DUTY TO CREDITORS IN INSOLVENCY AND THE ZONE OF INSOLVENCY: DELAWARE AND THE ALTERNATIVES

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I. INTRODUCTION

In *North American Catholic Educational Programming Foundation v. Gheewalla,*[1] the Delaware Court of Chancery held, and the Delaware Supreme Court affirmed, that creditors do not have standing to assert direct breach of fiduciary duty claims during insolvency or in the zone of insolvency.[2] *Gheewalla* also held that creditors do have standing to allege derivative claims during insolvency, but made no clear statement as to creditors' standing to assert such claims in the zone of insolvency.[3] This Note considers questions about the efficiency of Delaware's treatment of fiduciary duties to creditors and explores the doctrinal confusion regarding creditors' standing to assert deriva-

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1. *See generally* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, No. Civ. A. 1456-N, 2006 WL 2588971 (Del. Ch. Sept. 1, 2006), *aff'd*, 930 A.2d 92 (Del. 2007).

2. Zone of insolvency is a term used to describe a firm nearing insolvency, but not yet insolvent, and can be defined in a multitude of ways. Neither the Delaware Court of Chancery nor the Delaware Supreme Court "precisely define[d]" the term and the Delaware Supreme Court noted that their decision precluded the need for a precise definition. *Id.* at 98 n.20. Insolvency is usually defined as being unable to pay bills as they become due or possessing liabilities greater than the market value of all assets held. LaSalle Nat. Bank v. Perelman, 82 F. Supp. 2d 279, 290 (D. Del. 2000).

3. Direct claims allege that a breach of fiduciary duty caused a particular shareholder a particularized harm and damages are awarded to the shareholder. Derivative claims allege that a breach of a fiduciary duty harmed the firm and damages are awarded to the firm. *See generally* Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031 (Del. 2004). The Delaware Court of Chancery and Delaware Supreme Court decisions suggest, but do not hold, that creditors do not have standing to pursue derivative claims in the zone of insolvency. *See generally Gheewalla,* No. Civ. A. 1456-N. *See also* E. Norman Veasey, *Counseling the Board of Directors of a Delaware Corporation in Distress,* AM. BANKR. INST. J., Jun. 2008, at 60, 63 ("Whether creditors may bring derivative claims against directors of a corporation that is solvent but in the zone of insolvency is unclear, but doubtful as a practical matter.").

tive breach of fiduciary duty claims in the zone of insolvency.[4] In carrying out these analyses, this Note assesses the creditor protections provided by Delaware and federal law (Part II), the relevant corporate governance policy considerations (Part III), the efficiency of denying creditors standing to assert direct or derivative claims in the zone of insolvency (Part IV), and arguments against granting creditors standing to allege derivative suits during insolvency (Part V).

Academic critics of zone of insolvency shareholder primacy assert that it incentivizes inefficient behavior and that a fiduciary duty to maximize the value of all claims against the firm would instead produce greater efficiency.[5] One way to effectuate such a regime is to provide creditors with access to derivative and/or direct lawsuits in the zone of insolvency. However, such a change is unwarranted because existing creditor protections are sufficient[6] and the economic models relied upon by these critics are based on unrealistic assumptions about actor behavior and market conditions.[7] On the other hand, courts should not foreclose creditor access to derivative breach of fiduciary duty claims during actual insolvency (as opposed to the zone of insolvency), a change advocated by Hu and Westbrook.[8] Both debt and equity holders benefit from such claims because it is in all claimants' interests to rectify director malfeasance and creditors may have more resources than shareholders to pursue such lawsuits. Such a foreclosure would also increase reliance on bankruptcy proceedings,[9] an outcome usually considered undesirable for shareholders.

4. *See In re* I.G. Servs., Bankr. Nos. 99-53170-C, 99-53171-C, Adv. No. 04-5041-C, 2007 WL 2229650 (Bankr. W.D. Tex. July 31, 2007) (suggesting that creditors may receive standing to pursue derivative suits in the zone of insolvency); *In re* Vartec Telecom, Inc., Bankr. No. 04-81694-HDH-7, Adv. No. 06-03506, 2007 WL 2872283, at *4 (Bankr. N.D. Tex. Sept. 24, 2007) (same); Veasey, *supra* note 3, at 64-65.

5. *See, e.g.*, Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214 (1999) (alleging that shareholder value maximization causes inefficient director behavior).

6. *See* Part II.B.

7. *See* Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 831–46 (2008).

8. *See generally* Henry T. C. Hu & Jay L. Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321 (2007).

9. *See generally id.* at 1376–1401.

Thus, this Note concludes that Delaware's regime is optimal and should be emulated by other jurisdictions (Part VIII). However, the Court of Chancery should clarify that creditors do not, in fact, have standing to bring derivative claims in the zone of insolvency (Part VI). This distinction requires courts and directors to determine whether firms are insolvent: the methods by which Delaware Courts make this determination are assessed in Part VII.

II.
Creditor Protections

This Part assesses the sufficiency of protections available to creditors under Delaware and federal law. Section A discusses the development of Delaware's current fiduciary duty regime which grants creditors standing to assert derivative breach of fiduciary duty claims during insolvency. Section B examines other creditor protections.

A. *Delaware's Regime*

Delaware courts have long recognized that during insolvency a firm's "property may be administered as a trust fund for the benefit of creditors."[10] *Credit Lyonnais Bank Nederland v. Pathe Communications Corporation* first raised the issue of creditor standing to assert breach of fiduciary duty claims in the zone of insolvency.[11] In *Credit Lyonnais,* Chancellor Allen described the corporation as the primary recipient of fiduciary duties when a firm is in the "vicinity of insolvency."[12] In this zone, directors would be "protected by the business judgment rule if they, in good faith, pursued a less risky business strategy because they believed a more risky strategy might render the

10. "The fact which creates the trust is the insolvency, and when that fact is established, the trust arises, and the legality of the acts thereafter performed will be decided by very different principles than in the case of solvency." Bovay v. H.M. Byllesby & Co., 38 A.2d 808, 813 (Del. 1944).

11. Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

12. "Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act." *Id.*

company unable to meet its obligations to its creditors."[13] In *Geyer v. Ingersoll*, the Court of Chancery held that fiduciary duties run to creditors during insolvency in the context of denying a defendant's motion to dismiss, but the court did not precisely define the nature of fiduciary duties owed to creditors nor decide whether creditors had standing to assert direct suits or derivative suits in the zone of insolvency.[14] In *Product Resources Group, L.L.C. v. NCT Group, Inc.*, Vice Chancellor Strine sought to clarify whether *Credit Lyonnais* created a fiduciary duty to creditors in the zone of insolvency by stating that Chancellor Allen's opinion in that case "attempted to emphasize that directors have discretion to temper . . . risk" in the zone of insolvency but did not create "a new body of creditor's rights law."[15] Although this statement could be construed to mean that directors owe no fiduciary duty to creditors when the firm operates in the zone of insolvency (as such a duty would constitute a novel development), it does not explicitly state this principle. *Product Resources Group* also held that creditors could receive standing to pursue derivative claims during insolvency.[16] However, Strine explained that "the fact of insolvency does not change the primary object of the director's duties, which is the firm itself . . . . [I]nsolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value and logically gives them standing to pursue these claims . . . ."[17] He also stated in dictum that, because of the "fiduciary relationship" with creditors, "there might . . . exist circumstances in which the directors display such a marked degree of animus towards a particular creditor . . . that they expose themselves to a direct fiduciary duty claim by that creditor."[18] This statement seems to

13. Production Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 788 (Del. Ch. 2004) (citing *Credit Lyonnais Bank Nederland*, 1991 WL 277613).

14. Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787–89, 791 (Del. Ch. 1992) (noting that "neither party seriously disputes that when the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors" and holding that creditors could pursue derivative breach of fiduciary duty claims).

15. *Production Res. Group*, 863 A.2d at 787–88.

16. *Id.* at 792.

17. *Id.*

18. *Id.* at 798.

imply that creditors can receive standing to assert direct breach of fiduciary duty claims.

However, *Gheewalla* ultimately denied creditors standing to assert direct claims, rejecting the elements of the complaint that relied on this dictum.[19] Instead, creditors receive protection through "negotiated agreements," "security instruments," "the implied covenant of good faith and fair dealing," fraudulent conveyance statutes, and the Federal Bankruptcy Code.[20] The Delaware Supreme Court affirmed *Gheewalla*, establishing that creditors do not have standing to assert direct claims.[21] The Delaware Supreme Court also held that creditors have standing to assert derivative claims during insolvency, an issue upon which it had not previously ruled.[22] Although *Gheewalla* provides a solid foundation for analyzing and understanding the fiduciary duties owed to creditors, it failed to explicitly foreclose derivative claims in the zone of insolvency.[23] As a result, some courts have cited *Gheewalla* for the proposition that creditors may receive standing to assert such claims in the zone of insolvency, a practice which may not accurately reflect the Delaware Supreme Court's intent.[24] As discussed in Part VI, the Delaware Supreme Court must therefore clarify its ruling and specify that creditors should not be granted standing to assert derivative breach of fiduciary duty claims in the zone of insolvency.

B. *Other Creditor Protections*

This Section examines whether Delaware's regime leaves creditors too vulnerable to inappropriate director behavior.

19. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, No. Civ.A. 1456-N, 2006 WL 2588971, at *14 (Del. Ch. Sept. 1, 2006), *aff'd*, 930 A.2d 92 (Del. 2007).

20. *Id.* at *13.

21. *Gheewalla*, 930 A.2d at 101–03 (Del. 2007).

22. *Id.*

23. *See id.*; Veasey, *supra* note 3, at 62–63 (providing a comprehensive analysis of this issue).

24. *See In re* I.G. Servs., Bankr. Nos. 99-53170-C, 99-53171-C, Adv. No. 04-5041-C, 2007 WL 2229650 (Bankr. W.D. Tex. July 31, 2007); Mims v. Fail, Bankr. No. 04-81694-HDH-7, Adv. No. 06-03506, 2007 WL 2872283, at *4 (Bankr. N.D. Tex. Sept. 24, 2007) (citing *Gheewalla*, 930 A.2d 92) (holding that "[b]oth Texas and Delaware law recognize a cause of action for breach of fiduciary duty . . . when the corporation is either insolvent or in the 'zone' or 'vicinity of insolvency'"). *See also* Veasey, *supra* note 3, at 64–65.

Derivative breach of fiduciary duty claims provide creditors with little in the way of remedial relief because any damages are awarded to the firm. However, sufficient creditor protections exist outside of the law of fiduciary duties. Some voluntary creditors have the ability to protect themselves ex ante by negotiating thorough contractual covenants which can be enforced through breach of contract claims.[25] They are also protected by limited "implied covenants of good faith."[26] Public bond holders are not in a position to bargain for individualized covenants, but the underwriting process helps to provide them with some protection.[27] Stephen Bainbridge believes that since the underwriting process is a repeat transaction, most "[u]nderwriters will not sully their reputation . . . for the sake of one issuer."[28] Incentives for underwriters to provide bondholders with protection are even greater in "firm commitment underwriting, [where] the underwriters buy the securities from the issuer."[29]

Although voluntary creditors have varying levels of contractual protection and involuntary creditors may have none,[30] all creditors remain protected by fraudulent conveyance law.[31] Many of the transactions that creditors can assert as involving direct breaches of fiduciary duty (under a hypothetical regime in which creditors had standing to assert such claims during insolvency or in the zone of insolvency) can already be enjoined as fraudulent conveyances. Thus, creditors do not need the extra protection provided by direct breach of fiduciary duty suits to address such malfeasance. During bankruptcy, fraudulent conveyance law allows a trustee to "avoid . . . any transfer . . . or any obligation incurred by the debtor [within two years before the date of filing] with actual intent to hinder, delay or defraud" creditors.[32] In situations "[w]here the

25. Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 651–52 (1996).

26. *Gheewalla*, 930 A.2d at 100-01. *See also* Katz v. Oak Indus. Inc., 508 A.2d 873, 880–82 (Del. Ch. 1986).

27. *See* Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 362 (2007).

28. *Id.*

29. *Id.*

30. Schwarcz, *supra* note 25, at 651–52 (1996).

31. *See generally* 11 U.S.C. § 548 (2006); DEL. CODE ANN. tit. 6, § 1304(b)(11) (2009).

32. § 548 (a)(1)(A).

debtor receives less than reasonably equivalent value in exchange for the assets transferred or obligations incurred, fraudulent conveyance law applies even absent actual intent to hinder, delay, or defraud if the debtor was, or became, 'insolvent' after giving effect to the transfer or obligation."[33] It also protects against transfers "to a . . . partner in the debtor, if the debtor was insolvent on the date [of] such transfer . . . or became insolvent as a result . . . ."[34] Similar protection exists both under Delaware law (with a statute of limitations of four years for most types of fraudulent conveyance claims)[35] and the laws of most other states. Creditors of insolvent firms may also pursue involuntary Chapter 11 filings.[36]

In addition, voluntary creditors can supplement these protections by taking a proactive approach to minimalizing the losses caused by firm insolvency. Voluntary creditors can, for instance, try to force shareholders to internalize the risk of default at the onset of the lending relationship by demanding higher returns.[37] Although the creditor will still "sustain a loss . . . it will recoup that loss through the interest rate it receives from other borrowers."[38] Creditors can also address, ex ante, the possibility that directors may be overly eager to maximize shareholder value when the firm is near insolvency. For example, creditors can hedge their risk by investing in convertible securities, allowing them to profit from investments that are risky but may produce high equity returns.[39] Although creditors do not have standing to assert direct breach of fiduciary duty claims in Delaware, sufficient protections remain in

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33. Schwarcz, *supra* note 25, at 653 (citing § 548(a)(1)(B)). *See also* tit. 6, § 1304(a)(2).

