

# PLAYING WITH HOUSE MONEY: DIRECTORS' FIDUCIARY DUTIES IN A DISTRESSED CORPORATION

## INTRODUCTION

A corporation's financial distress exacerbates many corporate governance conflicts. For example, directors and officers of solvent corporations must direct and manage on behalf of the common shareholders,<sup>1</sup> and are under no obligation to consider the interests of the firm's creditors.<sup>2</sup> Therefore, as a company weakens, directors have an incentive to risk further deterioration by attempting to generate future return for shareholders.<sup>3</sup> Such shareholder loyalty is, however, directly adverse to the interests of creditors who generally prefer to preserve corporate assets for liquidation and distribution.<sup>4</sup>

The Delaware Court of Chancery has used various methods to determine the point at which a company becomes not merely distressed, but insolvent, warranting a shift in the directors' loyalty from the stockholders to the contractual creditors. Furthermore, the method to effectuate the shift itself is unclear. As such, director duties in distressed companies and the various analyses used to determine the extent of such distress are in need of clarification.

Historically, Delaware courts have used a company's ability to pay its debts and whether its liabilities exceed the market value of its assets to assess the company's solvency.<sup>5</sup> A single formula, however, cannot accurately measure the solvency of all companies because each company has a unique combination of assets (some more readily resalable than others), liabilities, operating leverage (ratio of fixed to variable costs), investors (debt-to-equity ratios), etc. For example, while a manufacturing company with steady earnings and fixed assets may better weather an economic downturn, a tech

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1. *TW Servs., Inc. v. SWT Acquisition Corp.*, Nos. 10427, 10298, 1989 WL 20290, at \*7 (Del. Ch. Mar. 2, 1989).

2. *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1519 (S.D.N.Y. 1989) (stating that debt holders are entitled to no benefits beyond those bargained for and memorialized in the bond indenture); *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992).

3. See Kelli A. Alces, *Strategic Governance*, 50 ARIZ. L. REV. 1053, 1088 (2008).

4. See Jonathan R. Macey & Maureen O'Hara, *Solving the Corporate Governance Problems of Banks: A Proposal*, 120 BANKING L.J. 326, 329 (2003) ("[S]hareholders have a strong incentive to increase risk because they can allocate their losses to third parties while still receiving any gains that might result from the risky behavior.").

5. *Geyer*, 621 A.2d at 789.

company with volatile earnings and an appetite for risky projects is more likely to invest in a high-return venture generating value for the residual claimant shareholders.

Therefore, to accurately assess a company's solvency, courts must look to the market's evaluation of a given company's future prospects. Such an approach uses the market's assessment of the company's specific characteristics, including its risk relative to the market as measured by the company's levered equity beta.<sup>6</sup>

Furthermore, director fiduciary duties in an insolvent corporation may shift to the creditors as the new residual claimants.<sup>7</sup> Delaware law, however, is unsettled concerning whether the directors' duties (1) are merely not breached by action taken for the primary benefit of creditors (*permitting* director action on behalf of the creditors) or (2) actively shift from the shareholders to the creditors (*requiring* director action on behalf of the creditors). Delaware must devise a reliable standard to increase certainty in director decision making. One potential solution is to implement option number one—directors' duties are merely not breached by action taken for the primary benefit of creditors—in distressed yet solvent companies and implement option number two—actively shift directors' duties from the shareholders to the creditors—once the corporation is insolvent.

This Comment attempts to clarify to whom directors of distressed and insolvent corporations owe their duties. It begins with a brief overview of corporate capital structure, follows with an explanation of the current law concerning fiduciary duties in a distressed corporation, and concludes by suggesting minor adjustments that can clarify directors' duties as a company approaches insolvency.

## I. CAPITAL STRUCTURE BASICS

### A. *How Companies are Financed*

To finance ongoing operations, a company may use internal capital (retained earnings) if available, or issue debt, equity, or preferred stock (a hybrid debt/equity instrument).<sup>8</sup> Each method

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6. See *Fed Request Comments on Calculation Methods for Priced Services*, 70 Fed. Reg. 29512, ¶ 94-201, at 5-7 (2005), available at 2005 WL 6724890; Samuel C. Thompson, Jr., *Demystifying the Use of Beta in the Determination of the Cost of Capital and an Illustration of Its Use in Lazard's Valuation of Conrail*, 25 J. CORP. L. 241, 288 (2000).

7. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) ("When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value."); *Geyer*, 621 A.2d at 787.

8. John E. Moose & Patrick M. Jones, *Debt or Equity: How the Classification of Hybrid Securities Can Turn a Good Company Bad*,

has benefits and drawbacks, the magnitude of which depends on specific firm characteristics.<sup>9</sup> Two major theories attempt to explain capital structure decisions.<sup>10</sup>

First, the trade-off theory suggests that

large, mature companies with stable cash flows and limited opportunities for investment should have higher leverage ratios, both to take advantage of the tax deductibility of debt and because of their lower financial distress costs. At the other end of the spectrum, smaller companies with significant growth opportunities should make limited use of debt to preserve their continuing ability to undertake positive-NPV [net present value] projects.<sup>11</sup>

Essentially, the trade-off theory assumes that large, stable companies generally have less volatile cash flows (indicating a greater ability to make debt payments), more readily resalable assets (able to generate cash upon liquidation and reducing the cost of financial distress), and fewer intangible assets (which generally have minimal liquidation value). Such characteristics result in a greater debt capacity and an ability to utilize a debt tax shield, therefore reducing borrowing rates.<sup>12</sup>

Second, the pecking-order theory suggests that

actual corporate leverage ratios typically do not reflect capital structure targets, but rather the widely observed corporate practice of financing new investments with internal funds when possible and issuing debt rather than equity if external funds are required. In the pecking-order model, an equity offering is typically regarded as a very expensive last resort. The theory is based on the premise that managers avoid issuing securities, particularly equity, when the company is undervalued. And even if the company's stock is currently fairly valued, the market reaction to the announcement of a new equity offering is expected to cause the company's stock price to fall below fair value.<sup>13</sup>

Therefore, the pecking-order theory accepts that, regardless of the specific firm's characteristics, equity financing, such as a seasoned offering, will be used only when the marginal cost of

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MONITORDAILY (Mar./Apr. 2007), <http://www.monitordaily.com/debt-equity-classification-hybrid-securities/>.

