

## ARTICLES

### FINANCIAL TWILIGHT RE-APPRAISAL: ENDING THE JUDICIALLY CREATED QUAGMIRE OF FIDUCIARY DUTIES TO CREDITORS

Anil Hargovan & Timothy M. Todd

ISSN 0041-9915 (print) 1942-8405 (online) • DOI 10.5195/lawreview.2016.450  
<http://lawreview.law.pitt.edu>



This work is licensed under a Creative Commons Attribution-Noncommercial-No Derivative Works 3.0 United States License.



This site is published by the University Library System of the University of Pittsburgh as part of its D-Scribe Digital Publishing Program and is cosponsored by the University of Pittsburgh Press.

## ARTICLES

# FINANCIAL TWILIGHT RE-APPRAISAL: ENDING THE JUDICIALLY CREATED QUAGMIRE OF FIDUCIARY DUTIES TO CREDITORS

Anil Hargovan & Timothy M. Todd\*

### ABSTRACT

*Directors owe fiduciary duties of care and loyalty to their corporations, and by extension to their shareholders. When a corporation approaches or enters insolvency, however, courts have recently found that the fiduciary duty calculus may change. Recognizing that creditors have financial interests similar to those of shareholders at or near insolvency, courts in several countries have extended fiduciary duty protection to creditors on equitable grounds. This trend has led to a state of flux and uncertainty in corporate law. Consequently, courts and commentators are battling to fully comprehend the controversial subject of director fiduciary duties to creditors in various jurisdictions.*

*Due to this jurisprudential flux, unresolved issues include, for example, the core notion that the duty arises when the company enters into an “ill-defined sphere” known as the “zone” or “vicinity” of insolvency. The law is remarkably short of specific judicial guidance as to how directors who engage in commercial risk-taking with a view to corporate rescue should discharge their duties without harming the*

---

\* Anil Hargovan is an Associate Professor in the School of Taxation and Business Law, University of New South Wales, Australia. Timothy M. Todd is Associate Dean for Academic Affairs and Associate Professor of Law at Liberty University School of Law; he also served as the 2015 John Raneri Fellow in the School of Taxation and Business Law, University of New South Wales, Australia. The authors would like to thank Mr. Zachary Hurt for his assistance with this Article.

*interests of creditors. Indeed, the debate continues even on the critical doctrinal question of whether such a duty is even needed.*

*This Article uses corporate law in both the United States and Australia as emblematic of the real practical concerns inherent in the expansion of fiduciary duties. Consequently, the Article argues that the judicial recognition of directors' fiduciary duties to creditors when at or near insolvency is objectionable, both from a policy and a doctrinal standpoint, and that any further attempt to develop the common law in this regard should be jettisoned in favor of reliance upon the existing, or modified, statutory regime aimed at creditor protection during times of financial distress.*

## Table of Contents

I.	Introduction .....	138
II.	Background.....	141
	A. The Perceived Problem: Distorted Risk-Taking Dynamics.....	141
	B. The American Evolution and Current State of Play .....	143
	C. The Australian Evolution and Current State of Play .....	147
III.	Problems with the Duty .....	150
	A. Dubious Jurisprudential Genesis .....	150
	B. Defining Insolvency .....	151
	C. Defining the “Zone” of Insolvency .....	154
	D. Defining the Duty.....	157
	E. Utility Issues .....	159
	F. Creation of Creditor Moral Hazard .....	162
IV.	Policing the Problem.....	163
	A. Existing Tools Provide Adequate Protection .....	163
	1. Creditors’ Ability to Contract <i>Ex Ante</i> .....	163
	2. Bankruptcy and Insolvency Law .....	166
	3. Fraudulent Transfer and Preference Law .....	168
	4. Restrictions on Dividends and Distributions .....	170
	5. Receiverships and Dissolution .....	171
	6. Insolvent Trading .....	173
	7. Other Established Protections .....	177
	B. If Existing Protections Are Not Sufficient, Solutions Must be Created Legislatively .....	179
V.	Conclusion .....	180

## I. INTRODUCTION

Directors owe fiduciary duties of care and loyalty to their corporations, and by extension to their shareholders. When a corporation approaches or enters insolvency, however, courts have found that the fiduciary duty calculus may change. Recognizing that creditors have financial interests similar to those of shareholders at or near insolvency, courts have extended fiduciary duty protection to creditors on equitable grounds. This trend has led to a state of flux and uncertainty in corporate law.

Consequently, courts and commentators are battling to fully comprehend the controversial subject of director fiduciary duties to creditors in various jurisdictions, including the Commonwealth countries,<sup>1</sup> Ireland,<sup>2</sup> and North America.<sup>3</sup> Indeed, this debate continues even on the critical doctrinal question of whether such a duty is even needed. Moreover, even among those who advocate for such a novel duty, questions still abound regarding the contours of the duty—for example, whether the duty is independent and enforceable by creditors.<sup>4</sup> And, to add to the confusion,

---

<sup>1</sup> In the United Kingdom, see *Ultraframe (UK) Ltd. v. Fielding* [2005] EWHC 1638 (Ch) (UK); *In re MDA Inv. Mgmt. Ltd.* [2004] 1 BCLC 217 (UK); *Facia Footwear Ltd. v. Hinchcliffe* [1998] 1 BCLC 218 (UK); *W. Mercia Safetywear Ltd. v. Dodd* [1988] BCLC 250 (UK); *Winkworth v. Edward Baron Dev. Co. Ltd.* [1986] 1 WLR 1512 (UK). See also *Hellard & Anor (Liquidators of HLC Envtl. Project Ltd.) v. Carvolho* [2013] EWHC 2876 (Ch) (collecting UK authorities). For New Zealand authorities, see *Nicholson v. Permakraft (NZ) Ltd* [1985] 1 NZLR 242 (CA); *Hilton International Ltd v. Hilton* [1989] 1 NZLR 442 (HC). For Australian authorities, see *Spies v The Queen* (2000) 201 CLR 603 (Austl.); *Walker v Wimborne* (1976) 137 CLR 1 (Austl.); *ASIC v Sydney Invest House Equities Pty Ltd* (2008) 69 ACSR 1 (Austl.); *Westpac Banking Corp v Bell Grp Ltd (in liq) [No. 3]* (2012) 89 ACSR 1 (Austl.); *ASIC v Sydney Invest House Equities Pty Ltd* (2008) 69 ACSR 1 (Austl.); *Addstead Pty Ltd v Liddan Pty Ltd* (1997) 25 ACSR 175 (Austl.). For judicial authorities in Singapore, see *Chee Yoh Chuang and Another (as Liquidators of Progen Engineering Pte Ltd (In Liquidation)) v. Progen Holdings Ltd* [2010] SGCA 31 (Sing.); *Chip Thye Enterprises Pte Ltd (in liquidation) v. Phay Gi Mo and Others* [2004] 1 SLR 434 (Sing.). For a comprehensive discussion on the authorities in Commonwealth jurisdictions, see generally ANDREW KEAY, *COMPANY DIRECTORS' RESPONSIBILITIES TO CREDITORS* (2007); ANDREW KEAY, *DIRECTORS' DUTIES* (2d ed. 2014).

<sup>2</sup> See *Harlequin Prop. (SVG) Ltd. v. O'Halloran* [2013] IEHC 362 (Ir.).

<sup>3</sup> In Canada, see, e.g., *Caron Belanger Ernst & Young Inc. ex rel. Peoples Dep't Stores Inc. v. Wise*, [2004] 3 S.C.R. 461 (Can.). In Delaware, see *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007); *Quadrant Structured Prods. Co. v. Vertin*, 115 A.3d 535 (Del. Ch. 2015). In California, see *Berg & Berg Enters. v. Boyle*, 100 Cal. Rptr. 3d 875 (App. 6th Dist. 2009).

<sup>4</sup> See *Spies* (2000) 201 CLR 603 (Austl.); *Re New World Alliance Pty Ltd* (1994) 122 ALR 531 (Austl.); *Int'l Swimwear Logistics Ltd v Australian Swimwear Co Pty Ltd* [2011] NSWSC 488 (Austl.); see also ROBERT P. AUSTIN & IAN RAMSAY, *FORD'S PRINCIPLES OF CORPORATIONS LAW* 8.100 (16th ed. 2015); cf. *Corporations Act 2001* (Cth) s 588G (Austl.) (permitting creditors in certain circumstances to recover from directors because of directors' insolvent trading); Anil Hargovan, *Directors' Duties to Creditors: A*

debate exists even in various jurisdictions on whether the duty is dead or alive.<sup>5</sup> Fortunately, some courts in the United States,<sup>6</sup> the United Kingdom,<sup>7</sup> Canada,<sup>8</sup> and Australia<sup>9</sup> are now of the view that individual creditors of an insolvent company have no right to assert *direct* claims for breach of fiduciary duty against directors; however, even in those jurisdictions, the broad formulation of the directors' duty to consider creditors' interests during insolvency is still plagued by many unresolved issues.

These unresolved issues include, for example, the core notion that the duty arises when the company enters into an "ill-defined sphere"<sup>10</sup> known as the "zone" or "vicinity" of insolvency, which, as recognized by at least one U.S. court, is "even less objectively determinable than actual insolvency."<sup>11</sup> The law is remarkably short

---

*Doctrinal Mess*, 3 NOTTINGHAM INSOLVENCY & BUS. L. E-J. 135, 136 n.4 (2015) (UK), [https://www.ntu.ac.uk/nls/document\\_uploads/174820.pdf](https://www.ntu.ac.uk/nls/document_uploads/174820.pdf).

<sup>5</sup> For example, in Australia, consider the scholarly debate between James McConvill, *Directors' Duties Towards Creditors in Australia After Spies v The Queen*, 20 CO. & SEC. L.J. 4 (2002) (Austl.); in reply Anil Hargovan, *Directors' Duties to Creditors in Australia After Spies v The Queen—Is the Development of an Independent Fiduciary Duty Dead or Alive?*, 21 CO. & SEC. L.J. 390 (2003) (Austl.); see also James McConvill, *Geneva Finance and the "Duty" of Directors to Creditors: Imperfect Obligation and Other Imperfections*, 11 INSOLVENCY L.J. 7 (2003) (Austl.); in reply Anil Hargovan, *Geneva Finance and the "Duty" of Directors to Creditors: Imperfect Obligation and Critique*, 12 INSOLVENCY L.J. 134 (2004) (Austl.); see also Hargovan, *supra* note 4, at 135–36.

<sup>6</sup> See, e.g., *Gheewalla*, 930 A.2d at 103. Notwithstanding the contraction of the duties in Delaware corporate law, it is unclear the extent to which that contraction has been exported to other states.

<sup>7</sup> *Kuwait Asia Bank EC v. Nat'l Mut. Life Nominees Ltd.* [1991] AC 187 (N.Z.); *Yukong Line Ltd. v. Rendsburg Invs. Corp.* [1998] 4 All ER 82 (Eng.); *W. Mercia Safetywear Ltd. v. Dodd* [1988] BCLC 250 (UK). For collection of judicial authorities, see *Jetivia SA v. Bilta (UK) Ltd.* [2013] EWCA (Civ) 968 (Eng.).

<sup>8</sup> *Caron Belanger Ernst & Young Inc. ex rel. Peoples Dep't Stores Inc. v. Wise*, [2004] 3 S.C.R. 461 (Can.).

<sup>9</sup> See Hargovan, *supra* note 4, at 136 n.4.

<sup>10</sup> *Berg & Berg Enters. v. Boyle*, 100 Cal. Rptr. 3d 875, 890 (App. 6th Dist. 2009).

<sup>11</sup> *Id.* at 894. Indeed, a court in the United Kingdom recently observed that

The Defendants accepted that the creditors' interests duty can arise in circumstances where the company is not actually insolvent. Something short of actual insolvency is sufficient. The question is, how close to insolvency does the company have to be? The Defendants argue that it has to be very close to insolvency, the Claimants contend that it is enough if there is a real, as opposed to a remote, risk of insolvency. The list of authorities in which this test has been expressed and applied is a long one, yet the final position seems not to be at all clear.

of specific judicial guidance as to how directors who engage in commercial risk-taking with a view to corporate rescue should discharge their duties without harming the interests of creditors.<sup>12</sup> It is for such reasons that a commentator has labeled the doctrine a “mess,”<sup>13</sup> noting that “it is extraordinarily difficult to slice the world into categories of solvency, insolvency, and the vicinity of insolvency.”<sup>14</sup>

This Article uses corporate law in both the United States and Australia as emblematic of the real practical concerns inherent in the expansion of fiduciary duties. Consequently, this Article argues that the judicial recognition of directors’ fiduciary duties to creditors when at or near insolvency is objectionable, both from a policy and a doctrinal standpoint, and that any further attempt to develop the common law in this regard should be jettisoned in favor of reliance upon the existing, or modified, statutory regime aimed at creditor protection during times of financial distress.

The Article is structured as follows. Part II addresses the perceived problems that underpin the duty to consider creditor interests. It also discusses the origins of the duty, as fashioned by the courts in the United States and in Australia. Part III addresses the myriad problems identified with the operation of the duty and exposes its inherent limitations as a meaningful remedy to creditors. Part IV canvasses the existing tools that are capable of combating the mischief and offers support for the view that the development of the law in this area by the judiciary is superfluous. Part V concludes by demonstrating that the foundation for the duty is questionable and strengthens the case for its abolition.

---

BTI 2014 LLC v. Sequana S.A. [2016] EWHC (Ch) 1686 (UK).

<sup>12</sup> Hargovan, *supra* note 4, at 137; Anil Hargovan & Jason Harris, *For Whom the Bell Tolls: Directors’ Duties to Creditors after Bell*, 35 SYDNEY L. REV. 433, 435 (2013) (Austl.).

<sup>13</sup> Jonathan Lipson, Assoc. Prof. of Law, Temple Univ., Remarks at the 4th Annual University of Maryland Business Law Conference (Nov. 4, 2005), *in* Royce de R. Barondes et al., *Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies—History & Background*, 1 J. BUS. & TECH. L. 229, 230, 237–38 (2007).

<sup>14</sup> *Id.* at 239.

