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Solving creditor problems in the twilight zone: Superfluous law and inadequate private solutions

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ABSTRACT

Fiduciary duties are an integral part of the corporate law landscape. The law and economics analysis of these duties, especially the duty of directors to maximize shareholder wealth, shows that these duties fill contractual gaps, saving on transaction costs. Although duties to shareholders are well settled, duties to other participants such as creditors or employees are heavily debated. In this paper, we use an agency theory framework to address the relative efficiency of a duty to creditors, a duty to refrain from wrongful trading, or contractual devices. Such an analysis makes clear what effect these rules have upon the behavior of shareholders and boards and whether these rules can efficiently address agency problems. The upshot of the analysis is that both types of rules protect creditors, but the same can be said of specific contractual solutions. It is therefore unclear if the rules mitigate costs above and beyond what could be achieved by contract. Furthermore, the analysis shows that the type of bankruptcy system matters as well. Creditor protection is best delivered via a board friendly bankruptcy system instead of with a creditor friendly system that includes a wrongful trading rule. The conclusion is that creditor duties, or wrongful trading rules, are superfluous, while private solutions are still inadequate to solve all the agency problems in a way that the proponents of both types of creditor protections aim for.
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1. Introduction

Do directors owe creditors anything? Anything, that is, beyond what is required of directors by contract and debtor–creditor law, like laws against fraudulent transfers? Despite decades of scholarship, and myriad articles, there is no consensus on the issue.

Directors have duties of loyalty and care, enforceable by shareholders to varying degrees in almost all jurisdictions.[1] But should creditors also enforce these duties?

We use organizational theory, particularly agency theory, to examine the issue. Application of agency theory to the problem is not new in this field. But what is new is to take it as the central notion.

Agency theory is more typically the unstated background assumption of discussions of duties to creditors, reflecting the widespread use of agency theory in general discussions of corporate law, particularly in the United States. We use agency theory to highlight specific behavioral problems that rules, regulations and private contracting may solve or mitigate.

The analysis in this paper shows two main things. First, a fiduciary duty to creditors or a wrongful trading rule does protect creditors, but the same can be said of contractual solutions. It is unclear whether the rules mitigate costs above and beyond what could be achieved by contract. Second, we show that a fiduciary duty or a wrongful trading rule forces a control shift in the distressed firm. The efficiency of this shift depends on the ownership structure of the debt and equity claims in the firm, but we argue that in all instances a reorganization-based bankruptcy rule is preferable. In short, duties to creditors will be unnecessary in economies that have well-developed reorganization systems, like the United States and Canada,[2] while in economies which are dominated by liquidation systems such duties will not provide efficient incentives to restructure. Moreover, since reorganization systems probably have benefits independent of those examined in this paper, it would seem that there is little reason to use fiduciary duties to protect creditors. Rather adoption of a reorganization system would seem to better suit the overall goals of most bankruptcy systems.

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[1] See Kraakman et al. (2009) for a discussion. The duty of care tends to be somewhat aspirational in Delaware: Lubben and Darnell (2006).

[2] See Ben-Ishai and Lubben (2011) for a comparative overview.

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The structure of the paper is as follows: the next section reviews the fiduciary duties that apply to directors, including potential duties to creditors. Section 3 reviews agency theory. We introduce a simple classification scheme of the ownership structure of firms that helps to identify the scope of agency problems that arise and whether or not a duty to creditors will be relevant. Section 4 discusses the effects of alternative regulatory solutions to the specific agency problems we identify. Section 5 brings these effects together and Section 6 concludes.

2. Fiduciary duties in the twilight zone

This section examines both the existing fiduciary duties that directors are subjected to in most jurisdictions, and the potential duties they owe to creditors. The latter duties are varied, even inconsistent across jurisdictions, and comprise not only fiduciary duties but also similar mechanisms, such as wrongful trading rules and other rules that impose liability on directors for a firm's financial collapse.[3]

2.1. A shareholder maximization duty?

The board of directors and senior management of a solvent company typically owe fiduciary duties to the corporation and its shareholders.[4] Generally, no such duties are owed to creditors of a solvent company.[5] Rather, the obligations owed to creditors are defined by contract.[6] The fiduciary duties owed to the corporation and its shareholders include the duty of loyalty and the duty of care.[7]

The duties of loyalty and care are always enforceable by the shareholders, at least before the appointment of a trustee, and are often said to buttress a broader duty to maximize shareholder value. The shareholder maximization norm allegedly arose out of the famous *Dodge v Ford Motor Co*.[8]

Summarizing the case to the extreme, Henry Ford had decided to stop paying out special dividends in order to expand the business, lower the prices of his cars and improve quality. He was of the opinion that he earned too much and had an obligation to benefit the public, workers and customers. Minority shareholder Dodge complained of improper altruism. The court agreed with that and stated: "it is not within the lawful purposes of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefitting others."[9]

