1995

Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors

Ann E. Conaway

Delaware Journal of Corporate Law

VOLUME 20 1995 NUMBER 1

REEXAMINING THE FIDUCIARY PARADIGM AT CORPORATE INSOLVENCY AND DISSOLUTION: DEFINING DIRECTORS' DUTIES TO CREDITORS

BY ANN E. CONAWAY STILSON*

TABLE OF CONTENTS

*Associate Professor of Law, Widener University School of Law; J.D., Temple University School of Law; B.A., University of Georgia.

In October of 1990, Chancellor William T. Allen of the Delaware Court of Chancery appointed Professor Stilson to serve as master pro hac vice *in a case of first impression in the United States. The case,* In re RegO Co.,[1] *involved the classic conflict between mass products liability claims and corporate dissolution law. RegO, a Delaware corporation, manufactured allegedly defective component parts to a liquified petroleum gas system. These defects had caused, and were projected to cause for decades into the future, personal injury and property damage to consumers. In* RegO, *a Delaware corporation elected to dissolve and wind up its business pursuant to newly-enacted and amended dissolution*

[1]623 A.2d 92 (Del. Ch. 1992).

statutes.[2] *Ostensibly, management pursued dissolution in order to preserve corporate assets against escalating litigation costs, insurance premiums, and judgments rendered in the products liability suits.*

The dissolution statutes, arguable "tort reformist" legislation, seemed to answer all the calls for reform by tort proponents. The statutes required: (1) "sufficient security" for all future unknown claims and/or claimants; (2) temporal parity among contingent and unknown claimants; and (3) pro rata payments for claims of "equal priority" to the extent the corporation had "insufficient funds" to pay "all claims and obligations in full." The "tort reform" theory, however, was unacceptable in practice. Indeed, the statute was so rife with ambiguity and risk-assumption by directors that it was amended in 1994. This article reflects Professor Stilson's perceptions on RegO *and the issue which the case left unanswered — the nature and scope of directorial duties to creditors in modern corporate jurisprudence.*

I. INTRODUCTION

The "directorial duty to creditors" exists as an apparent anachronism in present corporate jurisprudence. The duty is anachronistic in the sense that it was born out of the nineteenth century trust fund doctrine[3] and carried forward into the twentieth century without regard to the circumstances giving rise to its genesis.[4] As currently articulated, the duty to creditors arises upon dissolution[5] or insolvency[6] of the corporate

---

[2]*Id.* at 94. *See* DEL. CODE ANN. tit. 8, §§ 280-282 (1991).

[3]*See* 16A WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8217 (perm. ed. rev. vol. 1988) (permitting equity to create a "trust fund" upon the assets of a corporation for the benefit of stockholders and creditors); *see also infra* notes 359-420 and accompanying text (discussing the development of the trust fund doctrine).

[4]*See infra* notes 411-20 (tracking the application of the trust fund doctrine in the twentieth century).

[5]In a dissolution, the corporation is terminated, its assets liquidated, and the proceeds distributed to its creditors and stockholders according to statutory, contractual, or common law priorities. Dissolution has been described as

> a termination of the entity [that] ends its capacity to act as a corporate body. The remains, so to speak, may necessitate a liquidation and an extinguishment of all its prior relations in respect to the corporate enterprise, including the adjustment and payment of its debts, the distribution of its property or the sale of its property and the distribution of the proceeds. . . . The dissolution of a corporation is said to be that condition of law and fact which ends the capacity of the corporation to act as such, and necessitates a final liquidation and extinguishes all the legal relations subsisting in respect of the corporate enterprise. The dissolution intended by statutes governing the dissolution of corporations is a breaking up of the corporation. The

enterprise.[7] Unfortunately, present case law fails to provide managers with the tools for predicting exactly when insolvency occurs and, hence, when a duty to creditors exists.[8] Additionally, case law fails to address whether the duty to creditors gains ascendancy over, or operates as a complement to, traditionalist directorial obligations to stockholders.[9]

---

term has its ordinary meaning of separation into component parts.

8 SEYMOUR D. THOMPSON & JOSEPH W. THOMPSON, COMMENTARIES ON THE LAW OF CORPORATIONS § 6415 (3d ed. 1927) (footnotes omitted).

[6]Insolvency is said to occur in one of two situations. The first circumstance giving rise to insolvency occurs when the corporation's liabilities exceed its assets and there is no reasonable expectation that the business can be continued ("bankruptcy" insolvency). Freeman v. Hare & Chase, Inc., 142 A. 793, 795 (Del. Ch. 1928). The second circumstance resulting in insolvency arises when the corporation is unable to pay its debts as they come due in the ordinary course of the business ("equitable" insolvency). *Id.*

[7]*See infra* note 36 and accompanying text; *cf. In re* Liberty Trust Co., 130 B.R. 467, 472 n.11 (Bankr. W.D. Tex. 1991) (noting the distinction between dissolution and liquidation under Texas law).

[8]*Compare* Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12,150, 1991 Del. Ch. LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 DEL. J. CORP. L. 1099, 1155 (1992) (articulating a directorial duty to creditors where a corporation is "operating in the vicinity of insolvency") *with* Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. Ch. 1992) (concluding that the fiduciary duty to creditors arises upon insolvency "in fact").

[9]"Traditionalist" corporate theory considers a corporation to be an entity separate from its owners, and thus independently liable for its contract and tort obligations. PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATIONS § 1.01.1 (1983). Because traditionalist corporate theory recognized the independence of the corporate entity from its shareholders, management of the entity was placed in the hands of directors who were duly elected by the shareholders. *See* DEL. CODE ANN. tit. 8, § 141(a) (1991). Corporate law thereby separated the powers of the owners and managers to the entity. By dividing management from equity ownership, corporate law acknowledged the potential abuse of stockholders by directors. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (referring to the "omnipresent specter" of directorial self-interest). In response, corporate law imposes a fiduciary duty upon directors to act honestly and in good faith when carrying out the business affairs of the corporation (the duty of care). *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993). Corporate law also requires directors to refrain from placing their own interests before those of the stockholders and the corporation (the duty of loyalty). Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). A director's failure to fulfill these fiduciary duties can result in personal liability. *See, e.g.*, *id.* at 893 (finding directors personally liable for a breach of their fiduciary duty of care).

The entity theory of corporate law traces its history at least to mid-nineteenth century England. *See* BLUMBERG, *supra*, § 1.01.1. In the United States, the entity theory has received such widespread acceptance that corporations have been accorded many of the constitutional protections previously applied only to natural persons. *See, e.g.*, First Nat'l Bank of Boston v. Bellotti, 435 U.S. 765, 784 (1978) (corporation has a First Amendment right to freedom of speech); Hale v. Henkel, 201 U.S. 43, 76 (1906) (corporation is protected from unreasonable searches and seizures); Smyth v. Ames, 169 U.S. 466, 546 (1898) (corporation cannot have its

Finally, the parameters of this duty, and its correlative standards of judicial review, are nebulous.[10] Indeed, courts have not delineated whether the duty to creditors is akin to (1) the established corporate duties of care and loyalty;[11] (2) an informational obligation analogous to that of the corporate duty of disclosure;[12] or (3) an obligation coextensive with the contractual duties of good faith and fair dealing.[13]

Failure to fulfill their statutory or common law responsibilities may result in astounding personal liability for individual managers.[14] Therefore, precise delineation of the nature and scope of the duty owed to creditors is crucial to directors who must oversee the business affairs

---

property taken without just compensation). *See generally* Note, *Constitutional Rights of the Corporate Person*, 91 YALE L.J. 1641 (1982).

The entity or traditionalist theory, however, has been the target of substantial criticism. For example, the Hohfeldian or "realist" theory of corporate law suggests that doing business in the corporate form is "nothing more than an association of such individuals." WESLEY N. HOHFELD, FUNDAMENTAL LEGAL CONCEPTIONS 197 (1923). Under a realist view of corporate law, therefore, owners of the corporation are liable for corporate debts.

Increasingly, corporate theory has moved away from the entity theory and in the direction of a contractarian model of governance. *See* BLUMBERG, *supra*, § 1.01.1. To contractarians (adherents to the Chicago school of economics), the traditional fiduciary model compromises the market for corporate control and thus impedes profit maximization to shareholders. Thomas L. Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 N.C. L. REV. 273, 274-75 (1991). As a consequence, scholars adhering to the contractarian model consider the corporation to be a simple "nexus of contracts" which allows corporate constituents to contract freely concerning their relationship to, and rights against, the corporate persona. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976); *see generally* William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989). Accordingly, contractarian scholars argue that the fiduciary model should be eliminated in favor of market control through a contract model of corporate governance. *See* Hazen, *supra*, at 274.

[10]For purposes of this article, all references to corporate "duties" allude to judicially or statutorily imposed *standards of conduct* as opposed to the *standards of judicial review* under which they are judged.

[11]*See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989).