## II. BACKGROUND

### A. *The Perceived Problem: Distorted Risk-Taking Dynamics*

A solvent corporation, by definition, will make creditors whole and leave a return of (ideally, an increase of) shareholder capital.<sup>15</sup> Indeed, it is this role of the corporate director—i.e., to maximize shareholder value—that serves as the foundational theory of corporate law.<sup>16</sup> When a corporation is solvent, this shareholder-maximization rule serves as a useful lodestar to directors: “maximize the long-run interests of the corporation’s stockholders.”<sup>17</sup> Creditor concerns are not a material issue as long as the corporation is solvent, as creditor capital is not then at risk; rather, it is the shareholders’ residual claim (and the potential reduction in its value) that serves as the ultimate financial backstop.<sup>18</sup> In other words, the loss of shareholder wealth serves as a financial check to director decision-making.

However, during insolvency, shareholder money is no longer in jeopardy because, by definition, there is no residual claim. In effect, the economic interests of creditors have supplanted shareholders as the residual claimholders of the firm.<sup>19</sup>

---

<sup>15</sup> A solvent corporation has more assets than liabilities; consequently, upon liquidation, after debtholders are paid, if sufficient funds remain, shareholders will receive their initial equity contribution and hopefully additional residual capital.

<sup>16</sup> The following authorities reflect the position in the Anglo-American jurisdictions. *See, e.g.*, *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (“A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.”); *see also* *Katz v. Oak Indus.*, 508 A.2d 873, 879 (Del. Ch. 1986) (“It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation’s stockholders.”).

<sup>17</sup> *Katz*, 508 A.2d at 879.

<sup>18</sup> In other words, when a corporation is solvent, mismanagement—and a resulting diminution in corporate profits—ultimately affects the corporation’s ability to maximize additional residual return to shareholders.

<sup>19</sup> As explained by Street, C.J. in *Kinsela v Russell Kinsela Pty Ltd (in liq)*:

But where a company is insolvent the interests of creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company’s assets. It is in a practical sense their assets and not the shareholder’s assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.

(1986) 4 NSWLR 722 at 730 (Austl.), *affirmed by Spies v The Queen* (2000) 201 CLR 603; *see also* Andrew Keay, *Directors’ Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-*

Stated otherwise, the fact of insolvency, as noted by the judiciary, “places the creditors in the shoes normally occupied by the shareholders—that of residual risk-bearers.”<sup>20</sup>

Consequently, there is a moral hazard problem because the shareholders no longer suffer economic risk, but the directors are still accountable to them. Thus, the shareholders may encourage the directors to take greater risks with the company’s assets—to the detriment of creditors. Indeed, when a company is in financial trouble (i.e., at or near insolvency), directors may be more willing to engage in excessive risk-taking.<sup>21</sup> The financial literature refers to this as the “overinvestment” theory;<sup>22</sup> legal literature describes this as the “at risk” or “slot machine” problem.<sup>23</sup>

In addition to the general level-of-risk concerns, in which the interests of creditors and shareholders diverge, other issues arise as well. These include a race to the firm’s assets,<sup>24</sup> liquidation analysis, and even potential “underinvestment” (avoiding investments that would benefit creditors and not shareholders).<sup>25</sup> In sum, the very nature of the firm creates conflicting incentives when it has a capital structure that consists of both debt and equity.<sup>26</sup>

---

*Protection of Creditors*, 66 MODERN L. REV. 665, 668 (2003) (UK). For collection of UK judicial authorities adopting this view, see *Madoff Sec. Int’l Ltd. v. Raven* [2013] EWHC (Comm) 3147 (UK).

<sup>20</sup> *Prod. Res. Grp., LLC v. NCT Grp., Inc.*, 863 A.2d 772, 791 (Del. Ch. 2004).

<sup>21</sup> See, e.g., Keay, *supra* note 19, at 668; see also DEPT. OF TRADE AND INDUS., 1 MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: FINAL REPORT ¶ 3.15 (2001) (UK) (“As the margin of assets reduces, so the incentive on directors to avoid risky strategies which endanger the assets of members also reduces; the worse the situation gets, the less members have to lose and the more one-sided the case becomes for supporting risky, perhaps desperate, strategies.”); Katherine H. Daigle & Michael T. Maloney, *Residual Claims in Bankruptcy: An Agency Theory Explanation*, 37 J.L. & ECON. 157, 157 (1994); Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors’ Duty to Creditors*, 46 VAND. L. REV. 1485, 1486, 1488–91 (1993).

<sup>22</sup> Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45, 46 (1998).

<sup>23</sup> See, e.g., Royce de R. Barondes et al., *Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies*, 1 J. BUS. & TECH. L. 229, 233 (2007). The slot machine hypothetical ably sums up the problem, i.e., directors would be more willing to “take the remaining assets of the company, throw them in a slot machine and see if you hit the jackpot[.]” *Id.*

<sup>24</sup> In other words, creditors enforcing their rights, such as repossession; this can cause disruption of firm activities and lead to even additional loss. Lin, *supra* note 21, at 1493.

<sup>25</sup> See *id.* at 1496.

<sup>26</sup> Barondes, *supra* note 22, at 48–49. In Jensen and Meckling’s seminal article, they note that an owner-manager of a firm with substantial debt “will have a strong incentive to engage in activities (investments)

### B. *The American Evolution and Current State of Play*

A corporation's board of directors manages its business affairs.<sup>27</sup> Because the board is the repository of corporate power, and that is divided from the ultimate ownership, the law imposes fiduciary duties on those directors.<sup>28</sup> In American jurisprudence, the director's fiduciary duties include a duty of care and a duty of loyalty.<sup>29</sup> The duty of care requires "directors of a corporation in managing the corporate affairs . . . to use that amount of care which ordinarily careful and prudent men would use in similar circumstances."<sup>30</sup> In practical terms, this means that board members must "inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties."<sup>31</sup>

The duty of loyalty generally prohibits board self-dealing. In other words, "directors cannot stand on both sides of the transaction nor derive any personal

---

which promise very high payoffs if successful even if they have a very low probability of success." Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 334 (1976). For additional economic analysis of the corporate form, see generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

<sup>27</sup> See, e.g., DEL. CODE ANN. tit. 8, § 141 (2011) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . ."); MODEL BUS. CORP. ACT ("MBCA") § 8.01(b) (AM. BAR ASS'N 2002) ("All corporate powers shall be exercised by or under the authority of . . . its board of directors . . ."). For a similar provision in Australia, see *Corporations Act 2001* (Cth) s 198A (Austl.).

<sup>28</sup> See, e.g., ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 6 (1932) ("The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear."). From an economic theory perspective, fiduciary duties serve as gap fillers for incomplete contracts between shareholders and managers. See, e.g., EASTERBROOK & FISCHEL, *supra* note 26, at 92 (noting that fiduciary duties are a "rule for completing incomplete bargains in a contractual structure").

<sup>29</sup> Some jurisdictions intimate additional or subsidiary duties, e.g., a duty of candor (disclosure), or a duty of good faith. See *Malone v. Brincat*, 722 A.2d 5, 11 (Del. 1998) ("The duty of directors to observe proper disclosure requirements derives from the combination of the fiduciary duties of care, loyalty and good faith."); see also *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 753–56 (Del. Ch. 2005) (explaining good faith).

<sup>30</sup> *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. Ch. 1963).

<sup>31</sup> *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); see also *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

benefit through self-dealing.”<sup>32</sup> Indeed, the duty of loyalty “requires an undivided and unselfish loyalty to the corporation [such] that there shall be no conflict between duty and self-interest.”<sup>33</sup> While generally proscriptive, the duty can also be prescriptive; this is particularly true in change-in-control transactions or director-interested transactions, which require that the entire fairness test be satisfied.<sup>34</sup>

The genesis of the purported fiduciary duty to creditors began with *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*<sup>35</sup> Credit Lyonnais Bank Nederland (“CLBN”) brought suit seeking a judicial determination of the lawfully elected board of MGM-Pathe Communications Co.<sup>36</sup> Because of claimed loan defaults, Credit Lyonnais declared itself to be the legal owner of a controlling stock interest of MGM stock; it also aimed to remove several individuals (who were named defendants) from the MGM board.<sup>37</sup> The underlying lawsuit arose from a leveraged buyout<sup>38</sup> that failed to meet expectations; CLBN was the principal lender in the highly-leveraged transaction.<sup>39</sup>

In considering whether the management team or CLBN breached fiduciary duties, the court noted that “[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.”<sup>40</sup> It then proceeded with a lengthy and now infamous footnote—footnote 55—stating that “[t]he possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic

---

<sup>32</sup> *Anadarko Petro. Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1988) (citing *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *Marciano v. Nakash*, 535 A.2d 400, 403 (Del. 1987)).

<sup>33</sup> *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

<sup>34</sup> The entire fairness test requires that the board must strike a fair price *and* deal fairly. *See, e.g., Kahn v. Lynch Comm’n Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994).

<sup>35</sup> No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

<sup>36</sup> *See* DEL. CODE ANN. tit. 8, § 225 (2011); *Credit Lyonnais*, 1991 WL 277613, at \*1.

<sup>37</sup> *Credit Lyonnais*, 1991 WL 277613, at \*1.

<sup>38</sup> A leveraged buyout, the “prototypical corporate transaction of the 1980s,” occurs when “a management or finance entrepreneur acquires control of a public company through borrowed funds.” *Credit Lyonnais*, 1991 WL 277613, at \*2. Moreover, “such a transaction replaces equity with debt on the company’s balance sheet and creates incentives for the discovery and implementation of operating efficiencies and for the sale or liquidation of inefficient operating units.” *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at \*34.

behavior and creating complexities for directors.”<sup>41</sup> The court then articulated a hypothetical about a solvent company that possessed a single asset of a \$51 million judgment against a solvent debtor; the judgment is on appeal and subject to modification or reversal. The company’s only liability is \$12 million owed to bondholders.

The court constructed a probability chart with the following expected values:

	Expected Value
25% chance of affirmance (\$51 m)	\$12.75
70% chance of modification (\$4 m)	2.80
5% chance of reversal (\$0)	0
Expected Value of Judgment on Appeal	\$15.55

The value of the equity is \$3.55 million (the expected value of the judgment less the outstanding liability). The court then considered various proposed settlement offers. For example, it hypothesized that shareholders would “plainly be opposed to acceptance of a \$12.5 million settlement (under which they get practically nothing).”<sup>42</sup> Moreover, the court also noted that shareholders may reject a \$17.5 million offer because “the litigation alternative, with its 25% probability of a \$39 million outcome to them (\$51 million - \$12 million = \$39 million) has an expected value to the residual risk bearer of \$9.75 million,”<sup>43</sup> which is substantially greater than the net \$5.5 million available in the \$17.5 million offer.<sup>44</sup>

However, the court concluded that, considering the “community of interests” the corporation represents, a rational actor should accept the best offer available over \$15.55 million. But, the court continued, “that result will *not* be reached by a director who thinks *he owes duties directly to shareholders only*.”<sup>45</sup> That result will only be reached if the director is capable of viewing the corporation as a “legal and economic entity.”<sup>46</sup> In conclusion, directors

---

<sup>41</sup> *Id.* at \*34 n.55.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* (the \$17.5 million less the \$12 million bondholder liability).

<sup>45</sup> *Id.* (emphasis added).

<sup>46</sup> *Id.*

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.<sup>47</sup>

After *Credit Lyonnais*, courts began to construe footnote 55 to mean that directors have discrete duties to creditors in the zone of insolvency.<sup>48</sup> Shortly after *Credit Lyonnais*, the Delaware Court of Chancery, in *Geyer v. Ingersoll Publications Co.*, addressed *when* those duties to creditors arise.<sup>49</sup> The court considered whether the duty arose at insolvency in fact or when a party institutes statutory proceedings (e.g., a bankruptcy petition); it held that “insolvency means insolvency in fact rather than insolvency due to a statutory filing . . . .”<sup>50</sup> Thus, in the early 1990s, the Delaware corporate law landscape was that in “insolvency in fact,” fiduciary duties were owed to creditors *à la Geyer*, but that in the “zone of insolvency,” duties *could* be owed *à la Credit Lyonnais*.

Other state and federal courts took notice of Delaware’s trailblazing push to assign new duties to creditors. Indeed, with Delaware corporate law being persuasive authority for many courts,<sup>51</sup> Delaware’s newly minted jurisprudence became its hottest export. State and federal courts across the country embraced the duty.<sup>52</sup>

---

<sup>47</sup> *Id.*

<sup>48</sup> See, e.g., Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Grp., Inc. (*In re* Buckhead Am. Corp.), 178 B.R. 956, 968 (D. Del. 1994) (“[B]ut owes its duty to the corporate enterprise . . . including the corporation’s creditors . . . .” (citing *Credit Lyonnais*, 1991 WL 277613, at \*34 n.55)).

<sup>49</sup> See *Geyer v. Ingersoll Publ’ns Co.*, 621 A.2d 784 (Del. Ch. 1992).

<sup>50</sup> *Id.* at 787.

<sup>51</sup> Courts have referred to Delaware as the “Mother Court of corporate law.” *Kamen v. Kemper Fin. Serv., Inc.*, 908 F.2d 1338, 1343 (7th Cir. 1990), *rev’d on other grounds*, 500 U.S. 90 (1991).

<sup>52</sup> *Carrieri v. Jobs.com, Inc.*, 393 F.3d 508, 534 n.24 (5th Cir. 2004) (“Accordingly, when a corporation reaches the ‘zone of insolvency[.]’ as with actual insolvency, the officers and directors have an expanded fiduciary duty to all creditors of the corporation, not just the equity holders.”) (citing *Jewel Recovery, L.P. v. Gordon*, 196 B.R. 348, 355 (N.D. Tex. 1996)); *Welt v. Jacobson (In re Aqua Clear Tech., Inc.)*, 361 B.R. 567, 575 (Bankr. S.D. Fla. 2007) (“An officer’s or director’s fiduciary duties are extended to the creditors of a corporation when the corporation becomes insolvent or is in the ‘vicinity of insolvency[.]’”); *Wasserman v. Halperin (In re The Classica Group)*, No. 04-19875 (DHS), 2006 Bankr. LEXIS 2599, at \*20 n.7 (Bankr. D.N.J. 2006) (“This Court is in accord with a recent trend in the law, which expands the

Courts embraced the zone-of-insolvency trigger as well.<sup>53</sup>

More recently, however, in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*,<sup>54</sup> the Delaware Supreme Court clarified that “no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency.”<sup>55</sup> Note, however, that this does not speak to *derivative* claims in the zone of insolvency. Additionally, the court held that “[c]reditors may nonetheless protect their interest by bringing derivative claims on behalf of the insolvent corporation or any other direct nonfiduciary claim . . . .”<sup>56</sup> Moreover, we would note that, even if it is now “safer” as a director in the zone of insolvency post-*Gheewalla*, there are still practical limitations in ascertaining whether the firm is operating in the zone of insolvency or in actual insolvency.<sup>57</sup> Thus, the seeming clarification in the law may not actually provide a substantial comfort to directors making decisions while in financial distress.

