on the ability of creditors to protect themselves. They do not challenge the doctrines’ overarching tenet, that a company’s financial condition should trigger changes in duty. In May 2007, for the first time, the Delaware Supreme Court in *North American Catholic Educational Programming Foundation v. Gheewalla* set out to define the modern law of duty shifting. Largely guided by existing critiques, the court subscribed to the doctrines’ overarching tenet, while stating that “insolvency” would be the trigger for their application.

Our methodology and our prescription are quite different. We focus on structure: that of the two corporate governance systems and that of at least two distinct sets of ownership rights held by shareholders. First, rather than addressing the needs of creditors through the bankruptcy governance system, a system designed for that very purpose, duty shifting imposes creditor-oriented tasks on a corporate governance system that is designed to serve the interests of shareholders. This leads to unacceptable mismatches in ends and means. Second, duty shifting fails to consider the foundational structure of either shareholder ownership rights or private property generally. The doctrines ignore “dynamic” elements of shareholder economic rights as well as voting and other ownership rights embedded in the concept of shareholder. Duty shifting imposes a unique duty on corporate debtors of a sort the law has never imposed on natural persons, with no justification. The result is to undermine deeply held understandings of the nature of private property and the proper incidents of its transfer.

Our prescription is to abolish this century-old doctrine. Regardless of financial condition, a corporation and its directors should never owe a duty to creditors, apart from constraints arising in contract and tort. Only when a corporation has passed on as a legal matter—to the heaven

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4. No. 521, 2006, slip op. at 15–16 (Del. May 18, 2007) (stating that court had “never directly addressed the zone of insolvency issue involving directors’ purported fiduciary duties to creditors”).
5. We thus exclude discussion of fraudulent behavior, inter alia. Cf. id. at 24 (distinguishing fiduciary duty claims from claims rooted in contract or tort).
or hell of federal bankruptcy law (and perhaps a reincarnation)—would matters change. A formal bankruptcy filing, unlike changes in financial condition, initiates the structural changes in governance systems and ownership rights that are essential to the proper resolution of the interests of creditors.6

A fundamental reexamination of this sort would be vital and timely, even apart from North American. Current, perhaps unprecedented, credit conditions worldwide suggest an increasing number of corporations may become insolvent and thus trigger the creditor-oriented duty shifting regime.7 On the other hand, shareholder rights are on the ascent. In the United States and abroad, seminal changes in the status of shareholders and the role of shareholder voting rights independent of shareholder economic rights appear to have begun in the past few years.8 The tension

6. We keep an open mind regarding one prebankruptcy duty directors might have to creditors: the duty to file for bankruptcy. Often directors may best serve shareholders as well as creditors by an early filing, but we do not attempt to find the answer here. Indeed, we suggest that, in our framework, the key item on the research agenda is to determine when such filings should be mandated. See infra Part V.

7. For one pessimistic view, see Steven Rattner, The Coming Credit Meltdown, Wall St. J., June 18, 2007, at A17 (stating that “money is available today in quantities, at prices and on terms never before seen in the 100-plus years since U.S. financial markets reached full flower”). Similar deterioration in corporate creditworthiness may be occurring in Europe. See Floyd Norris, Are High Credit Ratings Just a Thing of the Past?, N.Y. Times, Nov. 11, 2006, at C3 (asserting that European credit ratings are trending downward, but that trend is less advanced than in United States).


between the trend toward shareholder primacy and the asserted duties to creditors is increasing.

This Article is the first to analyze the duty shifting doctrines from a perspective that integrates corporate governance and bankruptcy governance considerations.\textsuperscript{9} That perspective leads us to propose a research agenda centering on the optimal initiation of bankruptcy proceedings.

This Article proceeds as follows. Parts I.A and I.B briefly describe the evolution of the duty shifting doctrines from that nineteenth century curiosity, the trust fund doctrine. The central point is that creditor protection via duty shifting was at its core a primordial, liquidation-oriented state common law response to the absence of federal, reorganization-oriented bankruptcy law. Part I.B concludes with an initial description of \textit{North American}. Part I.C sketches the emergence of bankruptcy law in the twentieth century, especially Chapter 11 reorganization, the type of bankruptcy chosen by the overwhelming majority of corporations of any size.\textsuperscript{10}

In Part II, we show that the duty shifting doctrines impose corporate ends that are in direct conflict with the “normal” (state law-centered) corporate governance system, while ignoring the (federal law-centered) bankruptcy governance system designed to achieve those very ends. In effect, the doctrines assign the protection of creditors to the wrong governance system.

Central to the argument is the fact that the interests of key corporate stakeholders—shareholders, creditors, management, and employees—are routinely in conflict with regard to tradeoffs between investment risk and reward, a conflict that grows more acute when the business is in financial difficulty.\textsuperscript{11} While modern finance theory and other analyses sug-

\textsuperscript{9} We are aware of only one other article that has called for a bankruptcy filing to trigger managerial duties to creditors, just published by Professors Rutherford Campbell and Christopher Frost. See Rutherford B. Campbell, Jr. & Christopher W. Frost, \textit{Managers’ Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)}, 32 J. Corp. L. 491, 522–25 (2007). It offers a helpful analysis and deploys some of the same points we make in this article. Campbell and Frost, however, ground their prescription largely on arguments rooted in the concept that “clear and efficient default rules are of the utmost importance.” Id. at 494.


\textsuperscript{11} The interests of shareholders and those of other constituencies do not always conflict, of course. Thus, from an instrumental standpoint, a corporation may further the interests of shareholders by making large (and visible) charitable donations to host

suggest that shareholders have largely unitary interests.\textsuperscript{12} Individual creditors typically vary greatly in their interests with regard to corporate risk taking. The corporate governance system offers no mechanism for resolving risk communities. In this Article, we are focusing on harder cases, where decisions do turn on which constituency matters.

In addition, when we talk of the “corporate objective,” we generally mean the core (i.e., primary) objective of the corporation. For a corporation to have as its core objective the furtherance of its shareholders’ welfare is not necessarily inconsistent with a corporation adopting as some lesser objective the promotion of the interests of nonshareholder constituencies.

This Article does not expressly analyze the general desirability of a “multiple constituency” philosophy or other corporate “social responsibility” matters. See infra note 16 (discussing how views we express in this Article are largely independent of multiple constituency issue). We believe this is appropriate for three reasons. First, the sole exception to the core duty to shareholders recognized in Delaware and most other states is that flowing from duty shifting. Irrespective of how one stands on corporate “social responsibility” generally, this exception exists as a matter of law and must be addressed. Second, Delaware and most other states have long rejected the “multiple constituency” approach and, if anything, have become more focused on the interests of shareholders in the past few years. Third, and perhaps most important, it is the rare public corporation that takes seriously the concept of a core duty to multiple constituencies; this is especially unlikely in today’s environment of hedge funds, private equity funds, and shareholder activism. Professor Robert Charles Clark recently noted that it does not appear that directors and officers ever consider a “multiple constituency” approach and, instead, “simply assume or state that the main effort is to maximize shareholder value.” Robert C. Clark, Major Changes Lead Us Back to Basics (A Response to the Symposium on My Treatise), 31 J. Corp. L. 591, 596 (2006). For a classic critique of a “multiple constituency” philosophy, see Comm. on Corporate Laws, Other Constituencies Statutes: Potential for Confusion, 45 Bus. Law. 2253 (1990); see also David A. Skeel, Jr., Icarus and American Corporate Regulation, 61 Bus. Law. 155, 175–76 (2005) (opposing multiple constituency approach to corporate law). But see Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247, 248–57 (1999) (advocating “team production” approach to understanding public corporations); see also Janis Sarra, Creditor Rights and the Public Interest: Restructuring Insolvent Corporations 101–02 (2003) (stating that, in Canada, directors act for all stakeholders).

12. At least as a starting point, in most cases, management concerned about shareholders need not consider the individual risk and time preferences of its shareholders. See Henry T. C. Hu, Risk, Time, and Fiduciary Principles in Corporate Investment, 38 UCLA L. Rev. 277, 287–95 (1990) [hereinafter Hu, Risk & Time] (arguing that using conventional capital budgeting technique generally leads to investment decisions that benefit all shareholders regardless of individual time and risk preferences); infra Parts II.B.1–2 (discussing corporate governance system and largely unitary interests of shareholders). In this Article, we focus primarily on the usual publicly held corporation. The special considerations associated with closely held corporations (such as those flowing from ill-diversified shareholders) are beyond the scope of this Article. We also assume, among other things, only one class of equity holders, all of whom are fully diversified and are concerned solely with their own material well-being. See infra Part II.B.2 (discussing stylized fact pattern involving only one class of equityholders). For a discussion of limitations to the unitary nature of the interests of shareholders, see infra note 155 and accompanying text.

In this Article, we leave aside attempts by one group of shareholders (e.g., controlling shareholders) to deprive another group of shareholders (e.g., minority shareholders) of their formal or informal ownership rights.
management conflicts among individual creditors or between shareholders and creditors.

Our analysis centers on the key task of corporate officers and directors: the deployment of current resources to achieve a future return.\textsuperscript{13} Such “investment decisions” pose special difficulties, because investments vary widely in their risk characteristics. High risk, high return projects, in research and development or otherwise, may well be shareholder-optimal and desirable to some creditors but anathema to other creditors and to management.

The often-proffered solution that directors should just maximize corporate value for the benefit of the “community of interests” of the corporation is almost meaningless. In particular, some key creditors will prefer a slow, possibly terminal, decline. Directors told to focus on creditor interests may avoid the entrepreneurial risk taking crucial to our country’s global competitiveness.

In Dearborn, the Ford Motor Company’s newly installed chief executive thinks the company is faced with two choices.\textsuperscript{14} The “safe” choice, that of plant closings and introducing a few hit vehicles but with little change in attitude, will not be enough to see the company through. The only hope for survival, he says, lies in a “full transformation” of the way Ford thinks about consumers and approaches the American market.\textsuperscript{15} Yet soon, the duty shifting doctrines may ease Ford’s directors toward the “safe” path, the one that may lead to its ultimate demise. In Michigan, in Silicon Valley, and elsewhere, mandated corporate timidity threatens the long-term viability of our economy.

The problem that the duty shifting doctrines address—management of a corporation in financial distress for the benefit of a variety of constituencies, each of which has differing interests—is precisely the focus of the bankruptcy system, including the dominant Chapter 11 reorganization pathway. In contrast to the corporate governance system, the federal bankruptcy system is predicated on, and seeks to resolve, the sharp divergence of interests among individual creditors and between creditors and other stakeholders. Control is allocated to the bankruptcy court, the public body that resolves such conflicts and is charged with a special responsibility to creditors. Thus, at whatever point creditor needs should

\textsuperscript{13} For more details about the core nature of investment decisions and a discussion of the difficulties they pose, see Hu, Risk & Time, supra note 12, at 279–80, 287–306.


\textsuperscript{15} Maynard, supra note 14.
become paramount, the corporation should file the bankruptcy petition that invokes bankruptcy governance.

In Part III, we suggest that the structure of shareholder ownership rights also requires the abolition of duty shifting doctrines. Relying on a simplistic residual claimant analysis, the doctrines assume that when a corporation becomes troubled, shareholders have lost their stake, and thus the creditors are the “real” owners.

This flies in the face of the foundational structure of ownership rights that has been in place since the emergence of the corporate form. Shareholders have broad economic rights as well as voting rights, inspection rights, rights to sue directors for fiduciary breaches, “maximization rights,” and other rights inherent to the very concept of ownership. The duty shifting doctrines misconstrue the economic rights and ignore altogether these so-called “embedded rights.”

In terms of economic rights, the doctrines rely on a static residual claimant analysis, positing that if a corporation is insolvent, shareholder claimants would receive nothing from an immediate liquidation and so no shareholder economic rights exist. In fact, immediate liquidations seldom occur. Even with deeply troubled corporations, shareholders typically enjoy the prospect of future cash flows that may arise on a change in fortunes or a change in management. These dynamic, call option-like

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16. We do not argue that the existing bundle of rights allocated to shareholders is the only possible one, but rather that the longstanding foundational structure of shareholder ownership rights should not be abandoned without compelling reasons. We also suggest that whatever rights are in the bundle at a given time should not be abrogated without transparency and due process. See infra Part III.C. We should also make it clear that we are not addressing larger questions of the social responsibility of corporations. Such questions involve social and political policies outside the scope of this Article. Comments from readers and our conversations with each other confirm to us that one does not have to be politically liberal or conservative to adopt the views we express in this Article. See also supra note 11 (discussing interests of multiple constituencies).


The “maximization right”—the right to require that management run the corporation in a way intended to maximize benefits to shareholders—is probably the most important of these embedded rights. This “maximization right” concept was introduced in Henry T. C. Hu, New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare, 69 Tex. L. Rev. 1273, 1288–1300 (1991) [hereinafter Hu, Shareholder Welfare]. However, to avoid the possibility of infinite regress, this Article’s ownership-based analysis is not dependent on the existence of this particular embedded right. It is sufficient for our purposes to rely instead on other, more structural rights, such as voting rights.
economic rights associated with the future cash flows of an ongoing corporate enterprise always have value.\textsuperscript{18}

Voting and other embedded ownership rights of shareholders are not considered at all by the doctrines’ residual claimant analysis, which implies they do not exist or have any value. In actuality, even if the company is troubled, shareholder exclusivity as to voting continues: Shareholders retain the right to select directors and approve other actions. Especially in today’s world of activist hedge funds—funds that sometimes use innovative financial techniques to acquire voting rights “decoupled” from any associated economic interest—it is now clear that shareholder voting rights have value and must be considered separately from shareholder economic rights.\textsuperscript{19} Similarly, other embedded rights continue irrespective of the company’s financial condition. For instance, shareholders continue to have the exclusive right to inspect corporate records. And shareholders continue to have the right to sue for fiduciary breaches.

The duty shifting doctrines effectively dilute or override such shareholder economic and embedded rights by imposing on the corporation and its directors a special duty to creditors—a duty not owed by any natural person. Proponents of duty shifting offer no persuasive justification for the imposition of this extraordinary duty to creditors. Moreover, the expropriation occurs automatically, without the transparency and procedural safeguards we normally demand in a market-based society.

The importance of Delaware to corporate law demands we return for a further analysis of North American in Part IV. Although North American makes the threshold for duty shifting more stringent, we suggest that the opinion mirrors conventional wisdom.

Part V suggests focal points for research relating to the protection of corporate stakeholders. Neither state corporate law nor federal bankruptcy law addresses the timing of the legal act of initiation of a reorgan-

\textsuperscript{18} The above static versus dynamic economic rights assertion does not depend in any way on “contingent claims analysis” (CCA—a branch of finance theory made possible by option pricing models), on any of the related finance theoretic scholarship, or on the validity of any related finance scholarship. Some finance theorists have used CCA analysis to analyze certain creditor-shareholder conflicts and, in doing so, viewed shareholders as call holders of some sort. See, e.g., Marc Chesney & Rajna Gibson-Asner, Reducing Asset Substitution with Warrant and Convertible Debt Issues, J. Derivatives, Fall 2001, at 39, 51 (stating that, under posited capital structure, equity “can be priced as a combination of down-and-out European calls that is similar to a vertical call spread”). For an introduction to call options and option pricing models, see Henry T. C. Hu, Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism, 102 Yale L.J. 1457, 1464–76 (1993) [hereinafter Hu, Misunderstood Derivatives].

As to the matter of options always having value, see infra note 221 and accompanying text.

\textsuperscript{19} See, e.g., Hu & Black, The New Vote Buying, supra note 8, at 814–19 (discussing recent emergence of this phenomenon and independent significance of shareholder voting and economic rights). This Article does not purport to address all of the implications of such decoupling. See infra Part V.
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zation proceeding. If, as we believe, this initiation is the proper point for duty shifting, it becomes clear that research should focus on the optimal transition between the two governance systems.

I. BACKGROUND

A. Overview: Three Duty Regimes and Two Host Governance Systems

Corporations are subject to three “duty regimes,” two under state corporate law depending solely on financial condition and a third under federal bankruptcy law depending solely on a legal filing. State corporate law governs all corporations, irrespective of financial condition, that have not filed for bankruptcy and generally assumes that shareholders are the key constituency. Corporations that have filed for bankruptcy are subject to federal bankruptcy law. Upon filing, federal bankruptcy law makes creditors the key constituency. Corporations that have not filed for bankruptcy, but are in a financial condition deemed sufficiently parlous, are subject to duty shifting. In the seminal 1991 case of Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., Chancellor William Allen stated that for corporations in the “vicinity of insolvency” the duties of management shift from shareholders to the full “community of interest[s]” of the corporation—a combination of the interests of creditors and stockholders, and perhaps others. In the May 2007 North American case, the Delaware Supreme Court modified the Credit Lyonnais trigger, stating that “actual insolvency” was needed before duty shifting arises. The duty shifting doctrines thus add a “shifted state duty regime” to the normal state duty regime and the federal bankruptcy duty regime.

Even though there are three duty regimes, there are only two “host” governance systems. The corporate governance system applies to all corporations that have not filed for bankruptcy. Thus, corporations subject to either the normal state duty regime or the shifted state duty regime operate under the corporate governance system. Corporations that have made a bankruptcy filing must operate instead under the different procedural and substantive rules established by the federal bankruptcy law—i.e., the bankruptcy governance system.

B. The Emergence of Modern Duty Shifting Within the Corporate Governance System

Ironically, the duty shifting doctrines can be traced to an 1824 case that had nothing to do with the corporate objective—or, indeed, even

20. See infra Part II.B; cf. supra note 11 (noting distinction between “core” and secondary corporate objectives and discussing multiple constituency issue).
21. See infra Part I.C.
24. See infra Part I.C.
any shifting of duties. Part I.B.1 and Part I.B.2 discuss, respectively, the origins of the trust fund doctrine in *Wood v. Dummer* and the genesis of duty shifting in the Delaware case of *Credit Lyonnais*.

1. **Modest Origins in the Trust Fund Doctrine.** — In *Wood v. Dummer*, Joseph Story was faced with a bank that was being dissolved. The board of directors caused the bank to declare substantial dividends, using monies vital to paying outside creditors. To protect creditors left holding worthless notes, Justice Story invented what came to be known as the “trust fund” doctrine.

Justice Story focused on what he termed “capital stock,” referring to the assets that the shareholders had put into the company: “[T]he capital stock of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank,” since “[t]he public, as well as the legislature, have always supposed this to be a fund appropriated for such purpose.” The Justice did not define the precise nature of the “pledge” or the “trust fund.” What mattered was that the dividends transferred those pledged funds to shareholders. The directors’ egregious behavior was exacerbated by the fact that this was a bank, historically an entity charged with special responsibilities and the only industry whose directors have long had genuine exposure to personal liability. Creditors could thus recover the monies from the directors.

The court did not seek to establish that the board of the bank owed a duty to run the bank in the interests of creditors. Instead, the court was concerned with using shareholder “self-help” to change the normal priority rules with respect to the disposition of corporate assets on liquidation.

25. 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,994).
27. *Wood*, 30 F. Cas. at 436.
30. Writing in 1940, Professors Merrick Dodd and Ralph Baker belittled the significance of the “trust fund doctrine”; all that Story meant “was that corporate property
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The decision, in other words, had little to do with the corporate objective and more to do with roguish behavior. Wood was an ad hoc response, a conceptually casual treatment of monies that were in the corporate till pledged in some ill-defined way to creditors. This was understandable. At the time, there was no federal bankruptcy statute and no attendant mechanisms for ensuring creditor priorities in bankruptcy.31

The excuse fit into the financial and legal context of the time. In the nineteenth century, “capital stock” and the related notion of paid-in capital were considered to have a colorable claim as creditor protection devices.32 Shares of stock had to have par value. Each share of the corporation’s capital represented the surrender to the corporation of a sum of money (or other property) that should persist throughout the existence of the corporation.33 Shareholders were forbidden from invading that amount for dividends, and the creditors could expect that amount to be on hand unless consumed by legitimate losses.34

Of course, such devices could do little to protect creditors. Among other things, there was no segregated “lockbox” to safeguard funds collected from shareholders. Instead, such funds were simply used to run the business and thus subject to the vagaries thereof. Moreover, as a practical matter, suspect valuations were often used for paid-in capital purposes.35

must be first appropriated to the payment of the debts of the company before there can be any distribution of it among stockholders—a proposition that is sound upon the plainest principles of common honesty.” Dodd & Baker, supra note 26, at 895.

31. The Bankruptcy Act of 1800 was repealed in 1803, and the next federal bankruptcy statute would not be adopted until 1841. It was 1898 before the United States began to have a continuous federal bankruptcy system. Theodore Eisenberg, Bankruptcy and Debtor-Creditor Law 216 (3d ed. 2004); Elizabeth Warren & Jay Lawrence Westbrook, The Law of Debtors and Creditors 108 (5th ed. 2005) [hereinafter Warren & Westbrook, Text, Cases & Problems]. Not coincidentally, Justice Story, in the years after Wood, was a leading advocate of adoption of a federal bankruptcy law. According to his son, he actually drafted the bill that became the 1841 Act. 2 Life and Letters of Joseph Story 407 (William W. Story ed., 1851).

This response was also understandable as a way of reaching the right result in the face of poorly drafted pleadings. See Bayless Manning & James J. Hanks, Jr., Legal Capital 31 (3d ed. 1990) (deeming Justice Story’s Wood opinion “simple, clear and wholly adequate for the particular problem with which he was confronted”); Norton, supra note 28, at 1062–63 (describing bill in equity as “poorly written”).

32. For an amusing discussion of this historical context, see Manning & Hanks, supra note 31, at 20–43.


34. One of the leading English cases was Trevor v. Whitworth, (1887) 12 App. Cas. 409, 411 (H.L.) (appeal taken from C.A.) (“[N]o reduction of capital otherwise than as allowed by statute is legitimate.”).

35. See Dewing, supra note 33, at 25–26 (arguing that aggregate par value representations are suspect).
The abandonment of such devices began in 1912, when New York passed the first state statute allowing the issuance of no-par value stock. By 1928, substantially all states permitted the issuance of no-par value stock for at least certain corporations. By 1980, the Model Business Corporation Act was revised to eliminate the concept of par value. Today, few corporations have stock with more than nominal par value, so the creditors’ “fund” represented by “paid-in capital” has virtually disappeared.