9. John Graham & Campbell Harvey, *How Do CFOs Make Capital Budgeting and Capital Structure Decisions?*, 15.1 J. APPLIED CORP. FIN. 8, 13–14 (2002).

10. *Id.* at 13.

11. *Id.*

12. *Id.*

13. *Id.* (footnote omitted).

additional debt exceeds that of equity.<sup>14</sup> Regardless of which theory best explains corporate financing behavior, both recognize the general principle that equity financing is more expensive than preferred stock, debt, and retained earnings.

*B. Why Equity is More Expensive than Debt*

Three reasons explain the disparity between the cost of issuing debt and equity.<sup>15</sup> First,

debt is typically secured by assets, whether real estate, machinery, receivables, inventory, or other things of value, which may be seized by the lender in case of default by the borrower. Equity ownership, by contrast, is not accompanied by any kind of security interest in the company financed by the equity holder. The equity holder cannot seize anything, the sole remedy of an equity holder generally being the right to vote at a shareholders' meeting.<sup>16</sup>

Second,

a company must pay holders of debt an interest rate, even if the company is loss-making (and failure to pay interest or to achieve debt coverage ratios may put the company into default and force a liquidation). Equity holders, by contrast, are paid dividends only to the extent that the company has been profitable, once all obligations in the ordinary course (e.g. servicing of interest payments) have been satisfied.<sup>17</sup>

Thus, the company is contractually obligated to pay a holder of its debt securities at the risk of defaulting upon nonpayment. This explains why companies with steady cash flows have higher debt capacities. Such companies are able use the cash to satisfy periodic debt payments, while a risky company with volatile earnings is more likely to default.<sup>18</sup> Conversely, equity holders receive dividends only

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14. *Id.*

15. Les Nemethy, *Why Equity Can Be So Much More Expensive than Debt*, LES NEMETHY'S INSTABLOG (Jun. 8, 2010, 10:35 AM), <http://seekingalpha.com/instablog/357768-les-nemethy/80692-why-equity-can-be-so-much-more-expensive-than-debt>.

16. *Id.*; see also *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007) ("While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights.").

17. Nemethy, *supra* note 15.

18. Additionally, the firm's steady cash stream increases its ability to utilize the tax shield created by the deductibility of its interest payments. Without positive earnings, the firm cannot fully utilize interest payment deductions.

when the company is able to pay such dividends, making equity a more malleable form of financing, thereby increasing its cost.<sup>19</sup>

Third, the holders of debt have a liquidity preference above holders of equity.<sup>20</sup> For example, “in the event of bankruptcy of a company, debt holders are satisfied in full before equity holders receive any proceeds of liquidation whatsoever. In other words, even an unsecured holder of debt will receive 100% of what is owed to him or her, before equity holders see a penny.”<sup>21</sup>

The debt holders’ liquidity preference therefore reduces the risk of holding debt relative to equity, which reduces the cost of debt and leads creditors to prefer risk-averse tactics as a corporation nears insolvency. Equity holders, however, generally prefer risky behavior with potentially high returns.

### C. Director Fiduciary Duties Protect the Interests of Equity Holders

Management is responsible for balancing the sometimes conflicting preferences of debt and equity holders; whereas debt holders may govern the terms of investment via contractual covenants and security agreements,<sup>22</sup> equity holders are without such protections (other than those provided in the corporation’s bylaws and charter). Therefore, Delaware law requires corporate directors to manage the company for the sole benefit of the company’s stockholders.<sup>23</sup>

Corporate law, however, draws a harsh distinction between the rights of common and preferred stockholders. For example, in *Equity-Linked Investors, LP v. Adams*,<sup>24</sup> the Delaware Court of Chancery states:

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19. Nemethy, *supra* note 15.

20. *Id.*

21. *Id.*

22. Chenyang Wei, *Covenant Protection, Credit Spread Dynamics and Managerial Incentives 2* (Nov. 29, 2005) (unpublished manuscript), available at [http://pages.stern.nyu.edu/~cwei/JobMarket\\_CovenantsSpreadCEOIncentive\\_ChenyangWei.pdf](http://pages.stern.nyu.edu/~cwei/JobMarket_CovenantsSpreadCEOIncentive_ChenyangWei.pdf).

23. *Ellingwood v. Wolf’s Head Oil Ref. Co.*, 38 A.2d 743, 747 (Del. 1944); *In re Trados Inc. S’holder Litig.*, 73 A.3d 17, 41 (Del. Ch. 2013); *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435, 452 (Del. Ch. 2010) (“[I]t is the duty of directors to pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred.”); *Equity-Linked Investors, LP v. Adams*, 705 A.2d 1040, 1042 (Del. Ch. 1997); *Geyer v. Ingersoll Publ’ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) (“[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms.”).

24. 705 A.2d 1040.