[12]Zirn v. VLI Corp., 621 A.2d 773, 778 (Del. 1993).

[13]*See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."); *see also* U.C.C. § 1-203 (1989) ("Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."). The term "good faith" is defined in the UCC as having subjective and objective attributes by requiring "in the case of a merchant . . . honesty in fact [(subjective and objective)] and the observance of reasonable commercial standards of fair dealing in the trade [(objective)]." U.C.C. § 2-103 (1989). The terms "good faith" and "fair dealing" are not defined in the *Restatement*.

[14]*See* ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 727 (4th ed. 1990) (noting that the personal liability of directors in Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), amounted to $23,500,000).

of a corporation. Moreover, managers who wish to utilize recent developments in the jurisprudence of business organizations[15] must divine whether the duty to creditors is subject to contractual amendment. Consequently, a reliable characterization of the directorial duty to creditors is integral to directors who must satisfy both traditional and contractual[16] corporate obligations.

The ambiguities surrounding the duty to creditors are aggravated by several recent developments in Delaware. For example, current amendments to the Delaware General Corporation Law (DGCL) permit the contractual *elimination* of a director's liability for violations of the corporate fiduciary duty of care in specific situations.[17] Interestingly, however, an analogous "opt out" of directorial liability for the fiduciary duty of care is lacking for persons who manage other Delaware business organizations.[18] Conversely, the Delaware Revised Uniform Limited Partnership Act (DRULPA)[19] and the Delaware Limited Liability Company Act (DLLCA)[20] authorize modifications and amendments to the managerial duty of loyalty which, at present, is inviolable under Delaware corporate law. Based on these evidently conflicting statutes, Delaware managers, and their counsel, must surmise Delaware's adherence to traditionalist or contractarian precepts.

On the common law front, three recent decisions of the Delaware Court of Chancery exacerbate the conundrum of planning for managers of Delaware business organizations. First, *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*[21] seemingly imposes a

---

[15]*See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1993).

[16]Contractarian theory considers the modern corporation to reflect a nexus of private ordering by the constituents to the firm. *See supra* note 9. Accordingly, contractarians support enforcement of corporate provisions which eliminate or restrict managerial duties and liabilities.

[17]DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1993) (permitting a charter provision which eliminates or limits the personal liability of a director or officer to the corporation or its stockholders for monetary damages for breach of fiduciary duties if (1) the duty was not one of loyalty to the corporation or its stockholders, (2) the breach did not involve acts or omissions in bad faith or result from intentional misconduct, and (3) the alleged conduct did not result in an improper personal benefit to the officer or director).

[18]*See* DEL. CODE ANN. tit. 6, § 17-1101(d) (1993) (permitting only the restriction, and not the elimination, of directorial duties); *see also id.* § 18-1101(c)(2) (1993).

[19]DEL. CODE ANN. tit. 6, § 17-1101(d) (1993) (permitting the expansion or restriction of any of a partner's duties and liabilities by provisions in a partnership agreement).

[20]DEL. CODE ANN. tit. 6, § 18-1101(c)(2) (1993) (allowing the expansion or restriction of any of a member's or manager's duties and liabilities by provisions in a limited liability company agreement).

[21]No. 12,150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 DEL. J. CORP. L. 1099 (1992).

directorial obligation to creditors where a corporation is "operating in the vicinity" of insolvency (thus extending directorial liability to a period pre-insolvency).[22] Second, *In re RegO Co.*[23] purports to exact a heightened standard of conduct from directors who elect to dissolve a corporate entity in the face of existing, contingent, and future unknown contract and tort claims, and thus extends directorial liability post-dissolution.[24] Finally, *In re USACafes L.P. Litigation*[25] creates a direct fiduciary relationship between directors of a corporate general partner and limited partners in a Delaware limited partnership,[26] and thus highlights the conflict between liability for misconduct by corporate managers and misconduct by partnership or limited liability company managers. Given these decisions, expanded use of contractual "opt out" provisions for managers of Delaware business organizations is likely.

This article addresses the duty to creditors from several perspectives. Part Two presents a hypothetical to examine the legal and practical implications of imposing a directorial duty to creditors. Part Three responds to the hypothetical by examining the statutory and common law alternatives available to our hypothetical directors. Part Four presents the theoretical arguments incident to a duty to creditors and the ramifications of its characterization in business organization law. The article concludes by advocating the abandonment of any corporate duty to creditors in favor of existing contractual obligations of good faith and fair dealing and common law actions for fraud. A corresponding abandonment of historical equitable doctrines is likewise suggested in light of equity's symbiosis with the duty to creditors. The article also recommends the adoption of a contractarian theory of corporate governance.

II. A HYPOTHETICAL ANALYSIS

A. *The Hypothetical Facts*

Assume a corporation is formed for the purpose of developing and manufacturing a product that will contain and aid in the removal of toxic waste spills. After five years in business, sales and profits are high, but the founders/directors of the business wish to disentangle themselves from the increasing stress of managing the company. Unfortunately, the

---

[22] *Id.* at *108, *reprinted in* 17 DEL. J. CORP. L. at 1155.

[23] 623 A.2d 92 (Del. Ch. 1992).

[24] *Id.* at 106-07.

[25] 600 A.2d 43 (Del. Ch. 1991).

[26] *Id.* at 48-49.

corporation has experienced recent liability exposure due to a batch of their product that was inadvertently manufactured with latent, material defects. In fact, the corporation currently has five pending personal injury suits, as well as a $1 million property damage claim outstanding as a result of these defective products.

The founders wish to dissolve the corporation, liquidate its assets, and invest whatever money remains in a new venture. This new venture will pursue a streamlined manufacturing process for the original corporation's product. The company's assets are valued at $15 million and supplier debts are a modest $1 million. The founders fully intend to pay the $1 million property judgment. The founders are concerned, however, about recent scientific studies that indicate that their product is likely to fail and cause future accidents similar to those involved in the property damage and personal injury claims. According to these reports, the founders can easily anticipate personal injury claims with a present value of $12.5 million for the next fifteen years.

In pursuing the termination of the business, the founders wish to know what duty they owe to their existing, contingent, and future unknown creditors. Specifically, they ask whether they may sell the company assets at auction, declare a dividend prior to any dissolution, and use those funds to capitalize a new Delaware limited partnership or limited liability company. This new entity will engage in a similar business, but will eliminate all managerial liability to creditors in its partnership or liability company agreement.

B. *A General Commentary*

The death of a corporate enterprise (whether through dissolution or an insolvency which leads to liquidation) presents difficult planning questions for corporate directors and officers. One aspect of these planning questions concerns the rights of creditors upon the corporation's demise.

These planning questions are further complicated where the defunct, or soon-to-be defunct, corporation engaged in the manufacture of a defective product that caused, and continues to cause, personal injury or property damage years to decades after its manufacture. The future tort liability (liability tail) of the corporation may serve as the impetus for a voluntary dissolution[27] or may cause an insolvency without a

---

[27]This "dissolution incentive" for corporate defendants has not gone unnoticed. *See, e.g.*, Mark R. Sarlitto, Note, *Recognizing Products Liability Claims at Dissolution: The Compatibility of Corporate and Tort Law Principles*, 87 COLUM. L. REV. 1048, 1052 (1987);

corresponding dissolution. In either case, the immediate dilemma posed to directors is how best to terminate the corporation, marshall its assets, pay its liabilities, and distribute any remaining monies to its stockholders.[28]

Clearly, the directors' decision to wind up the affairs of the corporation will be driven by a desire to minimize the future liability of the directors and shareholders of the business for products claims or for distributions made to the owners or managers upon liquidation.[29] On an instinctual level, one might advise the directors to dissolve the corporation and simultaneously to adopt a plan of distribution which would pay all existing and contingent contract and tort claims, as well as claims likely to arise within a reasonable time post-dissolution.[30] Any

---

see generally Michael D. Green, *Successor Liability: The Superiority of Statutory Reform to Protect Products Liability Claimants*, 72 CORNELL L. REV. 17 (1986); Harry G. Henn & John R. Alexander, *Effect of Corporate Dissolution on Products Liability Claims*, 56 CORNELL L. REV. 865 (1971); Theresa A. Nuhn, *Continuing Corporate Existence for Post-Dissolution Claims: The Defective Products Dilemma*, 13 PAC. L.J. 1227 (1982); Mark J. Roe, *Mergers, Acquisitions, and Tort: A Comment on the Problem of Successor Corporation Liability*, 70 VA. L. REV. 1559 (1984).

[28]Dissolution law typically requires that liquidating distributions be paid to creditors before any payment is made to shareholders (the "absolute priority" rule). *See, e.g.*, 3 MODEL BUSINESS CORP. ACT § 14.05(a) (1994) (requiring that provision be made for discharging corporate liabilities before distributions may be made to shareholders). This absolute priority rule may be compromised where the dissolving corporation anticipates future products liability claims subsequent to the statutory bar date post-dissolution. Commentators have argued that a failure to observe the absolute priority rule in the circumstance of long-tail tort claimants "disturb[s] the correlation between social efficiency and maximization of shareholder wealth" and encourages the dissolution incentive without concern for product or consumer safety. Sarlitto, *supra* note 27, at 1064.