### C. *The Australian Evolution and Current State of Play*

The jurisprudence on the nature of the directors’ duties to creditors remains a doctrinal mess in Australia.<sup>58</sup> This confusion finds its origin in the quintessentially cited dictum of Justice Mason in *Walker v Wimborne*.<sup>59</sup> The majority of the High

---

fiduciary duties of a corporate director or officer to include not only equity holders, but creditors as well, when a corporation is in the ‘zone of insolvency.’”)

<sup>53</sup> See *Carrieri*, 393 F.3d at 534; *Welt*, 361 B.R. at 575; *Wasserman*, 2006 Bankr. LEXIS 2599, at \*20 n.7.

<sup>54</sup> 930 A.2d 92 (Del. 2007).

<sup>55</sup> *Id.* at 100. Even though Delaware has since clarified its law on the matter, not all jurisdictions have readdressed the issue post-*Gheewalla*. Thus, whether the duty contraction will be exported as well remains to be seen.

<sup>56</sup> *Id.* at 103. For a judicial synthesis of Delaware law post-*Gheewalla* in this regard, see *Quadrant Structured Prods. v. Vertin*, 115 A.3d 535, 545–47 (Del. Ch. 2015).

<sup>57</sup> As we describe in Part II.B, *infra*, substantial practical limitations exist with respect to valuing various assets and liabilities in real-time to adjudge balance sheet solvency.

<sup>58</sup> This section relies extensively on Hargovan & Harris, *supra* note 12.

<sup>59</sup> (1976) 137 CLR 1 at 6–7 (Austl.) (“[I]t should be emphasized that the directors of a company in discharging their duty to the company must take account of the interests of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them.”); *Westpac Banking Corp v Bell Grp Ltd (in liq)* [No. 3] (2012) 89 ACSR 1 (Austl.); [2012] WASCA 157 at [2034] (Austl.) (per Drummond JA) (“This obligation cannot now be described as a ‘so-called duty’ . . . the principle [concerning directors fiduciary duties to creditors] . . . is now firmly entrenched in company law jurisprudence in Australia.”). For further

Court of Australia in *Spies v The Queen*,<sup>60</sup> a quarter of a century later, endorsed the dicta in *Walker v Wimborne* and, more significantly, shed light on its meaning. The High Court majority in *Spies* explained that the dicta in *Walker v Wimborne* “recognised that insolvency alters the relative weight that directors should give to shareholder interests as opposed to creditor interests, while it rejected the idea of directors’ independent fiduciary to creditors.”<sup>61</sup>

Indeed, the majority judgment in *Spies*<sup>62</sup> endorsed Professor Sealy’s rationale for Justice Mason’s dicta from *Walker v Wimborne* stating, “[these] were words of censure directed at conduct which . . . comes within some well-established rule of law, such as the law imposing liability for misfeasance, the expropriation of corporate assets or fraudulent preference.”<sup>63</sup> *Spies* pointed out that *Walker v Wimborne* “cautions that directors must remember that creditors may also be affected by a particular management decision.”<sup>64</sup> The latter case indicates that “when a company is in financial difficulty, directors must ensure that they balance the interests of various affected persons.”<sup>65</sup> Prior to subsequent judicial developments in the *Bell* litigation, discussed below, the conventional wisdom in Australia was that the duty to consider creditor interests was not pitched any higher than that expressed in *Walker v Wimborne*—a view supported by the influential dicta of the majority of the High Court of Australia in *Spies*.

Notwithstanding this important clarification on the topic, Drummond JA in the West Australia Supreme Court of Appeal in the *Bell* litigation expressed a different view which, extraordinarily, “appears to have elevated the directors’ duty from one of consideration to one of protection of creditors’ interests during a failed attempt at corporate rescue.”<sup>66</sup> The judicial approach adopted by Justice Drummond in *Bell*,

---

discussion of the Justice Mason’s dictum and the judicial development of a director’s duty to consider creditor interests, see Hargovan, *supra* note 5.

<sup>60</sup> (2000) 201 CLR 603 (Austl.).

<sup>61</sup> Hargovan & Harris, *supra* note 12, at 446.

<sup>62</sup> (2000) 201 CLR 603, 636 (Austl.).

<sup>63</sup> L.S. Sealy, *Directors’ Duties—An Unnecessary Gloss*, 47 CAMBRIDGE L.J. 175, 175 (1988) (UK); see also Hargovan & Harris, *supra* note 12, at 446.

<sup>64</sup> Hargovan & Harris, *supra* note 12, at 446.

<sup>65</sup> *Id.*

<sup>66</sup> Hargovan, *supra* note 4, at 137.

with respect to directors' duties to creditors, warrants closer attention, particularly the following statement:

Directors, in discharging their fiduciary duties to their company must, if the company is sufficiently financially distressed, have regard *and give proper effect to the interests of creditors* . . . courts will now intervene in an appropriate case, irrespective of the directors' beliefs and business judgments, to ensure that creditors are properly protected.<sup>67</sup>

With respect, this is not the correct statement of legal principle and is problematic for two main reasons. First, it “represents a radical departure from orthodox authorities.”<sup>68</sup> Justice Drummond’s approach “unreasonably shifts the directors’ duty to creditors away from its traditional focus of consideration (a balancing exercise), to become a positive duty to protect their interests when a company is in financial distress.”<sup>69</sup> It eschews the balancing approach taken by the trial judge in *Bell* and also adopted by Justice Carr, in dissent, in the Appellate Court in *Bell*. The latter approach, which accepts that the obligation to consider the interests of creditors does not mean that their interests are necessarily paramount, is preferable because it recognizes the practical difficulties that directors face during times of financial distress.

Second, “the approach undertaken by [Justice] Drummond seems to elevate the duty to a direct one to creditors, or at a minimum makes them the sole stakeholder group, rather than including their interests as merely one of a number that must be considered by corporate managers.”<sup>70</sup> As elucidated in *Walker v Wimbourne*, the obligation to have regard to creditors’ interests arises from acting in the best interests of the company.<sup>71</sup> Indeed, “[t]he ultimate goal of the duty is to benefit the company, and through it the creditors.”<sup>72</sup> As commentators have concluded, “[t]he interests of

---

<sup>67</sup> *Westpac Banking Corp v Bell Grp Ltd (in liq) [No. 3]* (2012) 89 ACSR 1; [2012] WASCA 157 at [2031] (Austl.) (emphasis added).

<sup>68</sup> Hargovan & Harris, *supra* note 12, at 446; *see also Spies v The Queen* (2000) 201 CLR 603 (Austl.); *Walker v Wimbourne* (1976) 137 CLR 1 (Austl.); *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 (Austl.).

<sup>69</sup> Hargovan & Harris, *supra* note 12, at 446.

<sup>70</sup> *Id.* at 447.

<sup>71</sup> *Id.* at 446.

<sup>72</sup> *Id.*; *see also Geneva Fin Ltd v Res. & Indus Ltd* (2002) 20 ACLC 1427, 1438 (Austl.).

the company, in the context of impending insolvency and corporate rescue attempts, should not be subordinated to the interests of sharing *pari passu* between unsecured creditors.”<sup>73</sup>

### III. PROBLEMS WITH THE DUTY

#### A. *Dubious Jurisprudential Genesis*

The insolvency-triggered duty to creditors is a judicial oak that has grown from a dictum acorn.<sup>74</sup> Its dubious jurisprudential underpinnings, as illustrated above with reference to the key cases in the Anglo-American jurisdictions, are troubling. In American jurisprudence, the duty sprang from dicta in a footnote dealing with a hypothetical fact pattern; in Australia, the duty also arose from dicta.<sup>75</sup> Even assuming arguendo that such a duty provides net utility,<sup>76</sup> its source is important to analyze from a legal theory perspective. Although legal rules and norms can emanate from various sources—e.g., positive law (legislation) or case law—the initial basis for the duty, as found in *Credit Lyonnais* footnote 55, is twofold: efficiency and fairness.<sup>77</sup> While efficiency may have some objective criteria,<sup>78</sup> fairness is a much more nebulous concept to adjudge; indeed, the law has historically wrestled with such an indeterminate standard. One need only consider the “chancellor’s foot” problem that historically plagued courts of equity. As John Selden famously quipped,

Equity is a roguish thing: for law we have measure, know what to trust to. Equity is according to ye conscience of him that is Chancellor, and as it is larger or narrower so is equity. ’Tis all one as if they should make the standard for the measure we call a foot, a Chancellor’s foot; what an uncertain measure would be

---

<sup>73</sup> Hargovan & Harris, *supra* note 12, at 447.

<sup>74</sup> In *Blue Chip Stamps v. Manor Drug Stores*, Justice Rehnquist famously likened private actions under Rule 10b-5 to the Securities Exchange Act of 1934 to a “judicial oak which has grown from little more than a legislative acorn.” 421 U.S. 723, 737 (1975).

<sup>75</sup> *Walker*, (1976) 137 CLR 1 at 6–7 (Austl.).

<sup>76</sup> Meaning the gains or efficiencies generated by the rule are greater than the costs imposed by the burden (e.g., compliance costs, uncertainty costs, etc.). The conclusion of this Article is that the duty does not provide a net utility because the compliance and other costs are too great or immeasurable, not to mention other costs and inefficiencies due to ever-shifting changes in the law.

<sup>77</sup> 1991 WL 277613, at \*34 n.55 (“[C]ircumstances 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 . . .”).

<sup>78</sup> As an example, a Pareto-superior decision. *See infra* Part III.D (discussing various economic efficiency analyses).

this. One Chancellor has a long foot another a short foot, a third an indifferent foot; 'tis the same thing in the Chancellor's Conscience.<sup>79</sup>

The same problems arise with duties to creditors. Whose measure or idea of fairness should be used here? Is it not *fair* to enforce a bargain as it was struck, i.e., in accordance with the promissory note or lending terms?<sup>80</sup> Do shareholders consider it *fair* for their economic agents (e.g., directors and officers) to obey different masters (i.e., creditors) whose economic interests are opposed to those of shareholders?

Another commonly advanced reason under the *fairness* argument is the inherent asymmetry of information that exists between directors and creditors: that is, it is impossible for a creditor to know whether a director will take excessive risks with creditor funds. However, that is the very nature of interest—it is (among other things) a measure of *risk*. Also, we would add that any inefficiency argument should apply in equal measure to other contracts. Due to bounded rationality,<sup>81</sup> *inter alia*, all contracts are subject to incomplete information and thus susceptible to *ex post* inefficiencies. Why, then, are corporate-creditor contracts subject to *ex post* recalculation and gap filling while other contracts are not? The current jurisprudence offers no explanation for this asymmetric treatment.

### B. Defining Insolvency

To be effective, a duty must have a clear triggering point. Although it may be easy to define insolvency in the abstract accounting sense (i.e., when liabilities are in excess of assets), the law has, for some time, recognized a tension in defining insolvency for other purposes.<sup>82</sup> Corporate and insolvency law has generally recognized two working definitions of insolvency. The first, the balance sheet test,<sup>83</sup> holds that insolvency exists when the “sum of such entity’s debts is greater than all

---

<sup>79</sup> JOHN SELDEN, THE TABLE-TALK OF JOHN SELDEN: WITH A BIOGRAPHICAL PREFACE AND NOTES 148–49 (3d ed. 1860).

<sup>80</sup> Of course, the involuntary creditor is used as a retort here. We address this later. *See infra* Part IV.A.I.

<sup>81</sup> Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 20 (2002) (explaining that bounded rationality “asserts that all humans have inherently limited memories, computational skills, and other mental tools”).

<sup>82</sup> *See, e.g.*, 15A FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 7360 (rev. vol. 2016 update); *see generally* David Morrison, *When Is a Company Insolvent?*, 10 INSOLVENCY L.J. 4 (2002).

<sup>83</sup> Also known as the “legal insolvency” test.

of such entity's property, at a fair valuation . . . ."<sup>84</sup> The second test, the cash flow test,<sup>85</sup> holds that insolvency exists when an entity demonstrates "an inability to meet maturing obligations as they fall due in the ordinary course of business."<sup>86</sup> Deciding what test applies, however, is not so simple. For example, Delaware courts have used either or both tests.<sup>87</sup>

Both of these tests, however, have substantial practical limitations in the director duty context. Even if a clear definition can be agreed upon, *measuring* insolvency can be devilishly nettlesome. Two significant challenges are methodology and timing. Under a balance sheet test, all corporate assets would need to be valued, including going-concern value and goodwill. Some liabilities—contingent liabilities, for example—can be difficult to value by their very nature. Even if the valuation methods were not an obstacle, how often should insolvency be measured—annually, quarterly, or dynamically (i.e., in real time)? A dynamic measure of insolvency could be cost prohibitive, as it might require continual valuation and appraisals (including appraisals of assets that are not easy to evaluate). Moreover, what if a board had to make a relatively quick decision? Would it need to wait for a formal appraisal to gauge insolvency before it could act on behalf of the correct constituency? Dynamic insolvency, then, would be too difficult a standard. On the other hand, annual or quarterly measures of insolvency may be too rigid or dated, particularly in times of market volatility and uncertainty, such as the "Great Recession" of 2008 and the subsequent global financial crisis. Under the cash flow test, what if insolvency were only temporary, due to an unexpected but soon-to-be resolved issue with a credit facility? The practical problems are legion.

Recognizing these issues, some have proposed the "irretrievable insolvency" test, which posits insolvency as "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face

---

<sup>84</sup> 11 U.S.C. § 101(32) (defining "insolvent" for purposes of federal bankruptcy law).

<sup>85</sup> Also known as the "equitable insolvency" test.