The trust fund doctrine fared almost as badly as its first cousin, par value. As early as 1893, the Supreme Court was getting skittish, emphasizing that the trust fund doctrine does not mean that “there is a direct and express trust attached to [corporate property].” By 1983, one Fifth Circuit opinion endorsed the notion that “[p]erhaps no concept has created as much confusion in the field of corporate law.”

In Delaware, the trust fund doctrine has an uncertain status. There is only one Delaware Supreme Court case touching on the doctrine, Bovay v. H.M. Byllesby & Co., and that 1944 case involved a “story of corporate financing and manipulation . . . somewhat extraordinary even for the period that ended so abruptly in October, 1929.” From its inception in 1928, a toll bridge company had been financially incapable of completing the toll bridge for which it was organized because of the promoters’ massive diversions of corporate funds; six years later, a federal district court adjudged it bankrupt.

While discussing the promoters’ fiduciary responsibilities, the court referred to the trust fund notion:

An insolvent corporation is civilly dead in the sense that its property may be administered in equity as a trust fund for the benefit
of creditors. The 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. The execution of a trust and the following and administering of trust funds are immemorial heads of equity jurisprudence.\(^44\)

The facts did not involve issues relating to the managers' breach of either the duty of care or the duty of loyalty. As in *Wood v. Dummer*, the case presented the crass diversion of funds unquestionably belonging to others. In addition, the *Bovay* court believed the doctrine was applicable only when the corporation is "dead."\(^45\) A final settling up of accounts, informed by such doctrine, is incident to proper burial. In other words, the court confined the doctrine to a corporation's termination.\(^46\)

The 1974 case of *Harff v. Kerkorian*\(^47\) was the first indication Delaware courts might move toward a sort of duty to creditors beyond those provided for by contract, but neither the Delaware courts\(^48\) nor the

\(^{44}\) Id. at 813 (citations omitted).

\(^{45}\) Id.

\(^{46}\) Today this common law doctrine has been displaced with respect to the termination of corporations by state statutory law relating to the "winding up" of corporations and by federal bankruptcy law. If shareholders wish to terminate a corporation outside of bankruptcy, the directors must follow specific statutory rules about notifying creditors, paying creditors, and distributing remaining property to shareholders. See, e.g., Rev. Model Bus. Corp. Act §§ 14.02, 14.06, 14.09(a) (2005); cf. Pac. Scene, Inc. v. Penasquitos, Inc., 758 P.2d 1182, 1183 (Cal. 1988) (stating that "Legislature has generally occupied the field with respect to the remedies available against the former shareholders of dissolved corporations, thus preempting antecedent common law causes of action"); Rev. Model Bus. Corp. Act § 14.05 official cmt. (stating that winding up process under Revised Model Business Corporations Act "does not have any of the characteristics of common law dissolution"). However, because of the ubiquity of bankruptcy law in the United States in the last century, use of winding up for insolvent corporations has been less important. In the United Kingdom, where business bankruptcy law is treated as part of corporate law, winding up is the customary "bankruptcy" process for insolvent corporations. See Roy M. Goode, Principles of Corporate Insolvency Law 19 (3d ed. 2005) (noting that usual method of insolvency proceedings in United Kingdom is winding up); Harry Rajak, Company Liquidations, at vii (1988) (remarking that winding up is usual course for insolvent corporations in United Kingdom).

\(^{47}\) 324 A.2d 215 (Del. Ch. 1974), rev'd on other grounds, 347 A.2d 133 (Del. 1975). The single corporate act challenged was the declaration of a dividend of $1.75 a share by Metro-Goldwyn-Mayer the previous year. The plaintiffs, holders of convertible subordinate debt, did not allege fraud or that the dividends violated either the governing indenture or any Delaware statute. Instead, the plaintiffs argued that defendants breached their fiduciary duty to the plaintiffs since defendants were the controlling stockholders and such dividends on the common stock hurt the market value of their debentures and the conversion feature. Id. at 221. Without citing *Bovay*, the trust fund doctrine, or offering much by way of analysis, the court suggested the possibility of debenture holders having extracontractual rights when there were "special circumstances" such as "fraud, insolvency, or a violation of a statute." Id. at 221–22. Nowhere did the *Harff* court suggest that these extracontractual rights involved a fiduciary duty to creditors.

\(^{48}\) See, e.g., Simons v. Cogans, 542 A.2d 785, 788 (Del. Ch. 1987) (quoting with approval 1987 chancery court opinion that "'(i) a debenture holder has no independent
courts in other states could be fairly characterized as recognizing the furtherance of creditor interests as one of the core corporate objectives. That is, until Credit Lyonnais.

2. Credit Lyonnais, the Delaware Chancery, and the Core Business Decisions of Corporations. — Credit Lyonnais represented a sharp break with prior creditor-duty cases and the trust fund doctrine from which they emerged. Substantially all the prior cases centered on roguish deviations from priority rules for the distribution of corporate assets. Instead of parceling out the assets properly, directors succumbed to near-larcenous behavior, especially in the end game. These earlier cases centered on attempts to evade priority rights, generally in the liquidation context. By contrast, Credit Lyonnais centered on the deployment of corporate assets to achieve future returns—that is, on the corporation’s investment decisionmaking. This focus moved judges from the familiar role of adjudicating rights of rival claimants to a fixed pool of assets to the novel, grander role of overseeing the core business decisions of corporations.

right to maintain a claim for breach of fiduciary duty and (ii) in the absence of fraud, insolvency or a statutory violation, a debenture holder’s rights are defined by the terms of the indenture” (quoting Cont’l Ill. Nat’l Bank & Trust Co. v. Hunt Int’l Res. Corp., No. 7888, 1987 WL 55826, at *4 (Del. Ch. Feb. 27, 1987)), aff’d, 549 A.2d 300 (Del. 1988). The Delaware Supreme Court expressly predicated the existence of any fiduciary duty owed by management on an “existing property right or equitable interest supporting such a duty”; until a debenture is converted into stock, the holder has no equitable interest and remains a creditor “whose interests are protected by the contractual terms of the indenture.” 549 A.2d at 304. The court also noted that “an equitable interest in the issuing corporation [is] necessary for the imposition of a trust relationship with concomitant fiduciary duties.” Id. at 303.

49. With perhaps one major exception, all of the decisions in which courts have allowed recovery on such grounds involved directors of an insolvent corporation diverting corporate assets for the benefit of insiders or preferred creditors. Professor Laura Lin groups the cases as follows:

(1) withdrawing assets from the insolvent corporation as alleged payment of claims that the directors had against the corporation, such as loans to the company or unpaid commissions; (2) using corporate funds to pay off the company’s loans that the directors had personally guaranteed; (3) engaging in transactions, usually without fair consideration to the company, for the benefit of its parent corporation or related entities; (4) pocketing the proceeds of a sale of all corporate assets to a third party or otherwise transferring property to a related entity, leaving the former corporation insolvent; and (5) other forms of self-dealing in which the directors use assets of the insolvent firm for their own benefit, such as pledging stock owned by the corporation as collateral to finance the directors’ personal stock purchases.


50. It is nonetheless noteworthy that the example used in Credit Lyonnais assumes a “dead” corporation, just like the carcasses in Wood and Bovay.
Priority decisions relate to the distribution of assets. Investment decisions, by definition, involve the use of assets, not their distribution. They determine how the corporation will deploy its assets to generate future value, value that may itself be distributed or invested yet again. Investment decisions are perhaps the most important ones made by corporate managers, animating all aspects of a corporation’s operations. They are also among the most difficult, since investments vary in their risk and time characteristics. This move from priority preservation to scrutiny of investment decisions represented a radical break of another sort as well, implicating control of the corporation, the theme centrally important to both the corporate and bankruptcy governance systems.

Chancellor Allen did not rely on prior corporate case precedent in his Credit Lyonnais opinion. Instead, he resorted simply to his understanding of moral hazard, a conflict of interest long familiar to economists.

Credit Lyonnais involved MGM-Pathe Communications Co. (MGM), a Delaware corporation that emerged in connection with a leveraged buyout. Within months of Pathe Corporation (Pathe) acquiring a controlling interest in MGM, MGM’s trade creditors forced MGM into bankruptcy court. Credit Lyonnais Bank Nederland (the Bank) was a lender to both MGM and Pathe. In connection with the Bank’s attempts to finance MGM’s escape from bankruptcy, the Bank installed its own management team. Following bankruptcy, Pathe, the controlling shareholder, challenged the bank-influenced management group’s refusal to sell MGM’s interest in UIP, a foreign movie distribution consortium, and to engage in certain other transactions. Pathe believed these sales would have been advantageous to it and that the refusal constituted a violation of fiduciary duty.

51. For a discussion of corporate “investment decisions” and their importance, see Hu, Risk & Time, supra note 12, at 279–81.

52. In fact, Credit Lyonnais not only intervenes as to investment decisions, but also as to the other major class of managerial decisions—financing decisions. For the distinction between investment decisions and financing decisions, see, for example, Hu, Risk & Time, supra note 12, at 279 & n.1 (characterizing investment decisions as “any use of current resources to achieve a future return” and financing decisions as, roughly speaking, “how the corporation obtains the money”).

53. For a discussion of this control versus economic rights theme in both the corporate governance system (i.e., voting rights versus economic rights) and the bankruptcy governance system (i.e., control versus priority), see infra Parts II.C–D, III.B. We have also independently considered this theme previously in our respective fields. In the context of the bankruptcy governance system, see Jay Lawrence Westbrook, The Control of Wealth in Bankruptcy, 82 Tex. L. Rev. 795, 797 nn.3–4 (2004) [hereinafter Westbrook, Control]; see also Goode, supra note 46, ¶¶ 2402 to 408. In the context of the corporate governance system, see Henry T. C. Hu & Bernard Black, Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms, 61 Bus. Law. 1011, 1013–14 (2006) [hereinafter Hu & Black, Taxonomy]; Henry T. C. Hu & Bernard Black, Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership, 13 J. Corp. Fin. 343, 353–55 (2007) [hereinafter Hu & Black, Decoupling].
Chancellor Allen rejected this claim, but it was unclear on what ground. He stated that there was “persuasive evidence” that the management group “acted prudently with respect to these transactions from the point of view of MGM,” and that in the troubled circumstances of this company, the management group was “appropriately mindful of the potential differing interests between the corporation and its 98% shareholder.” He described the existing law as follows: “At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the [residual] risk bearers, but owes its duty to the corporate enterprise.”

Thus, in this “vicinity of insolvency”—whatever that might mean—the board “had an obligation to the community of interest[s] that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation’s long-term wealth creating capacity.”

Chancellor Allen nowhere offered any case or statute in support of his assertions. His support consisted of a footnote setting out his version of a familiar analysis of a conflict between shareholders and creditors involving moral hazard: If shareholders perceive that they have little or nothing to lose, they will want the corporation to engage in “Hail Mary” risk taking that would ordinarily be rejected under normal risk-versus-return investment methodologies (e.g., a high risk, high return project that has a negative net present value).

55. Id. at *34.
56. Id. It seemed clear that Credit Lyonnais created a shield for directors, not a sword to be used against them. Indeed, several years after Credit Lyonnais, shortly before resigning from the bench, Chancellor Allen offered dicta that appeared to exclude duty shifting as a sword in the hands of creditors. See Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1041 (Del. Ch. 1997).
57. The famous footnote follows:

<table>
<thead>
<tr>
<th>Chance of Affirmance</th>
<th>Expected Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>25% chance of affirmance</td>
<td>($51mm)</td>
</tr>
<tr>
<td>70% chance of modification</td>
<td>($4mm)</td>
</tr>
<tr>
<td>5% chance of reversal</td>
<td>($0)</td>
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</tbody>
</table>

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 bondhold-
cate the relationship between this conception of directorial duties and the business judgment rule. Nor did he offer a general rule for the resolution of conflicting interests within this corporate community.58

The chancery court continued to adhere to duty shifting, albeit with evident discomfort. The November 2004 opinion in Production Resources Group L.L.C. v. NCT Group, Inc.59 set the table for the Delaware Supreme Court.60

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 $15.5 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.

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

58. Although Chancellor Allen’s litigation example implicitly weighs conflicting interests, there is no reason to believe that those weights were meant to (or even can be) used in nonlitigation contexts. See infra Part II.C.2.

59. 863 A.2d 772, 790–91 (Del. Ch. 2004). In this case, Production Resources had obtained a judgment against NCT Group, Inc., but had been unsuccessful in collecting the judgment. Production Resources claimed NCT was insolvent and sought to protect its interests by the appointment of a receiver for NCT under Delaware law. Production Resources also alleged that NCT’s board and one of its officers had breached their fiduciary duties. Credit Lyonnais and the trust fund doctrine came up in a procedural context: NCT claimed that this fiduciary breach count raised derivative claims that Production Resources had not properly pled. If the nature of the claim was direct, rather than derivative, the count would not be barred. See also U.S. Bank Nat’l Ass’n v. U.S. Timberlands Klamath Falls, L.L.C., 864 A.2d 930, 947–48 (Del. Ch. 2004) (“[D]irectors’ or managers’ fiduciary duties may extend to the interests of the company’s creditors when the company is in the ‘zone of insolvent’y.”), vacated, 875 A.2d 632 (Del. 2005); Odyssey Partners, L.P. v. Fleming Cos., 735 A.2d 386, 417 (Del. Ch. 1999) (“[W]hile directors normally do not owe creditors fiduciary duties, an exception exists in the case of insolvency . . . .” (citing Geyer v. Ingersoll Publ’ns, 621 A.2d 784, 787 (Del. Ch. 1992))); Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997) (discussing interests of common stockholders relative to those of preferred stockholders); Haft v. Haft, 671 A.2d 413, 422 (Del. Ch. 1995) (discussing inefficiencies of proxy voting); Geyer, 621 A.2d at 787
Court decision in North American, which relied heavily on its reasoning.\textsuperscript{60} In Production Resources, Vice Chancellor Strine questioned the Credit Lyonnais “vicinity of insolvency” financial trigger for duty shifting: He “doubt[ed] the wisdom of a judicial endeavor to second-guess good-faith director conduct in the so-called zone.”\textsuperscript{61}

However, Production Resources adopted duty shifting’s defining tenet that financial condition determines changes in fiduciary duty. When a firm has become insolvent, “it is settled that under Delaware law” the directors owe fiduciary duties to the creditors because the “residual claimants” of corporate assets are the constituency to which directors owe their allegiance. Before insolvency, the residual claimants were the shareholders; after insolvency, they were the creditors. The fiduciary duty was never owed to shareholders because of ownership, but rather because of their residual claimant status.\textsuperscript{62}

While Production Resources adopted a financial trigger more stringent than Credit Lyonnais, one federal bankruptcy court in Massachusetts went far in the other direction, holding that even financially sound corporations may be subject to duty shifting. In In re Healthco International, Inc., that bankruptcy court, applying state corporate law, held that directors of such corporations had a duty to creditors not to engage in a leveraged buyout if it created an “unreasonable risk of insolvency.”\textsuperscript{63} Under this approach, even healthy corporations can be subject to the state’s shifted duty regime, in which judges may substantially scrutinize the directors’ core business decisions.

3. The Literature. — Credit Lyonnais has proven an irresistible topic. By mid-2006, over 150 law review articles in the United States had cited the case.\textsuperscript{64} For practitioners, the decision and its progeny substantively changed the law with profound consequences. Their writings in innumerable memos to clients and in the legal literature generally focused on helping clients reduce litigation risk, critiquing the case law foundations

\footnotesize{\textsuperscript{60} N. Am. Catholic Educ. Programming Found. v. Gheewalla, No. 521, 2006, slip op. at 17–24 (Del. May 18, 2007) (discussing court of chancery’s opinion in Production Resources).}
\footnotesize{\textsuperscript{61} Prod. Res. Group, 863 A.2d at 790 n.57. Vice Chancellor Strine said, elegantly and accurately, that he did not need to “explore the metaphysical boundaries of the zone of insolvency” because the company was insolvent. Id. at 790.}
\footnotesize{\textsuperscript{62} Id. at 790–91.}
\footnotesize{\textsuperscript{63} Brandt v. Hicks, Muse & Co. (In re Healthco Int’l, Inc.), 208 B.R. 288, 302 (Bankr. D. Mass. 1997) (involving suit brought by trustee in bankruptcy on behalf of corporation but in interest of creditors). See infra Part I.E (warning that worthwhile “bet the company” risk taking may be precluded if Healthco is followed). It is worth noting that the corporation in Chancellor Allen’s example in Credit Lyonnais was solvent, albeit comatose and with no business to operate.}
\footnotesize{\textsuperscript{64} This is based on a search of the “U.S. Law Reviews and Journals, Combined” database on Lexis on August 4, 2006. Using the phrase “credit lyonnais /10 pathe” generated 160 items.}
for *Credit Lyonnais*, and complaining about the ambiguity of terms like “vicinity of insolvency.”

For legal academics, Chancellor Allen’s opinion had special resonance. Fully a decade before *Credit Lyonnais*, one academic had already noted the problem of firms “on the brink of insolvency” and suggested that the problem “might be avoided by a concept of corporate duty of officers and directors to the abstract firm, not just to its shareholders.”

Moreover, Chancellor Allen reached his decision not through the usual doctrinal analysis, but simply through the magic of social science. Legal academics thus had a poster child for dwelling on theoretical matters they found interesting rather than the rules “just-the-law” students usually preferred. Besides, this was social science at just the right level: no Greek letters or formal models, just arithmetic and a concrete litigation hypothetical.

Academics were also attracted to the as-if liquidation residual claimant analysis of the sort set out in *Production Resources*. Relying on moral hazard and as-if liquidation residual claimant themes, numerous academic analyses have almost treated duty shifting as being mandated by informed common sense. A recent corporate hornbook illustrates:

It makes sense to impose fiduciary duties to bondholders on the boards of such companies [in or near insolvency], because insolvency is a paradigmatic final period situation in which the market constraints characteristic of repeat transactions are inoperative. In addition, because a common outcome of bankruptcy reorganization is the effective elimination of existing shareholders and the issuance of equity in the post-reorganization firm to bondholders, the effect of insolvency is to render bondholders the de facto residual claimants.

Academic writings have sometimes helped clarify our understanding of duty shifting. Some have offered additional rationales for duty shifting, largely based on the need for paternalism and fairness to particular constituencies. To the extent academics have criticized duty shifting,

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66. Stephen M. Bainbridge, Corporation Law and Economics 431 (2002); see also Sabin Willett, The Shallows of Deepening Insolvency, 60 Bus. Law. 549, 561 (2005) (viewing insolvent company as “dea[d]” and its owners as having no real interest in it); cf. Janis Sarra, Taking the Corporation past the ‘Plimsoll Line’—Director and Officer Liability When the Corporation Founders, 10 Int’l Insolvency Rev. 229, 233–34 (2001) (asserting residual claimant justification for duty shifting in context of Canadian doctrine). The statements set out in the text represent the classic conflating of insolvency, an economic state, and bankruptcy, a legal proceeding. In a recent essay, Professor Bainbridge appears to have modified his views on duty shifting somewhat, but continues to subscribe to duty shifting’s vision that shareholders are nothing more than as-if liquidation residual claimants. See Stephen M. Bainbridge, Much Ado About Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency, 1 J. Bus. & Tech. L. 335 *passim* (2007).
however, they have done so largely on practical grounds. They typically rely on the uncertainties of a "vicinity of insolvency" standard, or on the ability of many creditors to protect themselves ex ante. The criticism does not look beyond the boundaries of the individual corporation and its constituencies and examine the "host" governance systems in which corporations operate.

The criticism has also generally been modest in its prescriptions. Even skeptics generally accept the duty shifting doctrines’ defining tenet that a company’s financial condition triggers duties to creditors. The analyses center on the proper financial trigger: Should it be insolvency, zone of insolvency, or some other yardstick? Overall, the criticism has

(discussing rationales for duty shifting with respect to performance creditors); Andrew Keay, Directors’ Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors, 66 Mod. L. Rev. 665, 693–98 (2003) (discussing rationales for duty shifting with respect to employees, customers, involuntary creditors, and many trade creditors); Lipson, supra note 49, at 1245–48 (discussing rationales for duty shifting with respect to tort and wage claimants).

We are sympathetic to the special needs of constituencies such as involuntary creditors but feel that any accommodation for those needs must be based on approaches far more finely tuned than duty shifting. See infra note 268 (elaborating on this and discussing pertinent bankruptcy statute provisions).


One recent article claims that a corporation’s use of net present value in deciding on investments would “[serve] the interests of all corporate constituencies.” See Remus D. Valsan & Moin A. Yahya, Shareholders, Creditors, and Directors’ Fiduciary Duties: A Law and Finance Approach, 2 Va. L. & Bus. Rev. 1, 4 (2007). As to their critical claim that “maximizing the value of the firm is functionally equivalent with maximizing shareholder value,” Valsan and Yahya note that one of the authors of this Article has “a different opinion” and outlines that opinion. Id. at 40 & n.108 (referring to Hu, Risk & Time, supra note 12). On there being a difference in opinion, we agree. Valsan and Yahya fail to address a number of crucial matters, including differences between diversifiable and nondiversifiable risk, the impact of shareholder diversification on how net present value calculations should be adjusted for risk, and corporate decisions that are not translatable into net present value terms. The closest Valsan and Yahya come to addressing the issue of diversifiable versus nondiversifiable risk appears at the end of footnote 157, wherein they appear to assume away conflicts between diversified shareholders and creditors on the ground that shareholders in a corporation would also hold bonds in the corporation—and in just the right amounts. Id. at 49 n.157.
been based on incremental improvements to existing duty shifting doctrines.

4. The Delaware Supreme Court’s Synthesis: North American. — Although Credit Lyonnais redefined the central principle of corporate law and the role of judges with respect to corporate decisionmaking, until recently the Delaware Supreme Court had never cited Credit Lyonnais. Although most courts and litigants appear to have assumed that Credit Lyonnais’s expansive duty shifting notions constituted Delaware law, in May 2007, the Delaware Supreme Court decided North American Catholic Educational Programming Foundation v. Gheewalla, modifying the financial trigger adopted by Credit Lyonnais but accepting its overarching theme of duty shifting.