[29]Most jurisdictions have adopted statutes which supersede the common law rule that dissolution terminated the corporation's capacity to sue or be sued. *See infra* notes 306-29 and accompanying text.

[30]Identification of an interval during which the corporation or its successor will be liable presents one substantial difficulty in providing security for future unknown claimants in the dissolution process. Certainly, to whatever extent legislation requires protection for *all* foreseeable injuries, the monies appropriated to fund trusts or escrow accounts will be depleted on an annual basis by administrative costs, attorneys' fees, and costs of defending personal injury suits. It seems that such an extended freeze on assets becomes counterproductive at the point when costs and fees exceed the amount of monies being paid to legitimate claimants.

An alternative appears to be an independent bar date after which remaining resources must be distributed to claimants who previously received only a partial payment due to the anticipated, yet unrealized, future injury of another consumer. *See infra* notes 194-205 and accompanying text. This claims assertion date would not be considered a statute of limitations because the period of repose would not begin to run on the exact date of an injury or manifestation of an injury. *Id.* Instead, the claims assertion date would serve to balance the interests of anticipated future claimants, as well as those who have present injuries and who have not received full compensation. *Id.* An *ad hoc* claims assertion date depending on the

monies in excess of the distribution plan would inure to the corporation's equity holders.

One attraction of such a plan of dissolution and accompanying scheme for distribution is its certainty of payment to contracting parties and posting of security for pending, and reasonably foreseeable, claims and claimants. Within that zone of certainty are suppliers and creditors of the liquidating corporation that have provided goods or services for several years and that have developed an expectation of, and reliance upon, repayment. Tort claimants who are ascertainable as of the date of the corporate termination, or within a reasonable interval post-dissolution, also share in the zone of certainty.

A dissolution and distribution scheme that compensates, or provides security for, only the above-mentioned claims and claimants has a further advantage. Such an arrangement would redeploy capital and assets into the stream of commerce within a reasonable time post-corporate liquidation. The beneficiaries of this redeployment scheme are not only those individuals who are in existence at the time of the corporation's demise but also those who are in need of the capital anticipated to be released by the dissolved corporation upon liquidation. Finally, the known and reasonably foreseeable claim[31] plan of distribution would provide the economic incentive to corporate managers to negotiate the prompt settlement of contingent or short-term future claims in order to place corporate assets back into productive use.[32]

---

nature of each case and the allegedly defective product would result in continuous review by the court of original jurisdiction at a cost that would often deplete assets beyond those available for distribution to claimants. *Id. Cf.* DEL. CODE ANN. tit. 8, §§ 280-282 (1994) (setting forth a 10-year bar date for unknown claims).

[31]"Foreseeable" claims are those which are not in existence at the time of dissolution or those which will manifest themselves during the post-dissolution winding-up interval but which are statistically foreseeable by the corporation at the time of dissolution, based upon the claims' history of the firm. Examples of future foreseeable claims include injuries resulting from exposure to asbestos, DES, electromagnetic fields, toxic chemicals, and use of defectively-manufactured products.

[32]Proponents for reform in the area of mass tort liability dispute such a combined dissolution and plan of distribution where it fails to provide relief for *all* future foreseeable claimants. To these proponents, corporate defendants who knowingly manufacture products with latent defects are chargeable for all resulting liability and, therefore, should not be able to evade that liability through a dissolution designed solely to limit long-term tort liability. *See* Green, *supra* note 27, at 49-58. The "corporate dissolution incentive," according to these proponents, should be eliminated through corporate legislation which requires some form of future protection for all delayed-occurrence injuries whether through mandatory trust funds, escrow accounts, or insurance. *Id.* at 50-51.

To these tort reform proponents, corporate statutory reform is mandated because liberalized successor liability law has proven an inadequate remedy for future products liability

Directors who wish to terminate a corporate enterprise in light, or because, of the company's products' history, therefore, face a legal dilemma: To what extent does corporate law impose an obligation upon directors to protect future unknown claimants who are, or foreseeably will be, plaintiffs injured as a result of products manufactured by the dissolved corporation. Because statistics may indicate a liability tail of several decades, directors must necessarily balance any provision made for contingent and prospective tort plaintiffs against the rights and needs of existing judgment creditors of the corporation.[33]

III. A RESPONSE TO THE HYPOTHETICAL

Fundamental corporate decisions that presently confront directors of dissolving or insolvent corporations necessarily weigh the rights of creditors against the redeployment of corporate assets for future economic gain. In the hypothetical, the founders/directors wish to dissolve the original enterprise in a manner that compensates creditors fairly but that preserves some assets for use in a new venture. The founders also wish to utilize recent amendments to the business organization law of Delaware to commence a new enterprise free from the creditor concerns which they now face.

In Delaware, directors have at least two options when considering dissolution of our hypothetical corporate enterprise. First, the directors can elect to proceed under sections 280 through 281 of the DGCL.[34] Alternatively, the directors can opt to precede dissolution with a sale of the firm's assets at auction, a settlement of all mature claims, and the payment of a liquidating dividend to stockholders from any surplus proceeds.[35]

---

claimants. *Id.* at 41. For example, under traditional corporate governance models, a liquidating corporation may precede its dissolution with a sale of all, or substantially all, of its assets to another corporate entity in combination with an agreement between the constituent corporations that the selling corporation's liabilities will not follow its former assets. In this manner, corporate assets leave the dissolved entity in return for cash which will be applied to the payment of corporate debts. As a consequence, all future income generated by the dissolved company's former assets will accrue solely to the successor corporation. Corporate law thus allows a sale of assets to defeat or, at a minimum, compromise the claims of creditors, stockholders, and consumers injured by products which manifest latent defects.

[33]*See* Sarlitto, *supra* note 27, at 1052 (citing REINSURANCE ASS'N OF AMERICA, LOSS DEVELOPMENT STUDY: 1985 EDITION 5 (1985) (suggesting that as much as 25% of general liability claims to insurers develop over the course of two decades).

[34]*See infra* notes 36-247 (discussing this option).

[35]*See infra* notes 248-420 (discussing this option).

Unfortunately, either alternative poses snares for the unwary manager. Because the deception results from the conceptual blurring of corporate insolvency and dissolution, the following materials expose, in detail, the pitfalls of maintaining a creditor remedy within corporate dogma.

For ease of comprehension, the remainder of Part Three is organized according to statutory and common law alternatives. The detail with which these topics is explored is necessitated by (1) the complexity of the legal issues presented and (2) the author's thesis that the creditor duty (and its historic precedence) should be abolished in favor of contract remedies and actions in common law fraud.

A. *Query: For Purposes of Defining Directorial Duties to Creditors, Will a Corporation with Significant Contingent and Future Unasserted Liabilities be Deemed to be Solvent or Insolvent at the Time of Dissolution?*

Present case law requires a determination of the solvency of a firm at the time of dissolution in order to delineate the parameters of directorial obligations.[36] In particular, if a firm is insolvent at the moment of dissolution, directors are said to owe a duty to creditors.[37] The logical corollary to the insolvency test is that no such duty exists if a corporation is solvent at dissolution.[38]

In the hypothetical, we must determine whether a dissolving firm that has, in the aggregate, liquidated, contingent, and future unasserted claims in excess of corporate assets is insolvent for the purpose of identifying directorial duties to creditors. Specifically, if the existence of contingent and future foreseeable claims render the hypothetical corporation insolvent, the directors owe a fiduciary duty to creditors. In addition, imposition of a directorial obligation to creditors would presumably

---

[36]*See, e.g.*, *Geyer*, 621 A.2d at 787 (concluding that the fiduciary duty to creditors arises upon insolvency "in fact"); *Credit Lyonnais*, No. 12,150, 1991 Del. Ch. LEXIS 215, at *108, *reprinted in* 17 DEL. J. CORP. L. at 1155 (articulating a directorial duty to creditors where a corporation is "operating in the vicinity of insolvency").

[37]*Geyer*, 621 A.2d at 787. Of course, the *Credit Lyonnais* opinion extends the duty to creditors to the interval preceding dissolution where the corporation is "operating in the vicinity of insolvency." *Credit Lyonnais*, No. 12,150, 1991 Del. Ch. LEXIS 215, at *108, *reprinted in* 17 DEL. J. CORP. L. at 1155.

[38]The true irony of the "duty to creditors" is that the duty arises at the precise moment at which the corporation, by definition, is unable to pay all creditor claims. Indeed, the duty suggests that *creditors must be paid in full at insolvency*! Yet, if the duty is only that creditors must be paid before equity holders, then the duty is redundant in light of basic principles of contract and commercial law.

compromise, if not preempt, the directors' duties to shareholders. Accordingly, if the duty to creditors attaches, the ability of our hypothetical directors to sell company assets at auction or to declare a dividend is manifestly curtailed.