<sup>86</sup> See, e.g., *Prod. Res. Grp., LLC v. NCT Grp., Inc.*, 863 A.2d 772, 782 (Del. Ch. 2004) (quoting *Siple v. S & K Plumbing and Heating, Inc.*, 1982 WL 8789, at \*2 (Del. Ch. Apr. 13, 1982)).

<sup>87</sup> See, e.g., *Prod. Res. Grp.*, 863 A.2d at 782 (using the cash flow test); *Angelo, Gordon & Co., L.P. v. Allied Riser Commc'ns Corp.*, 822 A.2d 1065, 1067 (Del. Ch. 2003) (using the balance sheet test); *Francotyp-Postalia AG & Co. v. On Target Tech., Inc.*, No. 16330, 1998 WL 928382, at \*5 (Del. Ch. 1998) (using the cash flow test).

thereof.”<sup>88</sup> Historically, this test has been used as the standard to appoint a receiver.<sup>89</sup> In the creditor-duty context, this standard would be more generous to directors than to creditors because it would effectively require the company’s dismal fate to be a *fait accompli*. However, the Delaware Court of Chancery has rejected this test as the standard for creditor-derivative claims.<sup>90</sup>

The definition of insolvency is central to the operation of the law on directors’ duties to creditors. Under Australian law, insolvency can be either an excess of liabilities over assets or a lack of liquidity.<sup>91</sup> Section 95A of the *Corporations Act 2001* (Cth) states that a person is solvent if, and only if, the person is able to pay all debts as and when they became due and payable.<sup>92</sup> The court has described the drafter’s effort, in the hope of reducing the scope for argument as to the test of a company’s insolvency, “as a surfeit of pleonasms.”<sup>93</sup> The discussion below offers a testament to the following judicial observation made by Justice Owen in *Bell Group Ltd v. Westpac Banking Corporation (No. 9)*: “The central feature of the insolvency concept is clear: a person is insolvent if he or she is unable to pay debts as they become due and payable. But thereafter, the fog descends.”<sup>94</sup>

Notwithstanding the voluminous case law and judicial guidelines, the inherent complexity surrounding the question of whether a company is solvent and the difficulties associated with this determination are captured in the following judicial passage in *Metropolitan Fire Systems v. Miller*:

---

<sup>88</sup> *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 115 A.3d 555, 557 (Del. Ch. 2015) (quoting *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, No. 1456-N, 2006 WL 2588971, at \*10 (Del. Ch. Sept. 1, 2006), *aff’d*, 930 A.2d 92 (Del. 2007)).

<sup>89</sup> *See Quadrant*, 115 A.3d at 556; *see also* *Atl. Tr. Co. v. Consol. Elec. Storage Co.*, 23 A. 934 (N.J. Ch. 1892). Interestingly, this standard evolved from New Jersey law, which was the corporate darling before Delaware. Under the New Jersey standard, insolvency triggered the power to appoint a receiver, and then the exercise of that power required an additional showing, i.e., no reasonable prospect of recovery. *Id.* This additional showing was due to the drastic nature of a receiver in that it replaces the board of directors. *Quadrant*, 115 A.3d at 558; *see also* *Salnita Corp. v. Walter Hldg. Corp.*, 168 A. 74, 75 (Del. Ch. 1933).

<sup>90</sup> *See Quadrant*, 115 A.3d at 560.

<sup>91</sup> *The Bell Group Ltd (in liq) v Westpac Banking Corporations [No. 9]* (2008) 70 ACSR 1 at [1065] (Austl.).

<sup>92</sup> *Corporations Act 2001* (Cth) s 95A (Austl.).

<sup>93</sup> *S Cross Interiors Pty Ltd v Deputy Comm’r of Taxation* (2001) 53 NSWLR 213 (Austl.); *see also* *BNY Corporate Trustee Services Ltd. v. Neuberger* [2013] 1 WLR 1408 (UKSC) 28 (appeal taken from Eng.) (discussing the complexities of the meaning of insolvency in the United Kingdom).

<sup>94</sup> (2008) 70 ACSR 1, 1064 (Austl.).

I do not doubt that many companies . . . would be found to be insolvent on particular days if . . . a balance sheet were taken at a particularly difficult trading time. It is also easy in hindsight . . . to be too artificial about the day to day running of a business in . . . a highly competitive ‘rough and tumble’ entrepreneurial field.<sup>95</sup>

Similarly, Justice Palmer, in *Southern Cross Interiors Pty Ltd v Deputy Commissioner of Taxation*, noted the difficulties of determining insolvency in the following situation:

There is conflict in the authorities as to whether, for the purpose of ascertaining insolvency, a trading debt is to be regarded as payable when it is required to be paid under the terms of the relevant contract or whether the Court can take into account normal or likely indulgences granted to the company by its creditors. The cases recognise that the former proposition may produce a test of unrealistic rigidity while the latter may produce a test which is so imprecise as to be impossible of consistent and principled application. Many judges have, therefore, struggled to find some middle ground between the two competing views. The result, unfortunately, is that the law on this point is in a state of some uncertainty.<sup>96</sup>

The discussion above illustrates that the legislative definition of insolvency, while apparently simple, is notoriously difficult to implement in complicated factual situations.<sup>97</sup>

### C. Defining the “Zone” of Insolvency

If the practical realities of using basic insolvency to trigger the duty are difficult, then expanding that triggering event to the amorphous *zone* of insolvency is practically impossible. Nevertheless, many courts have supported the view that the duty is triggered before technical insolvency.<sup>98</sup> Assuming *arguendo* that insolvency is amenable to practical demarcation, how far does its zone extend?

---

<sup>95</sup> (1997) 23 ACSR 699, 710–11 (Austl.).

<sup>96</sup> *S Cross Interiors Pty Ltd v Deputy Comm’r of Taxation* (2001) 53 NSWLR 213 (Austl.).

<sup>97</sup> See Morrison, *supra* note 82, at 18–19.

<sup>98</sup> See, e.g., Andrew Keay, *The Director’s Duty to Take Into Account the Interest of Company Creditors: When is it Triggered?*, 25 MELB. L. REV. 315, 329 (2001) (Austl.).

Defining this zone is particularly vexing. For instance, if the zone's frontier is too close to insolvency, then the rule offers little protection at the margins compared to using insolvency in fact. However, setting the duty's frontier too far away from insolvency (and thus deeper into clearly solvent territory) undercuts the entire stated purpose of the rule.<sup>99</sup>

To address this issue, some commentators have proposed frameworks to define the zone of insolvency.<sup>100</sup> One suggested approach involves consulting professional groups such as the American Institute of Certified Public Accountants ("AICPA"),<sup>101</sup> which has promulgated guidance for auditors to consider when analyzing an entity's ability to continue as a going concern.<sup>102</sup> The AICPA notes, for example, that an auditor should consider negative trends, other indications of possible financial difficulty (such as loan defaults or dividend arrears), internal matters (such as work stoppages), and external matters (such as legal proceedings or loss of intellectual property).<sup>103</sup>

Another proposed framework posits that the duty is triggered when "the circumstances of a company are such that its directors know, or can reasonably expect, that the action upon which they are going to embark could lead to the insolvency of the company."<sup>104</sup> Under this proposal, the triggering point would not be uniform, but would "take into account the circumstances of each company, so that the more obvious it is that the creditors' money is at risk, the lower the risk to which directors are justified in exposing the company."<sup>105</sup>

---

<sup>99</sup> See, e.g., *id.* (noting that extending the rule too far into solvency would result in "the effect of unreasonably interfering with the decision-making of directors, hamper the business of the company, and would be likely to lead to directors being over-cautious"). Indeed, courts have identified this problem. For instance, in *Kinsela, C.J. Street* "hesitate[d] to attempt to formulate a general test of the degree of financial instability which would impose upon directors an obligation to consider the interests of creditors." *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722, 733 (Austl.).

<sup>100</sup> See, e.g., Vladimir Jelisavcic, *Corporate Law—A Safe Harbor Proposal to Define the Limits of Directors' Fiduciary Duty to Creditors in the "Vicinity of Insolvency:"* Credit Lyonnais v. Pathe, 18 J. CORP. L. 145 (1993); Keay, *supra* note 98, at 334.

<sup>101</sup> See, e.g., Jelisavcic, *supra* note 100, at 164.

<sup>102</sup> AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, STATEMENT ON AUDITING STANDARDS, AU § 341, <http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00341.pdf>.

<sup>103</sup> *Id.*

<sup>104</sup> Keay, *supra* note 98, at 334.

<sup>105</sup> *Id.*

The above frameworks, which are largely qualitatively focused, can be rife with doubt, disagreement, and uncertainty. Further, they are subject to significant hindsight bias on judicial review. Thus, some commentators have proposed quantitatively focused frameworks.<sup>106</sup>

One such framework relies on a company's Z-score.<sup>107</sup> Developed by Professor Edward Altman, a Z-score is a type of "failure prediction model" that uses a multivariate analysis using financial ratios and variables.<sup>108</sup> The Z-score and its related variants have proved accurate in various contexts.<sup>109</sup> Professor Altman argued that companies earning a Z-score of less than 1.81 are in effect bankrupt,<sup>110</sup> and companies with scores greater than 2.99 are clearly non-bankrupt.<sup>111</sup> However, companies between 1.81 and 2.99 are in a gray area (or a "zone of ignorance," as Altman called it) because of susceptibility to error classification.<sup>112</sup>

Many quantitatively focused proposals argue that Altman's Z-score can serve as a defining point for the zone frontier. For instance, one proposal calls for a rebuttable presumption that firms are in the zone of insolvency if they have a Z-score

---

<sup>106</sup> See, e.g., Jon D. McLaughlin, *The Uncertain Timing of Directors' Shifting Fiduciary Duties in the Zone of Insolvency: Using Altman's Z-Score to Synchronize the Watches of Courts, Directors, Creditors, and Shareholders*, 31 HAMLINE L. REV. 145 (2008).

<sup>107</sup> See *id.*; see also Jelisavcic, *supra* note 100.

<sup>108</sup> Edward I. Altman, *Financial Ratios, Discriminate Analysis and the Prediction of Corporate Bankruptcy*, 23 J. FIN. 589 (1968). In particular, the Z-score is a weighted average of five ratios: (1) working capital/total assets; (2) retained earnings/total assets; (3) earnings before interest and taxes/total assets; (4) market value equity/book value of total debt; and (5) sale/total assets. *Id.* at 594.

<sup>109</sup> See HARLAN D. PLATT, WHY COMPANIES FAIL: STRATEGIES FOR DETECTING, AVOIDING, AND PROFITING FROM BANKRUPTCY 82–84 (1985); Jelisavcic, *supra* note 100, at 168 (citing Garland Chow & Richard D. Gritta, *Motor Carrier Bankruptcy in an Uncertain Environment*, 14 TRANSP. L.J. 39, 43 (1984) ("Z-scores have been independently tested in various industries with positive results."); McLaughlin, *supra* note 106, at 176 (citing Edward I. Altman, *Predicting Financial Distress of Companies: Revisiting The Z-Score and Zeta Models* (N.Y.U., Working Paper, 2000), <http://people.stern.nyu.edu/ealtman/Zscores.pdf>) ("The Z-Score has an accuracy rate of up to 93.9% when used one year from potential bankruptcy."); *id.* (citing Altman, *supra* note 108) ("The Z-Score's accuracy has remained consistent since its inception, predicting a company's future distress 'between 82% and 94%' of the time.").

<sup>110</sup> In his original study, Professor Altman defined bankrupt as "those firms that are legally bankrupt and either placed in receivership or have been granted the right to reorganize under the provisions of the National Bankruptcy Act." Altman, *supra* note 108, at 589 n.1.

<sup>111</sup> *Id.* at 606.

<sup>112</sup> *Id.*

of less than 1.81.<sup>113</sup> If the firm's score is greater than 1.81, it is beyond the zone of insolvency.<sup>114</sup> Another proposal rejects the Z-score as a safe harbor or presumption, arguing instead that it should be used to inform directorial decision-making.<sup>115</sup>

Thus, there is no uniform method by which to gauge the zone of insolvency. Courts and commentators have tried to define its contours but have simply been unable to capture a practical and objective test for it. We argue that such a nebulous standard, which underpins the duty to creditors, must be rejected.

#### D. Defining the Duty

For a judge to simply pronounce that a director has a fiduciary duty toward creditors (in whatever form, e.g., a shifted duty, expanded duty, discrete duty, etc.) is not sufficient. Indeed, as Justice Frankfurter explained,

But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?<sup>116</sup>

Even more perplexing is the judicial statement that, although direct duties are not owed to creditors, the directors *must consider* creditor concerns.<sup>117</sup> What does it mean to *consider* creditor concerns and interests? Does it mean to merely be aware of those concerns? Is this now a ministerial part of a directors' meeting—that is, to

---

<sup>113</sup> Jelisavcic, *supra* note 100, at 171.

<sup>114</sup> *Id.*

<sup>115</sup> See McLaughlin, *supra* note 106, at 186–87.

<sup>116</sup> SEC v. Chenery Corp., 318 U.S. 80, 85–86 (1943). In the corporate context, in particular, see Trenwick Am. Lit. Tr. v. Ernst & Young, LLP, 906 A.2d 168, 200 n.88 (Del. Ch. 2006) (noting that “simply saying that a director owes duties to the firm does little to define what those duties are and the end to which they are directed”). Similar questions have been posed by judicial authorities in Australia. See, e.g., *Hosp Prod Ltd v United States Surgical Corp* (1984) 156 CLR 41 (Austl.).

<sup>117</sup> *Westpac Banking Corp v Bell Grp Ltd (in liq) [No. 3]* (2012) 89 ACSR 1; [2012] WASCA 157 at [2031] (Austl.) (“At least where the company is facing insolvency as well as considering the company's interests the directors must consider the interests of its creditors . . .”) (quoting *Kalls Enterprises Pty Ltd (in liq) v Baloglow* [2007] NSWCA 191; (2007) 25 ACLC 1094 [162] (Austl.)).

discuss how the creditors might feel or be affected by a course of action taken by a distressed company?<sup>118</sup>

What, then, is the duty? Several options emerge.<sup>119</sup> First is the narrow formulation, which prohibits self-dealing and preferential treatment.<sup>120</sup> Second is the intermediate view, which mandates a duty to minimize losses.<sup>121</sup> Third is the expansive view, which mandates a duty to maximize long-term corporate wealth-creating capacity, including a subordination of shareholder interests to creditor interests.<sup>122</sup>

The case law often does not further define or elaborate upon the putative duty owed. Does it allow directors to act against shareholder interests? Even to the extent the duty has been limited to derivative actions, problems can still arise because of dueling derivative actions. For instance, a group of creditors could sue derivatively (on behalf of the firm), arguing that the board's path is too risky. But a group of shareholders could file a dueling derivative action (on behalf of the firm), arguing that the same course of action is too conservative.