34. § 548(b).

35. The statute of limitations for claims of non-intentional fraudulent conveyance is four years, but the statute of limitations for claims of intentional fraudulent conveyance extends for "1 year after the transfer or obligation was or could reasonably have been discovered by the claimant." tit. 6, § 1309(1).

36. *See* Hu & Westbrook, *supra* note 8, at 1345–46 (characterizing Delaware's recognition of creditor fiduciary duty claims as a holdover from nineteenth century corporate trust fund doctrine which was rendered obsolete by the Federal Bankruptcy Code).

37. Bainbridge, *supra* note 27, at 358.

38. *Id.*

39. *Id.*

the form of the bankruptcy code, fraudulent conveyance law, covenants and the utilization of proactive loss minimization.

III. CORPORATE GOVERNANCE ISSUES

This Part examines two corporate governance norms that would be altered by changes in Delaware's fiduciary duty regime and the implications of managerial opportunism in analyzing the effects of this regime. Section A describes two conceptions of the fiduciary duty to shareholders while Section B discusses the benefits of director independence. Section C analyzes the impact of managerial opportunism. First, Section C considers the extent to which a change in the recipient of fiduciary duties in the zone of insolvency can influence director behavior. Second, Section C examines how managerial opportunism limits the accuracy of economic models that attempt to predict the results of director behavior by assuming directorial adherence to a simplified conception of the fiduciary duty to shareholders.

A. *Conceptions of the Fiduciary Duty to Shareholders*

Shareholder primacy has long played a paramount role in delineating director fiduciary duty[40] and in shaping corporate governance norms.[41] Delaware does not statutorily recognize duties to other constituencies during normal business operations, unlike some other jurisdictions.[42] There are multiple ways to conceptualize the duty which is imposed upon directors by shareholder primacy.[43] The "traditional conception" of this "shareholder fidelity," which is usually used by courts to analyze fiduciary duties, asserts that a director's duty runs first to the firm and then to the shareholders as the residual beneficiaries.[44] This conception is based on "the presumption that

40. *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

41. "Corporate governance" is used here to refer to "the balance of power between officers, directors and shareholders." Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 460 (2004).

42. *See, e.g.*, CONN. GEN. STAT. ANN. § 33-756(d) (West 2009) (directors "shall consider" non-shareholder constituencies and the "long-term as well as the short-term interests" of the firm).

43. Hu & Westbrook, *supra* note 8, at 1355–56.

44. *See id.* at 1355–57.

what is good for the corporation is good for the shareholder."[45] In contrast, "actual shareholder wealth maximization," a more extreme but largely hypothetical form of shareholder primacy, describes an enforceable duty to increase short-term share value even at the risk of reducing a firm's long term viability.[46] This concept is usually used in the formulation of theories regarding the economic effects of the fiduciary duty to shareholders.[47] An expansion of the fiduciary duty to creditors into the zone of insolvency, especially if coupled with creditor standing to pursue direct breach of fiduciary duty claims, would undermine shareholder primacy as well as the general fiduciary duty to the firm which exists under the "traditional conception." This expansion of the fiduciary duty to creditors would undermine shareholder primacy because it would create a conflicting duty to a constituency (creditors) whose return on investment may no longer rely upon the firm's profits but rather upon the preservation of assets that would be useful in the event of a Chapter 11 reorganization or valuable in the event of a Chapter 13 liquidation.[48]

The Contractarian theory of corporate law provides a compelling justification for shareholder primacy,[49] describing "corporate law . . . [as] provid[ing] a standard form contract . . . . [When] the actual contracts reflected in the corporation's organic documents are silent, the law fills in the gaps."[50] The fiduciary duties can therefore be understood as "gap-fillers that complete the contract[ ]" with shareholders.[51] These contracts are necessarily ambiguous because exorbitant transaction costs prevent the creation of shareholder-director contracts that account for virtually all possible contingencies.[52] Although creditor contracts also contain gaps in protection,

45. *See id.* at 1356.

46. *Id.*

47. *See id.* at 1357–58.

48. This is an implicit element of the Financial Value Maximization approach (discussed in Part IV), which posits that directors should have a duty to avoid activities that could produce creditor losses in the event of a bankruptcy. *See* Smith, *supra* note 5, at 216–21.

49. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 90–93 (1991); Bainbridge, *supra* note 27, at 337.

50. Bainbridge, *supra* note 27, at 337.

51. *Id.* (citing EASTERBROOK & FISCHEL, *supra* note 49, at 92–93).

52. EASTERBROOK & FISCHEL, *supra* note 49, at 90–93.

Bainbridge differentiates between the level of vulnerability faced by shareholders and creditors, noting that "shareholder's investment . . . is a transaction specific asset, because the . . . investment is . . . at risk and turned over to someone else's control."[53] The agency costs created by this distinct relationship are known as "quasi-rents."[54] Bainbridge also distinguishes between the shareholder bargaining position and that of other constituencies, positing that "shareholders are poorly positioned to extract contractual protections. Unlike bondholders . . . whose term-limited relationship to the firm is subject to extensive negotiations and detailed contracts, shareholders have an indefinite relationship that is rarely the product of detailed negotiations."[55] He notes that the "dispersed nature of stockownership . . . makes bilateral negotiation of specialized safeguards especially difficult."[56] Because shareholders are not in the same position as creditors or bondholders to negotiate contractual protections, they are more deserving of the extra protection provided by being the recipient of fiduciary duties.[57]

B. *Director Independence*

The business judgment rule ("BJR"),[58] which advances director independence by restricting shareholder litigation, may seem to impinge upon shareholder primacy. It allows courts to address particular cases of "self-interest and sloth" while leaving directors with the flexibility to quickly react to changing business conditions without undue stricture.[59] Delaware corporations are also statutorily permitted to exculpate directors from assessment of liability for duty of care breaches, fur-

53. Bainbridge, *supra* note 27, at 360.

54. Quasi-rents are defined as "returns in excess of that necessary to maintain the asset in its current use." *Id.*

55. *Id.* at 361.

56. *Id.*

57. *See id.* at 361–62.