As applied to the hypothetical, it is clear that the conventional definitions of insolvency[39] fail to give consideration to contingent and future foreseeable claims against a corporation considering dissolution. For example, does the term "liability" encompass claims that, in good faith, are in dispute? Similarly, does the term "liability" include claims that are not in existence at the time of a firm's dissolution (or during the statutory winding-up period post-dissolution), yet are anticipated to arise in the decades which follow the firm's demise? If an affirmative response is given to either of the above questions, then corporations that otherwise consider themselves solvent at dissolution are, instead, insolvent and, thus, under an "obligation" to their creditors.

In *Ray v. Alad Corp.*,[40] a California court held that the California dissolution statute that required compensation of "known debts and liabilities"[41] clearly did not require payment of claims that arose "more than six months after the filing of the dissolution certificate."[42] Similarly, an interpretation of "liability," arguably, should not include "contingent" claims.[43] Although a party may presently assert a contingent claim, the claim is in dispute and, thus, "contingent" as to its success.[44]

Because many failing businesses exit corporate life through bankruptcy proceedings, bankruptcy courts have increasingly sought to

---

[39]*See supra* note 6.

[40]560 P.2d 3 (Cal. 1977).

[41]*Id.* at 9 n.5 (emphasis omitted). A "known" claim against a corporation anticipating dissolution includes rights under supplier contracts, mortgage obligations, employee wages, tax obligations, rights pursuant to indemnification agreements, judgements held by tort claimants, and all other claims against the corporation which are in existence and/or identifiable as to claim and claimant at the time of dissolution.

[42]*Id.* at 9. Although the court in *Ray* relied upon a literalist construction of the California statute, another court could reach a contrary conclusion based upon a liberal interpretation of "liabilities."

[43]A "contingent" claim is one which is already asserted or expected to be asserted against the corporation and, thus, is known and identifiable to corporate managers at the time of dissolution. A "contingent" claim, however, is disputed and, therefore, contingent as to its likelihood of success on the merits. Examples of contingent claims include suits in progress regarding breaches of contracts, agreements of indemnification, or claims of negligence by the corporation.

[44]*See* 3 MODEL BUSINESS CORP. ACT § 14.06 (d) (1994) (providing that the term "'claim' does not include a contingent liability or a claim based on an event occurring after the effective date of dissolution").

delineate directorial obligations to creditors under the Bankruptcy Reform Act of 1978 (Bankruptcy Act). The result is that, in bankruptcy actions, insolvency occurs when the sum of a debtor's obligations at fair value exceeds the value of all its property.[45] On the particular issue of the rights of future foreseeable claimants under the Bankruptcy Act, the court in *In re Johns-Manville Corp.*[46] held that future claimants do not hold "claims" in a bankruptcy sense but were instead "parties in interest" who were entitled to appear and be heard in the reorganization of the firm.[47] The court so concluded because (1) some state insurance laws predicated claims liability on *exposure* to asbestos rather than manifestation of injury;[48] and (2) to deny a forum to these "parties in interest" would simply bring the reorganized entity back to the bankruptcy court with each new post-organization asbestos suit.[49]

In 1992, the Delaware Court of Chancery considered the issue of corporate "insolvency" or "insufficiency of funds" under Delaware's recently-enacted dissolution statutes.[50] In particular, the court examined the effect of those terms in determining the rights of contingent and future unknown claimants to the assets of a dissolving corporation.[51] Due to the *RegO* court's attempt to delimit the statutory dissolution rights of existing and future unknown claimants to corporate assets, as well as the significant corporate issues which the case left unresolved, a detailed discussion of the case follows. In particular, the following sections will discuss whether creditors may use *RegO* to impose a directorial duty to

---

[45] 11 U.S.C. § 101(32)(A) (1994). This definition expressly excludes property subject to a legitimate exemption or property fraudulently conveyed by the debtor within the applicable statutes of limitations. *Id.* Express and contingent liabilities are considered in the bankruptcy process. *In re* Xonics Photochemical, Inc., 841 F.2d 198, 200 (7th Cir. 1988).

[46] 36 B.R. 743 (Bankr. S.D.N.Y. 1984). In *Johns-Manville*, the corporation ostensibly filed for reorganization due to a dearth of outstanding and anticipated health-related suits. *Id.* at 744. The court addressed a motion that was brought for the appointment of a legal representative for asbestos-exposed future claimants of Johns-Manville. *Id.*

[47] *Id.* at 757.

[48] *Id.* at 749.

[49] *Id.* at 746; *see also* Gregory A. Bibler, *The Status of Unaccrued Tort Claims in Chapter 11 Bankruptcy Proceedings*, 61 AM. BANKR. L.J. 145, 155-61 (1987) (discussing the concept of contingent claim liability in bankruptcy proceedings). *Cf.* A.H. Robins Co. v. Piccin, 788 F.2d 994 (4th Cir. 1986); *In re* Amatex Corp., 30 B.R. 309 (Bankr. E.D. Pa.), *aff'd*, 37 B.R. 613 (Bankr. E.D. Pa. 1983), *rev'd*, 755 F.2d 1034 (3d Cir. 1985); *In re UNR Indus.*, 29 B.R. 741 (Bankr. N.D. Ill. 1983), *appeal dismissed*, 725 F.2d 1111 (7th Cir. 1984), *motion granted in part, denied in part*, 46 B.R. 671 (Bankr. N.D. Ill. 1985).

[50] *In re* RegO Co., 623 A.2d 92 (Del. Ch. 1992).

[51] *Id.* at 106.

creditors when the corporation has significant contingent and future unasserted claims.

1. *In re RegO Co.* — Examining the Impact of Contingent and Future Foreseeable Claimants on the Duties to Creditors at Dissolution[52]

In re RegO Co. involved the dissolution of a Delaware corporation that had manufactured valves and component parts for liquified petroleum, anhydrous amonia, and other compressed gas systems.[53] Due to the explosive properties of compressed gas, RegO occasionally became involved in lawsuits for property damage or personal injury allegedly caused by the failure of its products.[54]

Until 1987, RegO was insured against such accidents and injuries.[55] In the mid-1980s, however, numerous judgments, resulting in liabilities of several million dollars, caused RegO's insurance premiums to increase significantly.[56] Because of these spiraling costs, RegO terminated its insurance policy and became self-insured in early 1987.[57]

After the company's decision to self-insure, RegO continued to experience large judgments in products liability suits, some of which involved products that had been in service for thirty years.[58] This continuing liability pattern motivated a decision by RegO's stockholder to reorganize RegO's business in order to relieve it of its "claims' legacy."[59] In pursuit of that decision, RegO's stockholder, Marmon Corporation, retained experts to assess the value of the company and to render an actuarial analysis for RegO's potential liability for liquified petroleum products currently in the market.[60] Approximately two months later, the experts reported to RegO an estimated present value of potential

---

[52]Various portions of the following section contain direct quotations from the Master's Final Report but are not identified as such because Professor Stilson, as master, authored the Final Report.

[53]*RegO*, 623 A.2d at 98. Liquified petroleum gas is extremely flammable and explosive and causes freezer burns when brought into contact with skin. *See id.*

[54]*Id.*

[55]*Id.*

[56]*Id.*

[57]*RegO*, 623 A.2d at 98.

[58]*Id.*

[59]*Id.* at 98-99.

[60]*Id.* at 99.

products liability claims greatly in excess of RegO's assets.[61] The experts' final report also anticipated claims occurring until the year 2027.[62]

Ostensibly as a result of these reports, as well as its prior claims' history, RegO sold substantially all of its operating assets to a Delaware corporation.[63] Three days after the asset sale, RegO filed a certificate of dissolution with the Delaware Secretary of State.[64] RegO continued to exist as a dissolved corporation under DGCL section 278[65] for the purpose of winding up its business.[66]

RegO's directors elected to wind up corporate affairs pursuant to former DGCL section 280(a).[67] RegO proposed the creation of a claimants' trust that would preserve and distribute to competing claimants all RegO assets that remained as of the effective date of the trust.[68] A *guardian ad litem* (guardian) was appointed by the court of chancery to represent the future products liability claimants.[69] RegO simultaneously petitioned the court of chancery, pursuant to section 280(c), for a determination of the amount and form of security to be provided for these foreseeable, yet unknown, products liability claimants.[70] RegO mailed notice of the section 280 proceeding to all persons and entities known to have pending claims against the company.[71]

As a result of its notice, RegO received widespread responses from potential claimants who sought security from the company for their anticipated claims.[72] These claims fell into one of three categories. The first category represented claims from general creditors of RegO that were paid by RegO in the ordinary course of winding up its affairs.[73]

---

[61] *RegO*, 623 A.2d at 99. The final report concluded that the current products liability claims amounted to a present value between $102,697,000 and $115,919,000. *Id.* The best-case estimation of RegO's value amounted to $53-60 million. *Id.*

[62] *Id.*

[63] *Id.* at 99. Throughout the *RegO* proceedings, allegations were made that RegO and the purchasing corporation were related entities. *In re RegO*, No. 11,651, Master's Final Report at 6 n.6. These allegations were not adjudicated in the action before Master Stilson. *Id.*

[64] *RegO*, 623 A.2d at 99.