The retort to the nebulous duty has generally been that directors should simply maximize shareholder value or consider the corporate enterprise. That is a seemingly enticing answer to the problem, but it is, unfortunately, myopic. Wealth maximization—the corporate enterprise view—deals only with pie expansion; it does not contemplate pie division decisions. Wealth maximization mantras are of no help because, by definition, the contemplated decision does not affect the value of the corporate enterprise.<sup>123</sup> Stated in terms of economic efficiency, it may not be possible to achieve a Pareto-superior decision<sup>124</sup> at or near insolvency; thus, one

---

<sup>118</sup> For any company—financially distressed or otherwise—it seems to be that, in all cases, the creditors are desirous of being repaid.

<sup>119</sup> See, e.g., McLaughlin, *supra* note 106; Robert B. Millner, *What Does It Mean for Directors of Financially Troubled Corporations to Have Fiduciary Duties to Creditors*, 9 J. BANKR. L. PRAC. 201 (2000).

<sup>120</sup> Millner, *supra* note 119, at 210; see also *St. James Capital Corp. v. Pallet Recycling Assocs. of N. Am., Inc.*, 589 N.W.2d 511 (Minn. Ct. App. 1999).

<sup>121</sup> Millner, *supra* note 119, at 211.

<sup>122</sup> *Id.* at 214.

<sup>123</sup> See Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 351 (2007).

<sup>124</sup> A Pareto-superior outcome is when at least one party is made better off and no party is worse off. See, e.g., RICHARD POSNER, *ECONOMIC ANALYSIS OF THE LAW* 17 (8th ed. 2011).

constituency may, of necessity, be left worse off than the other. Alternatively, perhaps the firm can achieve Kaldor-Hicks efficiency,<sup>125</sup> leaving the firm better off, but the creditors worse off.<sup>126</sup> In short, the current jurisprudence provides no answer to pie-division problems, i.e., those that involve true zero-sum decisions.<sup>127</sup>

### E. Utility Issues

The director-to-creditor fiduciary duty doctrine also imposes new compliance costs on directors and firms.<sup>128</sup> These costs are not readily ascertainable, for they depend on various factors, such as the definition of insolvency (balance sheet versus cash flow test) and the regularity of testing (real-time or quarterly, etc.). Monitoring costs will also depend on the firm's asset and liability profile (e.g., the need to value goodwill or estimate loss contingencies). Granted, for large publicly-traded companies, many of these variables are measured from time to time. However, this doctrine should apply in equal force to smaller firms, some of which may find the monitoring costs prohibitively expensive relative to any decisional utility that is derived. Other costs likely are increased too, due to the inevitable litigation surrounding the issue of duty and the increase in personal director liability that may affect the market of those willing to serve as directors. There is also another cost in uncertainty that is less easily calculated. In short, this doctrine undercuts the desired goal of corporate jurisprudence of having *stability* and *predictability*.<sup>129</sup> Simply speaking, the judicial morass here deprives directors "of the critical ability to determine *ex ante* whether their behavior comports with the law's demands, raising the transaction cost of corporate governance."<sup>130</sup>

---

<sup>125</sup> Kaldor-Hicks efficiency exists when an allocation produces more benefits than overall costs; in a Kaldor-Hicks efficiency, those made better off could, in theory, compensate those worse off. *See, e.g., id.* at 18.

<sup>126</sup> *See* Bainbridge, *supra* note 123, at 359.

<sup>127</sup> *See, e.g., id.* at 350; *see also* Matthew 6:24 ("No one can serve two masters, for either he will hate the one and love the other, or he will be devoted to the one and despise the other." (ESV)).

<sup>128</sup> As former Delaware Supreme Court Chief Justice Veasey noted regarding the zone of insolvency and director duties in that milieu: "[i]t is certainly an area where directors of troubled companies and their counsel face particular challenges and need expert counseling." E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1994 to 2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1432 (2005).

<sup>129</sup> Harff v. Kerkorian, 324 A.2d 215, 220 (Del. Ch. 1974) ("It is obviously important that the Delaware corporate law have stability and predictability."), *aff'd in part, rev'd in part*, 347 A.2d 133 (Del. 1975).

<sup>130</sup> Bainbridge, *supra* note 123, at 354–55.

The doctrine can also undercut other established insolvency principles, namely equitable distribution. In jurisdictions that recognize direct actions, for instance, this doctrine could encourage a race to the courthouse, because the first creditor to file or recover would be given *de facto* priority and would receive preferential treatment over other creditors. However, bankruptcy law and insolvency law generally are designed to circumvent this risk.<sup>131</sup> Federal bankruptcy law is intended to force a mandatory collective action with creditors to prevent the race-to-the-courthouse problem and provide for equitable (i.e., *pro rata*) liquidation.<sup>132</sup>

This doctrine (and the uncertainty associated with it) is difficult enough for directors, but it creates a true ethical dilemma for their counsel. Some commentators have staked the position that “no ethical or rational lawyer” should ever represent an insolvent corporation that is not in bankruptcy.<sup>133</sup> Worse still is the possible attendant liability against those lawyers for aiding and abetting a breach of fiduciary duty, which is cognizable in some jurisdictions.<sup>134</sup>

There are other issues with the duty as well; for example, it treats creditors as a homogenous class, which is not accurate. A firm’s creditors have different risk tolerances and are protected differently (e.g., a creditor may be secured, unsecured, or even oversecured). Indeed, undersecured or unsecured creditors often have interests similar to shareholders’ interests; consequently, they may be willing to take more risk to receive *some* payoff.<sup>135</sup> Conversely, secured, protected creditors have no interest in additional upside but rather favor liquidation. Thus, if the duty does run to “creditors,” which type of creditor is to be considered?

Part and parcel with the concept of fiduciary duty are subsidiary duties, such as the duty not to usurp a corporate opportunity. This duty would be completely unmanageable for many firms if it extended to the firm’s financial creditors

---

<sup>131</sup> See, e.g., CHARLES J. TABB, *THE LAW OF BANKRUPTCY* 4 (2d ed. 2009).

<sup>132</sup> *Id.* (“[T]he core function of bankruptcy is as a *collective creditors’ remedy* that furthers the goals of efficiency and of distributive justice.”).

<sup>133</sup> See, e.g., Bruce A. Markell, *The Folly of Representing Insolvent Corporations: Examining Lawyer Liability and Ethical Issues Involved in Extending Fiduciary Duties to Creditors*, 6 J. BANKR. L. & PRAC. 403, 403 (1997).

<sup>134</sup> See, e.g., *Amerifirst Bank v. Bomar*, 757 F. Supp. 1365, 1380 (S.D. Fla. 1991) (“[T]he majority of case law . . . recognizes a cause of action for aiding and abetting common law torts, such as breach of fiduciary duty.”); see also Markell, *supra* note 133, at 415 n.52 (citing cases).

<sup>135</sup> Moreover, we would add that under principles of modern financial theory, creditors are in a better position to reduce overall risk by diversifying their lending portfolio.

(particularly to a banking/financial conglomerate that is likely interested in *any opportunity* with a positive net present value). Similarly, how would the duty of loyalty apply in this context? Specifically, how does one determine which of the firm's creditors is entitled to primary loyalty? For example, if a firm has Big Bank A and Big Bank B as creditors and needs a new loan (and thus will be paying interest revenue to some institution), does it have to give both banks an equal ability to get the new loan? How would the duty of candor work with renegotiating a loan's terms? A firm that is at or near insolvency will need to be extremely savvy in the negotiation process.<sup>136</sup> A duty of candor may inhibit the ability to negotiate competitively. Finally, even if it's not the shareholders' money at risk, there's still director tension because the shareholders—not the creditors—vote on board elections and other material transactions. In sum, a legion of practical problems arises with such a duty.

The above problems demonstrate manifold costs with this duty not to usurp a corporate opportunity and the uncertainty in the law. Consequently, there is likely little net utility, if any, from such duty. This is particularly true when coupled with a proper understanding of the business judgment rule and the application of modern exculpation statutes.<sup>137</sup>

Finally, it is unclear the net utility and effect that this duty would have in the context of other entities that are largely creatures of contract, such as the limited liability company ("LLC"). The LLC is now ubiquitous in the United States and is the preferred option for new business formations.<sup>138</sup> And, under general principles

---

<sup>136</sup> The Delaware Court of Chancery in *Production Resources* noted this exact tension:

For example, the directors of an insolvent corporation must retain the right to negotiate in good faith with creditors and to strike fair bargains for the firm. To what extent should the "fiduciary" status of the directors impinge on such negotiations? Would it, for example, expose the directors to liability under principles of common law fraud for material omissions of fact to creditors in negotiations, and not simply for affirmative misrepresentations? And in precisely what circumstances would creditors be able to look directly to the directors for recompense as opposed to the firm?

*Prod. Res. Grp., LLC v. NCT Grp., Inc.*, 863 A.2d 772, 797 (Del. Ch. 2004).

<sup>137</sup> See, e.g., VA. CODE ANN. § 13.1-692.1 (2016).

<sup>138</sup> Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 459–60 (2010).

of LLC law, fiduciary duties can be modified by contract.<sup>139</sup> If the members of the LLC have relaxed fiduciary duties among themselves, how would that duty, which is now based in contract, be applied to third parties such as creditors?

#### F. *Creation of Creditor Moral Hazard*

We also argue that a law and economics approach bolsters our position. We are concerned that *ex post* risk shifting in relation to fiduciary duties to creditors creates a moral hazard problem. Moral hazard is the “economic phenomenon that insurance against loss reduces incentives to prevent or mitigate that loss.”<sup>140</sup> Here, the potential loss, of course, is the loss to the creditors who are not repaid. This nonpayment risk is normally reflected in the *stated interest rate* (i.e., the higher the risk of nonpayment, the higher the interest rate lenders charge). The insurance against that loss is now an *ex post* judicial recalculation of that risk of nonpayment by virtue of newly minted fiduciary duties.

In other words, the judicial doctrine of fiduciary duties to creditors allows creditors a second “bite” at the interest-calculating apple, this time with the benefit of hindsight. We are concerned with the potential deleterious effects this might have in the long run. For example, if creditors now know that they can seek payments for risk *ex post* and not bargain or calculate for that risk up front, then they are discouraged from policing that risk *ex ante*. Stated simply, allowing *ex post* risk shifting means that creditors who are not accurately calculating those risk premiums up front are in effect being subsidized by the judicial system. Creditors who are not efficient at forecasting and judging risk *should be forced out* of the lending market; they should not be allowed to continue making suboptimal lending decisions, the risks of which are ultimately borne by other constituencies.

---

<sup>139</sup> See, e.g., REVISED UNIF. LLC ACT § 110 (UNIF. LAW COMM’N 2006) (providing that fiduciary duties, with some limitations, may be modified by agreement); UNIF. P’SHIP ACT § 105 (UNIF. LAW COMM’N 2013) (same).

<sup>140</sup> Timothy M. Todd, *The Tail That Wags the Dog: The Problem of Pre-Merit-Decision Interim Fees and Moral Hazard in the National Vaccine Injury Compensation Program*, 63 U. KAN. L. REV. 1, 13 (2014) (citing Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 239 (1996)).

## IV. POLICING THE PROBLEM

### A. Existing Tools Provide Adequate Protection

#### 1. Creditors' Ability to Contract *Ex Ante*

This paper argues that the optimal solution is to scuttle this body of brooding jurisprudence and to enforce and encourage *ex ante* dickered contracts with bargained-for risk allocation. In sum, creditors are in the best position to police their risk.<sup>141</sup> This also comports with the axiomatic corporate principle that the relationship between a firm and its debtholder is contractual.<sup>142</sup> As expressed by the Court of Chancery in *Katz v. Oak Industries Inc.*:

Arrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.<sup>143</sup>

There are various practical methods by which a creditor can contractually minimize the risk of nonpayment. Obtaining collateral is one approach; the collateral can even be underlying shares of the company.<sup>144</sup>

Creditors can also draft negative covenants, which restrict debtors from incurring more debt, selling certain assets, or changing the underlying business activity.<sup>145</sup> Financial covenants are another option: for example, requiring the debtor

---

<sup>141</sup> Although, some commentators argue that “informational asymmetry between managers and creditors makes the debt contract inadequate to efficiently govern the debtor-creditor relationship.” Simone M. Sepe, *Directors' Duty to Creditors and the Debt Contract*, 1 J. BUS. & TECH. L. 553, 553 (2007).

<sup>142</sup> See, e.g., *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986) (“Under our law—and the law generally—the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature.”).

<sup>143</sup> *Id.* at 879.

<sup>144</sup> It is interesting to note that this was the genesis of the *Credit Lyonnais* case: It was an action under section 225 of the Delaware General Corporation Law to determine the proper persons to vote stock used as security to a loan agreement. See generally *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

<sup>145</sup> See, e.g., Frederick Tung, *Gap Filling in the Zone of Insolvency*, 1 J. BUS. & TECH. L. 607, 619 (2007).

to maintain financial ratios within certain agreed-upon ranges.<sup>146</sup> Upon default, a creditor often enjoys tremendous leverage to negotiate additional protections;<sup>147</sup> and a well-drafted credit contract often anticipates insolvency and provides adequate mechanisms to renegotiate that contract after default.<sup>148</sup> We see little utility that an ill-defined and unworkable judicial framework can add here, particularly considering that adequate *ex ante* measures exist.

Interestingly, the Supreme Court of Delaware has rejected special, *ad hoc* duties in other corporate contexts. For example, in *Nixon v. Blackwell*, the court refused to create “special, judicially-created rules to ‘protect’ minority stockholders.”<sup>149</sup> There, the Supreme Court emphasized that

[t]he tools of good corporate practice are designed to give a purchasing minority stockholder the opportunity to bargain for protection before parting with consideration. It would do violence to normal corporate practice and our corporation law to fashion an ad hoc ruling which would result in a court-imposed stockholder buy-out for which the parties had not contracted.<sup>150</sup>

The *Nixon* court continued by stating that such a judicially created duty would result in “inappropriate judicial legislation.”<sup>151</sup> Yet that is exactly what Delaware and other courts did (and continue to do) in the creditor duty context.<sup>152</sup> The same rationale that underpinned *Nixon*—that shareholders in a closely held corporation can protect themselves up front via various contractual agreements—should be even more compelling for the voluntary creditor, whose relationship is *entirely* contractual.