In North American, the plaintiff asserted claims against the defendant directors of a company called Clearwire, including breach of fiduciary duty. The claims arose from a failed project to acquire spectrum licenses from the plaintiff and others. The fiduciary breach allegedly arose from, among other things, stringing out the business after it was apparent Clearwire’s project could not go forward. The plaintiff alleged that the defendant directors owed it fiduciary duties as creditor because Clearwire was “either insolvent or in the ‘zone of insolvency.’” The plaintiff could

69. Indeed, its 2003 opinion in Omnicare, Inc. v. NCS Healthcare, Inc. could be read to reject duty shifting, although it did not cite Credit Lyonnais. In Omnicare, the majority noted:

Notwithstanding the corporation’s insolvent condition, the NCS board had no authority to execute a merger agreement that subsequently prevented it from effectively discharging its ongoing fiduciary responsibilities.
The stockholders of a Delaware corporation are entitled to rely upon the board to discharge its fiduciary duties at all times. The fiduciary duties of a director are unremitting and must be effectively discharged in the specific context of the actions that are required with regard to the corporation or its stockholders as circumstances change.

818 A.2d. 914, 938 (Del. 2003) (citations omitted).

70. For example, a June 2006 bankruptcy opinion indicates that, notwithstanding the critical nature of the issue, none of the parties even tried to dispute that Delaware law imposed fiduciary duties to creditors once a corporation was operating in the “vicinity of insolvency.” Official Comm. of Unsecured Creditors of Verestar, Inc. v. Am. Tower Corp. (In re Verestar, Inc.), 343 B.R. 444, 471 (Bankr. S.D.N.Y. 2006). In a July 2005 opinion, the chief judge of the District of Delaware’s Bankruptcy Court adopted the Credit Lyonnais insolvency or “vicinity of insolvency” as the trigger for duty shifting; she neither referenced Omnicare on this issue nor gave any indication that any litigant disputed her characterization. Liquidation Trust of Hechinger Inv. Co. of Del. v. Fleet Retail Fin. Group (In re Hechinger Inv. Co. of Del.), 327 B.R. 537, 548 (Bankr. D. Del. 2005).

71. N. Am. Catholic Educ. Programming Found. v. Gheewalla, No. 521, 2006, slip op. at 20 (Del. May 18, 2007) (“When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.”).

72. Id. at 3. Importantly, the lower court held it did not have to determine if Clearwire was insolvent or in the vicinity of insolvency, so the holding in the case must stand independent of that factual question. See N. Am. Catholic Educ. Programming Found. v. Gheewalla, No. Civ. A. 1456-N, 2006 WL 2588971, at *6 n.65 (Del. Ch. Sept. 1, 2006).
not sustain jurisdiction against the defendants in Delaware unless it had a right to assert the fiduciary breach directly against them. A derivative claim would have been insufficient to sustain jurisdiction. The supreme court held, as a procedural matter, that creditors would not have standing to bring a direct claim against directors, whether the corporation was insolvent or near-insolvent, and therefore the case must be dismissed for want of jurisdiction.\textsuperscript{73} That was the extent of its holding, strictly speaking.

The court’s dicta were far more interesting—it accepted duty shifting for the first time and prescribed the financial trigger for its application. In particular, the court rejected Credit Lyonnais’s “zone of insolvency” trigger in favor of the more precise (and stringent) trigger of “insolvency.”\textsuperscript{74} This was explicitly premised on the ambiguity of a “zone of insolvency” standard,\textsuperscript{75} a central focus of discussion in earlier cases and in the literature.

The court went on to suggest that the insolvency trigger gave creditors rights beyond those given them by contract and tort.\textsuperscript{76} When a corporation is insolvent, creditors are the “‘principal constituency injured by any fiduciary breaches that diminish the firm’s value’” and thus would have standing to maintain derivative claims against directors for alleged breaches of fiduciary duties.\textsuperscript{77}

\textit{North American} is best understood as a predictable crystallization of conventional wisdom and existing judicial analysis, especially the “residual claimant” analysis of Vice Chancellor Strine in \textit{Production Resources}. We return to \textit{North American} after working through the underlying difficulties.\textsuperscript{78}

Viewed from a historical perspective, duty shifting has undergone a remarkable transformation. From their emergence nearly two centuries ago, the doctrines centered on roguish behavior in the \textit{distribution} of as-
sets of dead corporations. Evasions from priority rules, often reeking of fraud, were the target. By contrast, modern incarnations centered on the deployment of assets by ongoing enterprises. As we have already seen, cases such as Credit Lyonnais and North American place judges in the role of reviewing the core business decisions of troubled corporations. This is bad enough. As we shall see, the creditor-oriented standards adopted for such judicial reviews make the doctrines untenable.

C. The Emergence of the Bankruptcy Governance System and Its Essential Conflict Resolution Functions

Bankruptcy law was ignored in Credit Lyonnais and mentioned only in passing in North American, which seems quite odd given that the concept of insolvency is central to the duty shifting doctrines. That myopia, failing to see the close connections between corporate law and bankruptcy law at the insolvency border, explains much of the confusion created by those doctrines.

Part of the explanation is historical. Bankruptcy law is relatively young. There was no federal bankruptcy law when Wood created the trust fund doctrine. Although the power to enact federal bankruptcy laws is one of the few specifically listed in Article I of the Constitution, it took more than a century for Congress to enact a permanent bankruptcy law, the Bankruptcy Act of 1898. Attempts during the nineteenth century produced only temporary, unsatisfactory statutes. Not until 1867 were corporations even added to the bankruptcy statute, and that statute was repealed a few years later. Thus much of the development of the trust fund doctrine evolved in the vacuum created by the absence of rules devoted to the disposition of corporate assets on insolvency.

Even in the 1898 Act, bankruptcy focused primarily on liquidation. Like the balance sheet that was its nineteenth century counterpart on the accounting side, it focused on a moment of insolvency followed by a sel-
As the reorganization of corporations became increasingly necessary, especially with regard to railroads, an entirely separate sort of insolvency proceeding developed: the equity receivership.85

Not until equity receivership collapsed during the Depression86 did Congress enact statutory reorganization procedures.87 Even then, the adopted procedures were in many ways undeveloped and rigid. Modern, flexible reorganizations had to await adoption of the Bankruptcy Code of 1978.88 The new Chapter 11 that emerged has been heavily criticized and has deserved much of that criticism. But its virtues are sufficient for it to serve as the model for reorganization law reform all over the world.89

Under the Bankruptcy Code, both natural persons and legal entities may choose between sellout or payout. Liquidation for corporations (sellout) is generally governed by Chapter 7 of the Code and reorganization (payout) by Chapter 11. In Chapter 7, a trustee in bankruptcy is appointed or elected by creditors.90 The trustee sells the property of the corporation and distributes the proceeds,91 after expenses, to the creditors according to a priority system that combines state law entitlements

84. The same thing was true of insolvency statutes around the world. Most of them, like the United States law, contained a “composition” provision, but those provisions were notoriously ill-designed and nearly useless. See generally 1 J.H. Dalhuisen, Dalhuisen on International Insolvency and Bankruptcy, pt. I, § 2.01 (1986) (describing development of corporate reorganization law and composition provisions in United States and western Europe).

85. See Lubben, supra note 82, at 1426–52 (discussing history of railroad industry receiverships in late nineteenth and early twentieth centuries); id. at 1425, 1444, 1469–70, 1471–72 (noting contemporary critics’ concerns that receivership arrangements were often characterized by collusion and self-dealing).

86. See generally Skeel, Debt’s Dominion, supra note 81, at 48–70 (discussing railroad receiverships in general).

87. Act of June 22, 1938, Pub. L. No. 75-696, 52 Stat. 840 (repealed 1978); Harvey R. Miller & Shai Y. Waisman, Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?, 78 Am. Bankr. L.J. 153, 167 (2004) (“The so-called ‘Great Depression’ of the 1930s was the catalyst for the codification of principles that had evolved in the Railroad Equity Receiverships.”); Charles J. Tabb, The Future of Chapter 11, 44 S.C. L. Rev. 791, 806 (1993) (“Chapter 11 is the product of experience. Equity receiverships were used because voluntary deals could not be made. Section 77B and then Chapters X and XI, which were designed to replace equity receiverships, were enacted for the same reason. So too with Chapter 11 in 1978.”).


89. See, e.g., Miller & Waisman, supra note 87, at 199–200 (noting that European countries are “moving] towards a reorganization model similar to . . . chapter 11”).

90. 11 U.S.C. § 701(a)(1) (“Promptly after the order for relief under this chapter, the United States trustee shall appoint one disinterested person . . . to serve as interim trustee in the case.”); § 702(b) (“At the meeting of creditors held under section 341 of this title, creditors may elect one person to serve as trustee in the case . . . .”).

91. § 704 (requiring trustee to “collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest”).
(like security interests) with bankruptcy priorities (like the one for employees).

In Chapter 11, the corporation’s management operates its business under court supervision, filing various reports and appearing regularly in court. The procedure’s goal is the adoption of a reorganization plan by a vote of the creditors organized by classes to reflect differing legal and economic interests. Creditors and other stakeholders get notice of important issues, legal and economic, and have an opportunity to object to whatever has been proposed. Shareholders are recognized as stakeholders in bankruptcy reorganization and fairly often emerge from the reorganization with an interest in the corporation, although frequently one of small value. The company’s business is managed by existing management, which exercises the powers of the Debtor in Possession (DIP), which in turn has the powers and duties of a trustee in bankruptcy, including fiduciary duties to all creditors. The supervising court is a specialized bankruptcy court within the structure of the federal district courts and exercises an exclusive federal jurisdiction over bankruptcy matters. Most cases are handled by members of a highly specialized bar. This recent, reorganization-focused procedure dominates as to corporations of any real size, although Chapter 11 can be, and often is, used for liquidation as well. The place of bankruptcy law and procedure in the resolution of the affairs of a troubled corporation is discussed in detail below.

Federal bankruptcy law did not exist at the time that state law duty shifting started to emerge. And only in recent decades has bankruptcy law fully achieved a sophisticated legal pathway for the governance of corp-

92. § 704(a) (listing trustee’s duties in administering Chapter 7 estate); 11 U.S.C.A. § 1106(a) (West 2004 & Supp. 2007) (giving Chapter 11 trustee most of duties of Chapter 7 trustee); 11 U.S.C. § 1107(a) (giving Debtor in Possession most of powers and duties of Chapter 11 trustee); § 1108 (giving Chapter 11 trustee power to operate debtor’s business).
93. § 1109(b) ("A party in interest . . . may raise and may appear and be heard on any issue in a case under this chapter."). In large cases, there is often a creditors’ committee that acts for creditors generally. § 1102 ("[T]he United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders . . . .").
95. 11 U.S.C. § 105(c); 28 U.S.C.A. § 157(b) (West 2006); 2 Collier on Bankruptcy ¶ 105.07 (rev. 15th ed. 2007).
96. Lynn M. LoPucki, The Demographics of Bankruptcy Practice, 63 Am. Bankr. L.J. 289, 311 (1989) ("Bankruptcy is probably among the most highly specialized areas of practice.").
98. See infra Part II.D.2.
porations in financial distress. This institution, Chapter 11, was specifically designed to permit management of deeply troubled corporations while addressing the widely divergent interests of individual creditors and creditor, shareholder, and other constituencies.

II. Duty Shifting and the Two Governance Systems: Incongruence of Ends and Means

Absent a bankruptcy filing, the “host” governance system for all corporations, including those subject to duty shifting, is the (normal) corporate governance system, a system largely defined by state corporate law, federal disclosure law, and related market forces. The central thrust of corporate law and scholarship for three-quarters of a century has been to ensure that self-interested agents, the managers, devote themselves to their principal, the owner-shareholders. Modern finance theory and other analyses help managers in this task, generally allowing managers to use as a starting assumption that shareholders have unitary, rather than conflicting, interests in connection with the all-important task of investment decisionmaking. The duty shifting doctrines are flatly inconsistent with the long-held aspirations of the field of corporate governance and they preclude the use of analytical techniques made possible by modern finance.

We begin with broad considerations as to risk taking, using investment decisions as the lens. We briefly discuss possible conflicts among different constituencies (e.g., between shareholders and creditors and between managers and shareholders) and among members of single constituencies (e.g., among creditors). We allude also to conflicts between shareholders and the corporation itself.

We can be more specific when we proceed to the interests of a single constituency: shareholders. Two fundamental questions arise. The first question is: What does it mean to act in the interests of shareholders, generally and in the context of investment risk taking? The answer is far from clear. We suggest that there are three foundational conceptions. One conception, commonly found in many statutes and opinions, reflects folk wisdom. This traditional conception has muddled duty shifting analysis by mistakenly assuming that the welfare of the corporation is identical to the welfare of the shareholder, in the area of risk taking and elsewhere. Two more modern conceptions are useful. As a first approximation, risk taking can be considered to be shareholder-optimal if such risk taking is consistent with either “actual shareholder wealth maximization” or “blissful shareholder wealth maximization.”

The second question is that of implementation: What actual investment decisionmaking techniques would be consistent with shareholder

99. See infra Part II.A.
100. See infra Part II.B.1.
optimaliy thus conceived\textsuperscript{101} We discuss the techniques modern finance theory offers—and one remarkable aspect of such techniques. Although a company’s shareholders will differ in their risk preferences, such differences can be largely ignored. This is fortunate. The underlying corporate governance system has no mechanisms for adjudicating such differences.

The duty shifting doctrines disrupt this equilibrium.\textsuperscript{102} First, if triggered, duty shifting requires corporations to act in the interests of creditors while the key mechanisms of the underlying governance system continue to direct managers to act instead in the interests of shareholders. Corporate ends conflict with system means.\textsuperscript{103}

Second, duty shifting requires corporations to resolve conflicting interests with respect to risk even though neither the underlying governance system nor modern finance theory offer guidance for their resolution.\textsuperscript{104} Duty shifting mandates a focus on the interests of creditors. Unlike the situation with shareholders, the interests of creditors are widely disparate with respect to corporate risk taking. New conflict adjudication responsibilities are imposed on corporations bereft of both the substantive rules and the adjudication mechanisms necessary to meet those responsibilities.

There is a simple solution: abolition of the duty shifting doctrines.\textsuperscript{105} Abolition would result in a duty to creditors arising coincident with a change to an underlying governing system specifically addressed to creditor needs. The key mechanisms of the bankruptcy governance system are largely directed at protecting the interests of creditors. Moreover, the bankruptcy system has sophisticated mechanisms for adjudicating the widely disparate interests of creditors and other stakeholders. With abolition, corporate ends would always be coupled with system means.

We integrate the foregoing analyses and address how duty shifting affects corporate risk taking.\textsuperscript{106} The overall effect is to exacerbate managers’ inherent aversion to risk and to encourage excessive worry about the corporate entity’s success or failure.

A. Stakeholder Conflicts as to Risk: Broad Considerations

Investment decisions lie at the heart of corporate management. The term “investment” comprehends any use of current resources in the hopes of achieving a future return.\textsuperscript{107} Whether the corporation is purchasing machinery, performing research and development (R&D), or

\begin{itemize}
\item \textsuperscript{101} See infra Part II.B.2.
\item \textsuperscript{102} See infra Part II.C.
\item \textsuperscript{103} See infra Part II.C.1.
\item \textsuperscript{104} See infra Part II.C.2.
\item \textsuperscript{105} See infra Part II.D.
\item \textsuperscript{106} See infra Part II.E.
\item \textsuperscript{107} Hu, Risk & Time, supra note 12, at 279.
\end{itemize}
pricing a product cheaply to break into a market, a corporation is making current sacrifices for future benefits.

Investment decisions "touch[ ] on, if not animat[e], all aspects of a corporation’s operations." By their nature, risk and time are the two key aspects of investment decisions. Stockholders, creditors, managers, and other constituencies not only have different risk and time exposures, but also have different risk and time preferences. Thus, what investment decisions should be undertaken depends critically on which constituency’s interests are to be furthered—the precise issue duty shifting addresses. Differing interests as to investment risk are found not only among these three constituencies, but also within them.

Sophisticated understandings of how risk taking relates to the interests of different constituencies and members of those constituencies became possible only in the past several decades. Elements essential to such understandings, such as portfolio theory, distinctions between systematic and unsystematic risk, and option pricing theory are the crowning achievements of a modern financial science that largely began in the 1970s. Key legal conceptions regarding the corporate objective, however, developed well before the emergence of financial science. As we shall see, the folk wisdom that assumes an alignment in interests between shareholders and the corporate entity with respect to risk taking has contributed to the problems discussed in this Article.

1. Shareholders and Creditors—and the Corporate Entity. — The conflict between shareholders and creditors regarding investment risk is the foundation on which rests much of the argument for duty shifting. One of the claims is that, in the financially troubled corporation, managers will engage in ill-advised (i.e., negative net present value), highly risky ventures, the burdens of which will fall entirely and inappropriately on creditors. Chancellor Allen makes exactly this moral hazard claim in Credit Lyonais. We explore this claim in Part II.E.

More broadly, the duty shifting cases, including North American, start from the basis that the welfare of shareholders can be equated to the welfare of the corporate entity. If so, requiring directors to act in the best interests of the corporation—in investment risk taking and other decisions—is coincident with their acting in the interests of shareholders. In
fact, this would be far more likely to be in the interests of creditors than of shareholders. As we shall discuss in Part II.B.2, modern financial theory suggests that risk taking that would be optimal for shareholders is different from that which would be optimal for either creditors or, perhaps surprisingly, for the corporation itself.

2. Managers and Shareholders. — The conflict as to investment risk between management and shareholders implicates the central task of modern corporate law: keeping professional managers of public corporations accountable to the shareholder-owners.\footnote{111} According to the Berle-Means framework, managers hold few shares but exercise substantial control over their firms.\footnote{112} Although shareholders own the company, they face serious collective action problems in controlling their agents, the corporate managers, who often have quite different interests.

Constraining managerial autonomy and reducing the divergence between managerial and shareholder interests are key to modern corporate governance, which has largely revolved around one question: What legal and market mechanisms will lead managers to act in the interests of shareholders?

With specific reference to investment risk, managers—and employees generally—desire investment risk taking that is suboptimal for shareholders. Managers of healthy companies generally prefer taking less risk than they would if they were acting in the interests of their presumptively diversified shareholders.\footnote{113} A shareholder has shares in many companies; a manager has only one job. Moreover, from stock options and other securities holdings, managers are typically poorly diversified. Certain stock option, compensation, and psychological factors can sometimes increase managers’ desire for too much risk rather than too little, but the broad pattern is fairly clear.\footnote{114} Indeed, recent research suggests that, because of ill-diversification, the cost to companies of the stock options they grant to managers generally far exceeds the value of the options to the managers.\footnote{115} We discuss in Part II.E the ways in which these

\footnote{111} Cf. Robert Charles Clark, Corporate Law 33–34 (1986) (stating that “major problem dealt with by corporate law” is how to keep managers accountable while allowing them great discretionary power).

\footnote{112} Adolph A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 5 (1932).


\footnote{114} For discussions of when managers may want to take more risk than would be optimal for diversified shareholders, see Hu, Misunderstood Derivatives, supra note 18, at 1492–95; Hu, Risk & Time, supra note 12, at 325–26, 328–32.

\footnote{115} See Brian J. Hall, The Challenge of Turning Managers into Owners, NBER Rep., Summer 2004, at 9, 10–11 (finding that insufficient diversification is important part of establishing strong ownership incentives); Brian J. Hall & Kevin J. Murphy, Stock Options for Undiversified Executives, 33 J. Acct. & Econ. 3, 8–21 (2002) (showing that stock options result in high costs to companies and lower values for managers).
managerial risk preferences may dovetail with those of some creditors in ways that exacerbate the problems caused by duty shifting.

3. Shareholders Inter Se. — As a legal matter, each shareholder has the same bundle of rights; unlike creditors, not only do shareholders have no individualized contracts with the corporation, they have no contracts at all. As a general matter, although there is a possibility of direct shareholder lawsuits, shareholder rights are primarily collective in nature. The collective rights arise when, for instance, the requisite percentage of shareholders cast votes in particular ways.

Shareholders may have substantial variations in their risk preferences. But, as we explain below, modern finance theory and other analyses suggest that, in most cases, the individual risk preference of shareholders is largely irrelevant to shareholder-optimal corporate investment decisionmaking. That is, in most circumstances, managers can assume shareholder interests that are largely unitary.

As a result, the host corporate governance system is not generally burdened to resolve deeply conflicting interests of disparate shareholders: In most cases, a simple directive to adopt an investment decisionmaking rule intended to maximize shareholder wealth would be roughly consistent with the interests of every shareholder, irrespective of that shareholder’s risk preferences. Managers maximizing the wealth of shareholders as a group generally help all shareholders pro rata. There are exceptions and limitations to these claims, and we return to this issue in Part II.B.2.

4. Creditors Inter Se. — The conflicts among creditors are far more difficult and severe. That is, it is much harder—indeed generally impossible—to adopt an investment decisionmaking rule that even roughly serves the interests of all creditors. Each creditor’s interest is not only different from the interests of shareholders but also from creditors in other creditor classes. Even within a class, every creditor has an individual contractual relationship with the corporation. Various creditors are likely to have radically different bundles of rights, because of varying legal priorities and different economic circumstances. For example,

For new evidence on how options holdings can sometimes substantially decrease executives’ willingness to take risk, see Katharina Lewellen, Financing Decisions When Managers Are Risk Averse, 82 J. Fin. Econ. 551, 556–69 (2006).

116. See infra Part II.B.


upon liquidation secured creditors might have claims on the firm’s assets before public debt holders. 119 Apart from liquidation rights, bank creditors typically have the protections of shorter maturity and a more restrictive set of covenants. These covenants directly benefit the individual creditor. When the covenants are breached, the individual creditor need not seek the vote of other creditors. 120 These creditor rights are individualized “constraint” rights, not group-oriented “maximization” rights possessed by shareholders. 121

Unlike shareholders, who face similar risks and returns from a common interest in the share price, creditors face far different risks and returns. Creditor attitudes toward corporate investment risk taking and other issues will vary accordingly. While secured creditors often want to liquidate their collateral promptly and forget the whole miserable experience, unsecured creditors often prefer a reorganization since they are likely to get little or nothing in a liquidation. 122 As a result, in some cases unsecured creditors and equityholders are allies seeking greater value in continuation of a business rather than liquidation. Similarly, the interests of those unsecured creditors with priority rights in a liquidation may


119. For a finance theory-oriented analysis, see Cheol Park, Monitoring and Structure of Debt Contracts, 55 J. Fin. 2157, 2172–85 (2000).