[65] *See* DEL. CODE ANN. tit. 8, § 278 (1991) (setting forth a three-year winding-up period for a dissolved corporation, subject to extension under appropriate circumstances).

[66] *RegO*, Master's Final Report at 6.

[67] *RegO*, 623 A.2d at 99.

[68] *Id.* at 100-01.

[69] *Id.* at 94.

[70] *See id.* at 102.

[71] *RegO*, 623 A.2d at 99.

[72] *Id.*

[73] *Id.*

The two remaining categories consisted of pending suits against the company or potential products liability actions that might be brought in the future against RegO.[74] The company rejected all claims for security included in the two latter categories.[75]

a. *Payment of Obligations Under the Plan and Trust Agreement*

In pursuit of its decision to wind up corporate affairs under former sections 280 and 281(a), RegO drafted a plan and trust agreement to provide for a "fair, orderly and equitable distribution" of the company's assets to holders both of existing claims and of potential future claims.[76] In an attempt to satisfy this express purpose, a proposed plan of distribution (the Plan) provided that on an effective date,[77] the claimants' trust would be formed to preserve and distribute RegO's assets to the extent provided by the trust agreement.[78] To that end, the trust agreement created six "obligations" categories for which claims could be made against the trust: (1) administrative obligations,[79] (2) pre-existing obligations,[80] (3) contractual obligations,[81] (4) non-product obligations,[82] (5) product obligations,[83] and (6) non-compensatory obligations.[84] The

---

[74] *Id.*

[75] *RegO*, 623 A.2d at 99.

[76] *RegO*, Master's Final Report at 8-9 (quoting Preamble to RegO Claimants Trust Agreement).

[77] The claimants' trust became effective on the date the trust was created to implement the proposed plan of distribution.

[78] *RegO*, 623 A.2d at 100.

[79] *Id.* at 101. Administrative obligations included costs and expenses incurred in the administration of the trust and in the litigation of claims brought against, or on behalf of, the trust. *Id.* Administrative expenses were granted priority over all other claims. *Id.* at 101 n.22.

[80] *Id.* at 101. Pre-existing obligations included all claims for amounts incurred prior to the effective date of the trust in connection with the winding up of the affairs of the company and contractual, product, and non-compensatory damage obligations existing, but unpaid, as of the effective date of the trust. *Id.*

[81] *Id.* Contractual obligations were claims which were determined to be properly payable pursuant to the asset purchase agreement executed by RegO or the indemnification provisions of the trust agreement. *Id.*

[82] *RegO*, 623 A.2d at 101. Non-product obligations were those obligations arising from claims other than product claims which were asserted in suits prior to the effective date of the trust and not settled or reduced to judgment until after the settlement date. *Id.*

[83] *Id.* Product obligations included all valid claims arising from settlements or judgments establishing claims for personal injury and property damage caused by products manufactured by the company, including related claims for indemnification or contribution. *Id.*

agreement then set forth a schedule for payment of these obligations that anticipated either payment in full, payment subject to a per occurrence cap, or payment only after all other obligations had been satisfied.[85]

For approximately five years after the establishment of the trust, the trustee[86] was to recommend to the court of chancery whether a date for asserting all product and non-compensatory damage claims should be

---

[84]*Id.* Non-compensatory damage obligations included those obligations arising from claims for punitive, exemplary, or other non-compensatory damages which were claimed in connection with a product claim. *Id.*

[85]*Id.* Specifically, the trust agreement allowed for remittance in full for all administrative obligations, pre-existing obligations, and certain contractual obligations as they matured. *Id.* Under proposed modifications to the trust agreement, claims for indemnification determined to be payable under the asset purchase agreement were to be paid subject to an interim limit and payment to the corporation which purchased RegO's assets for indemnification of defense costs were to be subject to the per occurrence limit, with any deficiency to be paid only if funds remained at the termination of the trust. *RegO*, Master's Final Report at 10. In addition, the trust agreement provided that all products liability obligations which were in existence but which had not been paid in full prior to the effective date, were deemed to be pre-existing obligations and thus entitled to be paid in full as they became due. *Id.*

Product obligations, non-product obligations, and non-compensatory damage obligations, except as noted above, which were settled or reduced to a final judgment after the effective date would be paid in full by the trustee up to the per occurrence interim limit. *RegO*, 623 A.2d at 101. Any product obligation covered by insurance would be paid up to the amount of available coverage. *Id.* at 101 n.25. If a product obligation was only partially remitted by insurance, the trust would pay the difference, subject to the interim limit. *Id.* The trustee could seek a modification to the interim limit by the court at any time. *Id.* The trust agreement also required the trustee to conduct a review and make a recommendation to the court at the end of five years of the trust regarding the appropriateness of the interim limit or whether an adjustment should be made to that limit. *Id.* These obligations would be paid for a proven occurrence in the order in which they arose. *Id.* at 101. To the extent two or more obligations relating to a single occurrence arose simultaneously and full payment would exceed the interim limit, payments would be made ratably. *Id.* at 101 n.26. If funds remained at the termination of the trust or the interim limit was thereafter increased, additional payments for partially unpaid obligations would be made up to the amount of the obligations owed or ratably as necessary. *RegO*, Master's Final Report at 11.

[86]The trustee, in exercising his duties under the agreement, could, but was not required to, consult with experts to the extent expert advice was sought. *RegO*, Master's Final Report at 13. The trustee could rely in good faith upon the expert, his information, opinions, reports, or statements if the expert was selected with reasonable care. *Id.* The trustee was also entitled to rely in good faith upon the records of the company and the claimants' trust as well as applicable information provided by trust employees. *Id.*

The trustee was liable for his own gross negligence or willful misconduct but was exempt from giving bond or security in connection with his appointment. *Id.* The trustee was also to be indemnified out of the assets of the trust for all relevant costs, expenses, judgments, fines, or amounts otherwise incurred in connection with the administration of the trust. *Id.* The trustee had a prior lien upon trust assets to secure payment of any amounts owed to him pursuant to the agreement. *Id.*

imposed (the claims assertion date).[87] In the event a claims assertion date was established at that time, or thereafter, as recommended to the court by the trustee, no further product or non-compensatory damage claim could be asserted against the trust if the claim arose after the date imposed.[88] Monies remaining in the trust upon a termination date[89] were to be distributed as follows: (1) ratably for remaining administrative obligations; (2) to the extent funds remained, ratably to the holders of contractual obligations, non-product obligations, and product obligations who did not before receive payment in full; (3) to the extent monies remained, ratably to all holders of non-compensatory damage obligations who did not receive full compensation; and (4) to the extent funds remained, to the sole stockholder of the company as of the effective date.[90]

b. *Interpretative Applications of Sections 280 and 281*

For the first time since the enactment of sections 280 and 281, the Delaware Court of Chancery had to consider the purpose of these sections and apply them to the plan and trust agreement proposed by RegO.[91] In

---

[87]*RegO*, 623 A.2d at 102. The trust was to terminate (the termination date) automatically on the date ninety days after the first to occur of the following two events: (1) all product, non-compensatory damage, and non-product claims asserted against the company or trust have been settled or reduced to final judgment and paid as provided in the trust agreement and the claims assertion date has passed; or (2) the trustee has consented to, and the court has approved, the termination of the trust. *Id.*

[88]*Id.*

[89]See *supra* note 87 for a definition of the termination date for the trust.

[90]*Id.*

[91]The Official Commentary to the 1987 amendment of § 280 states:

> New Section 280 creates a procedure that corporations may elect to follow in winding up their affairs, paying claims against the corporate assets and distributing any remaining assets to the stockholders. The section (and Section 281, as amended) is designed to provide a "safe harbor" such that if the procedures described in section 280 are followed and assets are distributed in accordance with Section 281, as amended, directors (or governing persons of a "successor entity" as defined in subsection (d)) will not be held personally liable to unpaid claimants of the corporation for having improperly distributed assets.