58. This rule creates a rebuttable presumption that directors acted in good faith, in a disinterested manner and in the "best interest of the corporation" on an "informed basis." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

59. E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-1994? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1412–14 (1995).

ther reducing judicial scrutiny of director action.[60] However, these measures do not simply protect directors: they also enhance shareholder value.[61] Diversified investors will not prefer overly risk averse directors, and judicial abstention from review of the majority of director decisions can help reduce directors' risk aversion.[62] Director autonomy is therefore of paramount importance in creating "efficient corporate governance" that will ultimately benefit shareholders.[63] Presumably, if Delaware courts were to expand fiduciary duty to creditors, the BJR would still apply.[64] Even with this continued protection, however, such expansion could undermine director independence by increasing directors' vulnerability to lawsuits from a variety of creditors.[65]

C. *Implications of Managerial Opportunism*

The protection afforded by the BJR creates difficulties in enforcing fiduciary duties and consequently in predicting directorial behavior.[66] As a result, Stephen Bainbridge believes that concerns over the scope of director duties in the zone of insolvency are academic.[67] However, because directors may try to faithfully fulfill their fiduciary roles, a discussion of the effects of Delaware's fiduciary duty regime on managerial behavior is not a moot exercise. Directors who attempt to fulfill their fiduciary duties must be provided with clear guidelines regarding the ambiguous zone of insolvency. Creditor pres-

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60. DEL. CODE ANN. tit. 8, § 102(b)(7) (2010).

61. Veasey & Guglielmo, *supra* note 59, at 1422.

62. *Id.* at 1422–27.

63. Bainbridge, *supra* note 27, at 366–68.

64. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 195 n.75 (Del. Ch. 2006); Angelo, Gordon & Co. v. Allied Riser Commc'ns Corp., 805 A.2d 221, 228-29 (Del. Ch. 2002) ("[T]he business judgment rule protects the directors *of solvent, barely solvent, and insolvent* corporations, and . . . the creditors of an insolvent firm have no greater rights to challenge a disinterested, good faith business decision than the stockholders of a solvent firm.").

65. *See, e.g.*, Tung, *supra* note 7, at 849–50.

66. Since the business judgment rule precludes judicial review of most business decisions, director behavior may depend largely on directors' unique proclivities. *See* Bainbridge, *supra* note 27, at 358–60.

67. *See id.* at 358 (noting that changing who receives fiduciary duties in the zone of insolvency may not have an effect on director behavior if such behavior is shaped largely by self-interest).

sure on directors in the zone of insolvency already encourages risk averse behavior,[68] and an explicit recognition of creditor duties in this ambiguous zone may exacerbate this issue.[69] It is also important to analyze the effects of director duties during insolvency. The possible effects of creditor standing to assert direct breach of fiduciary duty claims during insolvency are described by Hu and Westbrook: "A judge seeking to avoid" the BJR during firm insolvency "could hold that shareholder-optimal risk taking" does not constitute a "good faith" act in the "best interests of the company" as required by creditor duty.[70] They also speculate that it may cause practitioners to give directors legal advice to the effect "that . . . extremely conservative decisions are protected by [the fiduciary duty to creditors]."[71] Both directors of insolvent firms and directors of firms operating in the zone of insolvency need clear guidance to avoid overly cautious behavior.

However, Bainbridge's analysis of managerial opportunism in the context of distressed firms pinpoints one way in which financial models which predict that shareholder value maximization ("SVM") causes inefficient behavior in the zone of insolvency rely on unrealistic assumptions. Bainbridge asserts that SVM in the zone of insolvency is not the primary cause of irrational director behavior in the context of publicly held firms.[72] In such firms, "it is not clear that boards and managers will systematically favor either the interests of shareholders or creditors."[73] "Managerial opportunism . . . [is] the real risk present when a public corporation is in the vicinity of insolvency," not irrationality due to attempts to achieve SVM.[74] Bainbridge posits that the incentives created by the number of

68. For example, creditors can assert pressure by threatening to refuse requests for additional credit. Hu & Westbrook, *supra* note 8, at 1378.

69. *See* Smith, *supra* note 5, at 223–24 (characterizing a firm as being in the zone of insolvency if an investment is available that would result in insolvency in the event of its failure).

70. Hu & Westbrook, *supra* note 8, at 1380.

71. *Id.*

72. *See* Bainbridge, *supra* note 27, at 359. *See, e.g.*, Smith, *supra* note 5, at 221-23 (alleging that shareholder value maximization causes inefficient director behavior).

73. Bainbridge, *supra* note 27 at 358–59 (citing Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 683–84 (1993)).

74. *See id.*, at 358–60.

stock options owned by a director[75] and other individualized factors, such as the degree of shareholder control and firm health, are what will likely control director behavior.[76] SVM in the zone of insolvency only poses a problem when the controlling "shareholders exercise effective control."[77] However, this form of SVM, in which the controlling shareholder is favored, is not caused by adherence to fiduciary duties. This problem need not be addressed by fiduciary duty law as in "such firms . . . the costs of bargaining between shareholder(s) and creditors will be low enough to allow the latter to negotiate . . . particularized protections, such as shareholder guarantees of corporate debts."[78] Bainbridge's arguments regarding managerial opportunism serve as a reminder that models may not accurately reflect behavior and that relying on such models to shape corporate governance policy may be unwise.

IV.
Economic Effects of SVM in the Zone of Insolvency and the FVM Alternative

This Part examines the effects of Delaware's regime from the perspective of the larger academic debate concerning the validity of SVM in distressed firms. Analysis of these arguments is important in determining whether other jurisdictions should grant creditors standing to assert direct breach of fiduciary duty claims or derivative breach of fiduciary duty claims in the zone of insolvency, either of which would greatly alter "traditional conceptions"[79] of fiduciary duty. Economic models may indicate that a director who attempts to comply with the fiduciary duty to shareholders, usually characterized as "actual shareholder wealth maximization,"[80] is acting inefficiently.[81] Thus, some academics denounce SVM and instead promote "financial value maximization" ("FVM")[82] or "FVM

75. *See id.* at 358 n.113.
76. *See id.* at 358–59.
77. *See id.* at 358.
78. *See id.*
79. Hu & Westbrook, *supra* note 8, at 1356–57.
80. *See id.* at 1357.
81. Smith, *supra* note 5, at 268; Gregory Scott Crespi, *Rethinking Corporate Fiduciary Duties: The Inefficiency of the Shareholder Primacy Norm*, 55 SMU L. Rev. 141, 155–56 (2002).
82. Smith, *supra* note 5, at 268; Crespi, *supra* note 81, at 143, 155–56.

including performance creditors."[83] FVM is a conception of fiduciary duties that requires directors to maximize the value of all financial claims against the firm, not merely those of shareholders.[84] "FVM including performance creditors" differs from FVM in that the former posits that the most efficient fiduciary duty regime would be one that maximizes the value of both financial and performance based claims against the firm.[85] The models underlying these proposed fiduciary duty regimes assume that directors are the "faithful agents" of their constituencies and the following analysis excludes discussion of the flaws associated with this assumption.[86] However, it is important to keep in mind that SVM's impact on director behavior is reduced by managerial opportunism, by other agency issues (such as director incompetence), and by Delaware's usage of a "traditional conception" of duty rather than "actual shareholder wealth maximization."[87] Section A describes FVM and Section B critiques FVM.

