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A REJECTION OF ABSOLUTIST DUTIES AS A BARRIER TO CREDITOR PROTECTION: FACILITATING DIRECTORIAL DECISIVNESS SURROUNDING INSOLVENCY THROUGH THE BUSINESS JUDGMENT RULE

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INTRODUCTION

Fiduciary duties restrain the otherwise largely unfettered control of directors in directing corporate activity. These duties are generally conceptualized as being owed to the corporation for the ultimate benefit of its shareholders.[1] As the scope of corporate legal reasoning expands, so too have attempts to recognize the entitlement of interested parties other than shareholders to invoke fiduciary protections.[2] A significant hindrance to the discharge of these potentially expansive duties within shareholder primacy is judicial and regulatory emphasis on bright-line constructions of insolvency whereby duties change only once the corporation has become insolvent.

This Article draws attention to the difficulties that directors may face when seeking to discharge their duties as a corporation approaches insolvency, in particular when directors must discern the point at which a corporation has become insolvent. It argues that discretion allowed to directors by the business judgment rule will be crucial to overcoming these difficulties. To do this, this article examines the nature of duties owed by directors both before and after insolvency, and accepts the stance taken by Delaware courts in recent years towards an expansive understanding of a corporation's interests upon insolvency.[3] It then considers unresolved issues arising from how insolvency is defined and argues that the current view of insolvency as a bright-line threshold is overly simplistic and overlooks the multitude of metrics used to measure a corporation's financial condition. In its stead, this Article posits that the business judgment rule provides sufficient latitude for directors to navigate commercial activity nearing insolvency.

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1. "[T]he interests of the company as an artificial person cannot be distinguished from the interests of the persons who are interested in it." Brady v. Brady (1987) 3 BCC 535, 547 (appeal taken from Eng.).

2. Stakeholder theory is nothing new in corporate jurisprudence. *See generally* E. Merrick Dodd Jr., *For Whom Are Corporate Managers Trustees*, 45 HARV. L. REV. 1145 (1932); A.A Berle Jr., *For Whom Are Corporate Managers Trustees: A Note*, 45 HARV. L. REV. 1365 (1932). However, there is a resurgence on the topic, some of which has occurred via statutory reform outside the United States. *See* Companies Act 2006, c. 46 § 172 (UK); *see also* Christopher Brunner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385 (2008).

3. *See* Quadrant Structured Prod. Co. v. Vertin, 102 A.3d 155, 174 n.4 (Del. Ch. 2014); N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

Part I will provide an overview of duties owed by directors to the corporation and how the interests of corporations are understood by reference to the interests of shareholders. It examines whether the law prefers directors to unreservedly pursue shareholder wealth without regard for the interests of other stakeholders—termed absolute shareholder primacy—or whether directors can legitimately consider non-shareholder interests when engaging in commercial activity—termed non-absolute shareholder primacy. Part II examines the role of the business judgment rule in shielding directors from liability when they exercise discretion to balance the interests of stakeholders upon insolvency. Part III outlines changes to the duties of directors upon insolvency. It provides an overview of the requirement for directors to consider the interests of creditors along with the interests of shareholders and other stakeholders within a widened pool of relevant interests. It argues that conceiving insolvency as a bright-line threshold creates difficulties for directors who must navigate their corporations through the uncertainties of financial distress. Furthermore, this part explores the reality of solvency not as an absolute state, but rather as a spectrum wherein insolvency can continue to worsen. Part IV argues that the business judgment rule may provide a solution to these difficulties by giving deference to the directors' good faith assessments of the corporation's financial condition. This would mitigate the harshness of the bright-line insolvency threshold and provide flexibility to directors when navigating financial distress. Finally, Part V provides guidance to directors when acting under the auspices of the business judgment rule. This can be achieved by exploring how the interests of stakeholders, namely shareholders and creditors, should be reconciled when the corporation is both solvent and insolvent. It argues that directors are more than capable of balancing the interests of parties involved in the corporation, provided that their discretion remains shielded by the business judgment rule.

I. AN OVERVIEW OF SHAREHOLDER PRIMACY AND ITS IMPLICATIONS FOR CORPORATE BOARDS

A. SHAREHOLDER PRIMACY

As Keay opines, "[w]hile shareholder primacy acknowledges the fact that constituencies other than the shareholders play an important role in the life of a corporation, its aim is to ensure maximization of shareholder wealth."[4] A director's duties are perceived through this objective. While directors do not owe duties to shareholders, they do owe duties to the corporation and therefore owe loyalty to the corporation's objective. Deviating from this objective is occasionally supported academically but is

4. ANDREW KEAY, THE CORPORATE OBJECTIVE 280 (1st ed. 2011); *see also* Adams, Hermalin & Weisbach, *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. ECON. LITERATURE 58 (2010).

seldom applied by courts. This judicial reluctance is especially evident in American jurisprudence:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of the means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote themselves to other purposes.[5]

This exercise of discretion is generally referred to as the shareholder primacy model. It first arose in response to the power of corporate entities and their directorships, and has "grown rapidly, so much so that the 'administration of corporations', [has] become 'the crux of ... industrial life.'"[6] In seeking to place legal restraints on the economic power of corporate boards, Berle asserted that "managerial powers were held in trust for stockholders as the sole beneficiaries of the corporate enterprise."[7] Equating shareholders to equitable beneficiaries overcomes the difficulty at law, whereby shareholders are not legally the owners of a corporation and therefore cannot be the direct legal recipient of directorial concern. Accordingly, the restraints placed on directors under this model are "outgrowths of 'equitable rules somewhat analogous to those which apply in favour of a *cestui que trust* to the trustee's exercise of wide powers granted to him in the instrument making him a fiduciary.'"[8] Shareholder primacy therefore expands the obligations and duties of directors so that they are not merely acting as a constituent body or as an employee of the corporate entity, but rather as an agent of the corporation. These legal obligations are informed by the ultimate underlying objective of directorial operation: maximizing shareholder wealth.

B. ABSOLUTIST AND NON-ABSOLUTIST SHAREHOLDER PRIMACY

Shareholder primacy arguably means that "maximizing shareholder wealth is the corporation's *only* true concern, its *raison d'*ê*tre.*"[9] However, seminal case law allows for a less absolutist view, meaning that while shareholders are the dominant concern, the interests of other parties cannot be completely disregarded. Indeed, *Dodge* referenced the primary purpose of corporations and found that alternative interests cannot attain primacy over

5. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).
6. Paddy Ireland, *Back to the Future? Adolf Berle, the Law Commission and Directors' Duties*, 20 CO. LAW. 203, 205 (1999).
7. *Id*.
8. *Id.* (quoting A.A Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931)).
9. Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163, 164 (2008) (emphasis added).

shareholder wealth maximization.[10] *However,* even where one accepts that shareholder wealth maximization is the primary consideration of corporate boards, it is not necessary for boards to discount the interests of other stakeholders entirely. Instead, boards are fully capable of considering the consequences their decisions will have on other stakeholders and whether these consequences will ultimately impact the corporation or the shareholders.[11] Thus, directors should be able to consider the wider implications of their decisions without abandoning shareholder primacy as their dominant concern.

Though shareholder primacy remains the key rationale, the question of how alternative constituencies may inform business strategy has triggered significant academic and judicial debate. Mirroring the aforementioned dichotomy of absolute and non-absolute shareholder primacy deriving from *Dodge,* academics have disagreed on the appropriate tact to be taken. Indeed, this question played a central role in the seminal Berle[12] and Dodd[13] discourse. *Dodge* itself has fallen under increased scrutiny as a "charming and easily understood fable of shareholder wealth maximization."[14]

Shlensky offers an alternative stance that remains rooted in shareholder primacy by considering the view that decline in the surrounding neighborhood is ultimately harmful to the shareholders' interests[15] because the "short-term profits. . .made might be off-set by a diminution of . . . reputation."[16] This stance retains shareholders principally as the sole recipient of directorial focus, but conceptualizes the "ratable benefit" to shareholders as being legitimately informed by alternative constituency interests.[17] These ratable benefits may include sustaining long-term returns through improved employee or supplier relations or engendering goodwill through community engagement.

Stout argues that these cases are merely outdated dicta from states that are hardly known as bastions of corporate jurisprudence, especially in contrast to Delaware.[18] However, older Delaware caselaw presents contradictory views on this issue. The rule in *Katz v. Oak Industries* provides insight into the views adopted by Delaware courts on the conflict illustrated

10. *Dodge*, 170 N.W. at 684.

11. David Millon, *Radical Shareholder Primacy*, 10 U. ST. THOMAS L. J. 1013, 1016 (2013).

12. "[A]ll powers granted to a corporation or the management of a corporation . . . are necessarily and at all times exercisable *only* for the ratable benefit of all the shareholders as their interest appears." A.A Berle, *supra* note 8, at 1049 (emphasis added).

13. "[T]here is in fact a growing feeling not only that business has responsibilities to the community but that our corporate managers who control business should voluntarily and without waiting for legal compulsion manage it in such a way as to fulfill those responsibilities." Dodd, *supra* note 2, at 1153–54.

14. Stout, *supra* note 9, at 175.

15. Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968).

16. Keay, *supra* note 4, at 212.

17. A.A Berle, *supra* note 8.

18. Stout, *supra* note 14, at 166–67.

in *Dodge* and *Shlensky*. *Katz* states that courts should give deference to directors who "attempt" to favor "the long-run interests of the corporation's stockholders" at the occasional "expense of others."[19] This view preserves shareholders' interests as the sole concern of directors, but grants broad deference to directors in deciding whether to pursue short-term or long-term gain and in identifying how the interests of other stakeholders fit into the objective they choose. Ultimately, *Katz* affirms that the interests of other stakeholders are not themselves the end-goal for directors to pursue, meaning that, much like in *Dodge,* shareholders remain the board's primary consideration.

Unocal Corp. v. Mesa Petroleum Co. contains an even more expansive implication, stating that "the board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which *includes* stockholders,"[20] thereby implying that shareholders are but one constituency to be considered. However, while some of the judicial observations in *Unocal* can have general application, the case itself concerned a takeover bid—a particular circumstance in commercial life in stark contrast to day-to-day business activity.[21] Additionally, *Quadrant Structured Product Co. v. Vertin* and *North American Catholic Education Programming Foundation, Inc. v. Gheewalla* suggest that while shareholders retain primacy and creditors are incapable of independently thwarting shareholder primacy, creditors' interests may appropriately influence the manner in which directors perceive shareholder value maximization to best be realized.[22]

II. SHAREHOLDER ABSOLUTISM AND THE BUSINESS JUDGMENT RULE

The broad scope of discretion afforded to directorial decision-making in Delaware should not be understated. Shielding this discretion from much substantive judicial scrutiny is the business judgment rule.[23] The business judgment rule exemplifies the deference afforded by courts to board decision-making by playing a role in thwarting claims by corporate stakeholders.[24]

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19. Katz v. Oak Indus. Inc., 508 A. 2d 873, 879 (Del. Ch. 1986).

20. Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946, 954 (Del. 1985) (emphasis added).

21. For a discussion on the *Unocal* and *Revlon* standards for deciding the interests of the company during a change of control and the implications of these standards for corporate governance generally, *see* LEO E STRINE JR., RESTORATION: THE ROLE STAKEHOLDER GOVERNANCE MUST PLAY IN RECREATING A FAIR AND SUSTAINABLE AMERICAN ECONOMY A REPLY TO PROFESSOR ROCK 9-15 (2020).

22. *See* Quadrant Structured Prod. Co. v. Vertin, 102 A.3d 155, 174 n.4 (Del. Ch. 2014); N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

23. The business judgment rule is the "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

24. *See generally* Katz v. Oak Indus. Inc., 508 A. 2d. 873 (Del. Ch. 1986).

Deference to directors allows the board to unilaterally decide whether the interests of the corporation are to be understood by sole reference to shareholders or with a more expansive consideration of stakeholder interests necessary to further the success of the corporation. If directors did not have such deference, then the board may fail to consider the interests of stakeholders in any capacity. Instead, directors would myopically pursue shareholder primacy so as to avoid litigation brought by shareholders. Therefore, the facilitation of wider directorial discretion by the business judgment rule or any other means enables the consideration of wider constituency interests, albeit in a limited capacity.

To facilitate directorial authority, the business judgment rule extends its protection in the following manner:

> [D]irectors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, *act in a manner that cannot be attributed to a rational business purpose* or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.[25]

According to Strine, while "directors must make stockholder welfare their sole end, . . . other interests may be taken into consideration [but] only as a means of promoting stockholder welfare."[26] Therefore, when identifying the rational business purpose for their decisions, directors may account for the relevance of stakeholder interests in maximizing the value of the corporation for its shareholders. Given that the tasks of decision-making and identifying these rational business purposes is assigned to directors, the capacity for shareholders to repudiate the assertions of the board are significantly limited.[27] In realizing this, "case law interpreting the business judgment rule often explicitly authorizes directors to sacrifice shareholders' interests to protect other constituencies."[28] Therefore, *Dodge* and its ilk would be better understood as "evidence that corporate directors *ought* to maximize shareholder wealth [which is] what many believe the proper purpose of a well-functioning corporation should be."[29]

This does not preclude other interests from consideration, especially where the corporation faces either a change of control[30] or a real risk of

25. Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000) (emphasis added).

26. *See* Leo E. Strine Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 768 (2015).

27. *Id.*

28. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 303 (1999).

29. Stout, *supra* note 9, at 172–173.

30. *See* STRINE JR., *supra* note 21. *See also,* Leo E. Strine, Jr., *The Social Responsibility of Board of Directors and Stockholders in Change of Control Transactions: Is There Any 'There' There?*, 75 U.S.C. L. REV. 1167 (2002).

insolvency.[31] The role of the business judgment rule is therefore twofold: it firstly preserves the discretion of directions, and in turn, allows the board to adopt a non-absolutist shareholder primacy model. This means that while corporations will operate for the ultimate benefit of shareholders, the interests of other stakeholders will remain relevant in the exercise of board discretion. There is ongoing debate over whether the business judgment rule amounts merely to a form of judicial deference or abstention,[32] or whether it amounts to an active standard of liability.[33] However, this debate is irrelevant as in either case the business judgment rule preserves the discretion of the board, which in turn facilitates the balancing of interests between corporate stakeholders.