66 Del. Laws ch. 136, § 38 (1987).

The Official Commentary to the 1987 amendment of § 281 states:

> Section 281 is substantially new. Subsections (a) and (b) prescribe the procedures for distributing assets, including the distribution of remaining assets to stockholders, of a dissolved corporation which has and has not, respectively, complied with the provisions of Section 280. Subsection (c) deals with the liability of directors (and governing persons of "successor entities") to claimants whose claims against the dissolved corporation are ultimately unsatisfied.

general, the 1990 version of Delaware sections 280 and 281 required a dissolving corporation to provide notice of the impending dissolution to identifiable claimants. These sections also required the dissolving corporation to petition the Delaware Court of Chancery for a determination of the amount and form of security necessary to compensate claims that were not known to the corporation at the time of its demise but that the firm may reasonably have foreseen would arise prior to the expiration of any applicable statute of limitation.[92]

Specifically, section 280 set forth a method for providing notice of a corporation's dissolution to persons having claims against the dissolving entity.[93] Once responses were received from a claimant, the dissolving corporation could reject that claim, in whole or in part, by sending notice of the rejection to the claimant.[94] A similar procedure was set out in section 280(b) which required that the corporation forward notice of the dissolution to persons having contingent, conditional, or unmatured contract claims against the defunct corporation.[95]

The most innovative aspect of the 1990 provisions was section 280(c)(2)[96] which contained sweeping references to future unknown claimants. In particular, section 280(c)(2) required a dissolving corporation that provided notice in accordance with section 280(a) to petition the court of chancery for a determination of

> the amount and form of security which will be reasonably likely to be sufficient to provide compensation for *claims that have not*

Id. § 39.

[92]DEL. CODE ANN. tit. 8, § 280 (1991).

[93]*Id.* § 280(a)(1).

[94]*Id.* § 280(a)(2).

[95]DEL. CODE ANN. tit. 8, § 280(b)(1) (1991). Section 280(b)(1) provides:

> A corporation or successor entity electing to follow the procedures described in subsection (a) of this section shall also give notice of the dissolution of the corporation to persons with contractual claims contingent upon the occurrence or nonoccurrence of future events or otherwise conditional or unmatured, and request that such persons present such claims in accordance with the terms of such notice. Provided however, that as used in this section and in § 281 of this title, the term "contractual claims" shall not include any implied warranty as to any product manufactured, sold, distributed or handled by the dissolved corporation. Such notice shall be in substantially the form, and sent and published in the same manner, as described in subsection (a)(1) of this section.

Id. By this language, § 280(b) targets claims which likely will arise from indemnification agreements. Such claims are necessarily contingent upon the occurrence or nonoccurrence of future events, i.e., the events which will or will not result in liability.

[96]DEL. CODE ANN. tit. 8, § 280(c)(2) (1991).

> *been made known to the corporation or that have not arisen but that, based on facts known to the corporation or successor entity, are likely to arise or to become known to the corporation or successor entity prior to the expiration of applicable statutes of limitation.*[97]

Section 280(c)(2) also permitted the appointment of a *guardian ad litem* to represent the interests of future claimants who, under common law corporate jurisprudence, would lack standing to assert their potential claims during the winding-up process.[98]

A dissolved corporation or successor entity that had pursued the section 280 notice procedure was to pay, or otherwise make provision for, stockholders or claimants as set forth in section 281(a).[99] Section 281(a) specifically required: (1) payment of claims "made and not rejected" under section 280(a); (2) posting of "security offered and not rejected" for contractual claims arising under section 280(b)(2); (3) posting of "security ordered by the Court of Chancery" in any section 280(c) proceeding; and (4) payment of "claims that are mature, known and uncontested or that have been finally determined to be owing by the corporation or such successor entity."[100]

Section 281(a) further mandated that these claims be paid in full "if there are sufficient funds."[101] Conversely, where funds were insufficient, the statute provided that "such claims and obligations shall be paid or provided for according to their priority, and, among claims of equal

---

[97] *Id.* § 280(c)(2) (emphasis added). The term "successor entity" is defined in § 280(e) to include

> any trust, receivership or other legal entity governed by the laws of this State to which the remaining assets and liabilities of a dissolved corporation are transferred and which exists solely for the purposes of prosecuting and defending suits, by or against the dissolved corporation, enabling the dissolved corporation to settle and close the business of the dissolved corporation, to dispose of and convey the property of the dissolved corporation, to discharge the liabilities of the dissolved corporation and to distribute to the dissolved corporation's stockholders any remaining assets, *but not for the purpose of continuing the business for which the dissolved corporation was organized.*

DEL. CODE ANN. tit. 8, § 280(e) (1991) (emphasis added).

[98] *Id.* § 280(c)(2).

[99] DEL. CODE ANN. tit. 8, § 281(a) (1991).

[100] *Id.*

[101] *Id.*

priority, ratably to the extent of funds legally available therefor."[102] Any remaining funds were to be distributed to stockholders.[103] Finally, in the absence of actual fraud, the judgment of the directors of a dissolved corporation that had pursued the notice procedures of section 280 was to be conclusive with respect to the provisions made for the payment of mature obligations under section 281(a)(4).[104]

Stockholders of Delaware corporations who received distributions pursuant to sections 281(a) or (b) were not liable for any claim that exceeded the stockholders' pro rata share of the claim or the amount distributed to the stockholders, whichever quantity was less.[105] Stockholder liability was further limited (1) to the extent that claims against the dissolved corporation had to be initiated prior to the expiration of Delaware's three-year survival period[106] and (2) to the amount actually distributed to the stockholders.[107] Similarly, directors of a dissolved corporation, or governing persons of a successor entity, who had complied with the notice procedures of section 281(a) or (b) were not personally liable to claimants of the dissolved firm.[108]

In *RegO*, the guardian and petitioning claimants were at direct odds with the corporation regarding the proper interpretation of sections 280 and 281. According to RegO, these statutes were intended to provide a statutory process for the timely return of corporate assets to the market and a predictable dissolution vehicle for corporate management and

---

[102]*Id.* The term "priority" is defined at title 8, section 281(e) of the Delaware Code, as not referring "either to the order of payments set forth in subsection [281](a)(1)-(4) of this section or to the relative times at which any claims mature or are reduced to judgment." *Id.* § 281(e).

[103]DEL. CODE ANN. tit. 8, § 281(a) (1991).

[104]*Id.* Section 281(b), unlike § 281(a), applies to a "dissolved corporation or successor entity which has not followed the procedures described in § 280 of this title." *Id.* § 281(b). As a consequence, any Delaware corporation which elects not to pursue the § 280 notice procedures or to petition the court of chancery for a § 280(c)(2) determination apparently loses the presumption of good faith accorded to certain director decisions under § 281(a) which may result in liability against the firm's directors or stockholders.

[105]*Id.* § 282(a).

[106]*Id.* § 282(b) (referring to the three-year survival interval set forth in title 8, section 278 of the Delaware Code).

[107]DEL. CODE ANN. tit. 8, § 282(c) (1991).

[108]*Id.* This provision is noteworthy in the sense that present dissolution law leaves directors unprotected against future claims of personal liability by unpaid creditors. The legal bases for imposing directorial liability include the trust fund doctrine, fraudulent conveyance statutes, and successor liability. Delaware § 282(c) thus makes clear that directors are not subject to future indefinite liability where those directors comply with the notice procedures of §§ 280 and 281.

stockholders.[109] The guardian and certain claimants suggested a dual purpose. First, these parties argued that the statutes created a discernible and efficient dissolution procedure and incident safe harbor for management and stockholders.[110] Second, the guardian argued that the statutes created potential tort liability for those Delaware corporations that manufacture and place within the public domain products that have a propensity to cause property damage or physical injury to a statistically foreseeable class of plaintiffs for decades after the products' creation.[111]

This initial policy dispute was critical to the resolution of whether RegO's plan and trust agreement complied with sections 280 and 281 inasmuch as the statutes' policies would determine three fundamental premises of RegO's plan.[112] The first of these premises, viewed from RegO's perspective, was that the company was permitted under sections 280 and 281 not to pay all similar claims (including all potential future claims) ratably.[113] The second premise was that RegO was not required to provide security for all potential future claims for whatever period the company was able to predict that these claims might arise (the guardian's self-proclaimed "long view" of these statutes).[114] The final premise was that RegO could impose a per occurrence interim limit on some, but not all, claims against the trust, notwithstanding the identical nature of the underlying causes of action.[115]

RegO posited that the notice requirements of section 280(a) and the distribution directives of section 281(a) compelled a dissolved corporation to pay legitimate claims against the company as they matured during the statutory winding-up period, despite the nature of the claim or the existence of other suits arising from the same or similar occurrences.[116] For example, a products liability claimant who received a judgment during the winding-up process in excess of the value of a dissolved corporation's assets could execute against those assets to the exclusion of similarly situated products liability plaintiffs whose actions were still pending at the time the prior judgment was rendered.[117] Likewise, RegO's interpretation permitted the first judgment creditor to defeat, and

---

[109] *RegO*, Master's Final Report at 15.
[110] *Id.*
[111] *Id.* at 15-16.
[112] *Id.* at 16.
[113] *RegO*, Master's Final Report at 16.
[114] *Id.*
[115] *Id.*
[116] *Id.* at 22.
[117] *RegO*, Master's Final Report at 22.