Of course, the issue of involuntary creditors is often—and appropriately—raised as a rebuttal. We acknowledge the precarious position of involuntary creditors (e.g., tort claimants) under this Article’s conclusion insofar as they cannot police

---

<sup>146</sup> *See id.* at 619–20 (noting covenants such as requiring “certain levels of net worth, tangible assets, total capital relative to debt, and cash flow relative to debt service obligations”).

<sup>147</sup> *See id.* at 620.

<sup>148</sup> *See id.*

<sup>149</sup> 626 A.2d 1366, 1379 (Del. 1993).

<sup>150</sup> *Id.* at 1380.

<sup>151</sup> *Id.* at 1380–81.

<sup>152</sup> *See, e.g., Geyer*, 621 A.2d 784 (citing cases).

their risk up front by contract. Our response to the plight of the involuntary creditor is that existing and well-defined legal doctrines already police many instances of corporate and director misconduct that may affect them. We refer to this as the *default creditor safety net*, i.e., the default protections afforded to creditors under general corporate and related bodies of law.<sup>153</sup>

Commentators who adhere to the contractarian theory of the corporation, viewing the corporation merely as a “nexus of contracts,” will be steadfastly opposed to expanding the common law to include fiduciary duties related to creditor interests. The rationale for this opposition, even in the event of insolvency, can be summarized briefly as follows. According to the advocates of market restraint, such as Judge Posner,<sup>154</sup> creditors are expected to protect themselves against the risk of debtor default through reliance on contracts. Voluntary creditors are expected to build in a higher interest rate on the loan negotiated between the creditor and the company to reflect the commercial risks undertaken by the creditor. If the risk of loss is great, it is expected that a greater amount would be charged to compensate for that risk. Thus, creditors cannot be allowed to complain of loss caused by the debtor’s insolvency. The conventional wisdom is that the creditor has contracted to bear that risk and has factored compensation into the cost of credit.<sup>155</sup>

The advocates of market restraint also argue that creditors are free to bargain and to take additional contractual steps to protect themselves against any unforeseen change in risk. These additional steps generally place limitations on the commercial activities of the debtor company. Creditors can demand protection through the use of a variety of covenants,<sup>156</sup> such as loan covenants that stipulate how funds are to be used or that restrict the ability of a company to sell its assets. Viewed from a contractarian perspective, any extension of a director’s duty to encompass the interests of creditors is unwarranted.

The contractarian analysis is not, however, universally accepted. According to the critics of market restraint, such as Landers,<sup>157</sup> the type of contracting advocated

---

<sup>153</sup> See *infra* Part IX(A). Indeed, as we argue later in the Article, if society feels as though this safety net is not adequate, then the change should be made legislatively, not judicially. See *infra* Part IX(B).

<sup>154</sup> Richard Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 506–07 (1976).

<sup>155</sup> See, e.g., EASTERBROOK & FISCHER, *supra* note 26, at 51.

<sup>156</sup> Posner, *supra* note 154, at 504.

<sup>157</sup> See Jonathan M. Landers, *Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy*, 43 U. CHI. L. REV. 527 (1976).

by the contractarians may be neither possible in practice nor appropriate for trade creditors. Critics point out that the market is not perfect and that participants in that market may not have full information.<sup>158</sup> Thus, a creditor may not be fully compensated for his level of risk, because (in the absence of full information) his interest rate is likely to be lower than necessary for the level of risk undertaken. This in turn may result in inaccurate pricing of the loan, which may inadvertently result in a higher risk to the creditor, enabling the debtor company to externalize the cost of the debt.

The critics of market restraint also argue that not all trade creditors are in a position to demand security over all of the company's assets or insist upon loan covenants.<sup>159</sup> Some trade creditors lack the bargaining power, influence, or resources to protect themselves through contract. In such situations, trade creditors and involuntary creditors, such as tort claimants, are not in a position to shift back the risk.<sup>160</sup> Freedman, for example, argues that contractual waiver of limited liability may achieve an efficient result for the large creditor, but encourages the debtor to "lay off still more of the risk on to those less able to insist on such a contractual waiver."<sup>161</sup> Freedman concludes that "it is mainly the sophisticated creditor with bargaining power who seems to gain."<sup>162</sup> Even sophisticated creditors, as noted by Austin and Ramsay,<sup>163</sup> cannot foresee all contingencies and contract for protection against them. Nevertheless, we still maintain that the cost of this jurisprudence outweighs any practical utility and that existing statutory and judicial structures provide a reasonable safety net to police director chicanery toward creditors.

## 2. Bankruptcy and Insolvency Law

Bankruptcy and insolvency law provides adequate and societally approved protection to creditors in the event of corporate insolvency.<sup>164</sup> First, creditors who

---

<sup>158</sup> *See id.*

<sup>159</sup> *See, e.g.,* Judith Freedman, *Limited Liability: Large Company Theory and Small Firms*, 63 THE MOD. L. REV. 317, 332 (2000) (UK).

<sup>160</sup> *See id.*

<sup>161</sup> *Id.* at 351–52.

<sup>162</sup> *Id.* at 332.

<sup>163</sup> AUSTIN & RAMSAY, *supra* note 4, § 20.020.

<sup>164</sup> Interestingly, even though these purported duties are couched in terms of state law, the claims are often adjudged during a bankruptcy process in federal court. *See, e.g.,* Barondes et al., *supra* note 23, at 230

are concerned about the current and future state of a firm are entitled under American law to file an involuntary bankruptcy petition against the firm.<sup>165</sup> In particular, the creditors<sup>166</sup> can file a Chapter 7 or Chapter 11 petition using the allegation that the debtor<sup>167</sup> is not generally paying debts as they come due.<sup>168</sup>

Indeed, filing an involuntary petition can be a prudent move for creditors, particularly when there are concerns about the management's competence or concerns that the debtor might transfer assets in anticipation of collection and related proceedings.<sup>169</sup> After the petition is filed, the automatic stay stops collection action and mitigates race-to-the-courthouse concerns.<sup>170</sup> Moreover, the bankruptcy estate is also created, so if the firm acts in a manner that "suggests that the assets of the estate will be disposed of to the detriment of creditors,"<sup>171</sup> the court can limit the firm's power over its property;<sup>172</sup> it can even appoint an interim trustee if "necessary to preserve the property of the estate or to prevent loss to the estate."<sup>173</sup>

Bankruptcy proceedings, whether filed voluntarily or involuntarily, offer a panoply of protections to debtors and creditors. In the corporate reorganization

---

(noting that "the overwhelming majority of these cases wind up being litigated in bankruptcy court rather than the Delaware Court of Chancery").

<sup>165</sup> 11 U.S.C. § 303 (2012). Admittedly, involuntary bankruptcy petitions generally constitute a small portion of total number of bankruptcy cases filed. *See, e.g.*, COLLIER ON BANKRUPTCY ¶ 303.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2013).

<sup>166</sup> The number of creditors required to join the filing depends on the number of creditors that the debtor has. *See* 11 U.S.C. § 303(b) (2012).

<sup>167</sup> Under current bankruptcy law, there are limits to the type of firm that can be forced into involuntary bankruptcy. *See* 11 U.S.C. § 303(a); *see generally* COLLIER ON BANKRUPTCY, *supra* note 165, ¶ 303.04 (describing the persons against whom an involuntary petition can be filed); *id.* ¶ 303.05 (describing persons against whom an involuntary petition may not be filed).

<sup>168</sup> *See* 11 U.S.C. § 303(h)(1). Under Pt. 5.4 of the Corporations Act 2001 (Cth) in Australia, a creditor can initiate the compulsory winding up of a company through the issuance of a statutory demand. *Corporations Act 2001* (Cth) Pt. 5.4 (Austl.).

<sup>169</sup> *See* COLLIER ON BANKRUPTCY, *supra* note 165, at ¶ 303.01.

<sup>170</sup> *See* 11 U.S.C. § 362(a).

<sup>171</sup> COLLIER ON BANKRUPTCY, *supra* note 165, at ¶ 303.23.

<sup>172</sup> *See* 11 U.S.C. § 303(f).

<sup>173</sup> *See id.* § 303(g); *see also id.* § 1104 (for appointing chapter 11 trustee). In Australia, at any time between the filing of the application and the making of an order for winding up, the court has discretionary power to appoint a provisional liquidator to take control of the company. *Corporations Act 2001* (Cth) s 472(2).

context in particular, one salient example is the absolute priority rule. This rule provides generally that a junior interest (e.g., equity holders) cannot participate in a plan's distribution of property if any senior class (e.g., debtholders) dissents and is not paid in full.<sup>174</sup> In other words, this recognizes the basic corporate law principle that "debt comes before equity with respect to the debtor's assets."<sup>175</sup> This rule would govern any distributions to shareholders, and with court supervision to boot.

Additionally, in a reorganization bankruptcy, a creditor committee could bring derivative actions to recover property for the benefit of the estate.<sup>176</sup> This ability could be helpful, for example, if the creditors feel that the debtor firm unreasonably failed to bring a suit to recover a fraudulent transfer.

### 3. Fraudulent Transfer and Preference Law

Fraudulent transfer and preference law also protects creditors from financially-troubled debtors.<sup>177</sup> The purpose of these laws, which are found in many Anglo-American jurisdictions,<sup>178</sup> is to "protect a debtor's estate from being depleted to the prejudice of the debtor's unsecured creditors."<sup>179</sup> Normally there are two types of

---

<sup>174</sup> See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988) ("[T]he absolute priority rule provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan."); COLLIER ON BANKRUPTCY, *supra* note 165, at ¶ 1129.03; see also 9D AM. JUR. 2D BANKR. § 2978 (2006).

<sup>175</sup> COLLIER ON BANKRUPTCY, *supra* note 165, at ¶ 1129.03. Similarly, in Australia, see § 563A of the Corporations Act 2001 (Cth), which provides for the deferral of debts owed to members in their capacity as members until after all non-member claims have been satisfied. *Corporations Act 2001* (Cth) s 563A.

<sup>176</sup> See Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548 (3d Cir. 2003).

<sup>177</sup> In fact, these fraudulent transfer claims have been brought alongside fiduciary duty claims in the creditor context. See *Quadrant Structure Prods. v. Vertin*, 115 A.3d 535, 539 (Del. Ch. 2015).

<sup>178</sup> In Australia, see Part 5.7B of the Corporations Act 2001 (Cth) which targets certain transactions as voidable transactions, such as unfair preferences, uncommercial transactions, unfair loans, and unreasonable director-related transactions. *Corporations Act 2001* (Cth) Pt. 5.7B. The Supreme Court in the United Kingdom in *Rubin v. Eurofinance SA* [2012] UKSC 46, [2013] BCC 1 at 95, recently described the policy underlying such avoidance provisions as being

to protect the general body of creditors against a diminution of the assets by a transaction which confers an unfair or improper advantage on the other party, and it is therefore an essential aspect of the process of liquidation that antecedent transactions whose consequences have been detrimental to the collective interest of the creditors should be amenable to adjustment or avoidance . . . .

<sup>179</sup> See UNIF. FRAUDULENT TRANSFER ACT (UFTA) § 3 cmt. 2 (UNIF. LAW. COMM'N 2013).

fraudulent transfers: (1) those made with an actual intent to defraud creditors,<sup>180</sup> and (2) those made merely in suspicious circumstances (the latter is known as *constructive fraud*).<sup>181</sup> Because actual subjective intent to defraud is difficult to prove, even with the established “badges of fraud,”<sup>182</sup> constructive fraud is often the pursued claim. The classic elements of constructive fraud are insolvency and inadequate consideration.<sup>183</sup> Thus, if a debtor makes a transfer when it is insolvent or is about to become insolvent, fraudulent transfer law provides a remedy. Similarly, if a firm were about to engage in a transaction with “unreasonably small assets,” an action could also result.<sup>184</sup>

It is important to note that this protection exists in state law outside of bankruptcy; indeed, a creditor is still protected if the debtor were to file bankruptcy. Federal bankruptcy law allows a trustee to pursue state law fraudulent transfer claims and also provides a unique bankruptcy fraudulent transfer provision.<sup>185</sup>

Similarly, the law regarding preferential transfers could also help creditors. Federal bankruptcy law “avoids” (i.e., vitiates) a payment or transfer that a debtor makes, within a certain time period,<sup>186</sup> to a creditor on account of an antecedent debt that enables that creditor to receive more than it would otherwise.<sup>187</sup> The bankruptcy trustee is allowed to recover that payment from the preferred creditor.<sup>188</sup> Motives are irrelevant here; the question is simply whether one creditor was preferred over another. This provision supports the principle of equality of distributions among similarly situated creditors.

---

<sup>180</sup> See *id.* § 4(a)(1) (defining a fraudulent transfer as one that is made with “actual intent to hinder, delay, or defraud any creditor of the debtor . . .”).

<sup>181</sup> The UFTA defines constructive fraud as a transfer that does not involve receiving a reasonably equivalent value and the debtor was insolvent or becomes insolvent because of the transfer. UFTA § 5(a). See generally PETER SPERO, ASSET PROTECTION: LEGAL PLANNING, STRATEGIES AND FORMS § 3.04.

<sup>182</sup> See UFTA § (4)(b); *Twyne’s Case* (1601) 76 ER 809.

<sup>183</sup> See SPERO, *supra* note 181.

<sup>184</sup> *Id.*

<sup>185</sup> 5 U.S.C. §§ 544(b), 548 (2012).

<sup>186</sup> For bankruptcy purposes, the time period is ninety days before the date of the filing of the bankruptcy petition. However, the time period is extended to one year for preferential transfers to insiders. See 11 U.S.C. § 547(b)(4)(B) (2012).

<sup>187</sup> See *id.* § 547.

<sup>188</sup> See *id.* § 550(a).