A. AN EXPANSIVE BUSINESS JUDGMENT RULE: CONCERNS FOR ACCOUNTABILITY AND SELF-DEALING

Criticism of the business judgment rule often centers upon it weakening board accountability. By limiting the potential for shareholders to sue, there are fewer avenues for effective oversight. These concerns may be exacerbated where directors can account for interests other than the shareholders'. Even where shareholder welfare remains the "sole end" of corporate purpose,[34] the more discretion afforded to directors, the more difficult it becomes for shareholders to successfully argue that the directors' approach towards promoting shareholder welfare was incorrect.[35] This is coupled by the fact that the stakeholders, whose interests may be considered by directors, are not themselves given a cause of action and the role of oversight remains one entrusted to shareholders. One concern is that the more protective the business judgment rule is of director discretion, the greater the risk of self-dealing or other board-associated agency costs.[36] Reinforcing these concerns is the limited review contemplated by the business judgment rule. As Chancellor Allen concluded, "such limited substantive review as the rule contemplates (i.e., is the judgment under review 'egregious' or

31. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 788 n. 53 (Del Ch. 2004) (affirming that directors can account for the appropriate risks the company should undertake, and the implications of said risks for those involved in the company, when insolvency is an issue.)

32. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 95 (2004).

33. *Id.* at 90.

34. Strine Jr., s*upra* note 26, at 768.

35. A clear example of this difficulty has arisen in the United Kingdom which has put this enlightened shareholder model into legislation but has given significant discretion to directors in deciding how stakeholder interests serve the interests of shareholders. *See* Daniel Attenborough, *Misreading the Directors' Fiduciary Duty of Good Faith*, 20 J. CORP. L. STUD. 73–98 (2020).

36. *See e.g.,* Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1 (2011).

'irrational' or 'so beyond reason,' etc.) really is a way of inferring bad faith."[37]

The most common function of the business judgment rule is to shield directors from claims asserting breaches of the duty of care.[38] This may present a difficulty for directors who seek to balance the interests of stakeholders and any conflict that may arise between shareholders and creditors when the corporation is at or nearing insolvency. The reason for this difficulty is that cases concerning how directors conceive of a corporation's interests are typically cases concerning the directors' duty of loyalty, not the duty of care. Nevertheless, while caselaw concerning the duty of care appears the most abundant in business judgment rule analyses, the rule can shield directors for claims over breaches of other duties provided that directors act in good faith and in a manner "attributed to a rational business purpose."[39] Accordingly, if wider constituency considerations that ultimately promote shareholder interests were to inform a rational business purpose, then the business judgment rule may extend to business strategies past bare shareholder primacy.

The deference to directors is understandable because the aim of the business judgment rule is not to restrict directors acting in good faith. Instead, the focus is to detect bad faith decision-making, particularly in "the classic self-dealing loyalty context [wherein] directors will shoulder the burden [of proof]"[40] without the protection of the business judgment rule. The business judgment rule does not apply in instances of any "motives alleged . . . [involving] fraud, illegality or conflict of interest."[41] This ameliorates a major concern: the two-masters problem[42]—the concern that once directors are entitled to consider the interests of competing stakeholders, it becomes difficult to hold them accountable to the interests of any one group of interested parties[43] making them answerable to no party.[44] This lack of accountability allows directors to engage in self-dealing, but the business

37. *In re* RJR Nabisco, Inc. Shareholders Litig., 1989 WL 7036, at *13 n.13 (Del. Ch. Jan. 31, 1989).

38. "[T]he one thing about the business judgment rule on which everyone agrees is that it insulates directors from liability for negligence." STEPHEN BAINBRIDGE, CORPORATE LAW (4th ed. 2020) §6.1.

39. Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000).

40. Lyman Johnson, *Unsettledness Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 DEL. J. CORP. L. 405, 427 (2013).

41. *Shlensky v. Wrigley,* 237 N.E.2d 776, 780 (Ill. App. Ct. 1968).

42. "A manager who is told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither." FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 38 (1991). *See also,* Elaine Sternberg, *The Defects of Stakeholder Theory*, 5 CORP. GOVERNANCE INT'L R. 3 (1997).

43. Easterbrook & Fischel, *supra* note 42.

44. For an analysis of the interrelationship between shareholder disempowerment and board accountability, *contrast* Stephen Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) *with* Lucian Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 833 (2013).

judgment rule will not shield self-dealing directors. These directors will face heightened scrutiny for breaches of their duty of loyalty. Directors who engage in good faith balancing of stakeholder interests with an eye toward shareholder wealth maximization, provided they are not self-dealing, enjoy wide deference through the business judgment rule.

B. BALANCING THE INTERESTS OF CONSTITUENCIES AND THE AUTHORITY OF DIRECTORS

One concern may be that expansive recognition of constituency interests may itself be unduly restrictive of directorial decision-making. Jensen raised the concern that "[i]t is logically impossible to maximize in more than one dimension at the same time."[45] This concern arises where directors struggle to find an appropriate balance between competing interests, which may lead to less efficient outcomes than directors who pursue shareholder value single-mindedly. However, such a concern is less applicable to shareholder value maximization than it is to a scenario where directors can engage in stakeholder pluralism, that is, where stakeholder interests can be pursued alongside shareholder wealth as a legitimate end-goal. The duty of directors currently operable in Delaware does not accept that non-shareholder interests are themselves an end-goal, but rather simply a means to the end of creating shareholder wealth. This is compounded by the fact that shareholders can instigate claims on behalf of the corporation.[46] The other stakeholders are not themselves empowered to sue for breaches of these duties, even if directors have considered their interests when deciding business strategy. Shareholders may be unhappy with how directors integrate the interests of stakeholders into their business strategy. The widened scope of directorial discretion for integrating stakeholder interests may in turn create more opportunities for shareholder dissatisfaction. However, provided that directors are engaging in a good faith consideration of stakeholder interests towards a rational business purpose benefiting shareholders, they will remain shielded by the business judgment rule. Accordingly, any dissatisfied shareholders would struggle to successfully claim disloyalty on the part of the director. While directors may understandably be cautious over the risk of suit or internal challenge through shareholder meetings,[47] this caution would not be so significant as to prevent good faith business decisions from directors that consider the wider interests of stakeholders.

45. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 7 EUROPEAN FIN. MGMT. 297, 300–301 (2001).

46. Lucian A. Bebhuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance,* 106 CORNELL L. REV. 91, 108–116 (2020).

47. For a discussion on these risks of suit and the caution of directors, see James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984).

A useful lens for examining the latitude afforded to directors is Bainbridge's view of director primacy[48] and his argument that creating a wider scope of legitimate commercial strategy ensures the preservation of Kenneth Arrow's authoritarian decision-making in directorial conduct.[49] "[D]irector primacy accepts shareholder wealth maximization as the proper corporate decisionmaking norm, but rejects the notion that shareholders are entitled to either direct or indirect decisionmaking control."[50] Whether one advocates or criticizes director primacy, one must recognize the rather fundamental underlying concept of separation of ownership and control,[51] without necessarily approving of its normative consequences.[52] The value to a director primacy analysis here is highlighting the implications for corporations where directors are given increased latitude towards their decision-making. It does not reach any value judgment on whether it is preferable economically or socially to consider interests beyond those of shareholders. Instead, what can be acknowledged through director primacy is that the greater the deference for directors to consider stakeholder interests, the greater the discretion enjoyed by the board, both generally and where the board seeks to shield itself through the business judgment rule. Ultimately, existing law does not afford unfettered discretion to directors. This means that any asserted primacy of directors is not absolute. Non-shareholder constituencies do not themselves enjoy a cause of action and shareholders wealth maximization remains the objective of directors even if their path to achieving this objective is varied.[53]

48. *See* STEPHEN BAINBRIDGE, DIRECTOR PRIMACY: THE MEANS AND ENDS OF CORPORATE GOVERNANCE (2002), https://ssrn.com/abstract=330582; Bainbridge, *supra* note 32, at 111.

> 49. Kenneth Arrow's seminal work on organizational decisionmaking defined two basic decisionmaking structures: 'consensus' and 'authority.' Consensus is utilized where each member of the organization has identical information and interests and will therefore select the course of action preferred by all the other team members. In contrast, authority-based decisionmaking structures arise where team members have different interests and amounts of information. They are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.

Director Primacy, *supra* note 48, at 13–14; *See also* KENNETH ARROW, THE LIMITS OF ORGANIZATION (1974).

50. Director Primacy, *supra* note 48, at 21–22.

51. *See generally* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301 (1983); Michael C. Jensen & William H Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

52. For a thorough review of director primacy, *see* Brett McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of The New Corporate Governance in Theory and Practice,* 34 DEL. J. CORP. L. 139 (2009).

53. Strine Jr., s*upra* note 26, at 768.

III. DIRECTOR'S DUTIES UPON INSOLVENCY: SHIFTS IN DUTY AND DECISION-MAKING STAGNATION

Having established the interrelationship of the business judgment rule and directorial consideration of wider constituency interests, consideration must be given to the director's tasks surrounding corporate insolvency. The business judgment rule does not cease to apply when a firm is insolvent. The next section of this Article will look at the moment upon which insolvency is triggered and whether the business judgment rule may alleviate the difficulties created by a bright-line understanding of insolvency.

A. DISCHARGE OF DUTIES UPON INSOLVENCY: THE UNDERLYING RATIONALES

Delaware jurisprudence offers dual rationales for shifting fiduciary protection upon insolvency. Either "'[a]n insolvent corporation['s] property may be administered . . . as a trust fund for the benefit of creditors'"—the trust fund theory—or that "the directors owe fiduciary duties to the creditors because the 'residual claimants' of corporate assets are the constituency to which directors owe their allegiance [that being] after insolvency . . . the creditors"—the residual claimant theory.[54]

In either instance, the goal for directors shifts and the ultimate pursuit of shareholder wealth maximization may no longer be seen as the appropriate objective for guiding their commercial strategy. Were the motivations of directors to still pursue the wealth of shareholders in insolvency, directors would be perversely incentivized to take increased risks on behalf of shareholders who have nothing to lose and everything to gain, thereby creating a race to the bottom.[55] What this risk-taking amounts to will vary between cases but in the extreme might mean outright gambling.[56] Caselaw assessing the status quo of constituencies in insolvency is particularly reflective of how wider constituency recognition—with particular emphasis on creditor interests—should be best invoked.[57]

54. Henry T. C. Hu & Lawrence Jay Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1323 (2007).

55. Paul Davies, *Directors Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency*, 7 EUROPEAN BUS. ORG. L. REV. 301 306 (2006).

56. "So what's a desperate founder to do? Smith impulsively flew to Las Vegas and played blackjack with the last of the company money. Amazingly, when he came back the next week, he had turned the remaining $5,000 into $27,000— just enough for the company to stay in operation for another week" discussing a Fedex executives risky behaviour approaching insolvency. *See* M.H.C Bakker and R.J de Weijs *Basic Introduction to Expected Value Analyses and Investments Through the Corporate Form* 13 (Amsterdam Law School Legal Studies Research Paper No.2019-04).

57. This view is particularly prevalent where the trust fund theory has found root. *See,* Gregory V. Varollo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239, 250 (1992).

One question that has arisen is whether creditor interests become the singular focus of fiduciary consideration upon insolvency or comprise part of a wider residual corporate interest.[58] Where there is a shift to true "creditor paramountcy," the interests of an insolvent corporation "are in reality the interests of the existing creditors *alone*,. . . directors must put the interests of creditors before any other concern . . . and perhaps to the total exclusion of others' interests."[59] This approach may be favored by those averse to any semblance of a two-masters problem as it transfers the entirety of fiduciary protection to creditors.[60] This would reduce the potential for directors acting in bad faith to abuse their latitude were they to balance the interests of shareholders and creditors. It would also reduce potential difficulties for directors acting in good faith who struggle to strike a balance between competing interests. However, as discussed below, this absolute shift is particularly problematic since identifying the precise moment at which a corporation becomes insolvent can prove challenging. *Gheewalla* and *Quadrant* confirmed that creditor interests do not become paramount at insolvency, but rather form part of a wider pool of interests that directors must consider while navigating insolvency.[61] This is because the duties of directors remain owed to the corporation at all times even when the residual interests in the corporation have changed due to insolvency.[62] Silberglied rightfully noted:

> The Gheewalla court recognized that upon insolvency, what is in the best interests of the corporation often departs from what is in the best interests of stockholders, noting that '[w]hen a corporation is insolvent . . . its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.' Thus, the directors' duty is 'to maximize the value of the insolvent corporation for the benefit of all those having an interest in it'-whether creditors or stockholders.[63]

Under this view, insolvency triggers the creation of an expansive residual interest,[64] which ameliorates concern of an absolutist model by rejecting a significant shift between constituencies in favor of a consolidated

58. Quadrant Structured Prod. Co. v. Vertin, 102 A.3d 155, 174 n.4 (Del. Ch. 2014); *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns, Corp., No. 12150, 1991 WL 277613, at *34 n. 55 (Del. Ch. Dec. 30, 1991).

59. Andrew Keay, *Directors' Duties and Creditors' Interest*, 130 LAW Q. REV. 443, 444 (2014) (emphasis added).

60. *Id.*

61. *See generally* Quadrant, 102 A.3d 155; N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

62. Jared A Ellias & Robert Stark, *Bankruptcy Hardball*, 108 CAL. L. REV. 745, 761 (2020).

63. Russell C. Silberglied, *Litigating Fiduciary Duty Claims in Bankruptcy Court and Beyond: Theory and Practical Considerations in an Evolving Environment*, 10 J. BUS. & TECH. L. 181, 194 (2015) (citing Gheewalla, 930 A.2d at 103).

64. Hu & Westbrook, *supra* note 54, at 1323.

consideration.[65] This allows directors to balance the risks of further losses to creditors and retains the possibility, real or remote, that the corporation can return to a solvent position.