A. *Financial Value Maximization*

Thomas Smith utilizes "hypothetical bargain analysis"[88] in an effort to formulate the conception of fiduciary duty which would be desired by rational investors striving for Kaldor-Hicks efficiency[89] under a variety of assumptions.[90] One such assumption is that investors are fully diversified and hold perfect or near perfect market portfolios.[91] Because their investments are diversified in a manner which mirrors the proportions of assets in the market as a whole, they would benefit from a re-

83. *See generally* Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813 (2002) (advocating that directors maximize the value of both financial and performance based claims against the firm).

84. FVM including performance creditors will not be discussed at length. *See* Crespi, *supra* note 81.

85. Chaver & Fried, *supra* note 83, at 1843.

86. *See* Tung, *supra* note 7, at 820 n.49.

87. Hu & Westbrook, *supra* note 8, at 1356–57.

88. Smith, *supra* note 5, at 220.

89. "A Kaldor-Hicks-efficient transaction is one in which the winners could compensate the losers, whether or not they actually do." Tung, *supra* note 7, at 812 n.10 (citing RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 13 (6th ed. 2003)).

90. Smith, *supra* note 5, at 217–29 (setting up the FVM model).

91. *See id.* at 247–53.

gime in which there was a duty to maximize the value of all financial claims against the firm in the zone of insolvency.[92] Other proponents of FVM have attempted to address the distributional issues that would be created when investors do not hold market portfolios by advocating that creditors make side payments to shareholders[93] in an effort to produce Pareto efficiency.[94] Smith assumes that firms are almost always in the zone of insolvency, due to the presumed existence of complete or near complete capital markets in which risky investments that could cause insolvency are always available.[95] This implies that directors should almost always consider the value of all financial claims against the firm. The limited scope of this Note, however, does not allow for an analysis of the broader issues that would arise if the directors of healthy firms owed a fiduciary duty to creditors. Instead, Smith's theories will be analyzed here under the assumption that a firm operating in the zone of insolvency is one that is on the verge of insolvency.[96]

Smith posits that rational investors would choose FVM rather than SVM as the default rule to fill in gaps in the "corporate contract."[97] This choice would be rational given that Smith's economic model predicts that "actual" SVM will force directors to make inefficient decisions while the firm is in the zone of insolvency because shareholders (residual claimants with limited liability) usually desire riskier corporate investments when insolvency appears imminent.[98] These invest-

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92. *See id.* at 217–18.

93. *See* Crespi, *supra* note 81, at 144–45 (advocating the use of side payments to shareholders without fully addressing how such payments would be efficiently facilitated).

94. Tung, *supra* note 7, at 824 n.66 (characterizing Crespi's work as an attempt to make FVM more Pareto efficient). Pareto efficiency exists when a transaction may not be altered to make one party gain more value without making another party lose value. *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 14 (Richard A. Epstein et. al. eds., 5th ed. 1998).

95. *See* Smith, *supra* note 5, at 224–25.

96. However, judicial acceptance of a more expanded zone is not totally outside the realm of possibility and is worthy of discussion in another venue. *See* Brandt v. Hicks, Muse & Co. (*In re* Healthco Int'l, Inc.), 208 B.R. 288, 302 (Bankr. D. Mass. 1997) (finding a breach of fiduciary duty pursuant to a leveraged buyout with an "unreasonable risk of insolvency").

97. Smith, *supra* note 5, at 216–17.

98. *Id.* at 221–22.

ments are inefficient in that their expected total value may be lower than that of less risky choices.[99] Smith's example is reproduced here for clarity.[100] He argues that the inefficiencies described in this example are even more pronounced given the wide variety of complex derivatives now available.[101] This leads him to posit that SVM may only be considered economically efficient if creditor contracts are gapless or if it is a "supererogatory norm."[102] Another proponent of FVM argues that the inefficiencies created by SVM produce higher interests rates because costs are incurred when creditors are forced to contract around the so-called "inefficient norm" of shareholder primacy and further costs are created by the inevitable gaps in protection that remain.[103]

FVM is characterized as a "neotraditional" conception of fiduciary duty because it attempts to enforce "a duty running to the corporation itself."[104] This duty also exists under the

99. *Id.* at 221–23.

100. Smith's example describes a firm with $20 million in assets and $15 million in debt. Smith's "Investment 1" has a $10 million outlay, a "90 percent probability of being worth $12 million and a 10 percent probability of being worth $8 million." The expected value of Investment 1 is $11.6 million. Due to the firm's capitalization, "shareholders have a 90 percent chance of a $2 million gain, and a 10 percent chance of a $2 million loss, for an expected gain to shareholders . . . of $1.6 million." "Investment 2" has a $10 million outlay, a "10 percent probability of paying . . . $200 million [and a] . . . 90 percent probability of . . . [producing] $20 million" in losses. Investment 2's expected value is only $2 million but its expected value to shareholders is $6.5 million. Thus, rational shareholders are said to prefer Investment 2 to Investment 1 despite the risk that it imposes upon debt holders. *Id.* at 221–22.

101. *Id.* at 219–21

102. *See id.* at 230 n.41. Smith characterizes a supererogatory norm as a "[hyperbolic] normative prescription . . . to take into account . . . human weakness. Thus a general obligation to be generous to the poor might take the form of an ethical prescription . . . to give all one's belongings to the poor. One might think there is little danger that people will take this prescription so much to heart that they will actually inefficiently impoverish themselves, but they may take it seriously enough to actually live up to the real underlying obligation, which is to be generous to the poor . . . . [Therefore,] the norm 'maximize shareholder value' might be the formula that managers, inclined to serve their own interests rather than those of the firm anyway, would respond to best . . . ."

103. *See* Crespi, *supra* note 81, at 147–48 (further positing that these costs are greater than those that would be caused by a shift in the "locus" of director duties to FVM).

104. Smith, *supra* note 5, at 218.

traditional conception of fiduciary duty, but under the traditional view it is further defined as ultimately running to shareholders as the residual beneficiaries of the firm.[105] Unlike the traditional conception, the neotraditional conception "would require actions of managers that would sometimes benefit one class of claimants and sometimes another,"[106] implying that creditor duty should be expanded. This expansion could take the form of granting creditors standing to assert derivative breach of fiduciary duty claims in the zone of insolvency and direct breach of fiduciary duty claims in the zone of insolvency and insolvency. As will be demonstrated in Section B below, these radical departures from Delaware's regime are neither warranted nor desirable.