thereby moot the necessity of posting security for, an entire class of foreseeable, future products liability plaintiffs.[118] In addition, RegO suggested that where two or more creditors received judgments during the three-year survival interval[119] (that, in the aggregate, exceeded available assets), section 281 required pro rata payment to those liquidated creditors.[120] RegO concluded that section 281(c) necessitated this result because the company was then "insolvent" and had claims of equal priority which were reflected by judgments against the company.[121]

RegO maintained that these interpretations followed naturally from an application of subsections 281(a)(1)-(4).[122] Simply stated, section 281(a)(4) compelled payment of judgments that arose during the three-year survival period, notwithstanding that such payments might render an otherwise "solvent"[123] corporation "insolvent" and thus one which was unable to post security for future unknown claimants under section 280(c).[124] In addition, RegO emphasized the practical difference between the directive of section 281(a)(4) *to pay mature claims* and the requirement of section 281(a)(3) *to post security* for future unknown claimants.[125] To RegO, the claimants who suggested that RegO's obligation *to post security* suspended its respective duty *to pay* uncontested claims ignored the functional distinction between *posting security* for claims that may never arise and *paying* legitimate, liquidated debts.[126] Finally, RegO rejected any statutory interpretation that required ratable payments in its plan and trust agreement for claims of equal priority because, in its opinion,[127] RegO was solvent at all times before

---

[118] *Id.*

[119] *See* DEL. CODE ANN. tit. 8, § 278 (1991).

[120] *RegO*, Master's Final Report at 22.

[121] *Id.* at 22-23. Counsel for RegO concluded that this result was one of the few changes §§ 280-81 made to the prior dissolution laws in Delaware. *See id.* at 23 n.23 (referring to the Delaware Court of Chancery's opinion in Asmussen v. Quaker City Corp., 156 A. 180 (Del. Ch. 1931)).

[122] *Id.* at 23. *See* DEL. CODE ANN. tit. 8, § 281(a)(1)-(4) (1991).

[123] *RegO*, Master's Final Report at 23-24. RegO, therefore, interpreted § 281(a)(4) as addressing *mature* claims only. *Id.* at 24 n.25.

[124] *Id.* at 24.

[125] *Id.*

[126] *Id.* In other words, it was RegO's position that although the company had offered to post all of its assets as security under § 280(c)(2), until its plan and trust agreement were approved by the court, RegO's statutory and fiduciary duties to pay liquidated debts which occurred in the winding-up period were neither extinguished nor suspended. *Id.* at 24 n.26.

[127] *RegO*, Master's Final Report at 24. RegO noted that § 280(c)(2) contained no language which required the company to prioritize or prorate claims. *Id.* at 24 n.27. The statute only required the dissolving corporation to petition the court of chancery regarding the amount and

and during the litigation.[128] RegO defined "solvency" or "sufficient funds" as assets minus *liquidated* liabilities, classifying future unknown claims as irrelevant to a determination of a company's financial status at any particular interval.[129]

The guardian suggested a different interpretation of sections 280 through 282.[130] According to the guardian, RegO dissolved with full knowledge, and for the apparent purpose, of escaping its escalating exposure for products liability actions.[131] As a result, the costs and judgments which, by RegO's own estimates would substantially exceed the company's assets,[132] rendered RegO "insolvent" or with "insufficient funds" for the purpose of section 281(a) and thus required RegO to make payments ratably to holders of claims of equal priority.[133] The guardian apparently interpreted "priority" to entail obligations such as administrative expenses or federal taxes,[134] rather than products liability claims that matured or were reduced to a judgment at varying intervals before or after a corporation's announced dissolution.[135] In other words, the guardian's interpretations ostensibly placed all products liability suits,

---

form of security sufficient to provide reasonable compensation to future potential claimants. *Id.* Hence, RegO proposed to transfer all assets to a trust for distribution to legitimate creditors. *Id.*

[128]*Id.* at 24.

[129]*Id.* RegO claimed that Delaware's *primary* purpose in enacting these provisions was to provide a clear and efficient process for the timely return of assets to the capital markets following a corporation's dissolution. *Id.* at 25. RegO conceded, however, that a "competing concern" of the statutes was to avoid "unreasonably depriv[ing] people who have reasonable expectations of being made whole." *Id.* To RegO, these apparently competing concerns could be satisfied by giving effect to § 281(a)'s requirement that dissolved corporations both *pay* mature claims and *post security* for future unknown claimants. *Id.*

In this respect, RegO took issue with the guardian's position that §§ 280 and 281 were intended to protect officers, directors, and stockholders. *Id.* at 25 n.29. Instead, RegO suggested that any protection to these persons was simply a "fall-out of the fact that the protection is necessary in order to have the directors, in particular, give up the assets and send them back into the flow of commerce at whatever the legislatively desirable time is." *Id.*

RegO also argued that Delaware did not *intend* to create rights in future unknown claimants. *Id.* Nevertheless, such a result might *occur* should a board of directors decide to create rights in potential future plaintiffs and then secure a court order to that effect. *Id.*

[130]*Id.* at 25.

[131]*RegO*, Master's Final Report at 25.

[132]*Id.*

[133]*Id.*

[134]*See, e.g.*, *In re* Mitchell's Restaurant, Inc., 67 A.2d 64, 67 (Del. Ch. 1949) (granting priority to the federal government for collection of taxes over claims by the State Unemployment Compensation Commission of Delaware). It is unclear whether the above case remains valid Delaware law after the amendments to § 281.

[135]*RegO*, Master's Final Report at 25-26.

whether pre- or post-effective date and whether liquidated, existing, contingent, or unknown, into one claims' category.[136] This category had to be paid pro rata due to RegO's conceded inability to pay all these claims for whatever foreseeable period they would arise.[137] The guardian justified this resolution on two grounds. First, the explicit language of section 281(e) defined "priority" *not* to include "relative times at which claims mature or are reduced to judgment."[138] Second, the language of section 280(c), for the first time in any jurisdiction, made express reference to obligations owed by dissolved corporations to unknown, yet statistically foreseeable, claims and claimants.[139]

As a corollary to the second justification above, the guardian suggested that section 280(c) compelled RegO to post security for these long-tail claimants for the period in which, by the company's own actuarial analysis, these claims logically could arise.[140] The guardian argued that the legislature intended sections 280 and 281 to create present rights for predictable, future plaintiffs.[141] Once created, the statute required the dissolving corporation "to make adequate provision for" these claimants.[142] The guardian considered the "freedom-of-capital" motivation argument put forth by RegO to be, at best, a secondary purpose for the statutes.[143] Even if such a motivation existed, the guardian argued that it applied only when a corporation had funds sufficient to pay all claims.[144] In this way, the company would be able to set aside monies for all creditors and, thereafter, accelerate the time when distributions could be made to stockholders.[145]

---

[136] *Id.* at 26.

[137] *Id.*

[138] *Id.*

[139] *RegoO*, Master's Final Report at 26.

[140] Id.

[141] *Id.*

[142] *Id.*

[143] *RegO*, Master's Final Report at 27.

[144] *Id.*

[145] *Id.* Ironically, implicit in the guardian's argument is the diminishment of the contract and commercial law rights of present, liquidated creditors. The guardian would have these claims prorated, thus creating a subsidy for the future, yet unknown and unascertained, claimants.

c. *The* RegO *Opinions*

The central conflict in the *RegO* case involved the interpretation of section 280(c).[146] The issue, in particular, was whether the trust proposed by RegO provided "sufficient security" for the claims of existing claimants and also provided security which was "reasonably likely to be sufficient" for future unasserted claims.[147]

On this integral issue, the master and the court were in conflict. It was the master's opinion that the "reasonable security" language of section 280(c), as well as the mandate of section 281(b) that a dissolving corporation "make such provision as will be reasonably likely to be sufficient to provide compensation" for unknown claims, did not mandate the posting of security which guaranteed payment in full of all future foreseeable claims.[148]

The court, on the other hand, concluded that because all RegO's assets were concededly insufficient to "reasonably assure the payment of all foreseeable[,] future claims," the RegO trust was inadequate to offer the "full security" required by section 280(c).[149] The court nevertheless acknowledged that where a dissolving corporation transfers all of its assets to an entity dedicated to the preservation and distribution of those assets, the "inadequacy of those assets to offer full security ought not to deprive the directors of the corporation from proceeding" under the safe harbor procedures of sections 280 and 281(a).[150] In other words, if corporate assets are inadequate to secure full compensation to all future foreseeable claimants, the sufficiency of a proposed security arrangement will be determined by the "fairness" of the arrangement.[151] In the case of the RegO plan and trust, the court concluded that any plan that accorded full payment to existing creditors but that, at least initially, capped compensation to future claimants at an interim limit, was inappropriate.[152] The court based its ruling upon its conclusion that sections 280 through

---

[146]*RegO*, 623 A.2d at 102. *See* DEL. CODE ANN. tit. 8, § 280(c) (1991).