While the current approach forsakes the absolute shift that the trust fund theory may suggest is necessary, endemic to both approaches is the difficulty in identifying the trigger of insolvency. Under the *Quadrant*-*Gheewalla* model of wider consolidated constituency consideration, there is an explicit rejection of the court's view in *Credit Lyonnais*[66] calling for increased consideration of non-shareholder interests while approaching insolvency:

> When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.[67]

This suggests a strict dichotomy between pre- and post-insolvency, which not only does little to mitigate the moral hazard of shareholder orientation in nearing insolvency, but also restrains the capacity of directors to gradually shift strategy relative to solvency. This is because shareholder interests are viewed as primary prior to insolvency and the increasingly salient risks to creditors should not be capable of ousting shareholders from their dominant position. Accordingly, directors may struggle to incrementally change strategy pursuant to the risks of insolvency if their duties do not envisage any change prior to insolvency. As a result, irrespective of whether post-insolvency directorial attention is afforded to creditors alone[68] or a consolidated body of residual claimants,[69] the shift is triggered at a bright-line threshold.

B. AFFIRMING BRIGHT-LINE INSOLVENCY: THE REJECTION OF PRE-INSOLVENCY CHANGES IN DIRECTOR'S DUTIES

Delaware courts have rejected the notion that any alteration of fiduciary duty occurs when the corporation is in the zone of insolvency, and thereby affirming insolvency as the singular underlying metric for expanding directorial consideration:

> After *Gheewalla*, actual insolvency is the relevant transitional moment. Of course, the point at which a corporation becomes insolvent remains

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65. *Id.* at 1342 n.68.

66. Credit Lyonnais Bank Nederland, N.V. v. Pathe Comms, Corp., No. 12150, 1991 WL 277613, at *34, n. 55 (Del. Ch. Dec. 30, 1991) (standing for the proposition that the interests to which a director should consider may change prior to insolvency, i.e., in the zone or vicinity of insolvency).

67. N. Am. Cath. Educ, Programming Found. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).

68. Keay, *supra* note 59, at 444.

69. Hu & Westbrook, *supra* note 54, at 1342.

> debatable, is difficult to perceive in real-time, and can only be determined definitively by a court in hindsight. I suspect that when Chancellor Allen spoke of "the vicinity [or zone] of insolvency," [in *Credit Lyonnais*] he intended to recognize these practical ambiguities, rather than to expand the law.[70]

This not only rejects the zone of insolvency approach; it suggests that *Credit Lyonnais* cannot serve as precedent for such an assertion. Furthermore, in affirming the supremacy of a bright-line solvency and insolvency dichotomy, this dictum identifies the difficulty that this model creates—the ex-ante identification of insolvency. When a corporation faces financial difficulty, it is exceedingly more difficult in the moment to identify precisely when insolvency occurs than it is to identify insolvency in hindsight. Discerning insolvency is problematic even in the abstract as it lacks any singular or cohesive definition, an issue illustrated by Finch and Milman:

> A company is insolvent for the purpose of the law if it unable to pay its debts. … There is, [however], no single legal definition of inability to pay debts… The two main reference points regarding the inability to pay debts are the "cash flow" and the "balance sheet" tests … [and] defining insolvency at law is further complicated by the use of further tests … [such as] if [the company's] assets are insufficient for the payment of its debt and other liabilities together with the expenses of winding up.[71]

This theoretical confusion does not help directors tasked with identifying ex-ante when the insolvency threshold has been reached—a task capable of definitive determination "by a court in hindsight."[72] This difficulty in identification may hamper directorial decisiveness at a crucial moment when directors may be unsure of the propriety of any given strategy in light of the potential expansion of protected residual claimants.

C. THE UNCERTAINTY OF INSOLVENCY—BRIGHT-LINE OR OTHERWISE

Uncertainty surrounding the determination of insolvency has contributed to reluctance in recognizing a threshold triggering the point at which a corporation enters the even vaguer zone of insolvency.[73] It has been argued that the difficulties in defining the scope of this zone and using such a vague trigger to determine when directors must begin balancing interests may

70. Quadrant Structured Prods. Co. v. Vertin 102 A.3d 155, 174 n.4 (Del. Ch. 2014).
71. VANESSA FINCH & DAVID MILMAN, CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES, 119–21 (3rd ed. 2017).
72. Quadrant Structured Prod. Co. v. Vertin 102 A.3d 155, 174 n.4.
73. *See* Simon Passfield, *When Creditors' Interests Intrude: The Effect of Doubtful Solvency on Directors' Duties*, GUILDHALL CHAMBERS 176 (2013).

discourage board action.[74] Keay acknowledged the acute difficulty in describing the zone of insolvency:

> Although insolvency may suffer from imprecision, prescribing the triggering of the duty when the company is near to insolvency suffers even more from that problem, for it is impossible in many situations to say from what point a company is nearing insolvency, except where one is viewing the company's dealings ex post facto.[75]

While this skepticism supports Delaware courts' rejection of changing duties pre-insolvency,[76] it may equally overlook that expansive constituency consideration pre-insolvency does not necessarily entail discerning any bright-line threshold for the zone of insolvency akin to that demanded by stricter insolvency standards. Instead, one may expect an appreciable margin of conduct that is deemed acceptable in its proportionality either by the courts ex-post or the board ex-ante—with the choice between the two being a question of how duties are framed and how the business judgment rule operates.

D. The Perverse Incentivization of Shareholders Approaching Bright-Line Insolvency

As it stands now, "the focus for Delaware directors does not change" until the bright-line threshold is crossed, directors face a moral hazard in having to abide by shareholder incentives even where those incentives become perverse when approaching insolvency:

> Once the shareholders' equity has been dissipated*, or has been reduced to a very low level* and there is no prospect of its being rebuilt through the company's established business model, the incentive for the company controllers (if acting in the shareholder interest) is to take on excessively risk projects, for their attention can focus exclusively on the potential upside of decisions.[77]

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74. Both academic and judicial discourse offer various definitions for the zone of insolvency ranging from the zone of insolvency, financial distress, doubtful insolvency to mere financial difficulty. These have arisen in a multitude of common law jurisdictions and are well exemplified in Delaware and the United Kingdom. Finch & Milman, *supra* note 71. *See also* Colin Gwyer & Associates Ltd. v. London Wharf (Limehouse) Ltd. [2002] EWHC 2748, [74]. ; City of London Group Plc. v. Lothbury Financial Services Ltd. [2012] EWHC 3148, [54]; Re Idessa (UK) Ltd (In Liquidation) [2011] EWHC 804.

75. Andrew Keay, *The Director's Duty to Take into Account the Interests of Company Creditors: When Is It Triggered?*, 25 MELBOURNE UNIV. L. REV. 315, 327 (2001).

76. Shifting fiduciary duties within the zone of insolvency was contemplated in the *Credit Lyonnais* case. However, the subsequent judgments in *Gheewalla* and *Quadrant* make it clear that such an approach does not form part of the accepted Delaware jurisprudence. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns, Corp., No. 12150, 1991 WL 277613; N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007); Quadrant Structured Products v. Vertin, 102 A.3d 155, 174 n.4 (Del. Ch. 2014).

77. Davies, *supra* note 55, at 306 (emphasis added).

Preventing the potential negative consequences of this perverse incentive has been a key rationale behind the shift away from strict shareholder primacy at insolvency. Importantly however, both the trust fund and residual claimant approaches do not fully prevent directors from acting on this perverse incentive. Instead, it remains possible for directors to engage in overly risky activity as the corporation approaches but has not yet reached insolvency. Approaching insolvency,[78] the potential benefit of risky behavior likely outweighs the risk to shareholders whose equity is already nearly dissipated. Additionally, risky behavior is more dangerous pre-insolvency when directors have more resources available to facilitate reckless corporate activity.[79] By definition, when the corporation's condition may have degraded prior to insolvency, there are some resources left which a director acting under this perverse incentive could utilize towards turning the corporation around, even where the likelihood of success remains remote. Once a corporation has reached insolvency, directors are likely less capable of utilizing the resources of the corporation in a risky manner because the resources may have been depleted.

Yet, there may be directors who would prefer to no longer prioritize gains-making for the benefit of shareholders in order to prevent undue losses from being incurred by creditors. These directors may be concerned that were they to do so prior to outright insolvency, they may find themselves acting contrary to their duty of loyalty unless they can argue that the risks are ultimately undesirable for the shareholders as well. There are instances where the odds of taking such risks will not be favorable to shareholders, namely where the taking of a risk would dissipate any remaining equity value with only a remote chance of positive return. There will nevertheless be difficult cases wherein the likelihood of success is less clear and directors find themselves under significant pressure. Further difficulties may arise for directors when contending with different types of creditors. While certain creditors are assumed capable of contracting for their assumed risk, creditors may either not anticipate certain shifts in the corporation's risk profile[80] or may not be capable of adjusting for risk—a trait often assigned to employees

78. No singular test exists to identify the zone or vicinity of insolvency; however, variations include where there is "no reasonable prospect of avoiding insolvent liquidation." COMPANY LAW REVIEW STEERING GROUP, FINAL REPORT, Vol 1 (London, Department of Trade and Industry 2001) Ch. 3: Corporate Governance; see also, Rao, Sokolow & White, *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. CORP. L. 53, 65 (1996); Jonathan Rickford, *Reforming Capital*, 15 EUROPEAN BUS. L. REV. 919, 977 (2004).

79. "The *possibility* of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors" Credit Lyonnais, No. 12150, 1991 WL 277613, at *34 n.55 (emphasis added).

80. *See* LOUISE GULLIFER & JENNIFER PAYNE, CORPORATE FINANCE LAW: PRINCIPLES AND POLICY [3.2.2.2] (3rd ed. 2020).

or tortfeasors.[81] As such, there are numerous conflicting pressures for a director that apply not just past insolvency, but also as insolvency is looming.

The extremity of this bright-line shift in duty may exacerbate this perverse incentive because the perception of impending insolvency also creates a perception of an impending loss of shareholder pre-eminence, whether by an absolute shift in duties, or as recently confirmed, an inclusion of creditors within the residual claimant class.[82] Shareholder recklessness may therefore derive not only from their financial incentive, but also their incentive to retain sole fiduciary attention. While this issue can arise in both a trust fund shifting model[83] or a residual *Gheewalla-Quadrant* model,[84] the former, where the interests of creditors become paramount at insolvency, represents a more extreme shift from the shareholder's perspective. However, the position in *Gheewalla* and *Quadrant* makes it clear that upon insolvency the considerations of directors are to a widened pool of interest holders, including but not limited to creditors. Under this approach, the extent to which directors feel the need to prioritize shareholders to the undue detriment of others prior to insolvency may dissolve because the interests of shareholders are still valid following insolvency. Therefore, the extent to which these models may compound the perverse incentive of shareholders may differ. Nevertheless, the inclusion of a bright-line threshold in both models gives rise to the same moral hazard, exacerbating the pressure of a board already tasked with identifying the threshold of insolvency ex-ante[85] and thereby potentially discouraging directorial action until insolvency is confirmed.[86] It is therefore important for directors to enjoy some latitude not simply in how they balance the interests of interested parties before and after insolvency, but also in how they assess the financial condition of the corporation. Such latitude can be made available through the business judgment rule.

81. The distinction between adjusting and non-adjusting creditors was introduced by Bebchuk and Fried. *See* Lucian Bebchuk & Jesse Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L. REV. 857 (1996).

82. N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92 (Del. 2007); Quadrant Structured Prod. Co. v. Vertin, 102 A.3d 155, 174 n.4 (Del. Ch. 2014).

83. *See* Hu & Westbrook, *supra* note 54, at 1332–36.

84. Gheewalla, 930 A.2d 92; Quadrant,102 A.3d at 174 n.4.

85. "Of course, the point at which a corporation becomes insolvent remains debatable, is difficult to perceive in real-time, and can only be determined definitively by a court in hindsight." Quadrant, 102 A.3d at 174 n.4.

86. The variance in tests for insolvency and the uncertainty this brings has arisen not only in Delaware. Finch and Milman acknowledge the same difficulty in the United Kingdom, namely within the long-term interest model under the Companies Act 2006, c. 46 § 172. As such, "it is often extremely difficult, in practice, to identify the point at which the value of a business falls below the level needed to pay the creditors in full—and the law is not user-friendly in setting out the directors' obligations at a given time." Finch & Milman, *supra* note 72, at 596.

IV. MITIGATING THE HOLD-UP PROBLEMS OF BRIGHT-LINE INSOLVENCY THROUGH THE BUSINESS JUDGMENT RULE

One of the most significant comforts for anxious directors grappling with the uncertain discernment of insolvency is their afforded deference under the business judgment rule. This comfort stems not just from the deference given to directors in considering the interests of stakeholders, but also in the deference given to the assessments made by directors of the corporation's financial condition and whether the corporation has indeed become insolvent. Directors afforded such a margin may better stave off the influence of perverse incentives while avoiding the decision-making stagnation posed by having to identify an objective insolvency threshold, which "can only be determined definitively by a court in hindsight."[87] Otherwise, directors may be reluctant to act in the interest of shareholders for fear that their duties have already shifted, or vice versa. Instead, appropriate business strategy should respond to the corporate financial condition within this deferential margin to avoid an absolute jumping point. Since directors would never have to leap, they would also avoid wasting time looking for the threshold that leads to insolvency.