#### 4. Restrictions on Dividends and Distributions

Another protection that creditors have in state law is that of restrictions on distributions. Restrictions on the ability to pay dividends are nothing new in corporate law;<sup>189</sup> indeed, “[t]he rule against capital impairment has long been the fundamental restriction on dividends.”<sup>190</sup> Historically, state corporate codes required corporations to distinguish between “par value” and “stated capital.”<sup>191</sup> The underlying purpose is to keep some capitalization for the benefit of creditors.<sup>192</sup> In other words, in exchange for the state-provided franchise of limited personal liability, “the law seeks to safeguard creditors by requiring the making and keeping of a minimum investment in the business.”<sup>193</sup> The consequence of this requirement was famously elucidated by Justice Story in *Wood v. Dummer*: he noted that “the capital stock of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank.”<sup>194</sup>

Despite its noble goal, legal capital concepts generally proved unworkable.<sup>195</sup> For example, the margin of safety established by the legal capital requirements was largely arbitrary and had no relation to the risk profile of the business.<sup>196</sup> Consequently, instead of relying upon legal capital requirements,<sup>197</sup> state corporate codes now generally prohibit the paying of a dividend or distribution if the payment would result in either cash flow insolvency or balance sheet insolvency.

A prime example of this is found in the Model Business Corporation Act. Section 6.40 provides that no distribution may be made if, after giving effect to the distribution, (1) “the corporation would not be able to pay its debts as they become

---

<sup>189</sup> See generally Edward H. Warren, *Safeguarding the Creditors of Corporations*, 36 HARV. L. REV. 509 (1923).

<sup>190</sup> JAMES D. COX & THOMAS LEE HAZEN, 3 TREATISE ON THE LAW OF CORPORATIONS § 20:11 (3d ed. 2015).

<sup>191</sup> See MODEL BUS. CORP. ACT § 6.40 cmt. (1950).

<sup>192</sup> COX & HAZEN, *supra* note 190.

<sup>193</sup> *Id.*

<sup>194</sup> *Wood v. Dummer*, 30 F. Cas. 435, 436 (D. Me. 1824).

<sup>195</sup> See generally COX & HAZEN, *supra* note 190, § 20:19.

<sup>196</sup> See *id.*

<sup>197</sup> California and the Model Business Corporation Act largely led this paradigm shift in the law. See COX & HAZEN, *supra* note 190, § 20:19.

due in the usual course of business,” or (2) “the corporation’s total assets would be less than the sum of its total liabilities . . . .”<sup>198</sup> Such dividends are unlawful, and they are also the direct responsibility of the directors—i.e., the directors are *personally* liable for them.<sup>199</sup> Moreover, it is possible that a dividend could constitute both an unlawful dividend and a fraudulent transfer. In that case, both causes of action would be possible.<sup>200</sup>

## 5. Receiverships and Dissolution

Modern corporate law provides for the appointment of a receiver. In many jurisdictions, this ability is now statutory,<sup>201</sup> but receivership originated in equity. Statutes largely govern the grounds for appointment, and they generally require evidence of insolvency, imminent danger of insolvency, or even mismanagement or misappropriation.<sup>202</sup> Relevant here would be the insolvency, mismanagement, and misappropriation grounds.

State law can provide the express power to appoint a receiver upon insolvency.<sup>203</sup> Sometimes that appointment may be incidental to some other

---

<sup>198</sup> MODEL BUS. CORP. ACT § 6.40(c)(1)–(2) (1950). In Australia, § 254T of the Corporations Act 2001 (Cth) requires that a company not pay a dividend unless its assets exceeds its liabilities, the payment of the dividend is fair and reasonable to shareholders as a whole, and the payment does not materially prejudice the company’s ability to pay its creditors—for example, upon insolvency. *Corporations Act 2001* (Cth) s 254T (Austl.).

<sup>199</sup> See, e.g., DEL. CODE ANN. tit. 8, § 174 (West 2016); N.Y. BUS. CORP. LAW § 719(a) (2016); MODEL BUS. CORP. ACT § 8.33(a). See generally RICHARD A. BOOTH, FINANCING THE CORPORATION § 4.9 (2015).

<sup>200</sup> See, e.g., Official Comm. of the Unsecured Creditors of Color Tile, Inc. v. Blackstone Family Invest. P’ship, L.P. (*In re Color Tile, Inc.*), No. 96-76, 2000 WL 152129, \*2 (D. Del. Feb. 9, 2000).

<sup>201</sup> See, e.g., DEL. CODE ANN. tit. 8, § 291 (West 2016); CAL. CIV. PRO. CODE § 564(b)(5), (6) (2016) (providing for receiver when “a corporation is insolvent, or in imminent danger of insolvency, or has forfeited its corporate rights”); N.Y. BUS. CORP. LAW § 1202 (2016). In Australia, receivers can be appointed either privately (pursuant to instruments executed by companies that create a security interest over their assets in favour of a secured party) or publicly (through discretionary court appointment) under the various Supreme Court Acts in each state and under federal statute law, such as the Judiciary Act 1903 (Cth) and Federal Court of Australia Act 1976 (Cth). The Corporations Act also provides for the appointment of a receiver in certain circumstances. *Corporations Act 2001* (Cth) s 1323(1)(h).

<sup>202</sup> See generally FLETCHER, *supra* note 82, § 7709.

<sup>203</sup> See, e.g., CAL. CIV. PRO. CODE § 564(b)(5), (6) (West 2011); KAN. STAT. ANN. § 17-6901 (West 2016); N.J. STAT. ANN. § 14A:14-2(2)(a) (West 2016). See generally FLETCHER, *supra* note 82, § 7718; Stevens v. Carolina Scenic Stages, 208 F.2d 332, 336 (4th Cir. 1953) (“[A] court of equity may order a receivership when a corporation is insolvent, or in imminent danger of insolvency, when such receivership is for the

requested relief.<sup>204</sup> Even if a company is insolvent, a court may refuse to appoint a receiver if, for instance, it would be in the best interest of creditors that the business continue.<sup>205</sup> However, some jurisdictions require something more than simple insolvency;<sup>206</sup> in any event, insolvency together with mismanagement or misappropriation will be strong grounds for a receiver.<sup>207</sup> Other jurisdictions provide for a receiver upon a showing that the corporation is in imminent danger of insolvency.<sup>208</sup> Receivers can also be appointed upon a showing of misconduct or mismanagement.<sup>209</sup>

---

purpose of a bona fide liquidation of the affairs of the corporation, and the protection of the rights of creditors, according to their respective priorities . . .”).

<sup>204</sup> See *Murray v. Sup. Ct. of L.A. Cnty.*, 129 Cal. 628, 632 (1900); FLETCHER, *supra* note 82, § 7718.

<sup>205</sup> See, e.g., *McDougal v. Huntingdon & Broad Top R. & C. Co.*, 143 A. 574, 579 (Pa. 1928) (“[T]he continuation of the business may be for the best interests of the creditors as a class . . .”); *Doe v. Nw. Coal & Transp. Co.*, 64 F. 928, 930 (D. Or. 1894) (“[I]t may be to the best interest of the creditors that its business should continue, and its financial embarrassment will not necessarily prevent that result.”).

<sup>206</sup> See generally FLETCHER, *supra* note 82, § 7718; 75 C.J.S. *Receivers* § 21 (Supp. 2016).

<sup>207</sup> See, e.g., *McDougal v. Huntingdon & Broad Top R. & C. Co.*, 143 A. 574, 579 (Pa. 1928) (“But insolvency coupled with mismanagement or misappropriation of assets to the detriment of creditors is always ground for receivership.”). See generally R.E.H., Annotation, *Inherent Power of Equity, at Instance of a Stockholder, to Appoint Receiver for, or to Wind up, a Solvent, Going Corporation, on Ground of Fraud, Mismanagement, or Dissensions*, 43 A.L.R. 242 (1926).

<sup>208</sup> See, e.g., N.C. GEN. STAT. ANN. § 1-507.1 (West 2015) (“When a corporation becomes insolvent . . . or is in imminent danger of insolvency . . . a receiver may be appointed by the court . . .” (emphasis added)); CAL. CIV. PRO. CODE § 564(b)(5), (6) (West 2011); *Jacobson-Lyons Stone Co. v. Silverdale Cut Stone Co.*, 370 P.2d 68, 75 (Kan. 1962) (“It has been said that courts of equity are not required to withhold or postpone the exercise of their inherent power to do justice until a corporation has been completely wrecked by insolvency due to unfaithful, unlawful and corrupt practices of officers in control. In equity impossibility of attaining corporate objects is as good a ground for putting an end to operations as inevitable insolvency.”).

<sup>209</sup> See generally FLETCHER, *supra* note 82, § 7714; see also *Zuchowski v. Boxwood Coal Corp.*, 93 A.2d 119, 120 (Del. Ch. 1952) (“Unquestionably this court has inherent power to appoint a receiver for a solvent corporation by reason of fraud or gross mismanagement on the part of the officers of the corporation where there is real, imminent danger of material loss which cannot otherwise be prevented.”).

In addition to receivership, a creditor could also file for judicial dissolution of the debtor corporation.<sup>210</sup> Although this represents an extreme remedy,<sup>211</sup> this approach is nevertheless illustrative of existing protective devices under state law. The Model Business Corporation Act expressly provides two ways that a creditor can bring a judicial dissolution action against a corporation: first, if the creditor's claim, which has been reduced to judgment, has gone unsatisfied and the corporation is insolvent,<sup>212</sup> and second, if the "corporation has admitted in writing that the creditor's claim is due and owing," and the corporation is insolvent.<sup>213</sup>

## 6. Insolvent Trading

Many countries, excluding the United States, have wrongful or insolvent trading laws on their statute books.<sup>214</sup> The Australian insolvent trading laws are "arguably the strictest in the world,"<sup>215</sup> as noted by the Chief Justice of Western Australia, and reform is currently under consideration. The goal of such reform is to facilitate effective corporate restructuring and to provide a better balance during insolvency between encouraging entrepreneurship and protecting creditors.<sup>216</sup>

---

<sup>210</sup> See, e.g., ARIZ. REV. STAT. ANN. § 10-1430(C) (2013); CONN. GEN. STAT. ANN. § 33-896(2) (West 2015); FLA. STAT. ANN. § 607.1430(4) (West 2016); GA. CODE ANN. § 14-2-1430(3) (West 2003); 805 ILL. COMP. STAT. ANN. § 5/12.50(2) (2006); 15 PA. C.S.A. § 1982 (2016); VA. CODE ANN. § 13.1-747(2) (West 2016); see generally COX & HAZEN, *supra* note 190, § 26.5. Although, some states do not allow for a creditor action in this context, but rather allow a creditor to intervene. See ALASKA STAT. § 10.06.628(e) (West 2007); CAL. CORP. CODE § 1800 (2016); see also COX & HAZEN, *supra* note 190, § 26.5 & n.22.

<sup>211</sup> Brenner v. Berkowitz, 634 A.2d 1019, 1030 (N.J. 1993) ("Dissolution is an extreme remedy to be imposed with caution after a careful balancing of the interests at stake . . ."); Polikoff v. Dole & Clark Bldg. Corp., 184 N.E.2d 792, 795 (Ill. App. 1962) ("[T]he remedy of liquidation is so drastic that it must be invoked with extreme caution.").

<sup>212</sup> MODEL BUS. CORP. ACT § 14.30(3)(i) (1950).

<sup>213</sup> *Id.* § 14.30(3)(ii).

<sup>214</sup> For example, in the United Kingdom, section 214 of the *Insolvency Act of 1986* provides for wrongful trading; in New Zealand, section 135 of the *Companies Act of 1993* provides for reckless trading; and in Singapore section 340 of the *Companies Act* provides an offense for fraudulent trading.

<sup>215</sup> The Hon. Wayne Martin, Chief Justice of W. Austl., Official Opening Address at Insolvency Practitioners' Association of Australia 16th National Conference (May 28, 2009) (Austl.). For comparative study of insolvent trading regimes in other countries, see Jason Harris, *Director Liability for Insolvent Trading: Is the Cure Worse than the Disease?*, 23 AUSTL. J. CORP. L. 266 (2009).

<sup>216</sup> PRODUCTIVITY COMMISSION, BUSINESS SET-UP, TRANSFER AND CLOSURE NO. 75 (Sept. 30, 2015). The report was sent to the Federal Government on September 30, 2015 and publicly released on December 7, 2015. The Government noted the following rationale for insolvency law reform:

The deterrence regime under Part 5.7B of the *Corporations Act 2001* (Cth) provides that directors may incur civil or criminal liability, or that on “pain of personal liability,”<sup>217</sup> they may be required to pay compensation to the creditors if they allow their company to trade while the company is insolvent.<sup>218</sup> Section 588G(2) is a civil penalty provision enforceable by the Australian Securities and Investment Commission. Consequently, directors are potentially subject to a pecuniary penalty, a disqualification order, and compensation orders for loss arising from breach of the duty to prevent insolvent trading.<sup>219</sup> Criminal proceedings are reserved for offences linked to dishonesty and may lead to prison terms for up to five years.<sup>220</sup>

The New South Wales Court of Appeal considered the statutory purpose of the insolvent trading law in *Edwards v Australian Securities and Investment Commission*:

[It] is to discourage and provide a remedy for a particular type of commercial dishonesty or irresponsibility . . . [which] occurs when a company that is at or approaching insolvency obtains a loan, or obtains property or services on credit, and either there is a director who knows or suspects the insolvency or approaching insolvency, or a reasonable person in the director’s position would know or suspect it. In that situation, any director (whether or not personally involved . . .) can be made personally liable . . . [It] aims to encourage directors to carry out their

---

Concerns over inadvertent breaches of insolvent trading laws are frequently cited as a reason early stage (angel) investors are reluctant to get involved in a startup. Our current insolvency laws put too much focus on penalising and stigmatising the failures . . . .

See *National Innovation & Science Agenda, Improving Insolvency Laws to Encourage Innovation*, <http://www.innovation.gov.au/page/insolvency-laws-reform> (last visited Mar. 16, 2016). Consequently, “the Productivity Commission explored the impact that insolvent trading law has on the decisions facing directors and [recommended] a safe harbour defence for directors who fail in their restructuring efforts.” Jason Harris & Anil Hargovan, *Productivity Commission Safe Harbour Proposal for Insolvent Trading*, 68 CORP. DIRECTIONS 9, 10 (2016); see also *id.* (providing a critical comment on the law reform proposal); Anil Hargovan, *Governance in Financially Troubled Companies: Australian Law Reform Proposals*, 34 CO. & SEC. L.J. 483 (2016) (Austl.).