121. As to the concept of shareholders holding “maximization rights,” see supra note 17.

clash with unpreferred unsecured creditors. Some unsecured suppliers may, like employees, have a greater interest in the continued existence of a customer/employer than in the full payment of old debts. Even among unsecured lenders, banks and other institutional lenders are more eager to accept long-term solutions, including equity for debt, than are public bondholders or noteholders.

Finally, hedge funds—now major players in the troubled corporation setting—may complicate matters. One source believes that hedge funds may account for forty-seven percent of the trading volume in distressed debt and fifty-five percent of that in credit derivatives. Although their tactics can vary, hedge funds are often viewed as more aggressive with troubled borrowers, less predictable, and more short-term oriented than traditional creditors. Some funds engage in second-lien financing, hoping to obtain control of the company after its likely default, a goal that may conflict with both unsecured creditors and other creditors holding security.

These examples only scratch the surface of the many conflicts of interest among creditors as a company becomes financially distressed. Shareholders, unsecured bondholders, and supplier-creditors would possibly support a corporate investment with a positive net present value but high risk; secured creditors may well oppose such an investment.

In this Part, we have looked beyond duty shifting’s simple-minded presumption that creditors prefer safer corporate behavior than that preferred by shareholders. Understanding the risk preferences of managers—the actual corporate decisionmakers—and the widely divergent nature of creditor interests will be important in analyzing the advisability of duty shifting.

B. The Corporate Governance System and the Largely Unitary Interests of Shareholders

Having explored the conflicts among and within corporate constituencies, we now outline modern corporate governance’s central character-
istics relating to risk management. Two essential points emerge. The first essential point is the enduring nature of system means. As a matter of law, shareholders are the owners of the corporation and always will be during the life of the corporation; director fealty to owners is similarly immutable. The corporate governance system contemplates shareholders having full ownership rights in the corporation, including voting, inspection, fiduciary litigation, and other “embedded rights,” irrespective of the company’s financial condition. The corporate governance system’s mechanisms to ensure managerial adherence to the interests of shareholders are “hard-wired” for the life of the company. This corporate governance system contrasts dramatically with the ownership notion found in the duty shifting cases. Under the duty shifting cases, whether shareholders are, in effect, treated as the owners at any given time depends on the happenstance of how the company is doing financially at the moment. If it is not doing well, creditors are deemed to have become the “owners.”

The second essential point relates to the functional elegance of system ends. In making investment decisions that would maximize the share price, modern financial theory tells us that, as a first approximation, management does not have to ascertain or consider the diverse risk and time preferences of the company’s shareholders. Maximizing the share price benefits shareholders precisely in proportion to their stakes, a characteristic flowing directly from the legal nature of share ownership rights. The result of modern financial theory and legal shareholder ownership rights is that a directive to focus on shareholder interests has clear operational and theoretical meaning: Managements can and should use as a starting point the assumption of a largely unitary shareholder interest and can avoid adjudicating differences among shareholders.

1. Three Foundational Conceptions of a Duty to Shareholders and Alternate Meanings of “Shareholder-Optimal” Risk Taking. — The baseline assumption for the duty shifting cases is that management generally must run the corporation for the benefit of the shareholders. And the baseline corporate decision motivating the modern duty shifting cases is the investment decision. Credit Lyonnais was based solely on Chancellor Allen’s belief that shareholder-optimal risk taking in troubled corporations was improper. But what does a duty to shareholders mean? And, in this Article, what do we mean when we refer to shareholder-optimal investment risk taking?

It may be useful to use a framework that begins with three conceptions of shareholder fidelity, even though they are all merely first approximations. The first is the “traditional conception” of the corporate ob-

128. Of course, the identity of the owners may change.
129. See supra note 57 and accompanying text (analyzing Credit Lyonnais’s famous footnote 55).
130. The discussion in this Part draws on an evolving framework set out in Hu, Behind the Corporate Hedge, supra note 109, at 40–50 (addressing corporate hedging-related distinctions between “shareholder wealth maximization” and “shareholder welfare
jective as set forth in most state corporation statutes and judicial opinions, including duty shifting opinions. The second is the standard shareholder wealth maximization conception that dominates discussions of corporate finance. The third is a conception the framework dubs a “blissful” shareholder wealth maximization conception—a conception closest in spirit to the maximization of the “intrinsic value” of the company’s shares. Each of the three conceptions professes to be shareholder oriented, although the investment decisions may depend critically on which conception is chosen.

a. The Traditional Conception. — The traditional conception of the corporate objective is that a corporation should conduct business activities “with a view to enhancing corporate profit and shareholder gain.” Thus, “[a] business corporation is organized and carried on primarily for the profit of the stockholders.” The Revised Model Business Corporations Act requires each director to discharge his duties “in a manner the director reasonably believes to be in the best interests of the corporation.” For this purpose, the term “corporation” is “a surrogate for the business enterprise as well as a frame of reference encompassing the shareholder body.”

Similarly, the Delaware Supreme Court has stated that “[i]t is basic to our law” that the board has the ultimate responsibility for managing the corporation and that in discharging that function, “the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.”

In terms of issues central to this Article, the most striking aspect of these formulations is the presumption that what is good for the corporation is good for the shareholder. Indeed, this presumed identity is evident at times in North American itself. The Delaware Supreme Court states

maximization” from finance perspective); Hu, Nature of Sheep, supra note 109, at 392–95, 397–407 (analyzing one prominent corporation essentially run on hybrid of “actual” and “blissful” shareholder wealth maximization); Hu, Derivative Reality, supra note 115, at 996–1040 (discussing incompleteness of “shareholder wealth maximization”); Hu, Shareholder Welfare, supra note 17, at 1278–1309 (discussing financial innovation and the corporate objective, including new types of corporate securities and certain “short-termism” issues); Hu, Risk & Time, supra note 12, at 295–366 (discussing three basic conceptions of shareholder fidelity); Hu & Black, Taxonomy, supra note 53, at 1019 n.23 (discussing hedge fund activism and “short-termism”); Hu & Black, The New Vote Buying, supra note 8, at 814–63 (discussing shareholder ownership rights, shareholders that are “empty voters,” and how decoupling of economic ownership and voting ownership undermines existing legal and economic theories of corporate governance).

132. 1 Am. Law Inst., Principles of Corporate Governance § 2.01 (1994).
133. Id. § 2.01 reporter’s note 1 (quoting Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919)).
135. Id. § 8.30(a) official cmt. 2.
that “[i]t is well settled that directors owe fiduciary duties to the corporation.” Elsewhere the court states that “[i]t is well established that the directors owe their fiduciary obligations to the corporation and its shareholders” and that directors must generally act in the “best interests of the corporation for the benefit of its shareholder owners.”

It was natural for judges and others to presume this identity of interests between the corporation and its shareholders. But this kind of language muddles analysis of proper corporate risk taking.

Modern finance theory suggests that, in the usual publicly held corporation, serious conflicts exist between the corporation’s interest and the shareholders’ interests with respect to corporate investment decisions. As we shall discuss below, the investment risk taking that would be optimal from the corporation’s standpoint—or from the managers’ or creditors’ standpoint—differs radically from shareholder-optimal risk taking. Simply put, risk taking that is optimal for the corporate entity itself (and most managers and creditors) is likely to be too cowardly from the standpoint of well-diversified shareholders.

Other consequences of the traditional conception are also serious. It gives no clear operational or theoretical guidance for investment decisionmaking. It says to care about the corporation and the shareholder but fails to even acknowledge differences in interest, much less provide a rule for weighing the two interests in case of conflict. Since virtually every investment decision will involve conflict, the silence of the traditional conception means that it provides no guidance regarding how management should behave.

b. Actual Shareholder Wealth Maximization. — A second, more modern conception equates shareholder welfare with the trading price of shares. According to this view, shareholder wealth maximization is sought directly rather than as a byproduct of corporate welfare. Academic commentary typically assumes that there is a legally enforceable duty to maximize shareholder wealth. In fact, apart from

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138. Id. at 15, 19 (emphasis added); see infra Part II.E.
139. See infra Part II.B.2.
141. Hu, Shareholder Welfare, supra note 17, at 1282–83 (stating that “[m]ost academics now believe that shareholder wealth maximization is the basic pecuniary objective of the modern publicly held corporations”); see also supra Parts I.B.2, I.B.4 (discussing Credit Lyonnais, North American, and whether there exists duty to maximize shareholder wealth); infra Part IV (discussing North American and whether there exists duty to maximize shareholder wealth).
certain very narrow takeover contexts, judges have refrained from mandating an overarching duty to maximize share prices. Specifically, under current Delaware law, “[i]n the sale of control context, the directors must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders—and they must exercise their fiduciary duties to further that end.”142 But absent a transaction that will cause “a change in corporate control” or “a break-up of the corporate entity,” the directors are not obliged “to seek the best value reasonably available to stockholders.”143

This second conception is aspirational, perhaps more of a convenient myth than the usual enforceable legal rule. In normal circumstances, managers acting consistently with this shareholder wealth maximization goal in mind would be patted on the back by judges. The duty shifting cases, by their very nature, start from a default rule of a duty to shareholders, although they do not explicitly refer to shareholder wealth maximization.

However, except in the narrow context of takeovers, it is unlikely that judges would actively enforce adherence to these ends. Citing the business judgment rule, courts have typically refused even to entertain allegations of improprieties with respect to management decisions regarding either risk or time, the two key aspects of investment decision-making.144 With respect to key decisions in the normal (healthy) publicly held corporation context, directors who sacrifice the interests of shareholders in favor of other constituencies—by being too cowardly with respect to investment risk taking—are unlikely to be subject to any actual judicial challenge.

Nonetheless, this actual shareholder wealth conception, in contrast to the traditional conception, has operational and theoretical meaning with respect to investment decisionmaking. As will be discussed in Part II.B.2, modern investment decisionmaking tools evaluate the risk, time, and other dimensions of possible investments with the explicit purpose of maximizing shareholder wealth. Shareholders differ in terms of attributes such as risk and time preferences. But, roughly speaking, managers need not generally weigh the preferences or interests of one shareholder

143. Id. at 48; see also Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182–83 (Del. 1986) (detailing duty of board after authorization of management to negotiate sale of company).
144. See Paramount Commc’ns, Inc. v. Time, Inc., 571 A.2d 1140, 1154 (Del. 1990) (stating that “fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals”); Geller v. Tabas, 462 A.2d 1078, 1082 (Del. 1983) (relying on business judgment rule to strike plaintiff shareholders’ claims of breach of fiduciary duty from company making speculative investments in silver and United States Treasury bond futures contracts); Penn v. Pemberton & Penn, 53 S.E.2d 825, 829 (Va. 1949) (“They simply decided to do business in a very conservative way until there were reasonably good prospects of making substantial profits.”); Hu, Risk & Time, supra note 12, at 301–02 (discussing effect of business judgment rule and other cases).
against another in making these investment decisions. Successful implementation of these tools will increase shareholder wealth, generally benefiting all shareholders in proportion to their stakes.

c. Blissful Shareholder Wealth Maximization. — A third conception, first advanced in 1990, is that of “blissful shareholder wealth maximization” and is necessary to understand both what managers should do and what they actually do. Blissful shareholder wealth maximization calls not for the maximization of actual stock price but for an attempt to maximize what the stock price would be if (1) the stock market were omniscient and fully rational, and (2) managers were selfless in their devotion to shareholders. Managers are asked to be blissfully ignorant of the apparent irrationality and informational asymmetries associated with real stock markets. Loosely speaking, with this conception, managers are asked to focus on maximizing the intrinsic value of the shares.

This view focuses directly on shareholder welfare, but does not rely exclusively on the actual trading prices. There are at least two reasons to avoid such a complete reliance on stock prices. First, in the rough and tumble world of stock markets roiled by fads, bubbles, noise traders, and psychological and other quirks, the trading price of a share at any given moment can depart radically from the price that “rationally” reflects all publicly available information. Asking managers to focus exclusively on a variable that is subject to so many artificial influences could result in managers making decisions that pander to market foibles. Second, informational asymmetries between managers and capital markets are inevitable. Given such an information gap and investor skepticism about managerial loyalty to shareholders, directing managers to maximize actual share prices can sometimes lead to cutbacks in, for instance, worthwhile high-risk, long-term R&D projects.

In this Article, we reject the traditional conception altogether. The traditional conception found in statutes and in many judicial opinions is inconsistent with new financial learning and muddles the analysis of risk taking. When we refer to running a corporation for the benefit of share-
holders or like phrases, we have in mind, at least as starting points, the two shareholder wealth maximization conceptions, not the traditional conception. As we shall see in Part II.B.2, risk taking that would maximize the actual share price or blissful share price is far more likely to be better for shareholders.

We do not express a preference in this Article between actual shareholder wealth maximization, blissful shareholder wealth maximization, or some hybrid of these conceptions. Actual shareholder wealth maximization has its problems, but an increase in the blissful price of the shares, in contrast to an actual trading price, does not put food on the table. Moreover, the blissful price is far less certain—and thus susceptible to self-interested managerial calculations—than the actual trading price.

The choice between these two shareholder wealth conceptions is a difficult one and does have implications for corporate investment decisionmaking. Warren Buffett and Charlie Munger’s Berkshire Hathaway, for instance, explicitly alerted all its shareholders when it moved from its own modified version of blissful shareholder wealth maximization to what is tantamount to a hybrid of actual and blissful shareholder wealth maximization.147

For present purposes, it is enough that we move beyond the traditional conception and adopt as a predicate some form of shareholder wealth maximization. We now proceed to implementation: What specific investment decisionmaking techniques would be consistent with actual or blissful shareholder wealth maximization?

2. Implementing Shareholder-Optimal Risk Taking: Finance Theory and the Largely Unitary Interests of Shareholders as a Group. — Modern financial theory confirms, and relies on, the notion that managers can go a long way to making shareholder-optimal investment decisions without ascertaining the shareholders’ individual risk and time preferences. Standard investment decisionmaking tools allow managers to make decisions that would promote all the shareholders in proportion to their stakes, irrespective of diverse shareholder preferences. Manager-agents asked to further the interests of shareholders, in other words, are not generally put in the position of having to adjudicate significant conflicts among the shareholder-principals.

As just discussed, the traditional conception of the corporate objective assumes that the corporation’s welfare is coincident with the share-

holders’ welfare. This is generally incorrect. Modern financial theory indicates that corporations concerned about the shareholders’ welfare will generally take more and different risks than corporations concerned about the entity’s own well-being. A shareholder can, by holding a portfolio of stocks, diversify away much of the risk that a corporation might find undesirable.

More specifically, under the capital asset pricing model (by now long in the tooth, but nevertheless illustrative of modern financial theory), risk can be partitioned into “unsystematic risk” and “systematic risk.” Unsystematic risk arises from factors unique to the business of a particular company. Systematic risk arises from economy-wide factors that affect all businesses. Empirically, investors can eliminate almost all of their exposure to unsystematic risk simply by purchasing a large enough number of stocks—such as through holding a diversified mutual fund. Thus, the investor is left exposed only to systematic risk. As a general matter, it is factually reasonable and normatively defensible to run a corporation on the assumption that shareholders in publicly held companies are diversified.

Diversification has direct implications for corporate investment risk taking that would maximize the share price. In evaluating an investment, a corporation should not be deterred by or, indeed, much care about the

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150. Factually, the substantial majority of shares are now held by institutional investors; for instance, at year-end 2004, institutional investors owned 69.4% of the shares of the largest 1,000 companies in the United States. Institutional Equity Ownership up in 2003, Pensions & Investments, Oct. 17, 2005, at 32. Moreover, the individual investors who hold such minority stakes tend to be more sophisticated and well-off than, say, individual investors who only own mutual funds. Thus, one recent survey indicated that “59 percent of equity investors with household financial assets of $500,000 or more own both stock mutual funds and individual stock, compared with 20 percent of those with household assets below $50,000. Seventy percent of equity investors in this low-asset category solely own stock mutual funds.” Inv. Co. Inst. & Sec. Indus. Ass’n, Equity Ownership in America, 2005, at 14 (2005). In addition, most individual equity investors hold a broader range of investments, such as bond funds, money market funds, annuities, and investment real estate. Id. at 24. Normatively, it is not reasonable to manage a company for a small minority of shareholders who—by choice or ignorance—are not diversified, when the result is to prevent maximization of shareholder wealth using modern portfolio theory. For discussions of the general viability of running a corporation with well-diversified shareholder diversification in mind and some exceptions, see Hu, Nature of Sheep, supra note 109, at 392–94 (discussing Berkshire Hathaway); Hu, Shareholder Welfare, supra note 17, at 1306–09 (discussing why diversified shareholders do not benefit from corporate reduction of unsystematic risk); Hu, Risk & Time, supra note 12, at 361–66 (discussing wealth maximization problems associated with closely held corporations and inadequately diversified shareholders); cf. Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (“[C]ourts need not bend over backwards to give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying.”).
unsystematic risk of an investment even though such risk will affect the corporation. In net present value terms, a corporation should not reflect unsystematic risks in determining the appropriate denominators. A shareholder, by holding a well-diversified portfolio, eliminates such risks. Unlike the corporation, the well-diversified shareholder does not care about unsystematic risk.

There is thus a conflict between entity-optimal risk behavior and shareholder-optimal risk behavior. In evaluating investments, a corporation that is concerned solely with shareholder optimality (i.e., maximizing the share price), should generally take into account only the systematic risks associated with such investments and ignore altogether the nonsystematic risks. In contrast, a corporation that is concerned with its own well-being as an entity would be far less cavalier. This less cavalier, less shareholder-oriented corporation would, of course, generally be better for creditors concerned about repayment.

Notice the first set of implications of this effect of shareholder diversification: A focus on the welfare of the corporation—inherent in the traditional conception of the corporate objective—would lead the corporation to take less and different kinds of risk than a focus on the welfare of shareholders. In general, then, risk taking that is optimal from the standpoint of the corporation itself may be good for creditors, but is likely to be far from optimal from the standpoint of shareholders.

Modern financial theory and the shareholder wealth conceptions offer another set of implications even more important from the standpoint of evaluating duty shifting. Managements can make investment decisions largely on the basis of a unitary shareholder interest (one ultimately defined by how the overall capital market prices risk and time), without having to look closely at, much less adjudicate, the different preferences of individual shareholders.

Whether managers are maximizing the actual share price, the blissful share price, or some combination, not only do all shareholders benefit, but they benefit in amounts precisely proportionate to their stakes. Shareholder tax positions aside, in this limited sense the claim of unitary interest is obvious. The managers are not put in the position of adjudicating conflicting interests among shareholders.

Assume a corporation is faced with a promising, but high-risk, long-term investment. Some of the corporation’s shareholders may be risk averse pension funds that depend on dividends while other shareholders may be aggressive mutual funds looking for a “ten-bagger” over the next decade. Yet other shareholders may have risk and time preferences unknown to the company and difficult to ascertain.

Would management not have to adjudicate the conflicting preferences of shareholders in some fashion before it could make an investment decision? No, albeit with certain exceptions.151 Modern financial

151. For a more precise and detailed exposition of the ideas in this paragraph, see Hu, Risk & Time, supra note 12, at 287–95, 355–66. For contrary examples where the
theory offers investment analysis techniques that do not require managers to gauge the particular risk and time preferences of its own shareholders. Instead, in evaluating investment projects, the management can simply use the capital market’s “price” for risk and for time. For instance, a company that relies on the (somewhat dated) method of net present value with discount rates informed by the capital asset pricing model would use a discount rate derived solely from the market’s risk-free interest rate (“rf”), the beta of the project (i.e., a measure of the nondiversifiable risk associated with the investment project) (“\( \beta \)”), and the capital market’s rate of return applicable to that beta (“\( r_m \)”; none of these numbers depend in any way on the preferences of the company’s particular shareholders.\footnote{That is, the discount rate would be equal to: \( r_i + (\beta)(r_m - r_f) \), where: \( r_i \) is the time discount rate, \( \beta \) is the beta of the project, and \( r_m \) is the rate of return applicable to that beta.}

To the extent that the company, post investment, has characteristics unsuitable for a shareholder (and that the shareholder is aware of such changes), the shareholder would nevertheless benefit because he would sell the shares at the new, higher price. In effect, transmission belts link proper investment analysis decisions and the maximization of shareholder wealth.

These modern investment analysis tools are essential to managers seeking to maximize shareholder wealth. Any different view cripples management of the corporation’s investments. The directive to focus on the share price has meaning and provides an ever-expanding toolkit of associated decisionmaking tools. (It is important to note that the use of these tools requires a focus on a series of cash flows over time, not a one-time, snapshot view of assets and liabilities.\footnote{See infra Part III.A.}

These tools presume that capital markets function fairly well.\footnote{Brealey & Myers, supra note 131, at 21.} They do not assume, for instance, large divergences between the market price of shares and the true value of the shares. The blissful shareholder wealth maximization conception lacks the operational clarity of the actual shareholder wealth maximization. After all, even selfless managers are likely to use vastly different methods in determining intrinsic value. But at least as a starting point, one would expect the use of conventional investment decisionmaking tools.

We do not by any means suggest that shareholder interests are always unitary with respect to corporate risk taking. This would not be the case even with the stylized case of fully diversified shareholders and one class of equity, leaving aside “short-termism” issues (such as conflicts among different “generations” of shareholders). For instance, shareholder expectations as to a corporation’s risk taking—and corporate decisions to
hedge against risk—may differ significantly. Under such circumstances, corporate behavior that maximizes shareholder wealth can sometimes even reduce the welfare of many shareholders. Many of these shareholder conflicts can be alleviated by proper corporate disclosure.