A. CONTRASTING THE SCOPE OF THE RULE BETWEEN SOLVENCY AND INSOLVENCY

It is worthwhile to contrast how the operation of the business judgment rule changes relative to solvency. Prior to reaching insolvency, "directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."[88]

> [Conversely] the directors of an insolvent firm may consider the interests of creditors when assessing their fiduciary duty to the corporation, which in some cases might justify taking a "less risky" course of action such as an efficient liquidation. But, if the directors, in their business judgment, decide to take "extreme risk," that too will be protected by the business judgment rule.[89]

As such, the business judgment rule at insolvency will support risky shareholder-oriented stratagems [90] or decisions exhibiting marked consideration for non-shareholder constituencies, such as efficient

87. Quadrant, 102 A.3d at 174 n.4.
88. Gheewalla, 930 A.2d at 101.
89. Ellias & Stark, *supra* note 62, at 760–61.
90. An example of such a risky investment strategy was at issue in the *Quadrant* case and ultimately the claims made against the risky nature of the investment strategy were dismissed. *See* Quadrant, 02 A.3d at 174 n.2; *See also* Russell C. Silberglied, *Litigating Fiduciary Duty Claims in Bankruptcy Court and Beyond: Theory and Practical Considerations in an Evolving Environment*, 10 J. BUS. & TECH. L. 181, 199 (2015).

liquidation. Importantly, legitimate business judgment at solvency need not discount creditor interests entirely. The business judgment rule will protect decision-making attributable "to a *rational* business purpose"[91] with wider constituency consideration insofar as it ultimately serves shareholder interests. Accordingly, the business judgment rule expands at insolvency to allow greater regard for non-shareholder interests. This may alleviate some anxiety stemming from the uncertainties of insolvent business strategy by signaling a degree of deference to directorial decision-making.

B. Misconstruing Insolvency as a Failure to Consider Material Facts

In order to use the business judgment rule as a means of mitigating the harsh bright-line approach by Delaware, directors determining whether a corporation is indeed insolvent must be protected as a business judgment. This may be contradicted by dictum which disapply the business judgment rule in instances of a "grossly negligent process that includes the failure to consider all material facts reasonably available."[92] Were the conditions of insolvency or solvency perceived as objective material facts, then director action would be open to challenge for the failure to consider them and for pursuing a course of action favoring the incorrect conceptualization of residual claimants.

One could counterargue that the requirement to consider all material facts is a function of the business judgment rule's disinclination to protect omissions rather than acts.[93] The business judgment rule, as developed in Delaware, makes it impossible to treat wrongful omissions by directors on par with their wrongful decisions. The Delaware rule generally does not apply a standard to evaluate the substance of decisions by corporate directors. Instead, it asks questions regarding the process of directorial decision-making.[94]

Failure to correctly identify ex-ante the corporate financial condition that is discernible ex-post is not necessarily an instance of such omission, nor is it incapable of procedural scrutiny by the judiciary. Provided the relevant material that speaks to the corporation's financial condition was considered, arriving at an incorrect conclusion of solvency does not axiomatically entail

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91. Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000) (emphasis added).

92. *Id.*

93. "It is a presumption *that in making a business decision* the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). See also Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971); Robinson v. Pittsburgh Oil Refinery Corp., 126 A. 46, 49 (Del. Ch. 1924); Stone v. Ritter, 911 A.2d 362, 368 (Del. 2006); *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 968 (Del. Ch. 1996).

94. Robert T. Miller, *Wrongful Omissions by Corporate Directors: Stone v Ritter and Adapting the Process Model of the Delaware Business Judgment Rule*, 10 U. PA. J. BUS. & EMP. L. 911 (2008).

an omission of procedure or fact-finding. An example of this is illustrated in *Smith v. Van Gorkom* where the board therein failed to obtain financial advice.[95] Miller succinctly summarized the court's response to this failure:

> The Delaware Supreme Court found that a board considering a sale of the company had breached its duty of care because it failed to obtain a financial study of the intrinsic value of the company—a kind of study that could have been produced in a couple of days by the company's financial advisors or even its in-house financial professionals.[96]

The omission is therefore reliant not upon the substantive failure to discern corporate value, but rather the underlying procedural failure to compile and appraise the reasonable available or producible material facts underpinning the evaluation by the board. For directors seeking to be shielded by the business judgment rule, the requirement is not to draw correct conclusions from the material facts, but rather to ensure that material facts necessary to evaluate the financial condition of the corporation have been considered. Accordingly, a *Stone v. Ritter* omission [where directors are held to be in conscious disregard of their duties by failing to act] will not arise for failing to correctly assess insolvency so long as the board erred in their evaluation of the reasonably available and producible information and not in a failure to produce this information.[97]

C. BURIDIAN'S ASS: THE DILEMMA AND DEFERENCE IN SELECTING A TEST FOR INSOLVENCY

As one comes within the zone of insolvency, it becomes increasingly difficult to characterize and identify the bright-line threshold of insolvency. It is well documented that there remains no singular test for insolvency.[98] Instead, in both Delaware and further afield, case-by-case iterations range from insolvency[99] and doubtful insolvency[100] to mere financial difficulty.[101] This variety is compounded by the academically fruitful but practically enigmatic dichotomy between the balance sheet and cash flow tests. Under the balance sheet test, a corporation is insolvent where it has liabilities in

95. Smith v. Van Gorkom, 488 A. 2d 858, 863 (Del. 1985).

96. Miller, *supra* note 94, at 917.

97. Under *Stone v Ritter,* a director can be found in breach of their duty and not shielded by the business judgment rule where they have failed to act at all, as a failure to act is in conscious disregard of their duty to act in good faith. See Stone v. Ritter, 911 A.2d 362, 368 (Del. 2006); *In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 968 (Del. 1996); Miller, *supra* note 94, at 783.

98. The two most common broad tests for insolvency are cash-flow and balance sheet insolvency. *See* Robert J. Stearn, Jr. & Cory D. Kandestin, *Delaware's Solvency Test: What Is It and Does It Make Sense? A Comparison of Solvency Tests Under the Bankruptcy Code and Delaware Law*, 36 DEL. J. CORP. L. 165 (2011).

99. Colin Gwyer & Associates Ltd v. London Wharf (Limehouse) Ltd [2003] 74 BCC 885.

100. City of London Group Plc v. Lothbury Financial Services Ltd [2012] 54 EWHC 3148.

101. Re Idessa (UK) Ltd (In Liquidation) [2011] EWHC 804.

excess of the reasonable market value of its assets.[102] Conversely, the cash flow test considers a company insolvent where its "debts that [are] beyond the debtor's ability to pay as such debts matured,"[103] and this inability to pay may account for debts presently owed or debts that have not matured but whose repayment the company cannot meet at a future date.[104] Given this myriad of standards, one cannot feasibly assert that they represent a singular material fact representative of "solvency." Instead, they offer a means to derive conclusions from a multitude of underlying material facts. Furthermore, even where courts with hindsight disagree with the ex-ante judgment of the board regarding these insolvency metrics, mere disagreement is a far cry from a finding of procedural gross negligence under the business judgment rule.[105]

Importantly, were it desirable to prescribe a specific test for insolvency, it should occur judicially or legislatively. For certain matters—whether in regulatory compliance or litigation—the relevant insolvency metrics are indeed prescribed. For instance, the Bankruptcy Code allows for the avoidance of fraudulent transfers where a corporation was cash flow insolvent.[106] Conversely, when providing a general definition for insolvency, the Bankruptcy Code prescribes a balance sheet test that defines insolvency as the "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at fair valuation."[107] While one can envisage instances where such prescription is optimal, this does not arise universally. For example, "[u]nder *Gheewalla*, . . . [a] plaintiff can plead insolvency through allegations that meet *either* the 'balance sheet' test or the 'cash flow' test."[108] Affirming a multitude of solvency tests may be viewed as a means of providing directors with guidance in the form of a more

102. Trenwick Am. Litig. Tr.v. Ernst & Young, LLP, 906 A.2d 168, 195 n. 74 (Del. Ch.2006).

103. This cash flow test is adopted for avoiding transfers where the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation; and . . . *intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured." See* 11 U.S.C. §548(a)(1)(B)(ii)(III) (2006).

104. *See* Robert J. Stearn, Jr. & Cory D. Kandestin, *Delaware's Solvency Test: What is It and Does it Make Sense? A Comparison of Solvency Tests Under the Bankruptcy Code and Delaware Law*, 36 DEL. J. CORP. L. 165 (2011).

105. "Thus, directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose *or reach their decision by a grossly negligent process* that includes the failure to consider all material facts reasonably available." *See* Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000) (emphasis added).

106. "One provision of the [old] Bankruptcy Code incorporate[ed] two additional solvency tests. Section 548, which addresses fraudulent transfers, provides that a transfer may be avoided if, among other things, it was made while the debtor was unable to pay its debts as they came due. This is the cash flow test. To apply the test, an overall assessment must be made of the debtor's liquidity, which then should be compared to projected debt payments." Stearn, Jr. & Kandestin, *supra* note 98, at 173; *See* 11 U.S.C. § 548(a)(1)(B)(ii)(III)(2006).

107. 11 U.S.C. §101(32)(A)(2012).

108. Quadrant Structured Prod. Co. v. Vertin, 02 A.3d 155, 174 n.2 (Del. Ch. 2014) (emphasis added).

comprehensive understanding of the corporation's financial position. Rickford illustrates the guiding comprehensiveness of having the balance sheet and cash flow tests operate in tandem:

> [I]t could be argued that the requirement for a solvency certificate adds nothing to a test based on proper appraisal of the balance sheet… Arguably it would leave directors with less guidance as a matter of practice than the combined approach. The converse argument, for abandonment of the general solvency requirement and reliance on the balance sheet alone, clearly has serious disadvantages in terms of the signals to directors and the dangers of undue reliance on the balance sheet, which by its nature cannot fully portray the timing and degree of certainty of future cash flows and the company's flexibility.[109]

In those instances where courts do recognize a myriad of insolvency metrics, how boards grapple with these tests and their interrelationship itself becomes a question of business judgment. Otherwise, the flexibility and guidance which Rickford advocates for becomes a framework of potential pitfalls for the corporate board. It is here that one sees the importance that the business judgment rule applies in the absence of material omissions of fact or disregard of relevant information. Evaluating financial condition involves both a choice of metrics by directors and the processing of material data. Once one accepts that a business judgment of the corporation's financial condition is itself a decision shielded by the business judgment rule, one can acknowledge that directors are incentivized to consolidate the financial information and apply the relevant solvency tests. Without doing this, there should be a material omission and the business judgment rule would not apply. Accordingly, the business judgment rule can both facilitate directorial decisiveness whilst encouraging informed decision-making through the promise of protection.

D. THE RELATIVITY OF SOLVENCY AND INSOLVENCY

A model which avoids sole reliance on bright-line thresholds better recognizes that acceptable directorial conduct cannot simply be placed within internally homogenous categories as there is variance within those categories themselves. Insolvency is not absolute, but rather can be improved or worsened based on the degree of indebtedness. Although such a view has faced conceptual challenges due to the argument that any losses below a firm's value reaching null is actually loss to parties external from the firm itself.[110] The zone of insolvency entails a spectrum of corporate conditions

109. Jonathan Rickford, *Reforming Capital*, 15 EUROPEAN BUS. L. REV. 919, 977 (2004).

110. *See* Michael Schillig, *"Deepening Insolvency"—Liability for Wrongful Trading in the United States?*, 30 CO. LAW. 298 (2009) (detailing a conceptual analysis of the non-absolutism of insolvency).

between solvency and insolvency.[111] Even solvency is not absolute, and an overly solvent corporation potentially results from excessive caution failing to maximize shareholder value. Presuming then that there should be some absolutist shift in the duty at a precise moment of insolvency encourages this fiction of neat categorization, which in turn propagates the myth of precisely identifiable thresholds which dictate expected board behavior. Therefore, rejecting absolutism not only better aligns with acceptable board conduct, but it also better recognizes that directors conduct the affairs of the business in light of the relative financial position of the company based on how solvent or insolvent the company is.

1. The Existing Recognition of Relativity: Deepening Insolvency and Wrongful Trading

The need to adopt a relativist understanding of the degrees between solvency and insolvency is clearly exemplified by the [at times controversial] recognition of deepening insolvency principles across the corporate law of a myriad of American states.[112] Deepening insolvency recognizes liability "where the defendant's conduct, either fraudulently or even negligently, prolongs the life of a corporation thereby increasing the corporation's debt and exposure to creditors."[113] Initially it was conceptualized as an independent tort,[114] but has since largely been subsumed into a fiduciary ambit that informs the appropriate directorial duties in instances where the affairs of an insolvent corporation are managed in manners which deepen the extent of corporate insolvency.[115] The latter approach, articulated in *In re The Brown Schools*,[116] is perhaps preferable as the former tortious model imposes direct liability upon directors separate from and in potential misalignment

111. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991); Mark Arnold, *Directors' Duties in the Zone of Insolvency: Recent Developments*, SOUTH SQUARE DIGEST 46 (2015).

112. *See* Trenwick Am. Litig. v. Ernst & Young, L.L.P., 906 A.2d 168, 204–207 (Del. Ch. 2006) (rejecting the deepening insolvency theory); *In re* Glob. Serv. Grp., LLC, 316 B.R. 451, 457–459 (Bankr. S.D.N.Y. 2004) (also rejecting the deepening insolvency theory).

113. *In re* LTV Steel Co. Inc., 333 B.R. 397, 4211 (Bankr. N.D Ohio 2005); Smith v. Arthur Andersen LLP, 421 F. 3d 989, 1004 (9th Cir. 2005).

114. This was first recognized as an independent cause of action in Pennsylvania tort law for where "[t]he fraudulent and concealed incurrence of debt… causes damage to corporate property." *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 351 (3d Cir. 2001).

115. *See In re* LTV Steel Co., Inc., 333 B.R. 397, 421 (Bankr. N.D. Ohio 2005); Smith v. Arthur Andersen LLP, 421 F.3d 989, 1005 (9th Cir. 2005). *See also* Lawrence A. Larose, Samuel S. Kohn & Alexandra B. Feldman, *Deepening Insolvency – Is The Newest Tort Dead?*, 3 INT'L CORP. RESCUE 352, 361 (2006).