While the facts out of which this dispute arises indisputably entail the imposition by the board of (or continuation of) economic risks upon the preferred stock[,] which the holders of the preferred did not want, and while this board action was taken for the benefit largely of the common stock, those facts do not constitute a breach of duty.<sup>25</sup>

The court continued that the protections afforded to preferred stockholders are solely contractual, and therefore the board owes the preferred stockholders no duties outside those bargained for contractually.<sup>26</sup> To be sure, it is “the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, *etc.*, of preferred stock, where there is a conflict.”<sup>27</sup> Therefore, management owes preferred stockholders duties similar but subordinate to those owed to junior debt holders.<sup>28</sup>

In summary, liquidated assets are distributed first to senior debt holders followed by progressively more junior debt claimants, and finally to the preferred shareholders. Any remaining value is distributed ratably to the common shareholder residual claimants. The duties of corporate directors, however, follow an inverse hierarchy, owing duties primarily to the common shareholders. Only the presence of certain “special circumstances . . . e.g., fraud, insolvency, or a violation of a statute,” permit directors to consider the interests of claimants other than common shareholders.<sup>29</sup>

## II. DUTIES SHIFT AS A COMPANY APPROACHES INSOLVENCY

### A. *Shift in a Director's Duty from Shareholders to Creditors*

Directors' legal allegiance to a firm's equity holders weakens as a company approaches insolvency.<sup>30</sup> The reason for this duty shift is twofold. First, as a company's financial position deteriorates, its

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25. *Id.* at 1042.

26. *Id.*

27. *Id.*

28. Melissa M. McEllin, *Rethinking Jedwab: A Revised Approach to Preferred Shareholder Rights*, 10 COLUM. BUS. L. REV. 895, 898 (2010) (describing a “current trend of favoring fiduciary duties owed to the common shareholders over contractual obligations owed to the preferred shareholders”).

29. *Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974), *aff'd in part, rev'd in part*, 347 A.2d 133 (Del. 1975).

30. *In re NCS Healthcare, Inc., S'holders Litig.*, 825 A.2d 240, 256 (Del. Ch. 2002) (“Director Defendants certainly owe fiduciary duties to NCS and its stockholders. But, as directors of a corporation in the ‘zone of insolvency,’ the NCS board members also owe fiduciary duties to the Company’s creditors.”); *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) (stating that “the general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent ‘special circumstances,’” which include insolvency).

debt obligations approach the value of, and may eventually outweigh, its assets, resulting in “negative equity.”<sup>31</sup> Here, the debt holders become the firm’s residual claimants as the sale of the firm’s entire asset base fails to satisfy the creditors’ liquidity preference.<sup>32</sup> Therefore, allowing directors to act solely on behalf of the shareholders would incite risky behavior characteristic of “zombie firms,”<sup>33</sup> given that creditors (as the new residual claimants) bear the risk burden while the equity holders are the sole upside participants.<sup>34</sup> Such desperate attempts to generate value for shareholders jeopardize firm value currently available to creditors.

Second, debt holders are able to protect their interests via covenants—a protection generally unavailable to the common stockholder.<sup>35</sup> One reason creditors are willing to invest at lower rates than equity holders is their superior rights in a potential liquidation. Therefore, in an insolvent company, a “creditor’s interest is given major consideration because it is fair that creditors who expected and deserved no risk should not now risk losing all in an effort to recover more for [equity] investors.”<sup>36</sup> Accordingly, managers of insolvent companies must preserve assets for distribution to creditors rather than gamble with the firm’s dwindling capital in a desperate attempt to salvage a struggling corporation.

Though this shift in allegiance from the stockholders to creditors is theoretically sound, courts have struggled to determine the point at and extent to which the directors’ duties change.

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31. John A. Bogdanski, *Revisiting the Burden of Proving Fair Market Value*, 34 EST. PLAN. J. 43, 44 (Jan. 2007) (defining negative equity as “liabilities in excess of assets”).

32. *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, No. 1571-N, 2006 WL 4782378, at \*4 (Del. Ch. Aug. 10, 2006); ALAN R. PALMITER, CORPORATIONS EXAMPLES AND EXPLANATIONS 218 (7th ed. 2012) (citing *Geyer*, 621 A.2d 784).

33. *In re Trados Inc. S’holder Litig.*, 73 A.3d 17, 51 (Del. Ch. 2013).

34. Paul B. Lewis, *Trouble Down Under: Some Thoughts on the Australian-American Corporate Bankruptcy Divide*, 2001 UTAH L. REV. 189, 224 (“Since the equity of an insolvent debtor does not bear the burden of its risky behavior, an incentive is created for the equity holders to direct a firm to behave in an excessively risky fashion.”); Sydney Finkelstein, *How to Spot a Zombie Company*, FORBES (Feb. 14, 2012, 1:20 PM) <http://www.forbes.com/sites/sydneyfinkelstein/2012/02/14/how-to-spot-a-zombie-company/print/>. But cf. *Trenwick*, 2006 WL 4782378, at \*4 (indicating that although an insolvent firm’s directors’ primary objective is advancement of the creditors’ interests, “directors are [still] free to pursue value maximizing strategies”).

35. *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1518 (S.D.N.Y. 1989) (citing the American Bar Foundation’s *Commentaries on Indentures*); *Simons v. Cogan*, 549 A.2d 300, 302 (Del. 1988).

36. *In re Cent. Ice Cream Co.*, 836 F.2d 1068, 1070 (7th Cir. 1987).