B. *Critique of FVM*

Frederick Tung posits that FVM is based on at least three unrealistic assumptions and that it would therefore be an inefficient default rule.[107] The first unrealistic assumption is that shareholders and creditors hold market portfolios.[108] Distributional issues would result under FVM if they did not hold such portfolios, as side payments are unrealistic.[109] For example, FVM may reduce the value of undiversified shareholders' equity but such shareholders would not share in the upside enjoyed by creditors.[110] This disparity would be more pronounced than is suggested by proponents of FVM. Managerial behavior would become more cautious than is optimal when considering a possible investment's effect on the value of all financial claims against the firm due to a fear of increased litigation from a variety of well-funded creditors, who also exert

105. *See* Hu & Westbrook, *supra* note 8, at 1356–57.

106. Smith, *supra* note 5, at 218–19.

107. This Section contains an analysis of three of the assumptions underlying the FVM model which are identified as problematic by Tung, however, it does not address all of the problematic assumptions that he identifies. *See* Tung, *supra* note 7, at 827–52.

108. *Id.* at 844–46.

109. *Id.* at 844–46.

110. The conservative behavior mandated by FVM would benefit creditors by preserving the value of a firm's bankruptcy estate, but shareholders usually receive nothing in the event of a bankruptcy regardless of the estate's value. *See* Tung, *supra* note 7, at 844–49.

tremendous pressure by controlling future access to capital.[111] This could ultimately lead to investments in ventures that are less risky and less profitable than even FVM would suggest as optimal, thereby reducing a firm's enterprise value.[112]

The second unrealistic assumption of FVM is that few conflicts exist among creditors.[113] Under real world conditions, FVM would create a myriad of conflicting loyalties because creditors are not uniform and inter-creditor conflicts are likely to intensify near insolvency.[114] Inter-creditor conflicts exist both among claimants of the same priority and claimants of different priorities.[115] FVM fails to address the difficulty that directors would face in fulfilling their obligations to this diverse body of claimants[116] and thus does not recognize that increased agency costs would likely result.[117] The diversity among fiduciary duty recipients which would exist under FVM may also lead to increased litigation costs.[118] A 2009 Southern District of New York case discusses the hypothetical effects of granting creditors standing to assert zone of insolvency claims, stating that it "would risk . . . instances in which . . . directors must divert their collective focus from . . . shareholders and . . . reasonable efforts to repay . . . debts . . . . [E]xpenditure of resources on creditor-initiated litigation . . . [could] prevent the debtor-corporation from" avoiding the zone of insolvency.[119]

The third unrealistic assumption of FVM is that rational creditors would desire gapless contracts. Tung indicates that FVM would not create the most efficient ex ante bargain even if no inter-creditor conflicts existed, as some creditors would not benefit from gapless protection.[120] Such creditors would instead prefer to rely on bank monitoring systems to fill the

111. *Id.* at 849–50.
112. *See id.*
113. *Id.* at 831–39.
114. *See id.* at 831–32.
115. *Id.* at 831–32, 838–43 (*e.g.*, creditors of the same priority might have "differing stakes in the continuation of the borrower firm"); *see* Hu & Westbrook, *supra* note 8, at 1353.
116. *Id.* at 839–40.
117. *Id.* at 849–50.
118. Tung, *supra* note 8, at 829, 849.
119. RSL Commc'ns PLC v. Bildirici, 649 F. Supp. 2d 184, 206 (S.D.N.Y. 2009).
120. Tung, *supra* note 7, at 836–47.

gaps.[121] The "theory of delegated monitoring" posits that banks are in the optimal position to bargain for covenants that restrict expenditures and to monitor capitalization.[122] Other creditors will realize that banks are able to do a better job of monitoring firms than they can, even with additional covenants.[123] Such creditors may forego monitoring or entering into complex covenants, ultimately reducing the cost of borrowing.[124] This incentivizes firms to give banks covenants in exchange for relatively low consideration because it is in the firms' best interest to ensure that other creditors may "free ride" by utilizing banks' monitoring systems.[125] The continued use of delegated monitoring is preferable to an expansion of creditor fiduciary duty that does not allow creditors to forego contractual protection in favor of "free riding." Delegated monitoring is preferable because it is more efficient and requires no court intervention.[126]

FVM relies on unrealistic assumptions about the behavior of directors, shareholders, and creditors. Its application would undermine generally accepted corporate governance norms in an effort to extend additional protection to a corporate constituency that is already sufficiently protected. Thus, courts would be unwise to rely upon FVM in shaping decisions concerning zone of insolvency fiduciary duties.

V.
CREDITOR STANDING TO PURSUE DERIVATIVE CLAIMS DURING INSOLVENCY

This Part considers whether other jurisdictions should grant creditors standing to assert derivative breach of fiduciary duty claims during insolvency. Section A considers Tung's "contract primacy" alternative.[127] Section B considers Hu and Westbrook's critique of such claims.[128] Neither of the two approaches described in this Part provides sufficient justification

121. *Id.*
122. *Id.* at 836–39.
123. *See id.* at 836–41.
124. *See id.*
125. *Id.* at 836–39.
126. *Id.* at 815–16.
127. *Id.* at 815–17.
128. *See generally* Hu & Westbrook, *supra* note 8.

for courts to deny creditors standing to assert derivative breach of fiduciary duty claims during insolvency.

A. *Contract Primacy*

While Tung does not advocate the adoption of FVM, he also criticizes creditor access to derivative suits during insolvency.[129] He favors a "contract primacy" regime, or one in which "[s]hareholder primacy . . . remain[s] the default rule" but where "creditors [can] . . . negotiate for control . . . , displacing shareholder primacy."[130] His arguments rest on the assumption that creditors can contractually override shareholder primacy to proactively address the problems that it may cause when the firm is insolvent or in the zone of insolvency.[131] Because private contracts can fully address the inefficiencies that may be associated with shareholder primacy, creditor access to breach of fiduciary duty claims is deemed unnecessary.[132] However, the assumption that directors can readily contract out of shareholder primacy is not universally accepted.[133] Delaware allows the managers of Limited Liability Companies ("LLCs") to contract out of and modify most fiduciary duties,[134] but unlike LLCs, which are deemed "creatures . . . of contract,"[135] public firms are recognized as "creature[s] of statute."[136] Because public firms are defined by a separation of ownership and control, it is unlikely that Dela-

129. Tung, *supra* note 7, at 810, 864–65.

130. *Id.* at 809–10.

131. *Id.* at 853–54, 858–64.

132. *Id.* at 866–68.

133. *See id.* at 856 n.193. *See, e.g.*, Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1481 (1989) ("the corporation's directors and officers have a duty of loyalty to the corporation that cannot be substantially altered"). *But see* EASTERBROOK & FISCHEL, *supra* note 49, at 90–93 (asserting that "[a]ctual contracts always prevail over implied ones").

134. *See* DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c) (2005) (allowing LLCs to contract out of the fiduciary duties to equity holders). *But see* Mark M. Maloney & Michelle L. Carter, *Asserting Breach-of-Fiduciary-Duty Claims in the Context of Delaware LLCs*, AM. BANKR. INST. J., Sept. 2009, at 36 (questioning whether the Delaware Supreme Court will enforce contracts which attempt to eliminate the fiduciary duty to creditors during insolvency).