116. *In re* The Brown Sch., 386 B.R. 37, 48 (Bankr. D. Del. 2008); *see In re* Worldwide Wholesale Lumber, Inc., 378 B.R. 120, 127 (Bankr. D.S.C. 2007); Dan Schechter, *Although Trustee Cannot Assert Separate Claim for Deepening Insolvency, Claim for Breach of Fiduciary Duty May Be Based on the Same Type of Conduct [In re The Brown Schools (Bankr. D. Del.).]*, COMM. FIN. NEWS. 39 (2008).

with[117] the duties of directors solely owed to the corporation.[118] Acting in accordance with the duty to the corporation, directors' duties may be discharged "at the expense of others" without constituting a breach.[119]

2. Difficulties in Contemporaneous Bright-Line and Relativist Approaches.

Irrespective of whether deepening insolvency is operative as an independent tort or subsumed within a fiduciary ambit, the settled recognition that worsening the insolvent state of a corporation may breach the director's duties affirms the underlying legal acceptance of the relativity of insolvency. It is certainly the model of fiduciary subsumption which relies more heavily on the relativity of insolvency. This is because the direct tortious model compensates losses to corporate participants, conceptualizing the claim by reference to their personal losses as insolvent trading continues and the corporation's financial position worsens. Where a corporation is insolvent, the residual value in the corporation has dissipated but individual creditors are susceptible to further injury where insolvency deepens as creditors should receive a share *pari passu* of the remaining assets. Thus, the injury to creditors by the further diminishing of assets would provide a conceptually useful basis for deepening insolvency claims were such claims directly actionable by creditors. However, where deepening insolvency operates within the ambit of director's duties, the imposition of liability is only *conceptually* tenable where corporate solvency is conceived in relative rather than absolute terms since losses examined are solely those of the corporation and the incurrence of its worsening insolvent state disregards external or reflective losses.[120]

Were insolvency to be conceived as reaching a null value without further reduction—a conceptualization likely imputed from the extinguishment of share value—the parameters of deepening insolvency would find little application. In rejecting this strict imputation of share value as corporate value, deepening insolvency recognizes instead that "the corporate body is ineluctably damaged by the deepening of its insolvency, through increased

117. "What is in the interests of current shareholders who are sellers of their shares may not necessarily coincide with what is in the interests of the company. The creation of parallel duties could lead to conflict. Directors have but one master, the company." Dawson Int'l plc v. Coats Paton plc [1989] BCLC 233.

118. *In re* The Brown Sch., 386 B.R. 37, 48 (Bankr. D. Del. 2008); *In re* Worldwide Wholesale Lumber, Inc., 378 B.R 120, 126–27 (Bankr. D.S.C. 2007).

119. Katz v. Oak Indus. Inc, 508 A.2d 873, 879 (Del Ch. 1986).

120. Reflective losses refer to losses to parties which are reflective of a loss suffered by the company itself. Principal among these is the diminution of share value brought about by some harm directly occasioned upon the company. *See* Alan Koh, *Reconstructing the Reflective Loss Principle*, 16 J. CORP. L. STUDS. 373 (2016); Charles Mitchell, *Shareholders' Claim for Reflective Loss*, L. QUARTERLY REV. 457 (2004).

exposure to creditor liability."[121] Given that Delaware has sounded the "death knell" for independent claims in favor of fiduciary subsumption, it is clear that the operation of a director's duty has become increasingly underpinned by an explicitly relativist understanding of insolvency.[122]

Using a bright-line insolvency trigger would create issues with imposing liability for deepening the insolvent state of a corporation. Prior to reaching bright-line insolvency, directors acting in shareholders' interests may be incentivized to take risks that they would be restricted from taking past the bright-line. Therefore, avoiding a bright-line model means directors would not be contemporaneously grappling with determining the precise moment of insolvency ex-ante and concerns over deepening insolvency; a failure to correctly ascertain to whom duties were owed at a particular moment would trigger board liability. Not only is identifying the precise moment which triggers insolvency often unclear ex-ante, but it also may overlook the fact that major negative actions taken prior to insolvency can result in an even worse insolvent financial condition than minor negative actions taken following insolvency. This is because a risky but ultimately tolerated course of action prior to insolvency may result in deeper insolvency than a course of action taken in insolvency that may be challenged for deepening insolvency.[123] The differing propriety of risk appetites that may be envisaged before and after a bright line fails to adequately reflect the relative extent of insolvency that the courses of action allowed by these risk appetites may incur. Furthermore, any awareness of impending insolvency and associated restrictions on risk-taking derived from deepening insolvency and its equivalents may compound the already perverse incentive of boards to act riskily since their temporal window to hedge is significantly narrowed and the negative implications for hedging outside that window are notably bolstered. Therefore, a wider appreciation of solvent relativism that considers both improving solvency as well as deepening insolvency may alleviate these incentives prior to any bright line while also enabling potential corporate recovery.

3. Informing Decision-Making through Continuous and Relative Metrics

Where business judgment becomes less myopic in its focus on bright-line insolvency, increased emphasis may be placed upon metrics such as cost

121. Look Chan Ho, *On Deepening Insolvency and Wrongful Trading*, 20 J. INT'L BANKING & FIN. L. 426 (2005).

122. Michelle M. Harner and 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?*, 2008 ANN. SURV. BANKR. L. 1, 7 (2008); *see also* Trenwick Am. Litig. Tr. v. Ernst & Young, L.L.P., 906 A.2d 168, 174–75 (Del. Ch. 2006).

123. *See* Ian T. Mahoney, *The CitX Decision: Has the Tort of Deepening Insolvency Gone Bankrupt*, 52 VILL. L. REV. 995 (2007).

of equity or debt to estimate the impact of those decisions upon residual claimants. Increases in cost of capital are not fatal to a decision since cost fluctuations are subject to externalities, trade-off theory,[124] and adjustment by incoming investors.[125] Ultimately, the reliance on such metrics is something one would expect from directors already. Not only does it form good business practice, but failure to do so may signal irrational or grossly negligent behavior on the part of the director.[126] In such instances, the director would lose protection that is otherwise afforded by the business judgment rule.[127] As such, utilizing these metrics makes both sound commercial and legal sense for directors. However, while these metrics may provide useful guidance for the internal decision-making of directors, their efficacy may be stymied where the legal framework fails to appreciate the relativity of solvency and holds directors to a bright-line standard for appreciating when the firm has crossed the threshold between solvency and insolvency.

E. MAINTAINING DIRECTORIAL ACCOUNTABILITY: THE ROLE OF INFERENCES IN EX-POST JUDICIAL OVERSIGHT

One may question whether the business judgment rule as presented thus far would represent too much a dereliction of courts' supervisory role. It is evident however that courts do not omit evaluation of corporate financial condition in favor of blind allegiance to a board's presumptively sound business judgment. Instead, courts will discern a corporation's financial position with hindsight and make inferences as to the motivations and considerations of the board at the time.[128] Inferences may be drawn in both positive and negative forms, thereby either bolstering the business judgment rule or serving to rebut its presumption. In *Shlenksy* "the court in fact posited several legitimate business reasons for Wrigley's conduct … for example that 'the effect on the surrounding neighborhood might well be considered by a director'" without requiring that this motivation actually be evidenced by the directors.[129] Courts may equally make inferences as to insolvency. "In

124. Anila Cekrez, *A Literature Review of the Trade−Off Theory of Capital Structure*, ILIRIA INT'L REV. 125, 128–30 (2013).

125. *See* Bebchuk & Fried, *supra* note 81, at 864–67; *see also* Edward Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1927–30 (2013).

126. The standard laid out in *Brehm v. Eisner* states that directors may be grossly negligent for failing to account for material facts reasonably available. *See* Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000)*; see also* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 90 (2004).

127. *See* FRANKLIN A. GEVURTZ, CORPORATION LAW 282-284 (2000).

128. It is already well established in this Article that courts are aware that their determination of insolvency is the truly definitive one. "[A]ctual insolvency is the relevant transitional moment. Of course, the point at which a corporation becomes insolvent remains debatable, is difficult to perceive in real-time, and can only be determined definitively by a court in hindsight." Quadrant Structured Prods. v. Vertin, 102 A.3d 155, 174 n.4 (Del. Ch. 2014).

129. Bainbridge, *supra* note 32, at 90 (quoting Shlensky v. Wrigley, 237 N.E.2d 776, 780 (1968)).

Trenwick, then-Vice Chancellor Strine … held that the complaint had not adequately pled facts supporting a rational inference that the subsidiary … was insolvent."[130] Conversely, in *Quadrant,* the allegations "support[ed] the inference that [the controller] had reasonable cause to believe that [the corporation] was insolvent."[131] However, these inferences are clearly not intended to supplant directorial judgment as to whether insolvency existed, even though that fact may be most evident to a court ex-post. Instead, the inferences speak to the rationality of the ex-ante appraisal and subsequent conduct of board members. This approach is unsurprisingly deferential and certainly the preferable tact at mitigating strategic hold-up approaching insolvency.

F. CONCEPTUALIZING ACCEPTABLE BUSINESS JUDGMENT AS A MATTER OF ENFORCEMENT

Essential to the above centrality of the business judgment rule is the fact that in guiding boards' attempts to enact business strategies while faced with the risk of a change in their duties, one should not simply frame matters in terms of internal decision-making, but rather as a question of enforcement. Legal realism argues that, in examining "complex legal orders that comprise more than the law enacted by the state,"[132] one should consider not just blackletter law but also law-in-action.[133] Indeed, through the prism of enforcement intensity, one can acknowledge that boards may already reach judgments regarding the likelihood of enforcement. Accordingly, boards may weigh the overall corporate or personal benefits to breaching duties owed to claimant constituencies where retributive enforcement is not guaranteed.[134]

Even where boards act contrary to duties owed at either side of the bright-line, barriers to enforcement may act as a countervailing factor to this fiduciary derogation and thereby allow directors to make ex-ante judgments on strategies they perceive as preferable.[135] Barriers to enforcement may be endogenic to corporate structure, namely coordination costs for shareholders and costs to litigation,[136] derivative or otherwise. Endogenic factors are

130. Quadrant Structured Prods. v. Vertin, 102 A.3d 155, 191 (Del. Ch. 2014).

131. *See id.* at 197.

132. Jean-Louis Halpérin, *Law in Books and Law in Action: The Problem of Legal Change*, 64(1) ME. L. REV. 46, 46 (2011).

133. *See* Roscoe Pound, *Law in Books and Law in Action: The Problem of Legal Change*, 44 AM. L. REV. 12 (1910).

134. This reflects the overall doctrine of efficient breach. *See generally* Gregory Klass, *Efficient Breach*, in THE PHILOSOPHICAL FOUNDATIONS OF CONTRACT 362 (Gregory Klass, George Letsas & Prince Saprai eds., Oxford: Oxford University Press 2014).

135. *See* Jennifer G. Hill and Matthew Conaglen, *Directors' Duties and Legal Safe Harbours: A Comparative Analysis* (ECGI, Working Paper No. 351, 2017).

136. *See* Armour et al., *Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US*, European Corporate Governance Institute (Feb. 13, 2009), https://ssrn.com/abstract=1105355.

however less likely to be immediately evident in legal norms.[137] Once boards account for these countervailing considerations, they may engage in economically rational deviation[138] by assuming an otherwise sound business judgment and bearing the inherent risk of breach mitigated by enforcement barriers.

Where the risks posed to directors by bright-line insolvency are ameliorated by the business judgment rule, directorial appreciation of those endogenic and exogenic factors influence their appraisal of enforcement intensity. For instance, litigation costs for individual claimants are weighed against an altered probability of successful suit alongside the benefit to a potential collective action given that proceeds from these suits are typically[139] returned to the corporation, even where litigation costs are not borne collectively.[140] This presents an added difficulty for shareholders when weighing up litigation because while they may only be interested in their own potential benefit, the likelihood of successful litigation may depend on some engagement between shareholders as a collective. Equally, claimant coordination may differ between a small number of institutional creditors and a dispersed shareholder body. These factors exist independent of the fiduciary regime itself and will vary circumstantially. Nevertheless, when these factors are taken together with expansive deference given to business judgment, then the board may feel that legal challenges are less likely to arise. This formalized deference to business judgment coupled with the factual unlikelihood of challenge means that directors can be cognizant of this latitude as a balm to the uncertainties they face around insolvency.

It is worth iterating why having the business judgment rule in this instance ameliorates concerns for directors. Provided the case meets the

137. Like applicable standards of judicial scrutiny against the business judgment rule, for example.

138. The economic rationality for breaching fiduciary duties may arise in relation to providing benefit to other constituencies. The classic example of this is Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919). *See also* Martin Gelter, *The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance*, 50 HARV. INT'L L. J. 129, 142–143 (2009). However, one must also acknowledge that such derogations from fiduciary alignment may be an economically rational means for boards to acquire personal benefits. For analyses of where these costs arise, *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013); Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767 (2017).

139. Proceeds of suit for breaches of fiduciary duty are typically owed returned to the company and therefore divided between corporate beneficiaries However, there are also the exceptional circumstances wherein duties are owed to individuals, the breach of which result in individualised proceeds of suit. *See* Philip Rawlings, *Reinforcing Collectivity: The Liability of Trustees and the Power of Investors in Finance Transactions*, 23 TRUST L. INT'L 14 (2009).

140. *See* Moverly-Smith & Murphy, *Challenges to Collective Action Clauses: Can any Parallel be Drawn With Unfair Prejudice Petitions and Oppression of the Minority?*, 8 J. INT'L BANKING & FIN. L. 479 (2012).

business judgment rule requirements,[141] the burden of proof shifts away from directors and onto complainants. Accordingly, where a plaintiff "fails to meet her burden of establishing facts rebutting the presumption, the business judgment rule, as a substantive rule of law will attach to protect the directors and the decisions they make."[142] This shift in onus is not automatically inherent to the business judgment rule. Certain regimes, particularly outside the US which offer business judgment rule equivalents, retain the burden of proof on directors to demonstrate good faith or exhibit informed decision-making.[143] The extent to which onuses should legitimately shift is reflective of the dichotomy between the business judgment rule as a standard of liability and a doctrine of abstention, the latter possessing greater capacity for shifting onuses away from directors.[144] The standard of liability model may be more naturally qualified in ambit, whether that means "the business judgment rule shields directors from liability so long as they act in good faith … [or] simply raises the liability bar from mere negligence to, say, gross negligence or recklessness."[145] Conversely, a general doctrine of abstention results in courts abstaining "from reviewing the substantive merits of the directors' conduct unless the plaintiff can rebut the business judgment rule's presumption of good faith,"[146] thereby better facilitating a presumptive shift in onus. While a blanket shift is not axiomatic to the business judgment rule, Delaware's strong presumption[147] may better facilitate decisive business judgment; boards need not actively justify each decision or discernment of solvency.