### B. *Factual Insolvency Rather than Statutory Insolvency*

While courts have discussed various methods to assess a company's solvency, one certainty is that a statutory proceeding is not necessary to deem a company insolvent. For example, in *Geyer v. Ingersoll Publications Co.*,<sup>37</sup> Ingersoll and Geyer owned IPCO—a Delaware corporation.<sup>38</sup> As IPCO grew, it repurchased Geyer's shares in return for a \$2 million note.<sup>39</sup> As the corporation failed to make payments on the note, however, Ingersoll had it "surrender its major assets to third parties . . . for his personal benefit, at the expense of IPCO, while IPCO remained indebted to Mr. Geyer."<sup>40</sup>

Here, while Ingersoll argued that Geyer is merely a creditor and "directors do not owe creditors duties beyond the relevant contractual terms absent . . . fraud, insolvency, or a violation of a statute,"<sup>41</sup> and that "for the insolvency exception to apply, some sort of statutory proceedings (e.g., bankruptcy) must have begun rather than insolvency merely existing in fact,"<sup>42</sup> the court held that "insolvency means insolvency in fact rather than insolvency due to a statutory filing . . . for purposes of determining when a fiduciary duty to creditors arises."<sup>43</sup> The court reasoned that "Delaware case law . . . clearly states that it is the fact of insolvency which causes the duty to creditors arise [sic],"<sup>44</sup> and that "the ordinary meaning of the word insolvency" requires such a conclusion.<sup>45</sup> Therefore, to consider a company insolvent, which results in directors' duties shifting from equity holders to debt holders, a company need not file for bankruptcy or take alternative legal action.

### C. *The Point of Factual Insolvency—A Muddled Proposition*

Because a statutory proceeding is unnecessary to deem a corporation insolvent, courts must determine at what point a company becomes legally insolvent. The Delaware Court of Chancery has taken multiple approaches to this analysis and has left practitioners without a clear standard to apply. For example, in *Geyer*, the court determined that "[a]n entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business. . . . That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held."<sup>46</sup>

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37. 621 A.2d 784.

38. *Id.* at 786.

39. *Id.*

40. *Id.*

41. *Id.* at 787.

42. *Id.*

43. *Id.*

44. *Id.* at 787–88.

45. *Id.* at 789.

46. *Id.*

Furthermore, in 2007, the Delaware Supreme Court used a less precise “zone of insolvency” test to determine the point at which the directors’ duty shifts to the debt holders.<sup>47</sup> In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*,<sup>48</sup> Clearwire threatened the North American Catholic Educational Programming Foundation (“NACEPF”) with bankruptcy to force it to modify an existing contract in consideration for \$2 million.<sup>49</sup> To substantiate its claim, NACEPF argued that Clearwire owed it a duty, even though it was a creditor, because “Clearwire was either insolvent or in the zone of insolvency during the relevant periods.”<sup>50</sup> The Delaware Supreme Court determined that Clearwire operated in the zone of insolvency for “at least a substantial portion of the relevant periods.”<sup>51</sup>

To make such a determination, the court referred to the Court of Chancery’s opinion “that insolvency may be demonstrated by either showing (1) ‘a deficiency of assets below liabilities with *no reasonable prospect* that the business can be successfully continued in the face thereof,’ or (2) ‘an inability to meet maturing obligations as they fall due in the ordinary course of business.’”<sup>52</sup> Though the Chancery Court enumerated the above two factors to determine whether a company has fallen within the zone of insolvency, “[it] did not attempt to set forth a precise definition of what constitutes the ‘zone of insolvency.’”<sup>53</sup> Therefore, while the court identified certain criteria that “may” indicate a company has fallen within the zone of insolvency, the zone remains a nebulous concept relative to the mathematical precision of the asset-based approach utilized in *Geyer*.

Further, in *In re Central Ice Cream Co.*,<sup>54</sup> the Seventh Circuit used yet another approach to define the duties of directors. Here, Central Ice Cream Co. had failed and subsequently initiated a bankruptcy proceeding.<sup>55</sup> The company’s most valuable asset was a pending lawsuit in which it had “won a \$52 million verdict in state court in a fraud and contract suit against McDonald’s Corp.”<sup>56</sup> McDonald’s appealed, “but offered a settlement of \$15.5 million if Central accepted before the trial court acted. Central’s board of directors accepted.”<sup>57</sup>

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47. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 100 (Del. 2007).

48. 930 A.2d 92.

49. *Id.* at 95.

50. *Id.* at 97.

51. *Id.* at 98.

52. *Id.* (emphasis added) (footnotes omitted).

53. *Id.* at 98 n.20.

54. 836 F.2d 1068 (7th Cir. 1987).

55. *Id.* at 1069.

56. *Id.*

57. *Id.*

Central's shareholders filed suit and eventually appealed, citing "evidence [that] included the testimony of experienced attorneys, who opined that the 70% discount from the \$52 million verdict was too steep, given the merits of the case and what they saw as the likelihood of its affirmance."<sup>58</sup> In justifying his approval of the \$15.5 million compromise, the judge quoted the bankruptcy judge's approval of the settlement:

The Court has considered the views of the objecting shareholders and persons who claim an equity interest in Central. . . . [U]nder all the circumstances the settlement is also fair to stockholders, in that it will provide a million dollars to distribute to stockholders. To seek greater return for the shareholders at risk to the creditors would be most unfair. A creditor supplies to a business in return for getting paid an agreed price. A stockholder puts up risk capital as an investment. The creditor's interest is given major consideration because it is fair that creditors who expected and deserved no risk should not now risk losing all in an effort to recover more for investors.<sup>59</sup>

Essentially, the bankruptcy court determined that the settlement was appropriate, even though it drastically discounted the potential value available to shareholders, because it satisfied all creditor claims and allocated \$1 million to the equity holders.<sup>60</sup> The Seventh Circuit, however, later noted that while the bankruptcy court's decision protects creditors, and while "spurning the settlement would expose the creditors to risk[,] . . . this [risk] parallels the risk creditors face outside of the bankruptcy process as firms try to maximize the expected value of the enterprise. The bankruptcy court should try to implement, rather than alter, non-bankruptcy entitlements."<sup>61</sup>

Here, the Seventh Circuit advocated for an "enterprise value" approach, indicating that, while the \$15.5 million settlement was in the best interest of creditors, it reduced the expected value of the enterprise.<sup>62</sup> Such logic implies that management, regardless of to whom the proceeds of a sale would flow, should attempt to maximize the value of the enterprise.