Dodge v Ford is famous, but also rather controversial.[10] The facts are rather unique, even odd, and the duty it allegedly created may be the product of a chief executive unversed in modern public relations.[11] In most instances directors can safely ignore the norm allegedly created by this case, as their conduct will be protected by the business judgment rule in any event.[12]

The latter rule, and the addition of statutory protections like Delaware's section 102(b)(7), illustrate the largely hortatory nature of the duty of care, especially in the United States.[13] Absent a complete failure to act, director liability is rarely found for a lack of care.[14] Moreover, with the (possible) exception of the United States, directors often operate under an obligation to a broad range of constituents, making any generalized statements about shareholder maximization somewhat suspect.[15]

The duty of loyalty imposes an obligation to refrain from conduct that is either harmful to the corporation and its shareholders or is solely in the directors' or officers' own interests.[16] This duty is more robust than the duty of care, and operates as a general prohibition on self-dealing, unless the director can prove the transaction was fair to the corporation.

Both are said to support the goal of shareholder wealth maximization by prohibiting actions that no sane investor would agree to ex ante. As it currently stands, the academic debate seems still far from settled, but from a descriptive point of view American courts, or at least Delaware courts, apparently embrace it. The question in this paper is whether other norms should exist that would preclude, bound, or supersede the shareholder-focused norm.[17]

The key difficulty in introducing an additional norm, or norms enforceable by other stakeholders lies in enforcement. If the proposed alternative norm is not directly enforceable by the new stakeholder, it becomes little more than a cover for directorial self-dealing, the one thing a shareholder-focused norm clearly prevents. Thus, shareholder maximization remains the only apparent norm as much out of inertia as out of any strong normative attraction to the rule – other rules being just too difficult or costly to enforce, or too dangerous to not enforce.

2.2. Duty to creditors; a general discussion

The most common justification for extending the traditional corporate fiduciary duties to creditors turns on the absolute priority rule. The rule provides the order in which claimants are paid

[3] In the United States, the provisions of the new Dodd–Frank orderly liquidation authority that allow for recovery of officer and director salary earned within two years of a financial institution's collapse can be seen as an example of the latter.

[4] See Bainbridge (2002) for an introduction and Kraakman et al. (2009) for a jurisdictional overview. And, for example, California Corporations Code § 309(a) ("A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders . . .").

[5] Kraakman et al. (2009). See, for example, Lorenz v. CSX Corp., 1 F.3d 1406, 1417 (3d Cir. 1993), N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99–101 (Del. 2007).

[6] Pittelman v. Pearce, 8 Cal. Rptr. 2d 359 (Cal. Ap. 1992) (bondholder rights are defined by contract).

[7] Statewide Tobacco Services Ltd v Morley (1990) 2 ACSR 405. In Delaware, these duties are a matter of common law. In many other jurisdictions, even within the U.S., they are codified. For example, Australia Corporations Act 2001 §§ 180–83; Canada Business Corporations Act, R.S.C. 1985, c. C-44, s. 122(1). See also Ontario Business Corporations Act, RSO 1990, c. B16 (OBCA), s. 132(5); chapter 1, section 8 of the Limited Liabilities Companies Act of Finland ("The management of the company shall act with due care and promote the interests of the company.").

[8] 170 N.W. 668 (Mich. 1919). See for example, Bainbridge (2002, p. 410) for a short introduction to the case. But see, for example, Henderson (2007) for a discussion of the case against the specific political background of the case from which he concludes that the case does not create such a norm, but creates a rule which forces participants to contract on control rights.

[9] 170 N.W. 684 (Mich. 1919).

[10] Stout (2002).

[11] See Baird and Henderson (2007), Stout (2002), Henderson (2007) for recent discussions on the case.

[12] Baird and Henderson (2007) illustrate this with specific cases, but move even beyond that by questioning whether the cases show that even a general duty to shareholders does exists. They then develop the argument that it is efficient to abolish the shareholder maximization norm. In the United States the business judgment rule is a matter of common law, but in some jurisdictions, like Australia, it has been codified. See § 180(2) of the Corporations Act of New South Wales.

[13] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Under § 102(b)(7) of the Delaware General Corporation Law, a corporation may eliminate personal liability for breaches of the duty of care. Liability may not be eliminated for breaches of the duty of loyalty.

[14] Lexi Holdings Plc (In Administration) v Luqman & Ors [2009] EWCA Civ 117.

[15] § 172 U.K. Companies Act 2006; Sarra (2003).

[16] Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243–44 (Del. 2009).

[17] We leave the argument(s) for an even more general duty to stakeholders outside the discussion. The focus in this paper is on those participants with ownership-oriented claims on the firm and not so much on stakeholder claims. For a discussion of these arguments for a stakeholder duty see among others Kraakman et al. (2009), Bainbridge (2002), LoPucki (2004) and Stout (2002).

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