Throughout this Article, we assume this stylized case. Some of our arguments have less force in closely held companies or in companies with multiple classes of shareholders. Nevertheless, it seems clear that shareholders qua shareholders generally have much more similar interests than shareholders have vis-à-vis managers or creditors and more than creditors have among themselves. For the purposes of this Article, we believe it fair to characterize shareholder interests as being largely unitary. It is also clear that well-diversified shareholders would generally want corporate risk taking more venturesome than what would be optimal from the standpoint of the managers or the well-being of the corporate entity itself.

C. The Corporate Governance System and the Adjudication of Heterogeneous Interests

As we have seen, a corporation is subject to two alternative governance systems, depending on whether a formal bankruptcy filing has occurred. Absent a bankruptcy filing, the (normal) corporate governance system plays host, influencing and constraining managerial behavior through a variety of legal and market mechanisms. State corporate law and, to a lesser extent, federal non-bankruptcy substantive law (such as the provisions of the Sarbanes-Oxley Act) provide the legal environment. Market forces, enhanced by Securities and Exchange Commission (SEC) disclosure rules, are constantly at work.

Substantially all the mechanisms of this host governance system are directed at encouraging managers to focus on the future and the promise it holds for shareholders as a unitary group. The central concern is overcoming the Berle-Means problem of assuring that agent-managers serve the principal-shareholders’ interests.

In other words, the corporate governance system is premised on the concept of shareholders as owners who have unitary interests. The host system does not provide for adjudication across groups of stakeholders—since only shareholders matter—nor for adjudication among shareholders, who presumptively have no conflicts.

In this Part, we show the problems resulting from the failure of the duty shifting doctrines to consider the need for corporate ends to corre-

155. For examples of this counterintuitive situation and the associated distinctions between shareholder wealth maximization and shareholder welfare maximization, see Hu, Behind the Corporate Hedge, supra note 109, at 48–50; Hu, Derivative Reality, supra note 113, at 1033–36.

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spond with the mechanisms of the host governance system. First, duty shifting causes dissonance between ends and means. Under a shifted state duty regime, managers generally must further the interests of creditors, while the host system’s legal and market mechanisms continue to direct managers to act in the interests of the shareholders. Shareholder voting, inspection, remedial, and other embedded rights continue irrespective of any duty shifting, as do the market forces that discipline managers who do not keep their eyes on the share price.

Second, duty shifting specifies new ends without providing the means to attain them. Effectively, the doctrines have imposed conflict resolution responsibilities on a corporation lacking the substantive rules as well as the procedural mechanisms to resolve such interests. In so doing, the duty shifting doctrines force each non-bankrupt corporation to assume the responsibilities akin to that of the entire bankruptcy system. To compound the problem, there is no provision for the emergence from the state of limbo by either liquidation or reorganization.

1. Ends Against Means: The Dissonance of Continuing Shareholder-Oriented Means and Duty-Shifted Creditor Ends. — With the triggering of duty shifting, the formal ends of the corporation change. From this point on, the directors are to focus on the creditors’ interests. Alas, all of the host governance system’s legal and market mechanisms continue to focus on shareholders. This results in a bizarre dissonance where ends conflict with means.

Most of the central legal and market mechanisms of the corporate governance system are animated by one rule: Only shareholders have the vote, and they have the vote irrespective of the financial circumstances of the corporation. The board of directors has the power to control the enterprise, but only as elected representatives of the shareholders. The principal exceptions are when the power is allocated directly to the shareholders themselves, as with certain mergers and organic changes.

The exclusivity and immutability of shareholder voting power results in dissonance with the triggering of duty shifting. At the same time that

157. This theme, the need for an entity’s objective to correspond to the mechanisms of the host governance system, has been previously raised in the context of the governance of stock exchanges. See Means and Ends: NYSE Regulation, NYSE Group, and the Matter of Togetherness: Hearing on a Review of Self-Regulatory Organizations in the Securities Markets Before the S. Comm. on Banking, Housing, and Urban Affairs, 109th Cong., passim (2006) (statement of Henry T. C. Hu, Allan Shivers Chair in the Law of Banking and Finance, University of Texas School of Law).


159. See, e.g., William A. Klein & John C. Coffee, Jr., Business Organization and Finance: Legal and Economic Principles 124 (10th ed. 2007) (stating that, by statute, shareholders have right to vote in director elections and “fundamental matters” such as certain mergers, amendments of articles, and liquidation).
directors must further the creditors’ interests, the shareholders continue to elect the directors. Under the duty shifting doctrines’ framework, the managers remain the agents, while the creditors become the principals. But the new principals lack the right to choose their agents. The old principals continue to have that right and thereby continue to have some control over those agents. The result would be akin to allowing French voters to select the President of the United States.

Voting rights are not the only rights that shareholders continue to have under the corporate governance system, irrespective of any duty shifting. Shareholders continue to have the exclusive rights of inspection and, regardless of any remedial rights that creditors may acquire, retain the right to sue management for breaches of fiduciary duty. The general effect of these additional embedded rights is also to direct managers to act in the shareholders’ interests notwithstanding any duty shifting.

Market-based mechanisms relating to the vote are also incompatible with duty shifting. Linking votes to shares also facilitates the efficient operation of the market for corporate control. Managers that either cannot or will not run the company in the best interests of shareholders will cause the share price to drop, creating opportunities for outsiders to purchase shares at bargain prices and thereby obtain the voting power necessary to oust incumbent management. Regardless of the company’s financial condition, the market for corporate control seeks to cause managers to focus on the shareholders’ interests: After all, even in troubled times, creditors cannot seize control of the corporation except through bankruptcy.

The real world impact of these shareholder-directed legal- and market-based mechanisms has changed substantially in recent years with seminal changes in the role of the shareholder. As will be discussed in Part III.B.2 below, shareholders are now increasingly influential with respect to the choice of directors and the decisions the directors make. Thus an increasingly active conflict—between shareholders exercising greater

160. As to shareholder inspection rights and shareholder rights to sue for fiduciary breaches, see, for example, Melvin A. Eisenberg, Corporations and Other Business Organizations: Cases and Materials 258–75, 912–1039 (9th ed. unabr. 2005).

161. See, e.g., Sanford Grossman & Oliver Hart, One Share-One Vote and the Market for Corporate Control, 20 J. Fin. Econ. 175, 175–80 (1988) (arguing that one share-one vote rule encourages selection of best management team); Milton Harris & Artur Raviv, Corporate Governance: Voting Rights and Majority Rules, 20 J. Fin. Econ. 203, 226–28 (1988) (concluding that one share-one vote rule in conjunction with simple majority rule results in election of best management); Hu & Black, Decoupling, supra note 53, at 353–57 (discussing theoretical and empirical support for idea that linking voting rights to shares results in efficient market for corporate control); Hu & Black, The New Vote Buying, supra note 8, at 850–57 (same).

162. The creditor remedy of involuntary bankruptcy is often not terribly useful. See Susan Block-Lieb, Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small, 57 Brook. L. Rev. 803, 835–52 (1991) (explaining why creditors often disfavor involuntary bankruptcy). One question for further research is whether it should be easier for creditors to initiate a bankruptcy proceeding under some circumstances.
control and directors required to serve creditors—is added to the dissonance.

In the troubled corporation setting, these mechanisms may act with special force. First, hedge funds, newly important as shareholder activists, often look at troubled corporations as promising territory. They make aggressive use of such market and legal mechanisms to ensure that their interests as shareholders are vindicated.

Second, shareholder interests and creditor interests are especially divergent in the troubled corporation setting. As we have discussed, risk taking that is optimal from the point of view of well-diversified shareholders is far different from that which would be optimal from the standpoint of the corporate entity itself. As a general matter, creditors care far more about whether the corporation survives than do shareholders. This latent conflict is brought into sharp relief in the troubled corporation setting.

2. Ends Without Means: The Corporate Governance System Without Conflict Resolution Rules and Mechanisms. — The host corporate governance system also offers neither the substantive rules nor the procedural mechanisms to resolve conflicts among different constituencies.

To illustrate the absence of substantive rules for conflict resolution, one can slightly modify the example found in footnote 55 of the Credit Lyonnais opinion.163 To the $12 million owed to unsecured bondholders we add a class of subordinated debt holders of $20 million. The litigation opportunities from Credit Lyonnais are set out below:

<table>
<thead>
<tr>
<th>Chance of Event</th>
<th>Expected Value</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>25% chance of affirmance</td>
<td>($51mm)</td>
<td>$12.75</td>
</tr>
<tr>
<td>70% chance of modification</td>
<td>($4mm)</td>
<td>2.8</td>
</tr>
<tr>
<td>5% chance of reversal</td>
<td>($0)</td>
<td>0</td>
</tr>
</tbody>
</table>

Expected Value of Judgment on Appeal

If one accepts the note 55-type analysis, the current value of the equity is negative $16.45 million (that is, the $15.55 million expected value of judgment on appeal minus the $12 million owed to senior bondholders and minus the $20 million owed to subordinated debt holders).

What would Chancellor Allen’s community of interests framework suggest? Chancellor Allen felt that, under his hypothesized numbers and capital structure, the beneficent “community-of-interests” director should accept all offers of $15.55 million or more.164 The reasoning appeared to be that, after all, $15.55 million is the expected value of the judgment on appeal. For Chancellor Allen, $15.55 million was the key number from a normative perspective. The $15.55 million expected value of the judg-


ment on appeal does not change with our new capital structure. Presumably, Chancellor Allen would say the corporation should continue to accept all offers of $15.55 million or more.

But if the company in our modified example accepted $15.55 million, its subordinated debt holders would only receive $3.55 million toward the $20 million they are owed (since the senior bondholders would receive their $12 million first). Under the litigation alternative, there is a 25% probability of $20 million to the subordinated debt holders and $19 million to the stockholders (that is, there is $51 million - $12 million = $39 million left after paying off the senior bondholders). The expected value of the litigation alternative to the subordinated debt holder is $5 million (25% of $20 million). If the subordinated debt holders are diversified—and most are—they would not care about “nonsystemic risk” (i.e., a “beta” of zero); if the outcome of this litigation has no correlation with returns on other assets in such institutional investors’ portfolio, the risk is entirely nonsystemic. Subordinated debt holders would clearly prefer the litigation alternative.

Thus, the interests of one group of creditors (the subordinated debt holders) as well as equity are opposite to those of the other group of creditors (the senior debt holders). Under Chancellor Allen’s analysis, where settlement is appropriate at $15.55 million, the interests of the $20 million-strong subordinated debt holders are sacrificed in favor of the $12 million-strong senior debt holders. Thus, senior debt holders are roughly twice as important as subordinated debt holders. But why? No good reason exists for such a disparity.

As the foregoing illustrates, the corporate governance system does not provide substantive rules for adjudicating the conflicting interests of various stakeholder groups and members of those groups having differing interests. And the duty shifting cases do not step in to fill the gap. The closest the opinions come to providing a substantive rule is through the notion of the “residual claimant”: The responsible person must manage the assets for the benefit of the creditors with a liquidation priority, and “good luck” to the rest. As we explain below, this answer is not correct from a legal and economic perspective, especially in the context of an ongoing business.165

There is another, equally important, procedural point. The corporate governance system lacks the procedural mechanisms to undertake such dispute resolution tasks. The duty shifting opinions do not step in to fill the gap here either. Indeed, the cases do not consider the absence of such procedural means.

In short, the corporate governance system does not offer the substantive rules and procedural mechanisms to adjudicate the dispute resolution responsibilities imposed on the system by duty shifting. Nor do the

165. See infra Parts III.A–B.1.
duty shifting cases step in to deal with the absence of such rules and mechanisms.

D. Solution: The Bankruptcy Governance System and Its Adjudication Function

Fortunately, the United States has a bankruptcy system, which includes a reorganization pathway. The corporate governance system is predicated on shareholders as owners and presumes that the shareholders' interests are unitary. As such, it lacks means for adjudicating conflicting interests. The bankruptcy system is predicated instead on a court adjudication regarding ownership and presumes conflicting interests among different groups and among individual members of such groups. This bankruptcy system is focused on the adjudication of the heterogeneous interests and has a highly evolved set of mechanisms for doing so.

Remarkably, North American and the other duty shifting cases appear to disregard this alternative governance system, one that contemplates corporate ends consistent with those decisions. Perhaps the separation of corporate and bankruptcy law in the United States has blinded chancery court judges to the connection between the duty shifting doctrines and the bankruptcy alternative.166

The preexisting bankruptcy “solution” offers means-end rationality. To start, the ends of the process have operational meaning: Priority rules specify how to resolve the heterogeneous interests of identifiable stakeholders. Beyond this important matter, far more thought has been given to what the ends ought to be. The default context focuses policymakers’ attention on the private optimality and public interest associated with the adjudication of corporate stakeholders’ interests. Therefore, the bankruptcy legislation addresses those issues.167 As surely as corporate law is focused on the corporation being run for the benefit of shareholders,

166. By contrast, business bankruptcy law, under the rubric “insolvency,” is largely embedded in corporate law in the United Kingdom and most other common law countries. See Am. Law Inst., Principles of Cooperation Among the NAFTA Countries 1 n.2 (2003).

167. Some commentators have suggested that bankruptcy law must be limited to procedure, with all substantive policies to be found in other law. See Douglas G. Baird & Thomas H. Jackson, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy, 51 U. Chi. L. Rev. 97, 100–01 (1984) (arguing that bankruptcy law should only include substantive rules that preserve assets for collective good of investors as group); James W. Bowers, Whither What Hits the Fan?: Murphy’s Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution, 26 Ga. L. Rev. 27, 76–80 (1991) (arguing that efficient bankruptcy law would look like “just another specialized form of civil procedure”). There is no compelling reason for this dichotomy, given that the circumstance of general default may well create reasons for the application of different policies than would be appropriate in other contexts. Jay Lawrence Westbrook, Bankruptcy Control of the Recovery Process, 12 Am. Bankr. Inst. L. Rev. 245, 252 & n.40, 254 n.51 (2004) [hereinafter Westbrook, Process]; Westbrook, Control, supra note 53, at 855–56.
bankruptcy law is focused on the corporation that, because of financial distress, must be run for the interests and members of its various constituencies. Moreover, bankruptcy law contemplates the adjudication of interests and has diverse pathways for accomplishing this. The duty shifting cases adjudicate the interests by viewing a troubled corporation as a form of trust “res” to be liquidated for the benefit of claimants. This is a static, balance sheet notion of a corporation, resonant of the primordial bankruptcy approach. Modern bankruptcy law instead usually contemplates the corporation on a cash flow basis, focusing on the pie-maximizing possibilities of an ongoing enterprise with reshuffled claimant interests.

In short, the judicially crafted, ad hoc duty shifting doctrines offer no means to ensure that the conflict resolution responsibilities they impose can be met. But federal law gives the bankruptcy courts the powerful tools necessary to meet such responsibilities. We turn now to Chapter 11 as an example of how bankruptcy courts can perform these functions.

1. Governance in Bankruptcy. — The designers of Chapter 11 contemplated that corporations would use it to hold off creditors while resolving business problems and restructuring and refinancing debt. Management of a corporation (the Debtor in Possession or DIP) remains in control of a company as a surrogate trustee in bankruptcy—a considerable benefit. The so-called absolute priority rule is relaxed, so equity can retain some value in the reorganized company contingent upon the approval of large majorities of creditors. Supervision by the court, the United States Trustee, and often a committee of creditors ensures a due concern for creditor interests and provides a forum and a mechanism for the consideration of every affected interest. The DIP has a fiduciary duty to each of the creditors and to shareholders, while the court serves as a referee between equity and debt, and among creditors as well. While these duties raise inherent conflicts for the DIP-trustee, evolving case law is creating rules that guide the DIP regarding areas in which duties to one interest or another may be paramount. While many questions regarding beneficiaries’ conflicting interests remain unanswered, the structure is designed to generate answers to those questions.

Indeed, one of the key themes that we emphasize in this Article is the presence of two alternative governance systems; the principal-agent problems in the bankruptcy governance system are no less worthy of consideration than those that arise in the corporate governance system. The principal-agent problems associated with the two systems are different, stemming in part from differences in the “principal” and differences in the homogeneity of stakeholder interests. Finally, because of the somewhat diminished role of market discipline when a corporation is in bankruptcy, the need for legal mechanisms to address agency issues becomes manifest.

170. §§ 1126(c), 1129(a)(7)(A)(i).
Control is centrally important in both the corporate governance system and the bankruptcy governance system. Shareholder voting rights are the foundation of the corporate governance system, while public control is the central concept in bankruptcy law. In the corporate governance system, shareholders are the owners who, through their voting rights and otherwise, ultimately control the enterprise. The control of the corporation is in private hands. In the bankruptcy system, ownership is a more complex affair, one that the bankruptcy court, an impartial public body, adjudicates. The control of the corporation is in public hands.

In this Article, we have already touched on how duty shifting conflicts with the shareholder control architecture of the corporate governance system. In contrast, the ends sought by duty shifting precisely coincide with the architecture of the bankruptcy governance system. By establishing control over a debtor’s assets and affairs through a court or other public mechanism, the legislator achieves the prerequisite for the desired public policy result. Bankruptcy law’s central problem is the selection and governance of the agent exercising control. Unlike the

172. Concerning corporate control, see generally Hu & Black, Taxonomy, supra note 53, at 1013–14 (discussing how voting power is central to concept of share ownership); Hu & Black, Decoupling, supra note 53, at 344, 353–55 (discussing roles of shareholder vote and one share-one vote paradigm in theory of corporate governance and capital structure); Hu & Black, The New Vote Buying, supra note 8, at 814–15 (discussing vote as “core source of shareholder power” that serves instrumental and legitimizing purposes). As to control of bankruptcy proceedings, see Westbrook, Process, supra note 167, at 253 (noting that bankruptcy regimes universally give control of debtor’s assets to publicly designated official or entity).

173. As explained below, the public control may fall into the hands of private interests, but in principle it is always public.

174. The ends sought through application of bankruptcy laws vary greatly in theory and in practice around the world. Among the objectives might be the lowest possible cost for debt capital, a solution to the “collective action” problem faced by creditors, and the achievement of pari passu distributional fairness, among others.

175. Westbrook, Process, supra note 167, at 247. Central to the necessary control is a stay or moratorium on creditor actions. Virtually all bankruptcy systems provide for such a stay. In the United States, the stay is very broad and automatic, while in many jurisdictions the stay is granted only after a request to a court and may be limited in scope. See id. at 253. The breadth of the stay determines the breadth of bankruptcy court control and therefore the extent to which the policies of the legislature can be served. See, e.g., 11 U.S.C. § 302(a) (2000); Insolvency Act, 1986, c. 45, § 8, sched. B1, para. 44 (Eng.) (as amended by Enterprise Act, 2002, c. 40, § 248, sched. 16 (Eng.)). Japan is one of the countries in which a stay must be sought in each case. See Shinchihiro Abe, Recent Developments of Insolvency Laws and Cross-Border Practices in the United States and Japan, 10 Am. Bankr. Inst. L. Rev. 47, 53 (2002) (noting that Japanese law provides no automatic stay and discussing alternative temporary legal restraints on creditors); Kent Anderson, The Cross Border Insolvency Paradigm: A Defense of the Modified Universal Approach Considering the Japanese Experience, 21 U. Pa. J. Int’l Econ. L. 679, 705 (2000) (“Notably though, unlike the United States, no automatic stay is issued at commencement. Instead, debtor’s assets are only protected upon application for and granting of a ‘preservation measure’ (hozen shobun).” (quoting Hasan Ho [Bankruptcy Act], Law No. 71 of 1922, art. 155)); Shoichi Tagashira, Intraterritorial Effects of Foreign Insolvency
corporate governance system, the bankruptcy governance system has control features essential to the tasks contemplated by duty shifting, including the automatic stay that freezes all creditor actions.

Most corporations that invoke the bankruptcy system file for Chapter 11 bankruptcy reorganization. Under current bankruptcy law, the management of the debtor corporation in Chapter 11 controls the proceeding. If other parties—for example, secured creditors—control management, then they effectively control the corporation’s reorganization proceeding through management. However, the DIP as trustee has fiduciary duties to all creditors and to equity as well. Its conduct is scrutinized by the other parties in interest and supervised and controlled by the court. Thus, the control is constrained in real time and its exercise is relatively transparent.

For the most part, the courts efficiently dispose of businesses unlikely to reorganize successfully. If the business is unlikely to survive, the court can dismiss the case, convert it to a Chapter 7 liquidation, or, if the creditors prefer, confirm a liquidating plan in Chapter 11. Those companies with a chance to survive negotiate a payment plan with creditors that the court approves after all concerned have had an opportunity both to vote and to be heard in court. If shareholders have a legitimate possibility of retaining value in the reorganized business, they have a place at the negotiating table and a right to be heard in court. Each of these alternatives presents a distinct approach. Each has rules and procedures that are well understood, and each has a bar and bench specialized in their execution. In the great majority of cases, the proceeding has a clear and transparent beginning and end. The “parties in interest” can exercise legitimate influence in protecting their rights. The system of DIP management admittedly represents a sometimes awkward and conflicted balance of specific business expertise versus fiduciary responsibilities, but the problems are well known and in many respects well addressed.

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176. See Westbrook, Control, supra note 53, at 857–60.
177. Warren & Westbrook, Outcomes, supra note 97, at 3 (stating that forty percent of unsuccessful cases are dismissed or converted within six months and three-quarters gone within year of filing).
178. Every creditor is a “party in interest” entitled to participate actively in the bankruptcy proceeding. See, e.g., 11 U.S.C. §§ 102, 105, 1124(2); 7 Collier on Bankruptcy, supra note 95, ¶ 1109.01.
179. The DIP system was adopted in large part on the argument that existing management, for all of its faults, would manage the company better than some trustee in
2. Structure for Resolution of Conflicting Interests Across and Within Different Constituencies. — Two aspects of modern bankruptcy law are especially relevant to our discussion of the mismatches caused by duty shifting. First, the institutional structure and rules of the bankruptcy governance system are imperfect, but they are designed especially to address the claims of specific debtors, creditors, and others with stakes in a corporation. Second, the bankruptcy governance system today has a preferred solution to the resolution of such conflicting interests. Instead of liquidation, bankruptcy law is strongly oriented toward an agreed-upon plan to reorganize a corporation as an ongoing business, sometimes with the same ownership but often with a new ownership or a combination of the old and the new.