The Delaware Court of Chancery has also used the enterprise value approach to determine the point of factual insolvency. For example, in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*,<sup>63</sup> the court held that "[a]t least where a

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58. *Id.* at 1069–70.

59. *Id.* at 1070 (alteration in original).

60. *Id.*

61. *Id.* at 1072.

62. *Id.* at 1070.

63. No. 12150, 1991 WL 277613 (Del. Ch. Dec 30, 1991).

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>64</sup> Though the enterprise approach dominated insolvency analysis for a period of time, the Chancery Court recently abandoned it as “ultimately complicat[ing] rather than simplif[y]ing the difficult judgments faced by directors acting under conditions of uncertainty and the task confronted by courts who must review their decisions.”<sup>65</sup>

Six years after *Credit Lyonnais*, in *Orban v. Field*,<sup>66</sup> the Delaware Court of Chancery determined that a transaction is acceptable, regardless of whether the common stockholders receive any compensation, so long as the transaction obtains “the best price reasonably available.”<sup>67</sup> In *Orban*, George Orban founded Office Mart and, upon experiencing financial difficulties, agreed to merge with Staples.<sup>68</sup> The deal was beneficial for the preferred stockholders, however, the “common stockholders could only receive merger consideration if the value of the Staples shares exceeded \$35,062,470”—the equivalent of the preferred stockholders’ liquidity preference.<sup>69</sup>

The Delaware Court of Chancery held that the board did not breach its duty to the common stockholders by liquidating for an amount less than the liquidity preference.<sup>70</sup> “Whereas the preferred stockholders had existing legal preferences, the common stockholders had no legal right to a portion of the merger consideration under Delaware law or the corporate charter. The Staples’ transaction appeared *reasonably to be the best available transaction*.”<sup>71</sup> Thus, *Orban* stands for the proposition that where the “common stock had no economic value[,] . . . a transaction in which the common stockholders received nothing was fair to them” so long as it was reasonably the best available.<sup>72</sup>

Most recently, in *In re Trados Inc. Shareholder Litigation*,<sup>73</sup> the Chancery Court focused on the probability that the common shareholders will obtain value for their shares in the future should the directors refrain from selling the corporation.<sup>74</sup> In reaching the

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64. *Id.* at \*25.

65. *In re Trados Inc. S’holder Litig.*, 73 A.3d 17, 42 n.16 (Del. Ch. 2013). The *Trados* court, however, offered no explanation as to how the “enterprise” approach complicates the analysis.

66. No. 12820, 1997 WL 153831 (Del. Ch. Apr. 1, 1997).

67. *Id.* at \*1.

68. *Id.* at \*5.

69. *Id.* at \*6.

70. *Id.* at \*2.

71. *Id.* at \*9 (emphasis added).

72. *In re Trados Inc. S’holder Litig.*, 73 A.3d 17, 42 n.16 (Del. Ch. 2013) (referring to *Orban*, 1997 WL 153831, at \*5).

73. 73 A.3d 17.

74. *Id.* at 76.

conclusion that the transaction was fair, the *Trados* court stated that “the proper ‘test of fairness’ [is] whether ‘the minority stockholder shall receive the substantial equivalent in value of what he had before.’”<sup>75</sup>

Thus, because “*Trados*’s common stock had no economic value before the Merger . . . the common stockholders received the substantial equivalent in value of what they had before, and the Merger satisfies the test of fairness.”<sup>76</sup> The court further stated that the directors satisfied the entire fairness standard by proving that “*Trados* did not have a reasonable prospect of generating value for the common stock,”<sup>77</sup> and that “it did not have a realistic chance of generating a sufficient return to escape the gravitational pull of the large liquidation preference and cumulative dividend.”<sup>78</sup>

Therefore, *Trados* focuses on the value of the transaction relative to the value of the common stock, whereas *Orban* assesses the transaction value per se. Further, while common stock value may serve as somewhat of a proxy for the “best available transaction,”<sup>79</sup> *Trados* creates an explicit link between the market’s value of the common stock and the transaction value.<sup>80</sup>

An article written by Gregory A. Horowitz in 2013 titled *A Further Comment on the Complexities of Market Evidence in Valuation Litigation* initially detailed the complexities associated with utilizing market data to quantify a company’s financial distress.<sup>81</sup> For example, “substantial equity value, even in relation to debt, can be consistent with insolvency, and . . . substantial debt discounts can be consistent with solvency. These two potential forms of market evidence do not ‘speak for themselves,’ and cannot be reliably interpreted in isolation by a lay finder of fact.”<sup>82</sup>

The article continued by describing “a much simpler way to use market evidence to test solvency.”<sup>83</sup> Under this approach, a company is

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75. *Id.* (citing *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 114 (Del. 1952)).

76. *Id.*

77. *Id.*

78. *Id.* at 77.

79. *Orban v. Field*, No. 12820, 1997 WL 153831, at \*9 (Del. Ch. Apr. 1, 1997).

80. *Trados*, 73 A.3d at 76.

81. Gregory A. Horowitz, *A Further Comment on the Complexities of Market Evidence in Valuation Litigation*, 68 BUS. LAW. 1071, 1075–76 (2013).