Boards would enjoy an expansive business judgment rule outside of self-dealing contexts. This means that courts would presume the director's

141. The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Importantly the business judgment rule will not presumptively apply in certain instances. For instance, the business judgment rule will not immunize directorial omissions as it only applies to active decisions and judgments. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

142. Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989).

143. An instance of this is the business judgement rule offered under German corporate law. Per §93(1) Aktiengesetz, under which directors, shall be deemed not to have violated their duty if, at the time of taking the entrepreneurial decision, they had good reason to assume that they were acting on the basis of adequate information for the benefit of the company. However, unlike in Delaware, this does not involve a shift in the burden of proof. This shift provides a critical synergy to the proportionate fiduciary model advocated within this Article. *See* WILLIAM T. ALLEN, REINER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANISATION Ch. 8 (2nd ed. 2007); *see also* Aurelio Gurrea-Martínez, *Re-Examining the Law and Economics of the Business Judgment Rule: Notes for its Implementation in Non-Us Justifications*, 18 J. CORP. L. STUDIES 417 (2018).

144. *See* Bainbridge, *supra* note 32, at 90.

145. *Id.*

146. *Id.; see also* Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989).

147. "Essentially, the business judgment rule is a doctrinal vessel of judicial review into which the fiduciary duties of care and loyalty are fitted and subsumed." Johnson, *supra* note 40, at 424.

assessment of a corporation's financial condition as tenable unless otherwise demonstrated. Claimants can only successfully sue when they can overcome the decision-making deference provided by the business judgment rule. This will occur where claimants are able to establish that the board was grossly negligent in its efforts to evaluate the financial condition of the corporation or where the board failed to consider the relevant material facts necessary to make a reasonable judgment as to the corporation's financial condition.[148] While courts can still make inferences as to the board's undertakings,[149] the presumed legitimacy of directorial decisions concerning the company's financial position places directors in a favorable position to contend with uncertainties around insolvency.

V. FACILITATING BUSINESS JUDGMENT THROUGH RECONCILED CORPORATE CONSTITUENCIES

This Article has highlighted the challenge facing directors in identifying bright-line insolvency and the potential for ambiguity over the extent to which non-shareholder interests may inform corporate decision-making pre- and post-insolvency. The concerns of the former should be addressed under analysis of the business judgment rule. The remainder of this Article aims to shed some light on reconciling disparate constituency interests surrounding insolvency to facilitate decisive business judgment. Particularly, as *Quadrant* and other relevant cases affirm, both shareholders and creditors form part of a wider residual class once the corporation becomes insolvent.[150]

Wider policy justifications of aggregate consideration at insolvency do not necessarily extend to circumstances prior to insolvency. As such, while the *Gheewalla* and *Quadrant* line of cases emphasize an expansive conceptualization of residual claimants at insolvency, they equally reject expansive non-shareholder consideration pre-insolvency.[151] At a doctrinal level, the application of policy considerations—namely the moral hazard of boards pursuing insolvent shareholder interest—may be distinguished at solvency and insolvency since such considerations pre-insolvency may not be convincing enough to countervail concerns of inter-constituency conflict.

148. This language is borrowed from the test laid out in *Brehm*. "Thus, directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, *act in a manner that cannot be attributed to a rational business purpose* or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available." *See* Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000) (emphasis added).

149. *See Shlensky v. Wrigley*, 237 N.E.2d 776, 780–781 (Ill. App. 1968); Quadrant Structured Prods. v. Vertin, 102 A.3d 155, 168–169 (Del. Ch. 2014).

150. N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 99–101 (Del. 2007); Quadrant Structured Prods. v. Vertin, 102 A.3d 155, 174 n.4 (Del. Ch. 2014).

151. "In a solvent corporation, the residual claimants are the stockholders. Consequently, in a solvent corporation, the standard of conduct requires that directors seek prudently, loyally, and in good faith 'to manage the business of a corporation for the benefit of its shareholders.'" *Quadrant*, 102 A.3d at 174 n.4 (quoting *Gheewalla*, 930 A.2d at 101).

This distinction best illustrates why judicial deference towards wider constituency judgment is so markedly dependent upon insolvency, with non-shareholder consideration only possible as a limited *Shlensky* analysis pre-insolvency.[152] In either case, it may be necessary to affirm that constituency interests are indeed reconcilable, especially since one cannot simply invoke the policy objectives underlying corporate insolvency or bankruptcy frameworks to all business judgments.[153]

Assuming constituency interests are manifestly irreconcilable is an oversimplification endemic to strict shareholder primacy and the trust fund theory approach to insolvency.[154] Courts have acknowledged that constituency interests may inherently overlap.[155] The countenance of such commonalities adhere to the *Gheewalla-Quadrant* understanding of residual interests given their acceptance of the expansive class of interests upon insolvency. While such commonalities may not bridge the objective divide within the debt-equity dichotomy, they may still enable directors to balance the remaining competing interests within the hallowed ground of business judgment.

A. ACKNOWLEDGING EXISTING DISPARITIES WITHIN INDIVIDUAL CORPORATE CONSTITUENCIES

Although shareholders and creditors can hold comparable interests in a corporation, there are likewise numerous disparities that can arise between these groups. This may present significant challenges for directors seeking to find balance between the interests of stakeholders, but we already expect directors to balance competing concerns from within the shareholder class and we should likewise expect a similar capacity on the part of directors to balance competing concerns from a wider audience. Directors must consider the interests of the class of shareholders,[156] but this basic principle fails to acknowledge an obvious fact—individual shareholders can have interests contrary to those of the shareholder class.[157] The existence of a unified class interest is a legal fiction.

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152. *Shlensky v. Wrigley,* 237 N.E. 2d 776, 779–80 (Ill. App. 1968).

153. *See* Ellias & Stark, *supra* note 62, at 784–85; *see also* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859 (2003).

154. Hu & Westbrook, *supra* note 54, at 1332–36.

155. An example of such overlap is seen in *Fin. & Inv. Corp.* wherein a party was rejected to be a creditor seeking interest, but rather regarded as a preferred stockholder seeking dividend. *See e.g.*, Fin. & Inv. Corp. v. Comm'r, 57 F.2d 444, 445 (D.C. Cir. 1932).

156. "In no branch of the law has the equity court been more solicitous for the welfare of its wards than in those controversies involving *conflicting interests among stockholders and groups of stockholders.*" Norman D Lattin, *The Minority Stockholder and Intra-Corporate Conflict*, 17 IOWA L. REV. 313, 331 (1932) (emphasis added).

157. *See* KRAAKMAN ET AL, ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 41 (3rd ed. 2017).

It is therefore inconsistent to suggest that directors cannot consider creditor interests as it protects the interests of one individual constituency over others. Where the law refuses to shield a director for favoring one individual over all individuals in question, it readily allows an individual class—namely the shareholders—to garner absolute favor to the detriment of all other classes.[158] This becomes contradictory when examining the task entrusted to directors adhering to shareholder interests as a class. Directors must assess, eliminate, and balance competing interests of shareholders to fulfill duties owed to an artificially unified class.[159] This acknowledges the ability of directors to balance interests. Thus, it would be illogical to conclude that directors are incapable of balancing competing interests simply because the interests derive from competing groups or because the relevant interest holders have divergent agendas.

B. REASSESSING THE ALLEGED IRRECONCILABILITY OF SHAREHOLDER AND CREDITOR INTERESTS

While directors may be capable of balancing interests without inflicting disproportionate prejudice upon a particular constituency, certain interests are potentially incapable of reconciliation.[160] Where directors balance interests inter-shareholder, they are obliged to discount interests irreconcilable with the fictional class interest.[161] Therefore, if creditor interests are irreconcilable with those of the core class, then directors remain obliged to reject creditor influence upon corporate direction. Factors which will be examined for their potential irreconcilability include: (i) duration and extent of investment into the corporation, (ii) the residual nature of

158. "[C]ertain directors breached their duty of loyalty by 'indifference to their duty to protect the interests of the corporation and its minority shareholders,' because their primary loyalty was instead given to the interests of their employer [the majority shareholder]." *In re* Walt Disney Co. Derivative Litigation, 907 A.2d 693, 754 n. 452 (Del. Ch. 2005) (discussing the earlier case of *In re* RJR Nabisco, Inc. S'holder Litig., 1989 WL 7036, at *15 (Del. Ch. Jan. 31, 1989)); cf. Strassburger v. Earley, 752 A.2d 557, 581 (Del. Ch. 2000).

159. '[W]hen a firm has more than one shareholder, the very idea of 'shareholder wealth' becomes incoherent. Different shareholders have different investment time frames, different tax concerns, different attitudes toward firm-level risk due to different levels of diversification, different interests in other investments that might be affected by corporate activities and different views about the about the extent to which they are willing to sacrifice corporate profits to promote broader social interests . . . These and other schisms ensure that there is no single uniform measure of shareholder 'wealth' to be 'maximized.'" Stout, *supra* note 9, at 174.

160. This irreconcilability is one of the reasons against imposing a duty to consider creditors prior to insolvency. "'[T]here will be insoluble problems of reconciling conflicting interests' of shareholders and creditors if a duty to creditors applied other than where insolvency exists." ANDREW KEAY, COMPANY DIRECTORS' RESPONSIBILITIES TO CREDITORS 226 (2007) (citing Reginald Barrett, *Directors' Duties to Creditors*, 40 MODERN L. REV. 226, 231 (1977)).

161. This goes back to the notion that directors are to act in the interests of the company by reference of the interests of the shareholder class and not the divergent interests of individual shareholders. *See In re* RJR Nabisco, Inc. S'holder Litig., 1989 WL 7036 at *15 (Del. Ch. Jan. 31, 1989); cf. *Strassburger*, 752 A.2d at 581.

shareholder interests contrasted with the fixed value of creditor interests, (iii) the values for shareholders and creditors under balance-sheet and cash flow tests, (iv) the conflicting risk appetites of creditors and shareholders, (v) general differences between shareholders and creditors in what they perceive to be the ideal direction of corporate activity, (vi) the implications for shareholders and creditors were the board obliged to liquidate, and (vii) the differing contractual relationships which arise between shareholders and creditors. Each of these factors illustrate that while balancing competing interests is not always a simple task, it is a task that directors should nevertheless be capable of undertaking.

1. The Comparative Duration of Shareholder and Creditor Investment

Given the proprietary nature of shares and the role of shareholders as the corporate organ, one may expect shareholdings to be more static than credit instruments, which suggests shareholders have a more long-term perspective on corporate activity.[162] However, it is hardly reflective of modern practice to view shareholding as much less static than credit agreements, particularly where stock is publicly traded:

> As far as protection goes, if the shareholders are unhappy with the company's performance and/or way that it is being managed, shareholders are able to exit the company fairly easily by way of sale on the stock exchange, and this might be seen as a major protection for shareholders.[163]

Shareholders outside of closely held corporations[164] enjoy a powerful exit right which oftentimes reduces the durable connection of the shareholder to the corporation. Furthermore, shareholders focus on managing a diversified portfolio rather than on making individualized investments.[165] The focus of such shareholders or their investment managers is to maintain their desired risk-and-return profile in their portfolios, which renders the duration of their individual investments less consequential.[166] The opposite

162. Legal regimes vary on the emphasis given to such long-term perspectives. While Delaware does not mandate any such long-term view in the exercise of directorial duties, the United Kingdom has gone further through the introduction of the Companies Act 2006, c. 46 § 172(1), under which "[a] director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole." *See* Virginia Harper Ho, *Enlightened Shareholder Value: Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 77–80, 92 (2010); Jonathan R. Macey, *Corporate Social Responsibility: A Law and Economics Perspective*, 17 CHAPMAN L. REV. 331, 342–46 (2014).

163. ANDREW KEAY, THE CORPORATE OBJECTIVE 281 (1st ed. 2011).

164. *See* Eleonora Broccardo, Oliver Hart & Luigi Zingales, *Exit vs. Voice*, EUROPEAN CORPORATE GOVERNANCE INSTITUTE (Aug. 1, 2020), https://ssrn.com/abstract=3671918.

165. *See* BS Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992).

166. Kastiel Kobi & Nili Yaron, *In Search of the "Absent" Shareholders: A New Solution to Retail Investors' Apathy*, 41 DEL. J. CORP. L. 55 (2016).

may also hold true when a large or controlling stockholder faces greater losses, which would give them greater interest in overseeing the board. "If a controlling stockholder is merely mismanaging the business, she is injuring herself as well as the other stockholders[,]" and the greater the investment the greater this injury.[167] This is equally true for creditor interests because the greater their investment, the greater their losses will be upon insolvency. Creditors wield even less internal power than that of a minority shareholder as they are not a recognized corporate organ, except at insolvency and the subsequent inception of a creditor committee in liquidation proceedings.[168] Creditors may therefore be more concerned with corporate welfare than a less interested shareholder. This is significant because there are shareholders whose interests align more readily with those of creditors than with those of outlier shareholders. Therefore, since the current model does not view the inter-shareholder disparities as manifestly irreconcilable, it is unnecessary to do so in an expansive approach.

2. Reconciling the Fixed Value of Creditors' Interest and the Fluctuating Value of Shareholders' Residual Interest

The core of irreconcilable disparities between shareholders and creditors is the nature of shareholder interests to have fluctuating residual value, which contrasts with the fixed value of debt.[169] A simplified perspective on this disparity characterizes shareholders as the residual owners of the corporation,[170] yet "it is clear that shareholders hold no direct interest in the assets of the corporation."[171] Instead, "shares are merely a piece of property conferring rights in relation to the income and capital of the corporation" residual to outstanding corporate liability.[172] While this does not amount to ownership of the corporation itself, the value of their residual income stream will fluctuate between zero and any upward positive value; a stark contrast to fixed creditor value. Despite shareholding not being strict ownership, Easterbrook and Fischel attribute much of shareholders' quasi-owner governance rights, like voting rights, to the residual nature of their interest:

167. Paula J. Dalley, *The Misguided Doctrine of Stockholder Fiduciary Duties*, 33 HOFSTRA L. REV. 175, 195 (2004).

168. *See* 11 USC §1102 (2012).