135. Fisk Ventures LLC v. Segal, No. 3017-CC, 2008 WL 1961156, at *8 (Del. Ch. May 7, 2008).

136. Maloney & Carter, *supra* note 134, at 36 (citing *Fisk Ventures*, 2008 WL 1961156, at *8 (Del. Ch. May 7, 2008)).

ware courts will explicitly hold that the fiduciary duties to shareholders of public firms may be overridden through contracts with creditors. Although complex contracts may limit the instances in which the fiduciary duties, correctly viewed as "gap-fillers,"[137] will come into play, they cannot completely eliminate these duties or provide creditors with fully gapless protection. Moreover, a foreclosure of creditor access to derivative claims would also leave firms insufficiently protected. When creditors pursue such claims, they act as a stand-in for shareholders (who likely have little incentive or ability to monitor director behavior in the context of firms in which equity is valueless or near valueless).[138] Although Tung's analysis pinpoints many of the problems associated with FVM, creditor reliance on contract to address all inappropriate director behavior during insolvency would provide neither creditors nor the firm with sufficient protection. It therefore remains necessary to grant creditors standing to assert derivative breach of fiduciary duty claims during insolvency.

B. *Institutional Criticism*

Hu and Westbrook argue that "a duty to creditors . . . [should] aris[e] upon a formal bankruptcy filing . . . not 'insolvency' or another financial metric."[139] They characterize Delaware's approach as a remnant of corporate trust fund doctrine[140] which is imposed by those who fail "to see the close connections between corporate law and bankruptcy law at the insolvency border"[141] and which results in "institutional anomalies."[142] One such anomaly is the "incongruence of ends and means" produced by imposing upon directors a duty to behave in the "interests of creditors while the key mechanisms of the

137. Bainbridge, *supra* note 27, at 337.

138. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 102 ("Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.") (Del. 2007); Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 791 (Del. Ch. 2004) ("By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders– that of residual risk-bearers.").

139. Hu & Westbrook, *supra* note 8, at 1321.

140. *Id.* at 1332–45.

141. *Id.* at 1345.

142. *Id.* at 1403.

underlying governance system [e.g., shareholder election of directors] . . . direct managers to act . . . in the interests of shareholders."[143] A fiduciary duty to creditors "requires corporations to resolve conflicting interests with respect to risk even though neither the underlying governance system nor . . . finance theory offer guidance . . . ."[144] The difficulties associated with determining the risk preferences of creditors can be contrasted with the relative ease with which the preferences of shareholders may be predicted utilizing the "investment analysis techniques [provided by modern finance theory] that do not require managers to gauge the particular risk and time preferences of . . . [their] own shareholders."[145] Hu and Westbrook thus postulate that bankruptcy law is better able to address inter-creditor conflicts regarding risk preference than general corporate law.[146] They also assert that the possibility of facing creditors' breach of fiduciary duty claims during insolvency exacerbates agency costs, as overly risk averse directors can have license to ignore shareholder needs under the guise of fulfilling creditor duty.[147]

Although Hu and Westbrook conclude that the bankruptcy adjudication system provides the only viable means by which to address the diversity of creditor risk preferences,[148] they concede that an elimination of creditor access to derivative breach of fiduciary duty claims during insolvency may create difficulties for creditors who wish to address inappropriate director action because the "prompt initiation" of Chapter 11 proceedings rarely occurs.[149] Although "DIP [Debtor in Possession] . . . was thought to have substantially ameliorated [director reluctance to initiate Chapter 11] . . . [this] may be less true today . . . [with] [t]he development of routine management changes in connection with bankruptcy."[150] They also concede that this lack of "prompt initiation" is caused in part

143. *Id.* at 1349, 1368–69.

144. *Id.* at 1349.

145. *Id.* at 1362–63.

146. Judges actively guide bankruptcy reorganizations while taking into account creditors' preferences and priorities when deciding whether to approve reorganization plans. *Id.* at 1349.

147. *Id.* at 1378.

148. *Id.* at 1376–77.

149. *Id.* at 1400.

150. *Id.* at 1399.

by the rarity of involuntary Chapter 11 filings, but propose no new mechanism to address the issue.[151] Interestingly, while Hu and Westbrook advocate the elimination of creditor access to derivative breach of fiduciary duty claims and recommend the bankruptcy system as an alternative, they also acknowledge that some firms that are insolvent or in the zone of insolvency may never require bankruptcy.[152] Foreclosing creditor access to derivative claims during insolvency could force the initiation of involuntary Chapter 11 filings in situations where such proceedings may not be in the best interests of the firm or all of its creditors. Because Delaware's fiduciary duty regime grants creditors standing to assert derivative claims during insolvency, creditors may address director malfeasance without forcing the firm into bankruptcy.

Hu and Westbrook also assert that a fiduciary duty to creditors impinges upon shareholders' ownership rights, as it characterizes creditors as the owners of insolvent firms even though equity shares may still have value and the firm may be able to avoid bankruptcy.[153] However, shareholders will ultimately benefit if creditors' derivative breach of fiduciary duty claims prevent additional inappropriate directorial behavior, because it is in both creditors' and shareholders' best interest to prevent directors from breaching their fiduciary duties to the firm.[154] During insolvency, when equity is valueless or near valueless, shareholders have little incentive to pursue derivative lawsuits. Conversely, creditors may still have a substantial economic interest in the firm as its residual owners.[155] They also lack the collective action problems and monitoring difficulties faced by shareholders.[156] Thus, Delaware's regime does not impinge upon shareholders' rights but rather pro-

151. *Id.* at 1399–1400.

152. *Id.* at 1382–83.

153. *Id.* at 1383–96.

154. Because the harms which can be alleged by creditors are the same as those which can be alleged by shareholders and any damages are awarded to the firm, there is no discord between the desires of rational creditors and shareholders in this respect. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 792 (Del. Ch. 2004) ("the transformation of a creditor into a residual owner does not change the nature of the harm in a typical claim for breach of fiduciary duty by corporate directors").

155. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 102 (Del. 2007); *Prod. Res. Group*, 863 A.2d at 791.

156. Bainbridge, *supra* note 27, at 359–63.

tects shareholders when it may be inefficient for them to protect themselves.