82. *Id.*

83. *Id.* at 1077.

insolvent if the total “debt discount”—i.e., the difference between the amount of its debt claims and the fair market value of those debts—is greater than the fair market value of its equity; conversely, a company is solvent if the value of its equity exceeds its total debt discount.<sup>84</sup>

As an example, a company that “has a \$200 million market capitalization of equity but . . . has \$1 billion of public debt trading at \$.70 on the dollar (total debt discount of \$300 million), the market evidence establishes insolvency” because the debt discount (\$300 million) is greater than the market cap of the firm’s equity (\$200 million).<sup>85</sup> In accordance with this method, a company can also “prove solvency by showing that any debt discount is outweighed on the equity side.”<sup>86</sup> This approach is consistent with *Trados’s* use of market mechanisms to evaluate a firm’s solvency, though it requires additional calculation and research.

To summarize:

Case Name	Year	Court	Test
<i>Central Ice Cream</i>	1987	Seventh Circuit	Enterprise value approach.
<i>Credit Lyonnais</i>	1991	Delaware Chancery Court	Enterprise value approach.
<i>Geyer</i>	1992	Delaware Chancery Court	Liabilities in excess of a reasonable market value of assets held.
<i>Orban</i>	1997	Delaware Chancery Court	Transaction appeared reasonably to be the best available transaction.
<i>Gheewalla</i>	2007	Delaware Chancery Court	Zone of insolvency.
<i>Trados</i>	2013	Delaware Chancery Court	Whether the minority stockholder shall receive the substantial equivalent in value of what he had before.

### III. SHIFTING THE DUTY VS. FAILING TO BREACH THE DUTY

Delaware law clearly provides for a shift in directors’ fiduciary duties from equity holders to creditors at the point of insolvency.<sup>87</sup> To be sure, “[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

84. *Id.*

85. *Id.* at 1078.

86. *Id.*

87. *In re NCS Healthcare, Inc., S’holders Litig.*, 825 A.2d 240, 256 (Del. Ch. 2002).

enterprise.”<sup>88</sup> Further, “the general rule is that directors do not owe creditors duties beyond the relevant contractual terms . . . [however,] when the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors.”<sup>89</sup>

Indeed, “[i]f the firm is insolvent, its residual claimants are the creditors and it is for their benefit that the directors must now manage the firm.”<sup>90</sup> Though the directors’ duties shift to the creditors, “individual *creditors* of an *insolvent* corporation have *no right to assert direct* claims for breach of fiduciary duty against corporate directors. Creditors may nonetheless protect their interest by bringing derivative claims on behalf of the insolvent corporation or any *other* direct nonfiduciary claim.”<sup>91</sup>

While the duty shift is well settled, *Trados* creates a notable discrepancy. The general rule is that “the standard of conduct for directors requires that they strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm’s value, not for the benefit of its contractual claimants.”<sup>92</sup> The board owes its duties to the “[p]referred stockholders . . . only when they do not invoke their special contractual rights and rely on a right shared equally with the common stock.”<sup>93</sup>

*Trados* then held that “[a]lthough the defendant directors did not adopt any protective provisions, failed to consider the common stockholders, and sought to exit without recognizing the conflicts of interest presented by the Merger, they nevertheless proved that the transaction was fair.”<sup>94</sup> Essentially, the court held that the directors *did not breach* their duties to the common shareholders because the transaction satisfies the applicable fairness standard, even though the transaction was taken for the benefit of the creditors. The court, however, never states that the directors’ duties *shifted* upon insolvency; it merely fails to hold directors liable for actions taken on behalf of creditors, so long as the common shareholders receive “the substantial equivalent in value of what they had before.”<sup>95</sup>

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88. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 WL 277613, at \*1155 (Del. Ch. Dec. 30, 1991).

89. *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992).

90. *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, No. 1571-N, 2006 WL 4782378, at \*27 n.96 (Del. Ch. Aug. 10, 2006).

91. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007).

92. *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 40–41 (Del. Ch. 2013).

93. *Id.* at 39–40.

94. *Id.* at 76.

95. *Id.* at 78; *see also id.* (“In light of this reality, the directors breached no duty to the common stock by agreeing to a Merger in which the common stock received nothing. The common stock had no economic value before the Merger, and the common stockholders received in the Merger the substantial equivalent in value of what they had before.”).

Under the above analysis, an insolvent company's directors remain bound to the common shareholders, though actions taken on behalf of the creditors and preferred shareholders will not amount to a breach of such duties. Thus, the directors have an option: they may either play it safe and liquidate in the creditors' interest (not breaching their duty because the equity value is zero), or gamble with the firm's remaining value hoping to generate a windfall for the common shareholders on a risky investment.

#### IV. PROPOSED SOLUTIONS

##### A. *Trados Appropriately Determines the Point of Insolvency*

Of the Delaware Court of Chancery's various point of insolvency tests, only the *Trados* approach considers sufficient market analysis to avoid exacerbating a company's distress. The court assessed the transaction price relative to the company's market capitalization. Assuming that the company is publicly traded and that its shares are liquid, the millions who invest in the stock market each year value companies every few hundred milliseconds.<sup>96</sup> Importantly, such valuations consider the company's potential to generate equity value in the future.

The various pre-*Trados* approaches primarily considered a company's current financial information. For example, in *Geyer*, the court determined that a company is "insolvent when it has liabilities in excess of a reasonable market value of assets held."<sup>97</sup> The burden of the company's liabilities relative to its assets, however, depends on the characteristics of the specific company.<sup>98</sup> Furthermore, the "enterprise value" approach and the "reasonably the best available transaction" approach used in *Credit Lyonnais* and *Orban*, respectively, do not fully consider the firm's expected future value. Neither approach accounts for the market's expectation of the company's ability to regain value for the common shareholders in the future, sometimes measured by a company's price-to-earnings ("P/E") ratio, which is the amount investors pay per dollar of current earnings.<sup>99</sup>

Investors consider P/E ratios because low-volatility stocks, for example those with equity betas below one,<sup>100</sup> generally have lower

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96. Jacob Loveless et al., *Online Algorithms in High-Frequency Trading*, ACMQUEUE 1 (Oct. 7, 2013), <http://delivery.acm.org/10.1145/2540000/2534976/p30-stoikov.pdf>.