169. "The right of ordinary shareholders to participate in the capital of the company is generally limited to their entitlement to any surplus left over after all the liabilities have been paid, i.e., they have no guarantee of any return on a winding up. They are the residual claimants of the company. They take the lion's share of the risk, but, in the good times, they will take the lion's share of the rewards." LOUISE GULLIFER & JENNIFER PAYNE, CORPORATE FINANCE LAW: PRINCIPLES AND POLICY 2.2.1.1 (3rd ed. 2020).

170. Armour John, Deakin Simon & Konzelmann Suzanne J., *Shareholder Primacy and the Trajectory of UK Corporate Governance*, 41 BRITISH J. INDUS. RELS. 531, 542 (2003).

171. GULLIFER & PAYNE, *supra* note 169, at 3.2.1.3.2.

172. *Id.*

> Voting exists in corporations because someone must have the residual power to act (or delegate) when contracts are not complete. Votes could be held by shareholders, bondholders, managers, or other employees in any combination .... One might expect voting rights to be held by a small group with good access to information—the managers. Yet voting rights are universally held by shareholders, to the exclusion of creditors, managers and other employees .... The reason is that shareholders are the residual claimants to the firm's income. Creditors have fixed claims and employees generally negotiate compensation schedules in advance of performance. The gains and losses from abnormally good or bad performance are the lot of shareholders, whose claims stand last in line. As the residual claimants, shareholders have the appropriate incentives..., to make discretionary decisions. The firm should invest in new products, plants and so forth, until the gains and costs are identical at the margin.[173]

The superior position of shareholders is attributable to their residual interests in allowing their delegated authority, the board, to operate in a discretionary capacity.[174] As such, Fischel and Easterbrook conceive of the residual and fixed natures of shareholder and creditor interests contributing to disparities in board discretion.

Differences in shareholder and creditor value structures do not result in irreconcilable differences at either side of insolvency. During solvency, primary regard remains with shareholders with the board retaining discretion over how to preferably satisfy shareholder interests while appreciating the context of the company's indebtedness. Since the value of residual interests increase without any pre-defined growth limit, the directorial care required for creditors' interest is a subsumed aspect of shareholder value maximization. Creditors have no interest in corporate gains past guaranteed fixed value returns, and once those returns do not face undue risk, creditors are not disadvantaged by the overarching pursuit of shareholder wealth.

Conversely, during insolvency, the shareholder's pecuniary interest is dissipated while creditors face the diminishment of their otherwise fixed returns. Accordingly, credit value becomes residual[175] and provides support for the widened residual class affirmed in *Quadrant*.[176] Naturally, the extent to which an individual creditor is threatened depends upon any security held by the immediate creditor or other creditors before unsecured *pari passu* is

173. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67 (1991)

174. *See* Horst Eidenmüller, *Comparative Corporate Insolvency Law*, EUROPEAN CORPORATE GOVERNANCE INSTITUTE (June 23, 2016), https://ssrn.com/abstract=2799863.

175. When a firm has become insolvent, it is settled that under Delaware law the directors owe fiduciary duties to the creditors because the residual claimants of corporate assets are the constituency to which directors owe their allegiance. Before insolvency, the residual claimants were the shareholders; after insolvency, they were the creditors. The fiduciary duty was never owed to shareholders because of ownership, but rather because of their residual claimant status. Hu & Westbrook, *supra* note 54, at 1321.

176. Quadrant Structured Prods. v. Vertin, 102 A.3d 155, 174 n.4 (Del. Ch. 2014).

triggered.[177] The incentive for retributive actions under breaches of duty rises with this value at risk. However, this is offset by the potential for creditor disinterest deriving from costs of collective action, namely coordinated monitoring and enforcement, particularly where the outcome of incurring these costs offers little risk reduction.[178] Nevertheless, as insolvency deepens, creditor detriment correspondingly worsens in relation to the extent of insolvency, whereas the equity value plateaus at null value. This difference, which is relative to the deepening insolvency analysis, provides a crux for the challenge faced in reaching balanced business judgments.

3. Reconciliation of Fixed and Residual Values under Competing Balance Sheet and Cash Flow Tests

It would be improper for the law to wholly disregard shareholder value at the null value plateau of balance sheet insolvency, even though doing so would garner a reconcilable test as seen in trust fund theory[179] because the law seeks to give regard to prospects of recovery.[180] However, a strict adherence to the model that abandons shareholder interests under the trust fund theory is difficult to reconcile when accounting for such prospects. This gives rise to the conflicting dichotomy of strict balance sheet tests that emphasize the null value plateau, and cash flow tests which account for future potential recovery.[181]

As previously discussed, Delaware law declines from prescribing definitive insolvency standards.[182] The resulting friction in deciding which test to apply means that "Delaware case law on solvency is confusing and can lead to inconsistent results. Indeed, the precedent that a court chooses to

177. Mokal, *Priority as Pathology: the Pari Passu*, 60 CORP. L. J. 581, 616-620 (2000).

178. *See* JAMES M. BUCHANAN, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY 63–116 (1962); MANCUR OLSEN, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (2009).

179. Neil Ruben, *Duty to Creditors in Insolvency and the Zone of Insolvency: Delaware and the Alternatives*, 7 NYU J. L. & BUS 333, 335 (2010);
Mohammad R. Pasban, *A Review of Director's Liabilities of an Insolvent Company in the U.S and England*, JOURNAL OF BUSINESS LAW 33 (2001); Bovay v. H.M. Byllesby & Co., 38 A.2d 808, 813 (Del. Ch. 1944).

180. "[T]he directors of an insolvent firm may consider the interests of creditors when assessing their fiduciary duty to the corporation, which in some cases might justify taking a "less risky" course of action such as an efficient liquidation. *But, if the directors, in their business judgment, decide to take "extreme risk," that too will be protected by the business judgment rule*." Ellias & Stark, *supra* note 62, at 745.

181. Delaware allows for both tests in insolvency. The cash flow standard that has emerged in case law is that there is "no reasonable prospect that the business can be successfully continued in the face thereof." Stearn, Jr. & Kandestin, *supra* note 104. One such formulation also emerges in the English Insolvency law context wherein corporate bankruptcy orders shall be made in respect of a "a debt which the debtor has no reasonable prospect of being able to pay when it falls due." *See* Insolvency Act 1986 c. 45, § 271(1)(b).

182. *Supra*, Section IV(C).

follow may be outcome determinative."[183] This same conflict arises between the operation of both tests, which has created comparable difficulties in similar jurisdictions like Australia[184] and the United Kingdom.[185] While Gullifer and Payne argue that the cash flow test may be preferable where jurisdictions lack any significant legal capital requirements,[186] what remains clear is a lack of judicial certainty in selecting the appropriate test.[187] Selecting in favor of a particular test may be synonymous with favoring a particular interest group because each test sets the bright-line at a potentially different marker.[188] This itself may be symptomatic of the overreaching constituency conflict, with constituencies naturally pressuring for their favored outcome.[189]

> Granting deference to rational selection for insolvency tests may serve to break this impasse. Insofar as creditors become the dominant concern past balance sheet insolvency, directors can favor courses of action that improve prospects of corporate recovery provided that said prospects are not so remote as to be out of proportion with increased risk to creditors. Therefore, such a test would enable bona fide attempts at recovery while acknowledging the perverse shareholder incentive operable at the time. Gullifer and Payne highlight this possibility: "[o]nce the shareholders' funds in the company have been dissipated entirely, or at least reduced to a very low level, it is in the interests of the shareholders to encourage excessively risky projects."[190]

In this regard, the business judgment rule can provide an avenue to reconcile these tests with the conflict arising from residual and fixed interests of corporate constituencies. This would give credence to the understanding that while corporate rescue should be facilitated, corporate governance should operate with a similar flexibility given that "the purpose of insolvency law is not, however, to save all companies from failure."[191]

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183. Stearn, Jr. & Kandestin, *supra* note 104, at 166.

184. In the 2008 judgment of *The Bell Group Ltd*., Owen J indicated that the cash flow test is the appropriate test for determining solvency. However, he added that the balance sheet test should not be dismissed as irrelevant [as] "[i]n the light of commercial reality, all things considered, could the company pay its debts as and when they become due? Such an approach includes the balance sheet test." Ryan Purslowe, *Decisions in the Twilight Zone of Insolvency - Should Directors Be Afforded a New Safe Harbour*, 13 U. NOTRE DAME AUSTRALIAN L. REV. 113 117–118 (2011).

185. One can see the dichotomy of these two tests by comparing BNY Corporate Trustee Services Limited v Eurosail-UK 2007- 3bl 28 (UK Supreme Court 2013) and Carman v Bucci [2014] EWCA Civ 383.

186. GULLIFER & PAYNE, *supra* note 169, at 3.1.

187. *See* Rickford, *supra* note 109.

188. Stearn, Jr. & Kandestin, *supra* note 104, at 184.

189. *See* JD CULPEPPER, QUIET POLITICS AND BUSINESS POWER: CORPORATE CONTROL IN EUROPE AND JAPAN Ch. 1 (2011); *see also* Mark J. Roe & Travis G. Coan, *Financial Markets and the Political Center of Gravity*, 2 J. L. FIN. & ACCT. (2017); Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539 (2000).

190. GULLIFER & PAYNE, *supra* note 169, at 3.1.

191. FINCH & DAVID, *supra* note 76, at 596.

4. Reconciling Risk Appetites Across Corporate Constituencies

A notable dispute in the contended irreconcilability of risk appetites is "the level of risk [one] is willing to assume."[192] This presumes that creditors are risk adverse because the value of their investment is finite, unlike that of shareholders. Therefore, creditors may influence a corporation to pursue "a less risky business strategy because they believed a [riskier] strategy might render the corporation unable to meet its obligations to its creditors."[193] However, creditors are not wholly risk adverse because they diversify risk[194] and "most lenders do not have an incentive to seek early repayment, and would wish the lending relationship to go on for as long as possible if the corporation is solvent."[195] Therefore, since creditors do not reject risk, creditor duties need not amount to an absolute duty to liquidate. Any reconciliation of risk appetites should only account for shareholder appetite being riskier than creditors and should not accept any conjecture that creditors are wholly risk averse.

Furthermore, the contention that creditors and shareholders have manifestly irreconcilable risk appetites overlooks the disparity in inter-shareholder risk appetite. For instance, Bainbridge notes that: "[t]hough conventional finance theory assumes shareholders are risk adverse, rational shareholders still will have a high tolerance for risky corporate projects [since] the basic corporate law principle of limited liability substantially insulates shareholders."[196] This in isolation suggests irreconcilability since creditors have no such protection. However since "shareholders [and creditors] can largely eliminate firm-specific risk by holding a diversified portfolio,"[197] their risk appetites begin to converge. Of course, not all creditors are engaged in sophisticated risk diversification (trade creditors for instance),[198] just as not all shareholders are diversified in their investment.[199] It is however nonsensical to suggest creditors are fundamentally risk adverse because all gainful corporate activity entails some form of risk, and without such gain, a corporation cannot increase the value of the object of credit and would therefore be unable to ensure repayment after fixed overheads.[200] As

192. Joseph V. Rizzi, *Rethinking Risk Management–Again*, 23 COM. LENDING REV. 3, 5 (2008).
193. Ruben, *supra* note 179, at 335–336.
194. Samuel G. Hanson, M. Hashem Pesaran & Til Schuermann, *Scope for Credit Risk Diversification* (Univ. of Cambridge, Faculty of Econ., Cambridge Working Papers in Econ. 0519, 2005). *See also* JONATHAN BECK & PETER DEMARZO, CORPORATE FINANCE 10.6 (4th ed. 2017).
195. GULLIFER & PAYNE, *supra* note 169, at 3.2.2.
196. Bainbridge, *supra* note 32, at 111.
197. *Id.* at 112.
198. Steve Knippenberg, *The Unsecured Creditor's Bargain: An Essay in Reply, Reprisal, or Support?*, 80 VIRGINIA L. REV. 1967 (1994).
199. Mara Faccio, Maria-Teresa Marchica & Roberto Mura, *Large Shareholder Diversification and Corporate Risk-Taking*, 24 REV. FIN. STUDS. 3601 (2011).
200. BECK & DEMARZO, *supra* note 194, at Part 4.

previously noted, these risk appetites diverge once the perverse incentivization is triggered near insolvency. However, since this incentive should be discouraged, deference to business judgment that happens to be expressly averse to shareholder incentives may enable the use of creditor interests and risk appetite as a tether on the deviant shift in shareholder priority and appetite.

5. Reconciling the Seemingly Disparate Preferences in Corporate Direction

An attribute which entails significant disparity between interested parties is the desired direction of corporate activity. Through the prism of generalized risk appetite, it is presumed that creditors seek a minimalized risk contrary to profitability and shareholder maximization. Aside from the discussed flaws to this over-simplification, this view overlooks that more disparate business ideologies are accepted inter-shareholder.[201]

As a class, shareholders are presumed to primarily seek profit maximization, yet disagreement in attaining this is inevitable. Short term shareholders may only seek short-term gain. Furthermore, the diversity of an individual share portfolio may favor a given course of action contrary to other shareholders. This may influence not only general governance, but also the desirability of derivative action and whether the recovery of gain from suit outweighs litigation costs, the impediment to directorial decisiveness, and damage to corporate reputation.[202] Creditors conversely present a far more unified front in that they solely pursue repayment, and accordingly, "[t]he first main concern the creditor [has] is credit risk, that is, the risk of non-payment."[203] While this objective may be pursued in disparate means depending on duration, type, and degree of credit, such divisions do not contain the same scope of divisiveness capable in inter-shareholder conflict because the latter arises within a core corporate organ.