The bankruptcy governance system recognizes and specifically accommodates the sort of widely diverse interests often found among and within classes of claimants. Indeed, the structure for negotiating a plan of reorganization rests upon the creation of classes of stakeholders and voting within each class.\textsuperscript{180} Beyond conflicts among creditors, other interests may be entitled to assert themselves. In a number of countries, including the United States, the holders of equity often have legitimate grounds for asserting an interest, even in bankruptcy, especially if they can make a plausible showing that the company’s going-concern value may exceed its debt obligations or that creditors will receive more by giving equity owners or managers incentives to remain with the company on a going-forward basis.\textsuperscript{181} In addition, a number of jurisdictions, including the United States,\textsuperscript{182} implicitly or explicitly recognize interests beyond those of creditors and stockholders, for example those of communities or customers.\textsuperscript{183}

Control of a reorganization is both more complex and more important than control of a liquidation proceeding because of the greater impact of distress management and the complexity of possible results. Although reorganizations in the United States generally proceed relatively quickly, it is not uncommon for a large company to remain in Chapter 11 for over a year while its business problems are resolved and its assets re-
capitalized. During that time, the DIP typically engages in distress management: selling divisions, renegotiating collective bargaining agreements, terminating pension funds, and so on. As the business is re-shaped, the DIP’s choices will serve differently the interests of various creditor groups and of other stakeholders, including management. For example, secured creditors may press for asset sales to pay down debt and for generally conservative management strategies, while equity and subordinated debt holders might prefer investment in new products or new markets.

Even as the case is proceeding, the DIP must decide whether to reject or affirm executory contracts and whether to make “critical vendor” payments. Those decisions can greatly improve the positions of certain unsecured creditors to the prejudice of others. Various other business decisions can also redirect value and risk in ways that benefit some stakeholders and harm others. Above all, the DIP’s decisions about postpetition financing and the concessions made to lenders to obtain that financing will have a profound effect on all stakeholders. The manner in which the DIP manages the company greatly affects the final outcome for each stakeholder, regardless of the legal priorities at the time Chapter 11 was filed.

Given all these decisions, the DIP’s fiduciary duties to all stakeholders create deep conflicts, just as management’s obligations under the duty


186. For example, a creditor who has his contract assumed as part of a confirmed plan of reorganization will be promised full payment, §§ 502(b), 1129(a), whereas a creditor who has his contract rejected will be promised only a pro-rata payment as an unsecured creditor. § 502(g). “Critical vendors” are those whom the debtor seeks to pay immediately after filing bankruptcy because they are so “critical” to the debtor’s business that the debtor will fail without them. The Seventh Circuit has held that bankruptcy courts do not have the authority to grant critical vendor relief. In re Kmart Corp., 359 F.3d 866, 874 (7th Cir. 2004); see Steven J. Lubben, The “New and Improved” Chapter 11, 93 Ky. L.J. 839, 854 (2005). Other courts have expressed caution and hesitance toward “critical vendors” and at least one court has outlined a three-part test that must be satisfied in order for a creditor to attain such an elevated status over other general unsecured creditors, but many such orders have been approved. See, e.g., In re CoServ, L.L.C., 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002).

shifting regime do. But bankruptcy law differs from corporate law because it anticipates a highly complex set of owner-principals and contains a number of mechanisms and doctrines for channeling and resolving their conflicts.

The balance created by the DIP’s tools (including the exclusive right to propose a plan and the automatic stay) and the rights of creditors (to obtain information, to move to dismiss or convert to Chapter 7, and to vote against a plan of reorganization) produces considerable pressure to negotiate a plan that responds to all stakeholders’ interests. It also provides a framework for the negotiation of that plan and requires court approval under provisions designed to protect each creditor and creditor class. To the extent that contested legal issues make resolution difficult, the court can resolve those issues and approve settlements that avoid extended litigation. The bankruptcy rules also regulate the substantial market in claims trading that has arisen, permitting some market valuation of claims. In these and a number of other ways, Chapter 11 gives management and stakeholders the means to sort out the many competing interests.


189. 11 U.S.C. § 1103(c)(2)–(3).

190. A notable recent instance was the Chapter 11 proceeding filed by a huge power company, Mirant. In re Mirant Corp., 334 B.R. 800 (Bankr. N.D. Tex. 2005). There was a crucial dispute between shareholders and management as to the value of the company and therefore the amount of value, if any, that should be available to shareholders in a reorganization plan. Id. at 806. The court appointed a shareholder committee to represent the interests of that group and held hearings to resolve the dispute. Id. Following the court’s preliminary ruling, the parties settled on a plan. Id. at 811; see also Rebecca Smith, Court Orders Mirant to Revamp Calculation of Value of Company, Wall St. J. Online, June 30, 2005 (on file with the Columbia Law Review).


192. 11 U.S.C. § 1129(a)(8), (b).


194. Even this bankruptcy system, designed for negotiation and conflict resolution, has been strained by the development of credit derivatives. There is emerging concern
To illustrate the difference between conflict resolution in Chapter 11 and in the normal corporate context, consider an airline’s desire to buy more gates at an important hub airport. Suppose the management proposes to finance the acquisition with a loan secured by all of its gates at all airports, not just the gates being purchased. The gates will also secure some previously unsecured debt owed to the same lender. The loan would include some tight covenants limiting management discretion in operating the airline. The lender supports the proposal. But shareholders might prefer that the airline finance the gate acquisition from cash flow, avoiding both the possible loss of control of the gates to the secured creditor and the restrictions of the new covenants. Unsecured creditors might see the gates as valuable assets being removed from the pool of assets available to pay them in case the company liquidates.

Outside of bankruptcy and absent preexisting contractual commitments, managers need accommodate the concerns of creditors only to the extent that doing so would further the interests of shareholders. Moreover, managers generally have wide discretion to make business decisions of this sort which they believe to be optimal for shareholders.

Following a Chapter 11 filing, if management as DIP wishes to buy the gates, it must notify creditors and attend a hearing at which the various parties can voice their concerns. Admittedly, that process is more cumbersome and expensive than the normal corporate procedure outside of bankruptcy. It is always cheaper and faster for a self-interested party to make a decision in the shadows, but the conflicting interests inherent in this process require transparency and an opportunity for competing views if decisions are to be fair and to maximize value.

Finally, the transition costs associated with a move from the corporate governance system to the bankruptcy system, and of operation under the latter system, are probably lower than they once were. For one thing, the reputational costs of filing for corporate bankruptcy have decreased. Because so many companies, especially large and visible ones, have been reorganized without serious injury or inconvenience to customers, a company in financial distress can continue to operate, and even thrive, during a bankruptcy proceeding. There is no longer any reason to assume that a business cannot remain for a substantial period of time in a Chapter 11 proceeding without any greater loss of customers than it might have faced outside of a proceeding. The 7-Eleven stores on many American street corners illustrate how even consumer-oriented businesses can use

that, as a result, creditors sometimes may not have the normal economic incentives to maximize value and save a business because they have bargained away risk. See INSOL Int’l, Credit Derivatives in Restructurings 15–16 (2006); Frank Partnoy & David A. Skeel, Jr., The Promise and Perils of Credit Derivatives, 75 U. Cin. L. Rev. 1019, 1035 (2007) (providing example). For a related point, applicable in both the corporate governance context and the bankruptcy context, see infra Part V (referring to analytical framework conceiving “decoupling” of creditor contractual rights and creditor economic interests).
the process to address their financial difficulties. Moreover, studies suggest that the Chapter 11 process is not substantially more expensive or time consuming than the practical alternatives.

Thus, Chapter 11 offers a reasonably efficient method of resolving conflicting stakeholder interests and reorganizing a business. However, the problem of timely initiation of bankruptcy remains. Since most reorganization filings are voluntary, the debtor’s management decides when to file for Chapter 11. For that reason, the primary factor deterring the filing of a Chapter 11 in contemporary America is management’s fear of losing full control. While management as the DIP remains in control in many ways, that control is greatly diluted by the power of the court, the transparency requirements, and the right of all interested parties to be heard. Further, studies have shown that the management that led the company into financial distress is very often replaced, before or after the Chapter 11 petition is filed. For those reasons, notwithstanding the DIP system, management may have substantial incentives to resolve the debtor’s financial difficulties outside of bankruptcy.


198. This is not to say, of course, that in individual cases the costs associated with lawyers or managers may not be excessive.


E. Consequences of the Duty Shifting Doctrines

The duty shifting regime has a number of unfortunate consequences, but the most important may be how it affects corporate risk taking. The overall effect is to exacerbate management’s aversion to risk and encourage excessive worry about the corporate entity’s success or failure. The duty shifting doctrines are driven by the notion that managers in troubled corporations will take too much risk; the doctrines are, to use a favorite phrase of Warren Buffett and Charlie Munger, “‘precisely wrong.’”

The duty shifting doctrines presume that managers always engage in shareholder-optimal risk taking. In particular, when a corporation approaches insolvency and thus the shareholder has little to lose, the concern is that managers would adopt highly risky, even negative net present value projects because that would be best for shareholders. The shareholders would, in effect, enjoy a free ride with the creditors’ money. Our favorite example is the case of In re Tri-State Paving, Inc., in which it appeared that the directors removed the business’s last remaining cash and gambled the company’s fortunes at the tables of Las Vegas. Perhaps they were seeking to emulate Fred Smith, who, desperate for cash, flew to Las Vegas and won the $27,000 that saved a fledgling Federal Express.

Yet this assumption is puzzling. As we have seen, managers are generally unwilling to take shareholder-optimal risk even in a healthy corporation; there are few reasons to believe this would change when a corporation is troubled. Indeed, when a company becomes financially troubled, it is possible that its management’s disincentives to take shareholder-optimal risks increase. Various cultural pressures, themselves exemplified by the duty shifting doctrines, may press them “to take care to take care” rather than to take appropriate risks. Their natural inclination to protect salaries and benefits will be exacerbated, especially as the value of their firm-specific human capital and their securities holdings are likely to have substantially diminished. Under such circumstances, a “bet


202. For a discussion of the notion that the corporation’s assets now represent the creditor’s money—that is, the idea of the primacy of the residual claimant—see supra note 16 and accompanying text; infra Parts III.A., III.C.2, IV.


205. See supra Part II.A.2.
the company" strategy may be less appetizing for management than for diversified shareholders.206

In addition to these incentives, creditors—especially lenders—pressure management to protect creditors’ interests at a time when management must rely even more on creditors, and especially lenders.207 A company in financial distress will find it difficult to raise additional equity. Thus, management will likely seek needed capital to replace losses in the lobbies of banks and from other institutional investors, especially if those lenders have well-established stakes in the form of earlier credits. Not only will those lenders be willing to consider financing that might permit recovery, they may be anxious both to avoid a quick write-off and to improve their position in case of ultimate failure. Lenders often achieve the latter goal by obtaining a security interest or a corporate restructuring that isolates a pool of assets—for example, a finance subsidiary—for their privileged access in the event the business fails.208

Equally important is the fact that such additional credit may buy influence or even de facto control from a management eager to avoid the loss of ultimate control that arises even in bankruptcy under the Chapter 11 DIP system in the United States.209 As the lenders’ influence grows, managers may be pressured to make decisions about risk that favor debt holders rather than shareholders. The duty shifting doctrines are not needed to shift management focus in this way. The doctrines serve instead to justify a self-interested shift and perhaps to exaggerate it.210 Worse still, the decisions made by management and lenders in creating and maintaining such an alliance will be relatively opaque, even in a public company.

Contrary to conventional wisdom, timidity is the greatest danger with regard to risk taking in a distressed corporation.211 Yet the effect of the

206. One exception might be where options that are well out of the money (as may be the case with troubled corporations) tempt managers to engage in “bet the company” behavior—the increase in volatility alone would, under standard option pricing models, increase the value of their options. See, e.g., Hu, Risk & Time, supra note 12, at 328–29 (discussing incentive effects of stock options on managerial risk taking).

207. See Adler et al., supra note 200, at 8–9 (stating that “debtors now frequently enter bankruptcy with little or no liquid assets and require an immediate debtor-in-possession . . . loan to continue in business, with the pre-bankruptcy secured lender . . . in a unique position to provide such a loan”).


209. See Skeel, Past, Present & Future, supra note 187, at 1920–21 (describing scenarios in which control has shifted through additional credit).


211. For an empirical exploration of the potential alliance of caution between management and bondholders, from the perspective of the bondholders, see Mark S.
Credit Lyonnais decision and other duty shifting doctrines may be to add the voices of the company’s lawyers to the anti-risk chorus. The lawyers may also advise that the business judgment rule would not protect directors.\textsuperscript{212} After all, the business judgment rule requires as preconditions “good faith” and the belief that the action was “in the best interests of the company.”\textsuperscript{213} And what is the “company” for this purpose? North American suggests, in effect, that this means “creditors”: On insolvency, the creditors are “the principal constituency injured by any breaches that diminish the firm’s value.”\textsuperscript{214} A judge seeking to avoid the effect of the business judgment rule could hold that shareholder-optimal risk taking by a troubled company meets neither of these preconditions. Equally pernicious, the lawyers might advise directors that any extremely conservative decisions are protected by their duty to creditors.

It is hard to imagine a worse result for the public interest in a dynamic, entrepreneurial society.\textsuperscript{215} We want managers to take risks, even perhaps to embark on “bet the company” projects when it makes sense to do so. We should reduce the opportunities for managers to engage in self-serving cowardice. There is nothing wrong with Boeing having bet

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\textsuperscript{212} See, e.g., Richard M. Cieri & Michael J. Riela, Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions, 2 DePaul Bus. & Com. L.J. 295, 303–06 (2004) (noting lack of clarity about whether business judgment or entire fairness rule applies to duties to creditors).

\textsuperscript{213} Under Delaware’s current formulation, the business judgment rule is “a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). On similar grounds, some lawyers have urged that directors may have a duty to cause their corporations to hedge against currency, commodity, and other market fluctuations. This reflects, among other things, a failure to distinguish between the welfare of the corporation and the welfare of diversified shareholders. See, e.g., Hu, Behind the Corporate Hedge, supra note 109, at 49–50 (discussing corporate hedging and varying approaches of gold mining companies); supra Parts II.B.1.a, II.B.2 (discussing conflicts between entity-optimal and shareholder-optimal risk behavior). It is increasingly recognized, by gold mining companies and others, that such advice is often contrary to the interests of shareholders. As one example, Barrick, the leading gold miner that had hedged aggressively against drops in the gold price, has recently moved significantly away from hedging as a policy matter. Canadian Press, Barrick Gold Corp. Goes Unhedged, Now Able to Sell Production at Spot Prices, May 2, 2007, available at Westlaw, Canadian Press Wire (on file with the Columbia Law Review) (noting how Barrick’s status as unhedged gold producer “marks the end of an era”).


the company on the 707, the first commercial jet airplane, or IBM having bet the company—spending more than the cost of the Manhattan Project—to develop the IBM 360. Our venture capital industry, the envy of the world, assumes it will lose its bets on most of its startups. It is an industry built on a business model arguably compromised by the duty shifting doctrines. The economic consequences will be even greater as the doctrines spread to healthy companies.

III. DUTY SHIFTING AND THE FOUNDATIONAL STRUCTURE OF OWNERSHIP RIGHTS

We have argued to this point that duty shifting creates structural mismatches between the two governance systems and the three duty regimes. In Part III, we offer critiques based on how duty shifting undermines the foundational structure of ownership rights.

We start with the incompatibility of the doctrines with the structure of shareholder ownership rights in place since the emergence of the corporate form. The doctrines ignore the “dynamic” elements of the economic rights of shareholders and ignore altogether the voting and other embedded rights of shareholders.

We accept that the classic structure of shareholder economic rights and embedded rights could be changed, at least prospectively, for some persuasive policy reason. However, no serious consideration has ever been given to changing the structure or altering those rights.

The duty shifting doctrines impose upon corporations and their directors a unique duty to creditors that does not burden any natural per-

216. See, e.g., Jim Collins, The Wizard, King, and Hobbit of Business, Fast Company, Apr. 2004, at 93, 95 (discussing IBM 360 project); The Selling of the 707, Fortune, Oct. 1957, at 129, 129 (stating that prior to first 707, Boeing had invested $185 million—$36 million more than Boeing’s net worth in previous year); Jerry Useem, 20 That Made History, Fortune, June 27, 2005, at 58, 60 (implying that 707 was negative net present value project); cf. Leslie Wayne, Boeing Bets the House—A Return to No. 1 Rests on Its New Dreamliner, N.Y. Times, May 7, 2006, § 3, at 1 (noting how Boeing is today resting its hopes on 787, its first new commercial airplane in a decade).


son. The shift in property rights that turns on changes in value violates fundamental societal norms as to transparency and legal process in the deprivation of ownership rights.

A. Shareholder Economic Rights

The duty shifting doctrines embody a fallacy that has the effect of assuming away valuable economic rights of shareholders. They are based on a view of “insolvency” that is rooted in nineteenth century balance sheet attitudes. In addition, they implicitly adopt the notion that all corporations that are “insolvent” at any instant in time are liquidated.

The Delaware Supreme Court’s “residual claimant” analysis in *North American* illustrates the aforementioned fallacy. It assumes that, when a company is troubled, shareholders are bereft of any economic interest in the company because the residual claimant would receive nothing upon liquidation of the company. This analysis, however, looks only at the “static” economic interests of the shareholder.

*North American*’s static as-if liquidation framework is at odds with the real world. In fact, insolvency is simply a nonevent as a legal matter in many circumstances. Many corporations that are insolvent at a particular point in time never enter bankruptcy and remain ongoing enterprises. Whether due to changing market conditions or better management, these corporations frequently return to prosperity. Shareholders thus reap the benefits of their dynamic economic rights associated with future cash flows.

In fact, irrespective of the immediate financial condition of the company, the shareholders have something in the nature of a call option on a brighter future.220 And call options always have value.221

The Delaware courts’ residual claimant analysis assumes away the existence of such dynamic, call option-like, economic rights. Indeed, language in *North American* seems directly contrary to the true state of affairs. The Delaware Supreme Court states that when a corporation is insolvent, the creditors are the “residual beneficiaries of any increase in value” as if the corporation will be liquidated the moment it becomes insolvent. This

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220. See supra note 18 and accompanying text (discussing this analysis and its relationship to “contingent claims analysis” approach in finance theory). That is, their economic ownership rights, as a legal matter, include a call option in the economic sense. A call option is a form of contract that gives the owner of the contract the right, but not the obligation, to buy an asset at a specified price. This contract has value to the owner that varies with, among other things, the exercise price under the contract, the current price of the asset, and the time remaining until expiration. See, e.g., Hu, Misunderstood Derivatives, supra note 18, at 1466–67, 1473–76 (discussing ability of contracts to insulate exogenous risk and describing independent variables influencing value of option).

221. This is because an option only gives rights and does not impose any obligations on the options holder: In other words, the obligation is one-sided. Consideration of options pricing models also confirms this. See Hu, Misunderstood Derivatives, supra note 18, at 1466–67, 1474–76 (discussing nature of obligations as to options and Black-Scholes option pricing model).
approach ignores entirely the possibility—indeed, the likelihood—that the corporation will not enter bankruptcy at all, much less be liquidated in connection.222

It is not coincidental that Chancellor Allen used a pure liquidation example where it may be easiest to assume that the decisionmaker should owe greater fidelity to the senior debt holders. The company had no operations and no prospects beyond distributing cash.223 Presumably, it would go through a winding up under state law or a bankruptcy to complete the liquidation process. But if the company had ongoing operations and prospects, it seems untenable simply to assume that its directors should manage the company on the basis of priorities that would prevail in a hypothetical liquidation distribution,224 given that insolvency by no means requires liquidation under modern bankruptcy law. Even in the liquidation context, the subordinated debt example shows us that postulating a duty to “creditors” disguises the typical conflicts of interest among creditors. Neither the narrow insolvency-based duty shifting doctrine nor Chancellor Allen’s broader community of interests notion purports to deal in any way with this issue,225 although we owe a debt of gratitude to the Chancellor for introducing an example that should eventually force consideration of the larger problem of default management.

Indeed, even if all insolvent corporations were the subjects of bankruptcy filings, the doctrines would be troublesome due to their assumptions. The perspective of modern bankruptcy law is focused not on liquidation but on reorganization of a business and the way forward.226 These doctrines implicitly assume that insolvency means death for a corporation, despite all the evidence to the contrary. The doctrines may lead a company to embrace a zombie-like state of decline and eventual death precisely because the doctrines would discourage the risk taking that may be necessary for survival.

B. Shareholder Voting and Other Embedded Rights

1. Of Permanent Value: Exclusivity and Immutability. — As we have discussed, only shareholders have the vote, and they have the vote irrespective of the financial circumstances of the corporation.227 This rule ani-

223. See supra note 57 and accompanying text.
224. See Lipson, supra note 49, at 1231–32 (“At the moment it matters most—the ‘vicinity of insolvency’—it will usually be difficult, if not impossible, to know whether the corporation will be able to reorganize, or whether it will have to liquidate.”).
225. See supra Part I.B.2.
226. It is instructive to note that even in England the “wrongful trading” provision penalizing directors for carrying on an insolvent business requires that they know the business has no reasonable prospect apart from liquidation. Insolvency Act, 1986, c. 45, § 214(3) (Eng.).
227. As to the core nature of shareholder exclusivity in voting power, see Hu & Black, Taxonomy, supra note 53, at 1013–14; Hu & Black, Decoupling, supra note 53, at 344,
mates most of the central legal and market mechanisms of the corporate governance system. In addition, shareholder exclusivity as to inspection rights continues and shareholders continue to have rights to sue for fiduciary duty.228

The duty shifting cases simply focus on the economic rights (and, as we just discussed, misinterpret those rights) and ignore entirely these embedded ownership rights. Nowhere in *Credit Lyonnais*, *Production Resources*, or *North American* is there any reference to these shareholder rights. Indeed, the residual claimant approach adopted in the two later cases only considers the economic rights of stakeholders. Using this approach, the Delaware Supreme Court suggests that, because shareholders in insolvent companies no longer have any economic stakes, they have no stakes at all in the company.229 Inherent in this move is the notion that shareholders only have economic rights.