97. *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 789 (Del. Ch. 1992).

98. See *supra* text accompanying note 20.

99. *Price-Earnings Ratio-P/E Ratio*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/price-earningsratio.asp> (last visited Sept. 5, 2014).

100. Todd Bunton, *4 High Yield, Low Beta Stocks*, ZACKS (Jan. 10, 2013), <http://www.zacks.com/commentary/25333/4-high-yield-low-beta-stocks>.

P/E ratios, indicating lower expected growth prospects.<sup>101</sup> Accordingly, the appropriate test to pinpoint insolvency for a low-growth, stable, dividend-paying company may differ from that of a high-growth, volatile, risky company.

One common technique to value a company's stock is to divide the present value of the company's future cash flows by its number of shares outstanding (the discounted cash flows ("DCF") valuation model).<sup>102</sup> An integral variable in the DCF model, along with the company's projected cash flows and growth rate, is an accurate cost of equity capital, generally approximated via the capital asset pricing model ("CAPM").<sup>103</sup> An important yet troublesome CAPM variable is beta—which measures a firm's volatility relative to an index.<sup>104</sup> All else equal, a higher beta indicates higher volatility and therefore a higher required return, resulting in riskier investments and greater growth opportunities.<sup>105</sup> This is one reason why risky ventures such as tech start-ups command higher returns on investment than relatively mature companies and why a given insolvency test may be appropriate for one company and not another.<sup>106</sup>

Furthermore, while the DCF valuation model is generally appropriate, an insolvent company's equity behaves like a call option on the firm's assets.<sup>107</sup> The option value can result in equity retaining material value even where a DCF analysis would otherwise deem it worthless.<sup>108</sup> An insolvent corporation's equity "is therefore best understood, not as merely the residual value in a hypothetical immediate liquidation, but as the option value associated with the ongoing right to purchase the assets of the enterprise by paying off the debt."<sup>109</sup> The equity, then, is analogous

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101. *Choosing Investments: Stocks*, FINRA, <http://www.finra.org/Investors/SmartInvesting/ChoosingInvestments/Stocks/> (last visited Sept. 5, 2014).

102. *Discounted Cash Flow (DCF) Analysis*, WALL STREET WANNABE, [http://www.wallstreetwannabe.com/?page\\_id=643](http://www.wallstreetwannabe.com/?page_id=643) (last visited Sept. 3, 2014).

103. *Definition of Cost of Capital*, FIN. TIMES: FT.COM/LEXICON, <http://lexicon.ft.com/Term?term=cost-of-capital> (last visited Oct. 1, 2014).

104. *Calculating and Interpreting Beta*, ILLUINOIS STATE UNIVERSITY, <http://www2.cob.ilstu.edu/kjbaue2/fil341/SV.pdf> (last visited Sept. 5, 2014).

105. Elijah Brewer III et al., *How Are Small Firms Financed? Evidence from Small Business Investment Companies*, ECON. PERSPECTIVES 15 (1996), available at <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.195.7362&rep=rep1&type=pdf>.

106. Michael A. Paschall & George B. Hawkins, *Do Smaller Companies Warrant a Higher Discount Rate for Risk? The "Size Effect" Debate*, 1 BUS. VALUATION ALERT (1999), available at <http://www.businessvalue.com/resources/Valuation-Articles/Small-Company-Cap-Rates.pdf>.

107. REAL OPTIONS IN CAPITAL INVESTMENT: MODELS, STRATEGIES, AND APPLICATIONS 307 (Lenos Trigeorgis ed., 1995).

108. Horowitz, *supra* note 81, at 1074.

109. *Id.*; see also Robert J. Stark et al., *Market Evidence, Expert Opinion, and the Adjudicated Value of Distressed Businesses*, 68 BUS. LAW. 1039, 1067 (2013).

to a call option “with a strike price equal to the market value of debt”<sup>110</sup> expiring on the date that the “equity is [expected to be] cancelled through bankruptcy.”<sup>111</sup> In this way, holding stock in the company “provides the shareholder the right, but not the obligation, to control the assets of the enterprise by paying off the outstanding debt.”<sup>112</sup> In other words, the firm’s shareholders hold a call option on the firm’s assets.<sup>113</sup> Thus, the court, by determining the point at which directors’ duties shift to creditors, provides the expiration date for valuation purposes of the equity holder’s option to purchase the assets of the company.

An option’s value increases as its time to maturity increases.<sup>114</sup> This is because the option has a minimum value of zero, while its maximum value can increase indefinitely.<sup>115</sup> Therefore, by using any method to determine a corporation’s point of insolvency other than by observing the market’s valuation of the company’s equity, a court effectively decreases the value of the company’s stock by setting a premature expiration date on the equity holders’ right to control the assets of the corporation.<sup>116</sup> Under the *Trados* test, however, shareholders must receive at least the market’s valuation of the company’s equity—which considers the company’s probability of generating future value—in order for directors to avoid liability.

Similar to a longer time to maturity, a higher volatility also increases an option’s value.<sup>117</sup> Therefore, directors of risky companies should remain duty-bound to equity holders deeper into distress than directors of less risky firms, as determined by the market’s assessment of the firm’s future potential. Accordingly, judging the fairness of a transaction using the market’s assessment of a company’s value avoids reducing the value of the pre-

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110. Stark et al., *supra* note 109.

111. Horowitz, *supra* note 81, at 1074.

112. Stark et al., *supra* note 109.

113. Fisher Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 649–50 (1973), available at <https://www.cs.princeton.edu/courses/archive/fall02/cs323/links/blackscholes.pdf>.