What emerges is a noteworthy contradiction within corporate law. Corporate law rejects creditor protection on grounds that this would unjustly diversify pursued corporate objectives.[204] In doing so, it accepts division within the shareholder class to such a degree that it amalgamates their objectives into an artificial compromise. By finally acknowledging this division, corporate law would not only be better equipped to tackle inter-

201. *See* Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 127; *see also* Zsuzanna Fluck, *The Dynamics of the Management-Shareholder Conflict*, 12 REV. FIN. STUD. 379 (1999).

202. Arad Reisberg, *Shareholders' Remedies: The Choice of Objectives and the Social Meaning of Derivative Actions*, 6 EUR. BUS. ORG. L. REV. 227 (2005).

203. GULLIFER & PAYNE, *supra* note 169, at 2.3.1.3.

204. Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance 1*, 106 CORNELL L. REV. 91 (2000); *see also,* D.J. Wood & R.E. Jones, *Stakeholder Mismatching: a Theoretical Problem in Empirical Research on Corporate Social Performance*, 3 INT'L. J. ORGANIZATIONAL ANALYSIS 229 (1995).

shareholder conflict, but also to adopt an expansive model that accounts for constituency interests contrary to absolute shareholder maximization without unduly restricting directorial discretion.

6. Rejecting the Allegation of Irreconcilability Stemming from an Absolute Duty to Liquidate

One may argue that contemporaneous residual consideration of creditors and shareholders is inconceivable because the duties owed to creditors amount to a duty to liquidate the corporation. One might support this view by reference to *Production Resources Group*, where the Delaware Court of Chancery found that:

> When a firm has reached the point of insolvency, … [t]he directors continue to have the task of attempting to maximize the economic value of the firm. The maximization of the economic value of the firm might, in circumstances of insolvency, require the directors to undertake the course of action that best preserves value in a situation when the procession of the firm as a going concern would be value-destroying. In other words, the efficient liquidation of an insolvent firm might well be the method by which the firm's value is enhanced in order to meet the legitimate claims of its creditors.[205]

While certainly a moot point during solvency,[206] were the duty to liquidate and preserve corporate value for creditors at insolvency the sum-total of the duty owed to creditors residually, then directors may struggle to reconcile this without corporate recovery aimed at shareholder value maximization. As the corporation begins to approach insolvency, the risk associated with corporate activity begins to shift towards creditors as there is an increased likelihood that risky transactions will result in the non-realization of creditor value. Again, upon insolvency, the role of directors is not to achieve an optimal outcome or Pareto efficiency between constituencies.[207] Instead, directors may be required to regard creditor interests and act with a requisite degree of prudence rather than simply hedge against greater returns for shareholders in a manner contrary to good faith or rationality expected by the business judgment rule.

While deepening insolvency may prima facie suggest that boards should liquidate as efficiently as possible to avoid worsening the corporate

205. Prod. Res. Grp. v. NCT Grp., 863 A.2d 772, at 790–91 n. 60 (Del. Ch. 2004).

206. *See* Davies, *supra* note 55, at 306.

207. "Resources are allocated in a Pareto-optimal fashion if and only if any further reallocation of them can enhance the welfare of one person only at the expense of another. An allocation of resources is Pareto superior to an alternative allocation if and only if no one is made worse off by the distribution and the welfare of at least one person is improved. These two conceptions of efficiency are analytically related in that a Pareto-optimal distribution has no distributions Pareto superior to it." Jules L. Coleman, *Efficiency, Utility and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 512–13 (1980).

condition,[208] it is notable that this doctrine is subsumed into directors' duties[209] which in turn serves the expanded residual claimant class.[210] Furthermore, its underpinning as evidence of solvency's relativity is not a one-way perspective, as solvency can likewise improve:

> This deepening insolvency principle should arrest the perverse incentive on the part of the management mentioned above to continue insolvent trading for as long as possible, and at the same time does not require them to proceed to immediate liquidation as soon as there is any insolvency risk.[211]

It is accordingly apparent that not all insolvent trading is pursued in the name of this perverse incentive. Indeed, Congress has supported the view that a business is worth more to everyone alive than dead.[212] As such, the scrutiny of any business judgments will not infer an immutable expectation of efficient liquidation, but rather an expectation that boards engaged ex-ante with the competing policies of facilitating corporate recovery without recklessly worsening financial integrity.

The UK framework demonstrates the difference between insolvent and solvent consideration of creditor interests, particularly in its contrasts to deepening insolvency.[213] Outside insolvency, directors must promote "the success of the company for the benefit of its members as a whole" while "hav[ing] regard [for] ... the company's business relationships with suppliers,"[214] otherwise labeled as creditors. This "regard" requirement is notably less onerous than creditor consideration upon insolvency. Where a director continues to trade wrongfully and "knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation," the director will "be liable to make such contribution (if any) to the company's assets as the court thinks proper."[215] Solvency considerations are therefore very much subsumed into a duty owed solely to shareholders, not coming anywhere close to a duty to liquidate or otherwise act with direct regard to creditors, whose interests are excluded from the residual class until insolvency. This statutory dichotomy can apply to the doctrinal underpinning of fiduciary scope to illustrate that the duty to

208. Ho, *supra* note 121, at 428.

209. *In re* Brown Sch.. 386 B.R. 37, 48 (Bankr. D. Del. 2008); Schechter, *supra* note 116.

210. Quadrant Structured Prods. v. Vertin, 102 A.3d 155, 174 (Del. Ch. 2014).

211. Ho, *supra* note 121, at 428.

212. *In re* Glob. Serv. Grp. LLC, 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004); David C. Thompson, *A Critique of "Deepening Insolvency," a New Bankruptcy Tort Theory*, 12 STAN. J. L. BUS. & FIN. 536, 550 (2007).

213. "Although developed in parallel and in ignorance of each other, both the deepening insolvency theory and wrongful trading regime are animated by the desire to redress the perverse incentives of the management of an insolvent firm." Ho, *supra* note 121, at 433.

214. Companies Act 2006, c. 46 § 172 (UK).

215. Insolvency Act 1986, c. 45 § 214 (UK).

liquidate is not absolute, but rather a case-by-case efficiency concern,[216] and without absolutism, a creditor-oriented possibility of liquidation does not manifestly contradict shareholder primacy such that directors may fulfil their obligations across corporate constituencies.

7. Contractual Nexuses as a Guidance for Constituency Reconciliation

While contract must inevitably play a crucial role in corporate relations, it is a problematic substitute for fiduciary protection. Contract is often proffered as an alternative to expansive fiduciary recognition[217] by arguing that contractual adjustment by creditors offsets risk sufficiently[218] without assistance from directors' duties.[219] On the other hand, "contract primacy" preserves shareholder primacy "as a default rule ... [stemming from] the original shareholder contract,"[220] while allowing managers to "contract away their duty of loyalty ...in piecemeal fashion."[221] This is certainly the more middle ground approach. Contract neither justifies the non-recognition of creditor interests[222] nor overrides the otherwise nonwaivable duties of directors to the corporation.[223] Instead, appraisal of the contractual matrix surrounding the firm informs the business judgment of the directors as to

216. The "directors of an insolvent firm may consider the interests of creditors when assessing their fiduciary duty to the corporation, which in some cases might justify taking a 'less risky' course of action such as an efficient liquidation. But, if the directors, in their business judgment, decide to take 'extreme risk,' that too will be protected by the business judgment rule." Ellias & Stark, *supra* note 62, at 760–61.

217. "[T]he relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature" Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986).

218. Charles K. Whitehead, *Creditors and Debt Governance* in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW (Hill & McDonnell ed. 2013); *see also* Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115 (2009).

219. "It is the obligation of directors to attempt, within the law, to maximize long-run interests of corporation's stockholders [and doing so] 'at the expense' of others does not . . . constitute a breach of duty." *Katz*, 508 A.2d at 879.

220. Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L. J. 809, 855 (2008).

221. *Id.*

222. Were this the case then shareholder value maximization may incentivize the efficient breach of contracts, which is unlikely to the policy desired by courts and regulators. This may also give rise to increased undercutting by creditors in relation to their own position in insolvency, relative to the rest of the creditor class. For an exploration of such creditor undercutting, most significantly in the realm of contractually defined thresholds of priority and charge crystallization. *See* Mokal, *supra* note 177, at 616–20; *see also* Jackson & Kronman, *Secured Financing and Priority among Creditors*, 88 YALE L. J. 1143 (1989); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887 (1994); Bebchuk & Fried, *supra* note 81, at 857.

223. *See* Tung, *supra* note 220; *see also* Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1481 (1989).

which strategy is appropriate.[224] This contractual matrix, at least insofar as it is comprised of debt contracts, will be particularly sensitive to the financial condition of the corporation. Contracts obviate much uncertainty by allocating protection "according to each stakeholder's respective contribution,"[225] thereby guiding directorial judgment without requiring "contract primacy,"[226] nor enabling "overly risk adverse directors…to ignore shareholder needs under the guise of fulfilling creditor duty."[227]

8. Identifying a Reconciled Aggregate Class of Constituents

Granting credence to the widened residual class of interests would not present an insurmountable task since it all occurs as a matter of business judgment. As a matter of efficiency during solvency, directorial interest should primarily align to the shareholders due to their residual status:

> In order to maximize the firm's value when the company is solvent, directors' duties in that period need to be aligned with the shareholders rather than creditors. Since the losses are borne by the shareholders first, when assessing strategic decisions directors should give paramount consideration to the risk profile of that group.[228]

Furthermore, by their nature, "residual claimants to the firm's assets... have appropriate incentives to take economically rational decisions,"[229] thereby retaining a greater incentive to monitor agents and ensure corporate success.[230] However, similar to the task now faced by directors serving in an artificially created unified class of shareholder interests, once their directorial obligations span multiple constituencies directors must then identify the aggregate class of corporate interests—especially where the residual benefit begins to shift away from shareholders towards creditors.[231] Therefore, a

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224. A central aspect for the application of the business judgment rule is that directors are required to have considered all information reasonably available to them. This would understandably include the pre-existing contractual obligations facing the company. The directors will however be given deference by the courts when deciding what level of information the board should reasonably consider. *See In re* RJR Nabisco, Inc. Shareholders Litig., 1989 WL 7036, at *13 n.13 (Del. Ch. 1989).

225. Min Tan, *Why Not Stakeholder Theory*, 34(5) COMPANY LAW. 148, 155 (2013).

226. A "contract primacy regime [is] one in which '[s]hareholder primacy . . . remains[s] the default rule but where "creditors [can] . . . negotiate for control . . . ,displacing shareholder primacy,' per Ruben, *supra* note 179, at 352 (citing Tung, *supra* note 220, at 809-810) (alteration and ellipsis in original).

227. Ruben, *supra* note 179, at 354 (emphasis added); Hu & Westbrook, *supra* note 54, at 1321.

228. GULLIFER & PAYNE, *supra* note 169, at 3.1.

229. Eidenmüller, *supra* note 174, at 15.

230. "As the residual claimants, shareholders have the appropriate incentives..., to make discretionary decisions. The firm should invest in new products, plants and so forth, until the gains and costs are identical at the margin." EASTERBROOK & FISCHEL, *supra* note 173.

231. "When a firm has become insolvent, 'it is settled that under Delaware law' the directors owe fiduciary duties to the creditors because the "residual claimants" of corporate assets are the constituency to which directors owe their allegiance. Before insolvency, the residual claimants were the shareholders; after insolvency, they were the creditors. The fiduciary duty was never owed to

party with a nominal interest would either see their interests align with those of the aggregate class or be characterized as a deviant interest overridden by the class. This approach to directorial fiduciary duty allows suitable compromise in directorial direction largely unfettered by minority activists minorities. It also avoids overt reliance on a threshold wherein duties shift under the trust fund theory[232] or are expanded at a bright-line trigger within a residual framework under *Quadrant.*[233]

CONCLUSION

The emphasis on bright-line insolvency in the discharge of fiduciary duties presents significant challenges to directors. These challenges are somewhat mitigated by the fact that courts do not expect an absolute shift from shareholder value maximization to creditor protection and efficient liquidation. Instead, courts conceive of an aggregate residual class of interests comprising of shareholders and creditors alike. This prevents an extreme shift from sole primacy of shareholders at solvency to sole primacy of creditors at insolvency. While the extent of a director's change in strategy may be less extreme, the severity of overt reliance on a bright-line moment, at which insolvency is reached, remains a significant thorn in the side of directors seeking to grapple with a corporation's financial distress. An emphasis on the business judgment rule, with regards to both balancing constituency interests and the ex-ante identification of insolvency, serves to best alleviate these difficulties.

The potential for reduced accountability may be of some concern, but as this Article demonstrates, accountability remains where the business judgment rule is absent—namely, self-dealing and gross negligence. Furthermore, Arrowian theory tells us that there comes a point where there is a trade-off between accountability and facilitating the authority of directors to exercise their business judgment for the aggregate interests of debt and equity providers. The need for such authority may be all the more preferable when the corporation is facing insolvency and decisive action by the board is desired. To quote a rather seminal adage, the courts are "'not final because [they]are infallible, but [they] are infallible only because [they] are final."[234] Neither courts nor boards are infallible, but someone must be final."[235]

Ultimately, it is not the judiciary who must attempt corporate rescue or protect corporate investors ex-ante. Neither is it the judiciary who have presumed business expertise,[236] nor do they enjoy an albeit capitalist

shareholders because of ownership, but rather because of their residual claimant status." Hu & Westbrook, *supra* note 54, at 1340.

232. *Id.* at 1359.

233. Quadrant Structured Prods. v. Vertin, 102 A.3d 155, 174 n.4 (Del. Ch. 2014).

234. Brown v. Allen, 344 U.S. 443, 540 (1953).

235. Bainbridge, *supra* note 32, at 121.

236. Dodge v. Ford Motor Co., 170 N.W. 668, 508 (Mich. 1919).

democratic legitimacy[237] in their representation of shareholders. Accordingly, constraining the deference owed to directors attempting to grapple with the uncertainties of insolvency may ultimately undermine boards in their good faith endeavors to prevent or limit the fallout of insolvency.

237. *See* Kraakman et al., *supra* note 157, at Ch 3.