The corporate governance system has a deeply embedded notion of shareholder ownership far broader and more enduring than is acknowledged in the duty shifting cases. There is some irony in this. Chancellor Allen has himself recognized the importance of shareholder voting rights and that such voting rights are integrally related to the concept of ownership and the exercise of directorial power. In the celebrated case of *Blasius Industries v. Atlas Corp.*, Chancellor Allen noted that shareholder voting rights are “critical to the theory that legitimates the exercise of power by [directors and officers] over vast aggregations of property that they do not own.”230 Yet when times are bad, Chancellor Allen apparently viewed the exercise of directorial power against the interests of those who elect them as not only legitimate, but mandated.231

353–55; Hu & Black, The New Vote Buying, supra note 8, at 814–15; see also supra Parts II.B, II.C.1, II.D.1.

228. Indeed, as discussed in Part IV infra, shareholders have the exclusive right to sue directly for breaches of fiduciary duty.


231. See supra Part I.B.2. Other mechanisms of the corporate governance system, however, continue to operate in favor of shareholder interests. The market for corporate control is animated in large part by share prices: a low share price flowing from “bad” management that would attract bidders and a subsequent higher share price after a spell of “good” management. Incentives force corporate managers to focus on maximizing shareholder wealth. (Indeed, if corporate managers instead managed the company in the interests of creditors as directed by duty shifting, an unwelcome hostile takeover would be all the more likely.)

Another factor aligning managers with shareholders is that managers typically have large securities holdings, including shares and stock options, in their companies. Even when companies are troubled, those securities holdings continue to incentivize managers to focus on the share price. As noted above, these factors may or may not outweigh the
ABOLITION OF THE CORPORATE DUTY TO CREDITORS

It is elementary that principals can choose their agents and, accordingly, the stockholder franchise is the legal centerpiece of the governance system. These matters go beyond the instrumental. Absent accountability to shareholders, the power vested in directors has no legitimacy. From the very beginning of the modern corporation, to be a shareholder has necessarily involved possession of voting, inspection, and other embedded rights. Although shareholders can continue to vote, inspect, and sue, the shifting of duties from shareholders to creditors renders such embedded rights meaningless. Nothing short of the fundamental destruction of core shareholder ownership rights is at stake in the application of the duty shifting doctrines.

2. Of New Value: Recent Trends and the “Decoupling” of Voting Rights.—Recent trends emphasize the increasing value of shareholder voting rights: The role and influence of shareholders in the running of corporations appear to have changed dramatically in the past several years. And, in the past few years, hedge funds have pioneered innovative methods for “decoupling” voting rights from economic ownership. These recent trends as well as this new phenomenon suggest that voting rights must now be seriously—and separately—considered in any analysis of the property rights of shareholders.

The role of hedge fund activism and other market forces is well recognized. Less well recognized is the fact that hedge funds are starting to engage in large scale, often hidden purchases of the voting rights of other shareholders. Through over-the-counter derivatives and other financial products, voting rights can now be increasingly “decoupled” from economic interest in a company. In one example, the hedge fund Laxey Partners held about one percent of the shares of British Land but, to the surprise of British Land, voted over nine percent of its shares. Just before the record date, Laxey had secretly borrowed almost forty-two million shares.

This new phenomenon is relevant to our analysis because, among other things, it shows that hedge funds believe voting rights can have influence over management that creditors often enjoy during periods of financial distress. See supra notes 202–211 and accompanying text.

232. See supra note 8.

233. See, e.g., Hu & Black, Taxonomy, supra note 53, at 1014 (“Sometimes [hedge funds] hold more votes than shares—a pattern we call ‘empty voting’ because the votes have been emptied of an accompanying economic interest.”); Hu & Black, Decoupling, supra note 53, at 348 (describing practice of “empty voting” by hedge funds); Hu & Black, The New Vote Buying, supra note 8, at 815 (analyzing decoupling of economic ownership from voting power and corporate governance implications); Scannell, supra note 8 (recounting instances of “empty voting” by hedge funds); White, supra note 8 (“The concern centres on the increasing ability of hedge funds and other sophisticated investors to accumulate large voting positions while having little, or even negative, economic interest in a company.”); see also infra Part V (discussing implications of decoupling for our analysis).

material value independent of the economic rights of ownership. If they
do not, these quintessential sophisticated investors would not be devoting
such energy to engaging in “empty voting” and related decoupling
activities.

Even leaving this phenomenon entirely aside, other trends suggest
that shareholder influence is indeed increasing and thus that share-
holder voting rights are important. Observers with widely divergent views
on the desirability of enhanced shareholder power agree that the role of
shareholders in corporate governance has undergone a sea change in the
past several years.235

The central focus of the shareholder vote is the election of directors.
Although director elections in public companies have been mostly sym-
bolic since the emergence of the publicly held corporation, this situation
has changed dramatically and is likely to change more in the next several
years. The first development relates to how directors are elected. Previ-
ously, nearly ubiquitous plurality standards of voting strengthened direc-
tors’ reelection chances, but stockholder activists began encouraging
companies to move to a majority voting standard, which made stock-
holder votes cast against a nominee more meaningful.236

Such pressure apparently has had a significant effect. At the start of
2005, fewer than thirty of the Standard & Poor’s 500 had bylaws or poli-
cies requiring a majority voting standard.237 By early 2006, this figure
had increased to roughly 145.238 While we remain to be persuaded, some
observers believe that this reflects a major shift in the balance of power
between shareholders and corporate boards.239

235. Those who view this change positively refer to a “new corporate governance
paradigm” while those who look askance speak darkly about opening the “floodgates to
contested elections.” See, e.g., Brooke A. Masters, Shareholders Flex Muscles, Wash. Post,
June 17, 2006, at D01 (quoting Patrick McGurn of Institutional Shareholder Services as
saying that “new corporate governance paradigm [is] emerging” with respect to
shareholder power); Memorandum from David A. Katz & Laura A. McIntosh, Wachtell,
Lipton, Rosen & Katz, to Clients, Corporate Governance: A Seismic Shift in the Mechanics
of Electing Directors (July 27, 2006) (on file with the
Columbia Law Review) (stating that
“[t]his is a dynamic moment in the history of public company shareholder voting” and that
certain changes in voting mechanics “threaten to open the floodgates to contested
elections”).

236. See, e.g., infra note 246 and accompanying text (discussing impact majority vote
system would have had on reelection of Disney chairman Michael Eisner).

237. Masters, supra note 235.

238. Id.

239. See Claudia H. Allen, Study of Majority Voting in Director Elections i–v (Feb. 5,
Columbia Law Review); Companies Switch to Tougher Majority Voting for
13 (2006); Masters, supra note 235. In June 2006, at the end of the proxy season, Wachtell
Lipton, a firm long oriented to director primacy, admitted that the majority voting
standard “will become universal.” Memorandum from Martin Lipton, Gregory E. Ostling
& David M. Adlerstein, Wachtell, Lipton, Rosen & Katz, to Clients, Majority Voting—A
Look Back at the 2006 Proxy Season (June 12, 2006) (on file with the Columbia Law
Another development relates to what is likely to be voted on by shareholders at a typical annual meeting. As recently as several years ago, incumbent directors rarely faced annual reelection; by the end of 2007, “more than half of the nation’s 500 biggest publicly traded companies will hold annual elections, up from 45 percent two years ago.” Furthermore, shareholder activists have been increasingly successful in addressing “poison pills” and other mechanisms helpful to incumbent management.

Likely developments driven by the SEC and the New York Stock Exchange promise to level the playing field further. In December 2005, the SEC proposed amendments to the rules regarding the delivery of proxy materials that would allow both issuers and shareholders, even in the absence of shareholder consent, to satisfy proxy requirements by posting the materials on a website with thirty days notice, making it cheaper and hence more likely that dissidents would wage fights and perhaps succeed. In July 2007, the SEC proposed a rule that would allow shareholders who own five percent of a company for one year to propose bylaw amendments governing how directors are elected (as well as another rule calling for the exact opposite). In October 2006, the NYSE adopted several recommendations of its “Proxy Working Group” and submitted them to the SEC for approval. One of the recommendations would restrict brokers from voting street name shares in uncontested directorial


241. Memorandum from David A. Katz & Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz, to Clients, Corporate Governance Update: Poison Pills—Maintain Flexibility in Takeover Defense (Jan. 26, 2006) (on file with the Columbia Law Review). Under shareholder pressure, companies have increasingly eliminated takeover defenses or submitted them to a shareholder vote. In 2004 and 2005, shareholders voted on nearly seventy-five precatory shareholder proposals to rescind poison pills. Each received an average of fifty-seven percent of the votes cast. Lawyers advise corporations that the consequences of ignoring such majority votes “can be severe” and that they “should take care to avoid that situation if possible.” Id. at 3.


elections. Had this rule been in effect at the 2004 annual meeting of the Walt Disney Company under a “majority vote” standard, Disney’s chairman, Michael Eisner, would not have been reelected to the board.

Aside from directorial elections, precatory shareholder resolutions dealing with such matters as executive compensation not only appear to be garnering more votes, but seem to be influencing managements more. The sudden “mutually agreed” upon resignation of Bob Nardelli at Home Depot in January 2007 is attributable at least in part to his failure to address shareholder concerns regarding compensation. The man in the chicken suit at the annual meeting, taunting Nardelli to comment on his compensation, had won.

Moreover, in terms of judicial developments, rising shareholder antipathy to poison pills has spurred a Delaware Chancery Court opinion that appears, for the first time, to suggest shareholders may impose binding mandates on boards. Directors were “agents” of their shareholder “principals” and were bound by shareholder decisions. The court extends the analysis:

Agents frequently have to act in situations where they do not know exactly how their principal would like them to act. In such situations, the law says the agent must act in the best interests of the principal. Where the principal wishes to make known to the agent exactly which actions the principal wishes to be taken, the agent cannot refuse to listen on the grounds that this is not in the best interests of the principal.

In a January 2006 follow up opinion accompanying an order approving News Corp.’s motion for a pretrial appeal to the Supreme Court,

245. Report and Recommendations of the Proxy Working Group to the New York Stock Exchange 21 (June 5, 2006), at http://www.nyse.com/pdfs/PWG_REPORT.pdf (on file with the Columbia Law Review). About seventy to eighty percent of all publicly held companies’ shares are held in “street name,” meaning that the record owner is a broker, bank, or other depository. Id. at 10. Under NYSE’s existing Rule 452, brokers who hold shares for their clients and do not receive specific voting instructions prior to the meeting date may use the brokers’ own discretion in voting on any matters considered “routine.” Id. at 8. One of the items considered “routine” was the uncontested election of directors. Id. at 1. Historically, brokers have cast uninstructed shares “overwhelmingly” in support of the board’s recommendations, meaning that the incumbent board has a significant advantage in director elections and other matters. Id. at 14.

246. Eisner was reelected with fifty-five percent of the votes cast. Had broker votes not counted, Eisner would have received only forty-five percent of the votes. Id. at 9.

247. See Masters, supra note 235. A 2006 Council of Institutional Investors study found that sixty-one of the ninety-seven companies whose shareholder proposals received a majority vote in 2005 had taken action similar to that requested—more than double the percentage of the previous year. Id.


250. Id.
Chancellor Chandler softened his stance somewhat, indicating that he had “employed agency law principles to illustrate by analogy the gap filling nature of fiduciary duties.” Much to the surprise of the bar, the Delaware Supreme Court refused the appeal. Interpreted in the most modest terms, *Unisuper Ltd. v. News Corp.* suggests an emphasis on the furtherance of the shareholders’ interests. Interpreted more broadly, *Unisuper* suggests the beginning of a judicial shift in favor of allocating power from directors to shareholders.

The consequence of these recent trends and the new decoupling phenomenon is that the voting power of shareholders is becoming a distinct and valuable property right. Any serious analysis of the shareholder ownership rights cannot ignore shareholder voting rights. These developments may also suggest a rising tension between two legal trends: increased shareholder power and increased judicial pressure on directors to serve creditors’ interests.

C. Shareholder Ownership Rights and Private Property

1. A Special Corporate Duty to Creditors? — Outside of bankruptcy, our law does not generally recognize any noncontractual duty of natural persons to their creditors other than the usual strictures against fraud and other similar bad conduct. The supposed duty to creditors at the heart of the duty shifting doctrines is unsupported by any plausible argument that would distinguish corporations from natural persons vis-à-vis their creditors.

   It seems obvious that the search for justifying duty shifting should start with a general understanding of the duties of natural-person debtors to their creditors. Yet the duty of a human debtor to a creditor is itself a subject remarkably unexamined. Cases of debt enforcement fill the reporters. Thousands of law review pages each year are devoted to bankruptcy, secured credit, Truth in Lending, and many other debtor-creditor topics, but the foundation of the entire edifice of debtor-creditor law—the duties of the debtor to the creditor—has received almost no attention. A debtor’s duty seems for the most part to consist of the first pre-

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mise of contract law: pacta sunt servanda. The debtor has promised to pay and should pay. If payment is not forthcoming, the debtor should be made to pay what was promised, albeit within the constraints of quite limited contract remedies.

And there it ends. To explore fully the rationale for this limitation of the duties of debtors would require another article or perhaps a book. We do no more than sketch the story as it relates to the duty shifting doctrines. Because these issues have been largely ignored, we write on a nearly clean slate.

Laws relating to preferential payment, fraudulent transfers, and what the British call “transactions at an undervalue,” do not impose a duty on a debtor and do not provide a liability remedy against a debtor. The remedy in each case is that the debtor’s transferee must return the payment or other property involved. There are actions against debtors for injury to or concealment of the collateral of secured creditors, but those remedies appear to arise from the notion of interference with the creditor’s property interest, not from an independent duty owed to the creditor. They are largely grounded in fraud rather than any heightened duty to creditors.

The law does not even hint that an individual debtor’s behavior must change to conform to the interests of creditors when the debtor is in parlous financial straits. No doctrine proclaims that a person who is insolvent must not take unnecessary financial risks lest creditors be prejudiced (which is fortunate considering that a large percentage of Americans are insolvent on a balance sheet basis at any given moment). We would be astonished to hear that VISA has claimed a breach of fiduciary duty when one of its subprime customers started a risky new business or took up skydiving. Even residential mortgage lenders, who occupy a privileged position, would not make such claims. It has never been suggested that a homeowner owes a duty of any kind to the holder of a home


256. By an “individual” debtor, we refer throughout to a debtor who is a natural person rather than a legal entity.
mortgage, beyond the promise to pay and the risk of foreclosure if payment is not made.\(^\text{257}\)

In short, absent fraud or its close equivalent, no individual debtor in the United States has duties to creditors other than the contractual duties established by the agreement between them.\(^\text{258}\) Furthermore, although debtors are bound by those contractual restraints, the sanctions that enforce them are confined within the fairly narrow range of remedies permitted by the law of contract.\(^\text{259}\) Creditors ought to look to their contracts for protection and not elsewhere.\(^\text{260}\)

\(^{257}\) As with personal property, there is an action for conversion or waste if the debtor puts the collateral beyond a secured party’s reach, but that remains a property-based remedy, not an independent duty owed to the creditor qua creditor. It is also an ordinary, tort-like duty, not a fiduciary obligation.

\(^{258}\) Even after default, debtors do not owe their creditors fiduciary or other special duties. Instead, creditors are expected to include in their contracts such restraints on debtor behavior as they think necessary and appropriate. Both individual and corporate debtors are subject to receivership remedies in cases of fraud or similar conduct. Warren & Westbrook, Text, Cases & Problems, supra note 31, at 154–55. However, these remedies are conservative, protecting the value of the debtor’s property for the benefit of creditors, rather than imposing a liability duty on the debtor.

\(^{259}\) Sometimes these contractual duties are supported by the restraints imposed by property law with regard to collateral given as security, but those restraints are themselves quite narrow. There is a rich literature concerning the costs and benefits of expanding contract liability, but most of it in recent years has been focused on tort liability along the lines of tortious inducement of breach of contract. See, e.g., Mark P. Gergen, Tortious Interference: How It Is Engulfing Commercial Law, Why This is not Entirely Bad, and a Prudential Response, 38 Ariz. L. Rev. 1175, 1182–85 (1996) (exploring different prayers of damage under tortious interference that can create “an enormous potential scope in contract”); Harvey S. Perlman, Interference with Contract and Other Economic Expectancies: A Clash of Tort and Contract Doctrine, 49 U. Chi. L. Rev. 61, 70–72 (1982) (assessing costs of economic loss with respect to determining proper limits of liability for tortious act); James B. Sales, The Tort of Interference with Contract: An Argument for Requiring a “Valid Existing Contract” to Restrain the Use of Tort Law in Circumventing Contract Remedies, 22 Tex. Tech. L. Rev. 123, 127 (1991) (“Generally, contract remedies promote efficiency and predictability, whereas the intervention of tortious interference with contract introduces inefficiency and unpredictability.”). For a list of critiques of tortious interference’s ambiguities, see Gary Myers, The Differing Treatment of Efficiency and Competition in Antitrust and Tortious Interference Law, 77 Minn. L. Rev. 1097, 1109–10 (1993).


Apparently, lenders and other creditors do not often bargain for directors’ duties to protect creditor interests. One reason may be that they are not regarded as important or efficacious for creditors. Another possible reason is the risk of liability to a creditor found to have been in control of a corporation. See, e.g., Bergquist v. First Nat’l Bank of St. Paul (In re Am. Lumber Co.), 5 B.R. 470, 477–78 (Bankr. D. Minn. 1980). In addition, depending on the nature of the agreement, there may be questions as to its enforceability under Delaware law.
It seems plausible to think that this silence about debtors’ duties to creditors communicates an underlying normative assumption that contract remedies are all that are justified with regard to the collection of debts, absent fraud.\textsuperscript{261} It follows that noncontractual duties said to be owed to creditors by corporations or their directors must arise from something unique about corporations as debtors. Limited liability is the obvious characteristic relevant to this point. The argument would be that, because the corporation’s managers and owners are generally immune from suit for its obligations, special protections are necessary to avoid abuse of the corporate form vis-à-vis creditors.

In the modern age, it is hard to understand why limited liability should create this distinction between corporations and individuals.\textsuperscript{262} In the first half of the nineteenth century, when bankruptcy law was only an experiment, most business was done through proprietorships or partnerships, with unlimited personal liability. Limited liability corporations were a new and troubling phenomenon for creditors. Property exemption from debt enforcement was narrow in the common law world,\textsuperscript{263} so that, along with the lingering risk of incarceration,\textsuperscript{264} a proprietor or partner placed most of his or her property on the line when an obligation arose.\textsuperscript{265} In that world, the new corporate creature with limited liability appeared a ready candidate for abuse of creditors. That perception may account for the origins of the long since abandoned par value and paid-in capital rules discussed above.\textsuperscript{266}

\begin{footnotesize}


\textsuperscript{264} Imprisonment for debt retreated, but unevenly. Balleisen, supra note 263, at 12 (“From the 1820s onward, a growing number of states dramatically curtailed the use of imprisonment for debt, essentially restricting the institution to instances in which a debtor was guilty of gross fraud.”); Bruce H. Mann, \textit{Republic of Debtors} 106 (2002) (commenting that argument against imprisoning debtors—that old insolvency laws were based on fiction that debtors were criminal—resulted in New York abolishing imprisonment for most debt in 1831, while Pennsylvania waited eleven more years to abolish imprisonment for most debt).

\textsuperscript{265} Balleisen, supra note 263, \textit{passim} (discussing bankruptcy discharge of personal liability for business debts).

\textsuperscript{266} See Trevor v. Whitworth, (1887) 12 App. Cas. 409, 411 (H.L.) (appeal taken from C.A.) (“The surrender of shares . . . may be lawfully made without reducing the real capital, but no reduction of capital otherwise than as allowed by statute is legitimate . . . .”); Craig A. Peterson & Norman W. Hawker, \textit{Does Corporate Law Matter? Legal Capital Restrictions on Stock Distributions}, 31 Akron L. Rev. 175, 180–83 (1997) (discussing

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The modern world of granting credit assumes the availability of the bankruptcy discharge, along with exemptions and other asset protection rules. Thus, all the actors in commercial relationships understand that both corporate and individual obligations are backed by limited assets at best.\footnote{267} It is therefore anachronistic to suggest any great difference between individuals and corporations with regard to common law or corporate law duties because of the limited liability doctrine.\footnote{268}

The duty shifting doctrines rely on two policy justifications, presented as common sense. The first justification is moral hazard, the central argument in Credit Lyonnais. This justification can be quickly dismissed as a ground for distinguishing natural persons from corporations for this purpose. A natural person on the brink of bankruptcy may well decide to take a flier in Las Vegas. Nothing in the law would suggest that this debtor is violating any fiduciary duty to his creditors.\footnote{269} If anything, the moral hazard claim for corporations on the brink of bankruptcy has less force, a point we discuss above.\footnote{270} The second justification turns on the concept of the “residual claimant,” which we show below to be radically inconsistent with the structure of shareholder economic rights and shareholder embedded rights.\footnote{271}

2. The Automatic Deprivation of Property. — Duty shifting cases like Production Resources rely on a residual claimant argument rather than some special corporate duty.\footnote{272} As noted earlier, the notion here is that the managers always owe their duty to the residual claimants. In good times, the shareholders are the residual claimants; in bad times the creditors are. When the identity of the residual claimants changes, the focus of a manager’s duties should shift as well.
The effect of the as-if liquidation residual claimant approach is the creditor’s seizure of the shareholder’s legal ownership rights as soon as some sorry economic state arises. The duty shifting doctrines accomplish the seizure within the confines of the board room. There is no disclosure of a change in duty, partial or complete, to the shareholders or the capital markets, much less the other procedural and substantive safeguards expected to govern an involuntary transfer in a society based on private property. SEC disclosure requirements such as those flowing from the “Management’s Discussion and Analysis” and “Executive Compensation” items of Regulation S-K might arguably apply to duty shifting. But we are not aware of any corporation that has made such a disclosure.

Generally, United States law does not include an automatic change of ownership based on shifting financial values. Consider a natural person, Baker, whose home is worth less than the outstanding mortgage. Baker still owns the house. Indeed, Baker still owns the house even if the mortgage is under water and a payment or two has been missed. Baker has the option of holding onto the house and hoping for a housing bubble unless and until the mortgage holder goes through some specific legal steps.