114. David Becker, ZACKS, *How Is a Call Option Price Affected by an Increase in Expiration Time?*, <http://finance.zacks.com/call-option-price-affected-increase-expiration-time-3699.html> (last visited Sept. 5, 2014).

115. Espen Haug, *European Options Can Fall in Value with Increased Time to Expiration!*, WILMOTT (Aug. 30, 2006, 11:32 PM), <http://www.wilmott.com/blogs/collector/index.cfm/2006/8/30/Option-Value-Falling-With-Increased-Maturity>.

116. Brian Broughman & Jesse M. Fried, *Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups*, 98 CORNELL L. REV. 1319, 1324 (2012) (stating that a company’s “sale eliminates any ‘option value’ (upside potential) of the common stock . . .”).

117. Karen Smith, *Why Does Option Value Increase with Volatility? – The “Balloon” Effect*, OPTIONSANIMAL (Sept. 7, 2012), <http://www.optionsanimal.com/why-does-option-value-increase-with-volatility-the-balloon-effect/>.

bankruptcy equity given that the market dictates the maturity date on the equity holders' options. For the reasons stated above, such an approach has greater effect on the value of volatile companies than those with stable cash flows and growth projections. Thus, the *Trados* approach allows directors maximum time to attempt to regain value for the common shareholders, and is the appropriate method to evaluate the fairness of a distressed-company transaction.

### B. *Proposed Solution to the Duties Shift*

Although *Trados* appropriately assesses insolvency, it does not answer whether (1) director duties *shift* from common shareholders to creditors,<sup>118</sup> or whether (2) directors *do not breach* their fiduciary duties that remain to the common shareholders when acting in the creditors' best interests.<sup>119</sup>

The former creates an affirmative duty to act in the best interest of the firm's creditors. The latter permits director action on behalf of the creditors; however, the directors' duties do not shift to the creditors. For example, in *Trados*, Vice Chancellor Laster states the general rule that "in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders."<sup>120</sup> The Vice Chancellor, however, later states that

[t]he conditions *Trados* faced were not as dire as the defendants claimed, but they were suboptimal. In light of this reality, the directors breached no duty to the common stock by agreeing to a Merger in which the common stock received nothing. The common stock had no economic value before the Merger, and the common stockholders received in the Merger the substantial equivalent in value of what they had before.<sup>121</sup>

Essentially, the directors' duties remained to the common shareholders notwithstanding financial distress, but because the

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118. *Equity-Linked Investors, LP v. Adams*, 705 A.2d 1040, 1042 (Del. Ch. 1997); *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) (stating that "the general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent 'special circumstances,'" including insolvency); *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 WL 277613, at \*1155 (Del. Ch. Dec. 30, 1991) (noting that "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").

119. *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 78 (Del. Ch. 2013) (holding that even when the stockholders' equity was valueless, "no breach of duty occurred because the Merger price was fair").

120. *Id.* at 42.

121. *Id.* at 77-78.

transaction satisfied the court's entire fairness scrutiny, no breach occurred.

A potential solution is to apply the *Trados* approach during distress and the actual shift during legal insolvency. For example, in a distressed yet solvent corporation, directors owe their fiduciary duties to the common shareholders, but may also liquidate so long as equity holders "receive the substantial equivalent in value of what [they] had before."<sup>122</sup> Once insolvent, however, the directors' duties *shift* from the common shareholders to the preferred shareholders and creditors, requiring management on behalf of the contractual claimants.

Such a solution creates certainty by determining in whose interest directors must manage during corporate decline. For example, directors of a distressed company *may* attempt to provide value to the equity shareholders, however, any sale or liquidation in the creditors' interest that provides the common shareholders with the "substantial equivalent . . . of what they had before"<sup>123</sup> will not constitute a breach of duty. Once the corporation is insolvent, however, directors *must* ensure that creditors recoup maximum value from the faltering company. This approach is consistent with the view of the Delaware Supreme Court that

the directors owe their fiduciary obligations to the corporation and its shareholders. While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights. Delaware courts have traditionally been reluctant to expand existing fiduciary duties. Accordingly, "the general rule is that directors do not owe creditors duties beyond the relevant contractual terms."<sup>124</sup>

Thus, while creditors and preferred shareholders are able to protect their rights via contract at the outset of their investment, ordinary shareholders must rely on the directors' fiduciary duties to do the same. This approach protects the shareholders' reliance on fiduciary protections until the market has determined that there is no "reasonable prospect of generating value for the common stock," justifying a shift in director duties to the creditors.<sup>125</sup>

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122. *Id.* at 76.

123. *Id.*

124. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007) (footnotes omitted).

125. *Trados*, 73 A.3d at 76.

## CONCLUSION

Of the variety of methods used by the Delaware Court of Chancery to determine the point of insolvency, its approach in *Trados* is the most appropriate. It considers not only the corporation's financial metrics, but also other firm characteristics affecting a corporation's ability to generate future value.

Furthermore, the Delaware Court of Chancery has used two methods to effectuate the duty shift in distressed and insolvent corporations. The first is an affirmative shift in directors' fiduciary duties from equity holders to creditors. The second allows directors the freedom to act on behalf of creditors (though duties remain to the common shareholders) so long as equity holders receive the "substantial equivalent in value of what they had before."<sup>126</sup>

Delaware courts must develop a systematic application of the above two methods to create certainty regarding to whom directors owe their duties. The approach most consistent with the rights and risks of debt and equity financing is shifting the directors' duties to the creditors only when the company is insolvent. Until that point, the directors of a distressed yet solvent company should owe their fiduciary duties to the common shareholders and yet still have the freedom to liquidate in the creditors' interest—so long as the equity holders receive the substantial equivalent of what they had prior to the transaction.

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126. *Id.*

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