<sup>217</sup> *Woodgate v Davis* [2002] NSWSC 616; (2002) 42 ACSR 286 (Austl.).

<sup>218</sup> *Id.*; see also Anil Hargovan, *Director’s Liability for Insolvent Trading, Statutory Forgiveness and Law Reform*, 18 INSOLVENCY L.J. 96 (2010) (Austl.).

<sup>219</sup> *Corporations Act 2001* (Cth) ss 588G(2), 317E (Austl.).

<sup>220</sup> *Corporations Act 2001* (Cth) s 588G(3) (Austl.).

duties properly if the company is at or approaching insolvency, and provides a sanction if they do not.<sup>221</sup>

Several policies support insolvent trading law;<sup>222</sup> the Australian Treasury, for example, has noted the following:

- it encourages directors to be aware of their company's financial situation;
- it encourages directors to attempt to prevent the company continuing to trade if there are grounds for suspecting it is insolvent, for example, by relinquishing control so that the company's creditors can determine its future;
- it improves the position of an insolvent company's creditors by imposing liability for post-insolvency debts on directors who breach their duty; and
- it also provides an incentive for management to obtain competent professional advice when financial difficulties loom.<sup>223</sup>

The insolvent trading provisions under Part 5.7B of the *Corporations Act 2001* (Cth) allows for compensatory remedies against directors at the suit of the liquidator and in some circumstances of individual creditors.<sup>224</sup> In disregarding the separate

---

<sup>221</sup> *Edwards v Austl Sec Invs Comm'n* [2009] NSWCA 424 at [3] per Campbell JA. For discussion on the context, history and legislative purpose of the insolvent trading laws, see Niall Coburn, *Insolvent Trading in Australia: The Legal Principles*, in COMPANY DIRECTORS' LIABILITY FOR INSOLVENT TRADING 73 (Ian Ramsay ed., 2000).

<sup>222</sup> See, e.g., Jason Harris & Anil Hargovan, *Productivity Commission Safe Harbour Proposal for Insolvent Trading*, 68 CORP. DIRECTIONS 9, 10 (2016).

<sup>223</sup> TREASURY, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* ¶ 2.2.4 (Treasury Discussion Paper, Jan., 2010). For opposing views, see Dale Oesterle, *Corporate Directors' Personal Liability for "Insolvent Trading" in Australia, "Reckless Trading" in New Zealand and "Wrongful Trading" in England: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders*, in COMPANY DIRECTORS' LIABILITY FOR INSOLVENT TRADING 19 (Ian Ramsay ed., 2000). Dale Oesterle argues that the Australian insolvent trading law is "excessively protective of creditors and inherently impracticable." *Id.* at 20.

<sup>224</sup> For a detailed history of the insolvent trading provisions in the companies legislation prior to the amendments in 1993, see AUSTRALIAN LAW REFORM COMMISSION, GENERAL INSOLVENCY INQUIRY (Harmer Report) No 45, at 277–80 (AGPS, Canberra 1988), <http://www.alrc.gov.au>; the judgment of Lander, J. in *Capricorn Soc'y v Linke* (1996) 14 ACLC 431; Palmer, J. in *S. Cross Interiors Pty Ltd v Deputy Comm'r of Taxation* [2001] NSWSC 621; (2001) 39 ACSR 305; *Elliot v Austl Sec. & Inv Comm'n* [2004] VSCA 54; (2004) 48 ACSR 621.

legal nature of a company, the statute makes directors accountable for the company's debt if:

- (a) a person is a director of a company at the time when the company incurs a debt; and
- (b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
- (c) if, at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and
- (d) if that time is at or after the commencement of this Act.<sup>225</sup>

Moreover, section 588E assists in proving insolvency by allowing rebuttable presumptions on account of continuing insolvency and absence of accounting records.<sup>226</sup> However, a director can avoid liability by using section 588H, which provides several defences, including *inter alia*, that the director had “reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.”<sup>227</sup>

Australia's insolvent trading laws create a separate set of challenges, including the commercial pressures faced by directors when the company is in a precarious financial position:

[I]n some cases, it is not commercially sensible to summon the administrators or to abandon a substantial trading enterprise to the liquidators as soon as any liquidity shortage occurs. In some cases a reasonable time must be allowed to a director to assess whether the company's difficulty is temporary and remediable or endemic and fatal.<sup>228</sup>

---

<sup>225</sup> *Corporations Act 2001* (Cth) s 588G (Austl.).

<sup>226</sup> *Id.* § 588E.

<sup>227</sup> *Id.* § 588H. For further discussion of insolvent trading liability and related defenses, see JASON HARRIS, ANIL HARGOVAN & MICHAEL ADAMS, *AUSTRALIAN CORPORATE LAW* Ch. 18 (5th ed. 2016); Anil Hargovan, *Director's Liability for Insolvent Trading, Statutory Forgiveness and Law Reform*, 18 *INSOLVENCY L.J.* 96, 96–97 (2010).

<sup>228</sup> *Hall v Poolman* (2007) 65 ACSR 123 (Austl.).

This observation by Justice Palmer, together with the practical difficulties in working out whether the company is insolvent or whether the debt is due and payable, demonstrates the dilemma for directors under the current law. The question of a company's solvency "frequently is not black and white,"<sup>229</sup> particularly with large companies. In allowing a company to trade, in the circumstances depicted above by Justice Palmer, the director "can be faulted just as much for a premature cessation of trading as for continuing to trade while insolvent."<sup>230</sup> The existing law, which lacks a "safe harbor," can in this way hinder or prevent proper attempts at informal solutions. This issue is driving the recent proposals for Australian law reform,<sup>231</sup> which aim to strike a balance between protecting creditor interests and facilitating sensible commercial risk taking.

### 7. Other Established Protections

It should be noted that other legal concepts adequately serve as a reasonable safety net of protection. Fiduciary duties, even if not owed directly to creditors, still govern and circumscribe director conduct and serve as a check on director behavior. The prohibitions against self-dealing, interested transactions, bad faith, candor, etc., have a real effect on director conduct and still offer some measure of protection to creditors. As a practical example, directors still have a duty to be completely candid in the dissemination of financial and other information relating to the company.<sup>232</sup> This promulgated information can be helpful to a creditor. Similarly, directors are precluded from engaging in self-dealing transactions unless certain conditions are met; this rule, too, offers protection to creditors.

Policing self-dealing and the like is nothing new to the law. Other judicial doctrines, such as the trust fund doctrine, can also aid creditors. This doctrine, which is traceable to Justice Story in *Wood v. Dummer*,<sup>233</sup> initially posited that, upon insolvency, a corporation's capital stock is, in effect, held in a condition of trust for

---

<sup>229</sup> Joint Submission of Law Council of Australia, Insolvency Practitioners Association of Australia and Turnaround Management Association of Australia (2 March 2010), *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (Jan. 2010).

<sup>230</sup> ROY GOODE, PRINCIPLES OF CORPORATE INSOLVENCY LAW 443 (1997) (UK).

<sup>231</sup> See *supra* note 216 (noting the efforts of the Productivity Commission).

<sup>232</sup> Indeed, federal securities law also regulates the dissemination of financial and other information; this body of law also offers a prophylactic protection to creditors. See, e.g., Securities Exchange Act of 1933 § 5, 15 U.S.C. § 77e (2012); Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2012); Securities Exchange Act of 1934 § 13(a), 15 U.S.C. § 78m(a) (2012); 17 C.F.R. §§ 210.1-01, 240.10b-5.

<sup>233</sup> *Wood v. Dummer*, 30 F. Cas. 435 (D. Me. 1824).

creditors.<sup>234</sup> Other formulations included all corporate assets.<sup>235</sup> Although the modern application and understanding of the doctrine does not impose an actual trust,<sup>236</sup> it still stands for the proposition that, upon insolvency, corporate assets should be distributed for the benefit of creditors. However, some jurisdictions have held that state corporate dissolution statutes have largely replaced (and even preempted) this equitable doctrine.<sup>237</sup> Nevertheless, to the extent that the doctrine is still valid in some jurisdictions, it can police self-dealing and some of the other harms envisioned by the shifting/expanding fiduciary duty argument.

Finally, “piercing the corporate veil” (i.e., disregarding the corporate fiction, and holding directors personally liable for corporate actions) also serves as a judicial check on corporate conduct. Courts generally consider several factors—commingling of assets, noncorporate use of assets, failure to maintain required formalities, lack of adequate capitalization, and an array of other things—to determine whether respecting the corporate identity would result in injustice.<sup>238</sup> In this context, insolvency is actually an express criteria that courts have used in this analysis.<sup>239</sup> Indeed, the Delaware Court of Chancery has noted that, in cases of insolvency coupled with a shareholder benefit, “justice would require the piercing of the corporate veil in order to hold the benefiting shareholders responsible.”<sup>240</sup> Even more telling, the court noted that veil piercing “may also be applicable as the inability

---

<sup>234</sup> See, e.g., FLETCHER, *supra* note 82, § 7369.

<sup>235</sup> *Id.* & n.1.

<sup>236</sup> See, e.g., *id.* § 7373.

<sup>237</sup> *Id.* (“Accordingly, the adoption of corporate dissolution statutes has supplanted the equitable trust theory in most jurisdictions.”).

<sup>238</sup> See, e.g., *Pauley Petro. Inc. v. Cont’l Oil Co.*, 239 A.2d 629, 633 (Del. 1968) ([Disregarding the corporate entity] may be done only in the interest of justice, when such matters as fraud, contravention of law or contract, [or] public wrong . . . are involved.”); *O’Hazza v. Exec. Credit Corp.*, 431 S.E.2d 318, 320 (Va. 1993) (“[O]ne who seeks to disregard the corporate entity must show that the shareholder sought to be held personally liable has controlled or used the corporation to evade a personal obligation, to perpetrate fraud or a crime, to commit an injustice, or to gain an unfair advantage.”). See generally COX & HAZEN, *supra* note 190, § 7.8 (discussing the three primary variants of veil piercing, namely the instrumentality doctrine, alter ego doctrine, and identity doctrine).

<sup>239</sup> See, e.g., *Pearson v. Component Tech. Corp.*, 247 F.3d 471, 485 (3d Cir. 2001); *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, 540 F.2d 681, 686 (4th Cir. 1976).

<sup>240</sup> *Mason v. Network of Wilmington, Inc.*, No. 19434-NC, 2005 WL 1653954, at \*3 (Del. Ch. July 1, 2005).

to pay creditors becomes imminent and the corporation enters the ‘zone of insolvency.’”<sup>241</sup>

*B. If Existing Protections Are Not Sufficient, Solutions Must be Created Legislatively*

As we have demonstrated, there are many devices and doctrines available under general corporate and related bodies of law that already police many instances of director misconduct when companies are at or near insolvency. These doctrines are well-established and, consequently, are much better guides to inform director conduct. Coupled with the fact that many creditors can and should police their own risk up front via contracts, we see no need for a new judicial oversight mechanism that will only muddle well-delineated corporate principles. However, if interested stakeholders—such as academics, jurists, or policymakers—feel as though this existing safety net is not sufficient to protect a particular class of creditors (e.g., involuntary creditors),<sup>242</sup> any legislative remedy needs to be crafted carefully and clearly.

Indeed, modern corporate codes have utilized such clear-cut standards. One salient example is the Model Business Corporation Act (“MBCA”)’s approach to asset sales. MBCA § 12.02 requires a shareholder vote to approve any asset sale that leaves the corporation without a “significant continuing business activity.”<sup>243</sup> The code then provides a safe harbor by conclusively establishing significant continuing business activity if the corporation retains assets of at least 25% as well as 25% of income from continuing operations.<sup>244</sup> This type of bright line standard, here a safe harbor,<sup>245</sup> provides a clear standard by which directors can inform their conduct and decision-making.

If the default creditor safety net needs to be strengthened, the optimal solution is bright-line legislation. The entire problem with the current judicial morass is its undefined and ill-conceived boundaries and contours—it is simply too unclear a standard, and consequently it is not a meaningful standard at all. A legal standard is

---

<sup>241</sup> *Id.*

<sup>242</sup> Although, we emphasize that involuntary creditors can use many, if not all, of the devices already discussed in this paper, e.g., involuntary bankruptcy, seeking a receiver, etc.

<sup>243</sup> MODEL BUS. CORP. ACT § 12.02(a) (1950).

<sup>244</sup> *Id.*

<sup>245</sup> Meaning that it could be possible to be a significant continuing business activity even if these 25% thresholds are not satisfied.

only of practical import if it can inform conduct. The current jurisprudence, although well-intended, has had the opposite effect: It has made director compliance either impossible or too costly. Bright-line statutory enactments would alleviate some of those concerns.<sup>246</sup>

## V. CONCLUSION

This Article demonstrates that the judicial development of the law on directors' fiduciary duties to creditors is unwarranted and, for reasons advanced, is akin to advancing a cure in search of a disease. It has simply added more uncertainty, unrest, and cost relative to any marginal utility the rule offers over the existing default creditor safety net.

As Justice Hayne of the High Court of Australia has noted, the theory that directors owe duties to creditors in common law is "a solution in search of a problem."<sup>247</sup> Justice Haynes favors instead the view of the Delaware Supreme Court that "recognising 'fiduciary duties to creditors' in circumstances of insolvency may involve 'using the law of fiduciary duty to fill gaps that do not exist.'"<sup>248</sup> We agree. Consequently, the judicial quagmire of directors' fiduciary duties to creditors in the twilight zone of insolvency should be jettisoned forthwith.

---

<sup>246</sup> At this time, we do not propose any suggested legislative enactments, as we feel as though the current safety net is adequate for creditors. Although, we would generally be in favor of concepts such as safe harbors or days certain for insolvency. For example, federal bankruptcy law *presumes* that an entity was insolvent ninety days before filing for purposes of preference actions. See 11 U.S.C. § 547(f) (2012). Similar approaches could be helpful here.

<sup>247</sup> Justice K.M. Hayne, *Directors' Duties and a Company's Creditors*, 38 MEL. U. L. REV. 795, 814 (2014) (Austl.).

<sup>248</sup> *Id.* at 814 (quoting *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 100 (Del. 2007)).