It is true that in case of default, Baker’s mortgage holder has the right to foreclose, sell the house, and get paid from the proceeds, but those are all the rights it has and their exercise is heavily regulated and constrained. The loan officer cannot simply march into Baker’s house and set up a new branch in the living room. If the banker tried it, Baker would call the police. Furthermore, Baker has no obligation to manage the house or Baker’s affairs generally in the interests of the bank, short of egregious conduct amounting to conversion or waste. Nor does Baker have any such obligation with respect to unsecured creditors who have no interest in the house or in any other specific asset. After bankruptcy is filed, the bankruptcy stay honors these fundamental rules of property law by protecting the debtor’s ownership in property even if it has no value and even after a secured creditor has begun the foreclosure process.

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273. See Regulation S-K, 17 C.F.R. §§ 229.303, 229.402 (2007). Other, more specific, SEC disclosure requirements, such as those relating to limitations on the payment of dividends, may apply in certain narrow circumstances.

274. On a related point, Professor Lipson has made an effective attack on Credit Lyonnaise by recognizing that the duty shifting doctrines rest upon a confusion between priority and duty. See Lipson, supra note 49, at 1192.


276. See Restatement (Third) of Prop.: Mortgages § 4.1 (1997) (“A mortgage creates only a security interest in real estate and confers no right to possession of that real estate on the mortgagee.”); id. § 4.6 (outlining elements of waste and remedies for breach of duty by mortgagor).

277. See, e.g., Nissan Motor Acceptance Corp. v. Baker, 239 B.R. 484, 488–89 (N.D. Tex. 1999) (mem.) (holding creditor in violation of bankruptcy stay for failure to return car that was lawfully seized before bankruptcy but was not sold before bankruptcy was filed). The stay does not have effect if the foreclosure is complete before filing. See
In short, the as-if liquidation residual claimant status assumes certain economic rights (i.e., “static,” liquidation-based rights) but fails to consider other economic rights we associate with ownership (i.e., “dynamic,” call option-like rights).\textsuperscript{278} Outside the corporate context, those rights remain with the debtor-owner unless and until the appropriate legal mechanism has divested them and placed ownership elsewhere. The secured creditor has some additional property rights,\textsuperscript{279} but these are specific and limited.

These rules seem inevitable in a society like ours that requires clear ownership rules for the protection of market transactions and is deeply committed to notions of private property. Among other things, one cannot imagine property rights constantly appearing and disappearing as property increases or decreases in value. Changes in value do not change property rights until a legal mechanism has been invoked to give them that effect, generally with associated safeguards to protect the property owner.

Similarly, unsecured creditors of an insolvent corporation have various legal rights to sue and execute on judgments, as well as to collect damages for violations of their contractual covenants, but they do not have a right to take over the corporation or to control its affairs. In bankruptcy, creditors have a priority right in the distribution of proceeds from the sale of the business or from its continuing revenues. They may even have the right to elect a bankruptcy trustee to run the business, if the court approves,\textsuperscript{280} but they have no right to run it themselves. Among other consequences of these legal rules is the fact that the bankruptcy trustee will have a fiduciary duty to maximize value for other stakeholders, including equity, if that is reasonably possible, even if the creditors would rather have a sale that would leave equity in the lurch.\textsuperscript{281} A corporation is owned by its shareholders and they remain the owners until a legal process, like bankruptcy, displaces or dilutes their interests, just as a

\textsuperscript{278} Cf. JP Morgan Chase Bank v. Altos Hornos de Mex., S.A. de C.V., 412 F.3d 418, 426–27 (2d Cir. 2005) (finding that funds deposited in collection account from which creditor could withdraw for purposes of debt repayment were not property of creditor).

\textsuperscript{279} As to personal property, the rights to seizure, sale, and payment from proceeds are found in U.C.C. §§ 9-601 to 9-607 (2004). Some courts have tried to expand the rights of secured parties after default, but recent cases have insisted on the traditional bundle. See, e.g., In re Mitchell v. BankIllinois, 316 B.R. 891, 897 (S.D. Tex. 2004) (highlighting differences between lienholder and owner).


\textsuperscript{281} Cf. N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 505–06 (1913) (emphasizing that foreclosure proceedings take into account interests of both shareholders and creditors, even if creditors have “prior rights”); Louisville Trust Co. v. Louisville, New Albany & Chi. Ry. Co., 174 U.S. 674, 688 (1899) (discussing need to protect unsecured creditors from collusion between bondholders and stockholders); Bezanson v. Fleet Bank-NH, 29 F.3d 16, 20 (1st Cir. 1994) (holding that creditor for “loan in default cannot walk away with the collateral if it is worth more than the debt”).
completed foreclosure is necessary to divest Baker of ownership rights in a home.

The other major set of shareholder ownership rights are the control rights flowing from exclusive voting power, inspection rights, and remedial rights for fiduciary breaches. We have already noted how the duty shifting doctrines effectively ignore such embedded rights and that the doctrines effectively transfer at least a portion of this component of shareholder ownership to creditors.282 If those who control the destiny of the corporation are acting for a given interest, then to that extent that interest has control. That point is not merely theoretical. Rather than seeking to cause “shareholders’ duly elected board representatives”283 to act in the shareholders’ interests, the doctrines mandate that they are not to do so. Managers and directors are to exercise the power over those vast aggregations of property that they do not own on behalf of other nonowners—creditors and perhaps the “community of interests.” Although the shareholder franchise still exists, and thus the shareholders can vote to replace their agents, the replacement directors will be told to act for the non-owners’ benefit. Although shareholder inspection rights and shareholder rights to sue directors continue to exist, the meaningfulness of such rights becomes unclear when the directors’ duty lies with creditors.

Considerations of accountability, transparency, and deference to property rights all cut against the duty shifting doctrines. It has long been held that if a creditor takes control of a corporate debtor, the creditor will be exposed to liability if it uses its control in a way that is harmful to other stakeholders.284 One of the reasons for those doctrines is that such creditor control is often opaque, so that other stakeholders dealing with the debtor do not realize their fate is now in different hands.285 Closely related is the importance of associating responsibility with power, lest control be irresponsible. A third reason is the importance of preserving bright lines concerning ownership and control of property in a market society.286 Our law is generally careful not to permit displacement of an owner without a clear and transparent legal mechanism that leads to that result.

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282. See supra Parts II.B, II.C, III.B.
284. See, e.g., In re KDI Holdings, Inc., 277 B.R. 493, 515–16 (Bankr. S.D.N.Y. 1999) (listing elements to establish lender liability); see also Bratton, supra note 117, at 50–51 (noting that managing creditor can be held liable to stockholders).
IV. **North American Revisited**

Because Delaware is such an important jurisdiction, it is appropriate for us to return to the recent *North American* decision for a fuller analysis in light of all that has gone before in this Article. Recall that the plaintiff sued the directors of a Delaware corporation alleging they had violated their fiduciary duties to the corporation’s creditors at a time when the corporation was insolvent or in the zone of insolvency. The court held that there is no right of creditors to enforce directly against a director a claim of breach of fiduciary duty; such a claim may be made only derivatively, on behalf of the corporation. Nothing more was required to find that the Delaware court did not have jurisdiction of the claim, so it was unnecessary for the court to address the substantive matters related to the corporate objective.

What it did say relating to these matters was dicta. Although the dicta are somewhat ambiguous, the court seems to have taken two steps. The first represented a modest victory for sound corporate policy. It adopted “insolvency” rather than “zone of insolvency” as the financial trigger, reducing the likelihood of a duty shifted regime. The court sharply distinguishes near-insolvency from actual insolvency, denying creditors rights in the first instance and granting them in the second. Whenever a corporation is not actually insolvent, no consideration of the interests of creditors need concern directors.

Unfortunately, the Delaware Supreme Court takes the far more significant step of adopting duty shifting. For the first time, creditors of Delaware corporations would clearly have rights beyond those granted them in contract or in tort.

At its heart, this step is based on the notion that the directors never owe a duty to the shareholders per se. Instead, the directors owe a duty to the corporation’s residual claimants. When the company is solvent, those residual claimants are shareholders. When the company is insolvent, those residual claimants are the creditors. Thus, the focus of directors should shift from shareholders to creditors accordingly, along with the identity of those who would have standing to sue directors on behalf of the corporation. Thus, the court states:

> It is well settled that directors owe fiduciary duties to the corporation. When a corporation is solvent, those duties may be enforced by its shareholders . . . because they are the ultimate

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289. Id. at 19.

290. The Canadian Supreme Court has adopted a somewhat similar approach, through the “oppression” remedy. See Janis Sarra, Canada’s Supreme Court Rules No Fiduciary Obligation Towards Creditors on Insolvency—*People’s Department Stores v. Wise*, 15 Int’l Insolvency Rev. 1 passim (2006) (discussing oppression remedy). That court also imposed a duty of care owed to creditors. Id. at 9.
beneficiaries of the corporation’s growth and increased value. When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.

Consequently, the creditors of an insolvent corporation have standing to maintain derivative claims against directors . . . . The corporation’s insolvency “makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value.”291

As we have discussed earlier, this residual claimant analysis misconstrues the economic rights of shareholders and wholly ignores the embedded rights of shareholders and the role of private property. Moreover, the analysis nowhere considers the mismatch between governance systems and duty regimes. We need not repeat the analysis here.

The residual claimant analysis permits and requires the court to invoke the corporation’s interests as a “black box,” which obviates the need to address conflicting interests among different constituencies. Thus, the court talks about it being “well settled that directors owe fiduciary duties to the corporation” and “well established that the directors owe their fiduciary obligations to the corporation and its shareholders” and that the directors are to act “for the benefit of the corporation.”292 The court implies that these standards mean acting “for the benefit of all those having an interest in it.”293 Such a black box avoids addressing the fundamental conflicts between shareholders and creditors as well as conflicts among creditors. This black box language is resonant of the “traditional conception” of the corporate objective, a conception that had developed before modern finance theory, and presumes an identity of interests between the welfare of the shareholder and the welfare of the corporation.294 As discussed earlier, this conception serves to mislead as to the conflicting interests of shareholders and creditors and this language, at best, offers inadequate guidance as to what the law expects of the corporation and its directors.295

In Delaware after North American, it is good that these effects are limited to a period of actual insolvency rather than being suffered throughout the vicinity of insolvency, but it would be much better if they did not exist at all. There will be varying interpretations of the opinion, and its ambiguities and anomalies give the court much room to maneuver.

292. Id. at 15, 20, 23 (emphasis added).
293. Id. at 23 (emphasis added).
294. See supra Parts II.A.1, II.B.
295. See supra Parts II.A.1, II.B.
V. Focal Points for Future Research

In this Article, we have suggested the abrogation of the longstanding duty shifting doctrines in their entirety. Rather than three duty regimes and two host governance systems, we would couple ends with means: one duty regime for the corporate governance system and one duty regime for the bankruptcy governance system. Removal of such judicial clutter, in and of itself, has instrumental and philosophical value.

Future research should focus primarily on the transition between the two governance systems. The question of when it makes sense for a distressed corporation to initiate reorganization—or to have reorganization initiated against it—is perhaps the greatest difficulty with Chapter 11. This is in no sense an “alternative” to the duty shifting doctrines. Irrespective of whether the doctrines exist, issues of when the corporate governance system should be abandoned and when the bankruptcy governance system ought to be invoked—and by whom and how—need to be studied. Each system has its place. But that research can directly address the concern for creditors reflected in duty shifting.

The problem of prompt initiation is not addressed in the corporate governance system and inadequately addressed in the bankruptcy governance system. In most countries the usual complaint is that bankruptcy is initiated too late, so insufficient value remains either to reorganize or to maximize liquidation recoveries. The United States system’s adoption of the DIP system was thought to have substantially ameliorated the initiation problem. Management was more likely to accept the necessity for a bankruptcy filing since it could keep its positions. While that may remain true, it may be less true today to some substantial extent. The development of routine management changes in connection with bankruptcy (that is, changes shortly before or shortly after filing), along with increased control by lenders, may have cooled the enthusiasm of managers for the Chapter 11 solution or may have encouraged them to make arrangements prior to bankruptcy that seriously prejudice the interests of various stakeholders, including shareholders. These are among the key questions that require further research and perhaps policy initiatives.

Several common law jurisdictions have attempted to solve this problem by imposing a duty on directors to file for some sort of insolvency when the company has reached a stated financial condition such as “in-

296. As to the need to consider the timing issue, see Legal Dep’t, Int’l Monetary Fund, Orderly & Effective Insolvency Procedural Principles: Key Issues 53–55 (1999); cf. Hertig & Kanda, supra note 262, at 73 (stating that “all jurisdictions have devised ways to induce insolvent firms to file for bankruptcy with reasonable promptness”). In the United States, a key question for future research is determining whether the corporate governance system or the bankruptcy system should be the locus of the transition decision.

297. See Legal Dep’t, Int’l Monetary Fund, supra note 296, at 59; Warren & Westbrook, Text, Cases & Problems, supra note 31, at 397.

298. Westbrook, Control, supra note 53, at 859–60.
The failure to file leads to various sanctions, including personal liability for directors. It is a “stick” solution as compared to the “carrot” of management’s Chapter 11 control offered by the United States system. Unfortunately, it appears that this approach is perhaps less successful than the United States DIP incentive. Nonetheless, further research and creative ideas along these lines might produce a useful device.

The transition standard becomes increasingly difficult when one considers that involuntary bankruptcy filings are rare in the United States for a variety of reasons. If, as we assert, a bankruptcy filing should be the appropriate vehicle for shifting the corporation’s primary focus from shareholders to creditors, it is arguable that it should be made easier for creditors to bring involuntary petitions. On the other hand, making involuntary bankruptcies too easy to file creates serious costs as well.

It is difficult to define, much less to identify, the financial moment at which directors should be required to seek legal assistance in bankruptcy. This is more true if one believes that the directors should consider such a filing, not merely to protect the interests of creditors, but also to try to salvage the interests of shareholders, who might have a better chance of retaining some value from their investments if reorganization were sought earlier.

Furthermore, reliance on a formulaic financial-condition standard is probably a mistake. One of the weaknesses of the duty shifting doctrines is they assume that all insolvent or near-insolvent companies must liquidate. That is untrue. Not all such companies need even pass through Chapter 11 to survive. Serious behavioral and empirical exploration of directorial incentives and the timing of Chapter 11 filings would be enormously helpful.

299. Professors Hertig and Kanda say that most countries require directors to file an insolvency proceeding upon insolvency, but they seem to be focused primarily upon European countries. Hertig & Kanda, supra note 262, at 73. One example is Germany, where a failure to file for insolvency once a corporation is insolvent may subject directors to both criminal penalties and civil liability. Sandy Shandro, Germany: Failed to File? Go Directly to Jail!, Am. Bankr. Inst. J., Jan. 24, 2006, at 18 (including survey of European rules of this type). Such a filing by the directors of a German subsidiary of the Singer Group precipitated its worldwide bankruptcy in over one hundred countries. See Evan D. Flaschen, Anthony J. Smits & Leo Plank, Foreign Representatives in U.S. Chapter 11 Cases: Filling the Void in the Law of Multinational Insolvencies, 17 Conn. J. Int’l L. 3, 20 (2001). Other common law countries have penalties for “wrongful trading,” which means roughly continuing the business after it has become insolvent. See, e.g., Keay & Murray, supra note 2, at 34.

300. See Block-Lieb, supra note 162, at 805 (noting that “a surprisingly small number of involuntary petitions are filed each year”).

301. But see In re Liberate Techs., 314 B.R. 206, 218 (Bankr. N.D. Cal. 2004) (finding debtor’s bankruptcy petition premature because “[d]ebtor is very solvent, very liquid, and can sell its assets as a going concern outside of bankruptcy”).

302. See supra Part III.A.
had filed for Chapter 11 much sooner than they did? What do lawyers for bankrupt companies tell their clients’ directors during the months and years prebankruptcy?[^303] To what extent do lenders include “insolvency” covenants that may affect control of the corporation and in what ways?

There are also important research issues beyond those relating to the transition between the two alternative governance systems. Throughout this Article, we have assumed a stylized case, one involving, among other things, a public corporation with only one class of stock and well-diversified shareholders.[^304] Financial innovation has made capital structures increasingly complex.[^305] The analysis becomes more difficult when there is more than one class of equity holders, as when there is preferred stock or tracking stock. The interests of shareholders may no longer be largely unitary. And if shareholders are ill-diversified, the rationale for using the modern investment decisionmaking techniques is undermined.[^306]

The impact of modern financial innovation on our analysis and the optimal transition issue may well extend beyond this. For instance, our analysis generally presumes the usual shareholder, with the traditional coupling of voting rights and economic interest. But in the past few years, “supply” factors (such as the growth of certain equity derivatives) and “demand” factors (such as the growth of hedge fund activism) now facilitate the decoupling of voting rights from economic interests in ways and to an extent not seen before.[^307] Thus, through using a “coupled assets” strategy—such as through simultaneous holdings of equity derivatives—shareholders can reduce or eliminate their economic exposure, often easily and on a massive scale. The shareholder with the largest number of votes in a corporation could have no economic interest in the company whatsoever—or, even a negative economic interest. A shareholder with a negative economic interest—an extreme type of “empty voter”—would actually have incentives to vote in ways that reduce the company’s share price.[^308] The substantive “empty voting” issue is one-half of the decoupling problem in the shareholder context; the other half is in the area of disclosure relating to, for instance, “overall economic interest” and “hidden (morphable) ownership.” The extent of such shareholder


[^304]: See supra note 12.

[^305]: See, e.g., Hu, Shareholder Welfare, supra note 17, at 1292–1317 (discussing impact of financial innovation on capital structure and related matters).

[^306]: See supra note 150 (discussing exceptions to presumption of well-diversified shareholders).


[^308]: Id. at 814–27 (coining term “empty voting” and setting forth analytical framework for decoupling, in shareholder context, of voting rights and economic interest). The term “empty voter” does not refer only to those without any economic interest in a company. This term involves looking at the extent of voting power relative to the economic interest, not the absolute level of economic interest. Id. at 825.
decoupling is not fully clear, nor is the relationship, if any, between decoupling and our analysis.309

This analytical framework for shareholder decoupling—and its functional elements and terminology—might also be useful in the creditor context.310 Just as there are shareholder “empty voters,” there is a corresponding notion of what has been called “empty creditors” (or, alternatively, “empty covenant-holders”). The traditional conception of a creditor usually assumes a coupling of the contractual and other rights a creditor has (flowing from a loan agreement, bond indenture, or some other contract and, indirectly, from bankruptcy law) and its economic interest. Just as shareholders can now often easily reduce or eliminate their economic exposure on a massive scale through coupled assets such as equity derivatives, creditors can now often quickly reduce or eliminate their economic exposure on a massive scale through coupled assets such as credit derivatives. A creditor could enjoy covenant protections and other rights while having no economic exposure to the company—or even a negative exposure. Such creditors would be examples of “empty creditors.” Empty creditors are likely to behave differently from more traditional creditors and raise concerns parallel to those of empty voters and thus can be usefully considered using a parallel analytical framework. These substantive “empty creditor” issues constitute one-half of the decoupling problem in the creditor context; the other half is in the area of disclosure relating to, among other things, the creditors’ overall economic interest. Here, too, the shareholder decoupling framework can be useful. Half of the shareholder framework relates to the disclosure issues posed by the “hidden (morphable) ownership” made possible by, among other things, equity derivatives. Corresponding disclosure concerns posed by, among other things, credit derivatives exist in the creditor context. Neither the corporate governance system nor the bankruptcy governance system adequately address the kinds of decouplings between creditor rights and economic interests that are now possible.

Much theoretical and empirical analysis will be essential in the years ahead.

CONCLUSION

The failure of the duty shifting doctrines to invoke any correlative legal or market mechanisms leaves the existing corporate governance system in place, resulting in mismatches between ends and means. A simple, but radical, change is needed in corporate law in all the jurisdictions
that have adopted, or flirted with, the duty shifting doctrines. The troubled corporation exception, in its modest centuries-old form as well as in its modern adventurous incarnations, must be abolished in its entirety. That is, whether the corporation is insolvent, in the vicinity of insolvency, or rock solid, the economic condition of the corporation should not alone divert managers from their core focus on the interests of shareholders as a unitary group.

Abolition will result in the instrumental rationality that comes from the coincidence of ends and means. The normal state law-centered corporate governance system would mandate that every corporation to which it plays host must act in the shareholders’ best interests. Whether that corporation is healthy or otherwise, the ends are shareholder oriented as are the means. The alternate federal bankruptcy governance system is directed at furthering the interests of disparate creditors and adjudicating the inevitable conflicts among creditors. When a bankruptcy filing has occurred, these alternate ends apply and detailed rules and highly evolved tools provide the means for achieving these ends. Corporations can move between two governance systems with properly aligned ends and means.

Beyond the institutional anomalies, the duty shifting doctrines conflict with the structure of shareholder ownership rights and fundamental notions of private property. Shareholders have not only economic rights but, among other things, voting rights. The economic rights include not only “static” rights as a residual claimant upon liquidation but also the more important “dynamic” rights of an owner to future cash flows of an ongoing enterprise. These dynamic rights, like call options, are never worth zero prior to the end game. Voting rights, along with other embedded rights such as rights of inspection and direct rights to sue for fiduciary breaches, generally reside exclusively with shareholders, in good times and bad. This makes sense only if the people the shareholders select to manage the corporation remain correspondingly faithful. Voting rights have independent value, distinct from any economic rights, especially in today’s world. Duty shifting largely ignores the dynamic economic rights of shareholders and ignores altogether the embedded rights of shareholders.

More broadly, the doctrines’ creditor orientation has no parallel. No other legal doctrine comes close to mandating a pro-creditor change in debtor behavior simply because of a debtor’s financial difficulty. By so doing, these doctrines erode fundamental property rights, relegating shareholders to the role of renters, not owners.

We call for the abolition of the duty shifting doctrines in all their forms. From the integrated perspective of the corporate governance system and the bankruptcy governance system, the path forward may be difficult, but choosing it is not. The primary task that lies ahead is to address the proper transition between the two systems for governing corporations. We offer not the treasure but the map.