Hu and Westbrook also fail to recognize another important aspect of Delaware's regime: it allows Delaware courts to continue to actively guide the directors of distressed Delaware-incorporated firms and to help reform the corporate law of other states. Increased creditor reliance on the initiation of involuntary Chapter 11 filings to address fiduciary duty breaches during insolvency, especially if coupled with new federal mechanisms to facilitate and encourage such filings, would have the effect of increasing the federalization of fiduciary duty law. This change is inadvisable as the Delaware courts have proven to be better equipped to shape general corporate law than the federal courts or Congress.[157] Norman Veasey states that "increased federalization will lead to more uncertainty by introducing new corporate concepts . . . ."[158] He further asserts that "federal intrusion into internal corporate affairs, [jeopardizes] the degree of reasonable stability we have come to expect from Delaware judge-made law and legislation."[159] In this context, it would reduce directors' ability to discern ex ante the legality of their actions because compliance with fiduciary duties would not necessarily be analyzed in the predictable manner of the Delaware courts. It would also prevent Delaware courts from providing directors with guidance regarding insolvency-related issues that develop as business conditions evolve. Again, these factors suggest that Delaware's fiduciary duty regime is optimal.

VI.
DERIVATIVE SUITS IN THE ZONE OF INSOLVENCY

Parts II through V examined Delaware's treatment of fiduciary duties to creditors and concluded that the current regime is ideal. This Part examines a problem resulting from *Gheewalla*'s ambiguity. *Gheewalla*'s reasoning seems to indicate that creditors do not have standing to pursue derivative breach of fiduciary duty claims in the zone of insolvency.[160] Because

157. *See* Veasey & Guglielmo, *supra* note 59, at 1503–06 (discussing the Sarbanes-Oxley Act).
158. *Id.* at 1505.
159. *Id.*
160. *See Gheewalla*, 930 A.2d at 101–02.

such suits were not definitively foreclosed, however, some courts cite *Gheewalla* for the proposition that creditors have standing to bring derivative suits in the zone of insolvency.[161] This issue is of special concern given the variety of ways that the zone of insolvency may be defined[162] and the problems associated with an expansion of fiduciary duty to creditors into the zone of insolvency. Norman Veasey advises that creditor access to derivative lawsuits in this ambiguous zone would be "highly problematic."[163] However, although "the concept of the zone of insolvency should [not] give creditors standing to sue derivatively if the corporation is, in fact, solvent but close to the line of insolvency," Veasey nevertheless advises practitioners to hedge their bets in this area.[164] He argues that a "directorial focus on the best interests of corporate viability and a skeptical view of the wisdom of aggressive risk-taking would seem to be the best advice for fiduciaries of a corporation that is close to the line."[165] This sort of advice, which constitutes a conscientious attempt to help practitioners fully protect their director-clients, is a well-founded reaction to current zone of insolvency confusion that may ultimately encourage overly risk-averse behavior. Therefore, Delaware should specify that creditors do not have standing to assert derivative breach of fiduciary duty claims in the zone of insolvency. This qualification would allow directors to act without fear of creditor zone of insolvency claims. It would also allow other courts to properly apply Delaware law and reshape the corporate law of their own states with more doctrinal accuracy.

VII.
FINDING THE LINE: INSOLVENCY VERSUS THE ZONE OF INSOLVENCY

This Part examines whether Delaware should attempt to provide directors with a fully objective test for determining firm insolvency. Delaware law indicates that a firm is insolvent

161. *See, e.g.*, *In re* VarTec Telecom, Inc., 2007 WL 2872283, at *4 (Bankr. N.D. Tex. Sept. 24, 2007).

162. *See* Smith, *supra* note 5, at 223–25 (noting that firms are "always in the vicinity of insolvency"); Crespi, *supra* note 81, at 153 n.33.

163. Veasey, *supra* note 3, at 65.

164. *Id.*

165. *Id.*

when it "is unable to pay its debts as they become due in the ordinary course of business" or when "it has liabilities in excess of a reasonable market value of assets held."[166] This second test, or "balance sheet test," is based on a subjective valuation of assets.[167] Michelle Harner and Jo Ann Brighton point out that in its attempt to "provid[e] directors with . . . guidance," *Gheewalla* may have made the job of practitioners more difficult.[168] If reasonable but divergent asset valuations vary to the point that insolvency is shown by one but not by another, "[pre-*Gheewalla*,] lawyers. . . . would have counseled . . . that the company was in the 'zone of insolvency' and that [directors owed a fiduciary duty to creditors] . . . ."[169] Post-*Gheewalla*, directors can no longer assume that creditors are the recipient of their fiduciary duties when the firm nears insolvency and must instead make an effort to determine whether the firm is in fact insolvent using subjective market asset valuations.[170] This could create situations in which directors of distressed firms have no choice but to guess to whom their fiduciary duty runs.[171] However, outside of the litigation setting (where experts have an incentive to exaggerate their findings), the degree to which reasonable asset valuations may actually vary is somewhat limited.[172] Directors acting in good faith should be able to assess whether their firm is insolvent. Moreover, to avoid successful litigation, directors must simply refrain from engaging in actions that would allow for a plaintiff's rebuttal of the presumptions created by the business judgment rule. Since there is a low probability that a fully objective test for insolvency can be developed and since the negative ramifications of the current methodology are minimal, no changes are necessary. For those directors who attempt to fulfill their fidu-

166. LaSalle Nat'l Bank v. Perelman, 82 F. Supp. 2d 279, 290 (D. Del. 2000).

167. *See* Michelle M. Harner & Jo Ann J. Brighton, *The Implications of* North American Catholic *and* Trenwick*: Final Death Knell for Deepening Insolvency? Shift in Directors' Duties in the Zone of Insolvency?*, NORTON ANN. SURV. BANKR. L., 2008, at 1, 12–13.

168. Harner & Brighton interpret *Gheewalla* as foreclosing creditor breach of fiduciary duty claims in the zone of insolvency. *See id.*

169. *Id.*

170. *See id.*

171. *See id.*

172. *See* Peter B. Oh, *Gatekeeping*, 29 IOWA J. CORP. L. 735, 766–74 (2004) (examining expert witness incentives).

ciary duties, the ramifications of requiring subjective asset valuations are much less problematic than the consequences of granting creditors standing to assert zone of insolvency claims.

VIII.
CONCLUSION

Delaware's treatment of fiduciary duty to creditors is optimal, as demonstrated by an examination of other creditor protections, corporate governance norms, the FVM model,[173] the "contract primacy" alternative,[174] and institutional considerations.[175] However, the Delaware Supreme Court should explicitly hold that creditors do not have standing to assert breach of fiduciary duty claims in the zone of insolvency. This express restriction will resolve the doctrinal confusion that surrounds Delaware's fiduciary duty regime and will enable more accurate emulation by other jurisdictions. All state jurisdictions should have confidence that the benefits of following Delaware precedent in defining policies regarding directors' fiduciary duties in the context of distressed firms will far outweigh any negative consequences. States should therefore follow Delaware's example and grant creditors standing to pursue derivative breach of fiduciary duty claims during insolvency, but not in the zone of insolvency.

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173. *See generally* Smith, *supra* note 5.
174. *See generally* Tung, *supra* note 7.
175. *See generally* Hu & Westbrook, *supra* note 8.