[147]DEL. CODE ANN. tit. 8, § 280(c)(2) (1991).

[148]*RegO*, Master's Final Report at 33-34.

[149]*RegO*, 623 A.2d at 102.

[150]*Id.*

[151]*See id.*

[152]*Id.* at 107-08.

282 created present rights in future plaintiffs — rights that were co-extensive with those of existing claimants.[153]

2. Observations and Commentary on the Delaware Enactments

For the most part, the Delaware enactments must be viewed as an innovative and perceptive attempt to apportion claimant risks and director liability. In the market test of Delaware's efforts (i.e., the *RegO* case), however, the legislation reveals several deficiencies. Those deficiencies may be categorized as substantive, procedural, and theoretical.

a. *Substantive Concerns*

1. Do the Statutes Create Present Rights in Contingent and Future Unknown Claimants and Thereby Impose a Directorial Duty to These Claimants?

The essence of the *RegO* action was section 280(c).[154] Section 280(c)(2) required a dissolving corporation to petition the court of chancery for a determination of "the amount and form of security which [would] be reasonably likely to be sufficient" to compensate unknown, yet foreseeable, "claims."[155] Section 281(a) thereafter required that where funds were "insufficient" to pay all claims in full, such "claims and obligations" were to be paid or provided for according to their priority and, among claims of equal priority, ratably.[156]

According to the court, RegO had insufficient funds to assure full compensation for all future foreseeable claims.[157] Section 281(a), therefore, obligated RegO to prioritize and prorate the appropriate claims

---

[153]*RegO*, 623 A.2d at 106. Ironically, however, the court's interpretation does not reallocate assets between present and future claimants but rather strips assets from existing creditors in defiance of extant contract and commercial law principles.

[154]DEL. CODE ANN. tit. 8, § 280(c) (1991).

[155]The pertinent language of § 280(c)(2) states:

> A corporation or successor entity which has given notice in accordance with subsection (a) of this section shall petition the Court of Chancery to determine the amount and form of security which will be reasonably likely to be sufficient to provide compensation *for claims that have not been made known to the corporation or that have not arisen but that, based on facts known to the corporation or successor entity, are likely to arise or to become known to the corporation or successor entity prior to the expiration of applicable statutes of limitation.*

Id. § 280(c)(2) (emphasis added).

[156]*Id.* § 281(a).

[157]*RegO*, 623 A.2d at 102.

against the company, subject to the court's scrutiny of the fairness of the company's proposed security arrangement.[158] The master, however, submitted that the terms "claims," "obligations," and "insufficient funds," as used in sections 280 and 281, did not envision security of full payment of all future assertions of liability which are, by definition, inchoate and in existence solely in actuarial analyses.[159]

In 1994, the Delaware Legislature amended sections 280 and 281 to align more closely with the master's interpretation in *RegO*. For example, in 1994, a dissolving corporation may pay current claims without regard to the prorating of those claims against future unasserted claims.[160] In addition, existing claimants who receive notice of a firm's dissolution will be prohibited from bringing suit if their claim is not presented to the corporation within 60 days[161] of the notice or if they fail to initiate suit within 120 days after their claim is rejected by the corporation.[162] Further, after the 1994 amendments, directors who pursue a judicially-supervised dissolution must only make reasonable provision for (1) pending litigation claims,[163] and (2) claims that are likely to become known to the corporation within five to ten years of the date of dissolution.[164]

Unfortunately, the 1994 amendments to sections 280 and 281 do not alter the court's interpretation in *RegO* which, rather than reallocating assets among claimants, divested assets from existing creditors in disregard of contract and commercial law principles. In other words, the statutes remain unclear in their balance of existing claimants' present commercial and contract law rights with the disputed and contingent rights of pending and future foreseeable claimants. Consequently, an opening query is whether the reference in newly-amended section 280 to "claims" and in section 281 to "claims," "obligations," and "insufficient funds"[165] includes contingent and future unknown claims such that a

---

[158] *Id.* at 102-03.

[159] RegO, Master's Final Report at 33-34.

[160] DEL. CODE ANN. tit. 8, § 280(a)(1) (1994).

[161] The statute mandates that this 60-day period is the *minimum* amount of time that a corporation can require notice of a potential claim. *Id.* § 280(a)(1)(c).

[162] *Id.* § 280(a)(4).

[163] *Id.* § 280(c)(1).

[164] DEL. CODE ANN. tit. 8, § 280(c)(3) (1994). The amendments deleted all references to "applicable statutes of limitation" and an ostensible limitations period of five to ten years from the date of dissolution, according to the court's discretion, was substituted in its place. A similar limitations period was added for extrajudicial dissolutions. *See* 69 Del. Laws ch. 266, §§ 15, 20 (1994).

[165] *See* DEL. CODE ANN. tit. 8, § 281(a)(1)-(4) (1994).

corporation — for the purpose of defining directorial duties to creditors — may be deemed insolvent by analogy to the Delaware dissolution statutes.

For example, is a corporation that pursues judicial dissolution under section 280 (or an extra-judicial dissolution under section 281(b)) and that has contingent and future unknown claims, solvent or insolvent at the moment of, or the interval approaching, dissolution? If the Delaware dissolution statutes are applied by analogy to conclude that the corporation is insolvent, then the directors are subject to more stringent judicial scrutiny than if the corporation dissolved while solvent. Directors of the corporation likewise are severely constrained in their ability to exercise discretionary decision making. Accordingly, a determination of firm solvency or insolvency is essential for directors who contemplate a sale of corporate assets, the payment of dividends, or the settlement of pending claims prior to dissolution.

Resolution of this query is not merely academic. If the *RegO* opinion remains viable after the 1994 amendments and the terms "claims" and "obligations" under Delaware's 1994 revisions include *contingent*, as well as *provable or probable* claims, then innumerable corporations have "insufficient funds" with which to pay creditors. Thus, an accurate and practical determination of the intended interpretation of the 1994 modifications is critical to directors who must devise and implement a complex corporate dissolution.

For example, consider the hypothetical corporation that is formed for the purpose of developing and marketing a safe method for the transportation and disposal of radioactive waste. Under virtually all state corporate statutes, the original entity is permitted to incorporate with little or no initial capitalization.[166] Stock may thereafter be issued to the founders for no par, low par, or nominal par.[167] The obvious design of the incorporation of the venture is to limit the liability of the founders to

---

[166]*See, e.g.*, DEL. CODE ANN. tit. 8, § 102(a) (1991) (setting forth the required provisions of a Delaware Certificate of Incorporation); *id.* § 106 (defining the moment of corporate existence as the filing of the certificate of incorporation with the Secretary of State). *See also* 1 MODEL BUSINESS CORP. ACT §§ 2.02-.03 (1994) (containing analogous provisions).

[167]The concept of par originally was devised to create a safe balance sheet for creditors who chose to conduct business with a corporation. HAMILTON, *supra* note 14, at 308. Consequently, statutory provisions relating to par necessarily included provisions on stated capital, restrictions on the payment of dividends, share repurchases or other corporate transactions which directly or indirectly involved a distribution of firm assets which otherwise would be available for the payment of creditor claims. Today the historic use for par has largely been abandoned in favor of contract protection for creditors who do business with corporate entities.

the initial corporate capitalization or any assets purchased with these funds. The combined lack of statutory capitalization requirements and the permissible issuance of stock for nominal legal consideration permit the new corporate enterprise and its owners to undertake an exceptionally hazardous business with little or no capital against which any legitimate claims can be satisfied.[168] In this manner, state corporate law has effectively *encouraged* founders to engage in legitimate risk-allocation for the new business by promising risk-transference of foreseeable liabilities to those whom the corporation may harm through tort or contract.

Assume that the hypothetical corporation's directors elect to incorporate under Delaware law. The founders provide minimal initial capital and sell founding stock to themselves for an inappreciable amount. The corporation thereafter develops a process for the transportation and storage of radioactive waste that it sells to a buyer. Assume further that a failure of the process to perform as expected results in astounding personal injury and property damage. The company's future foreseeable liabilities are not easily calculated because radioactive materials have differing half-lives, divergent potentials for harm, and disputed latency periods for manifestation of injuries. If a buyer implements the developing corporation's process *in toto* and a disaster occurs, the question becomes whether the selling corporation is liable for contingent, predictable, and statistically possible damages that have occurred, or will occur, as a direct result of the failed performance of the seller's process. If the selling corporation is found to be liable under the *RegO* opinion, the question becomes whether the firm's directors may opt to dissolve the business under sections 280 through 282 with the singular intention of escaping these, as well as other, claims arising from the same accident.[169]

Under the 1994 amendments, it appears that the corporation may elect to dissolve either under section 280 (judicially-supervised dissolution)[170] or section 281 (extrajudicial dissolution).[171] Either option requires the

---

[168]As a practical matter, of course, the firm must obtain seed capital in order to undertake required research. This initial capital may be raised, however, through loans or the sale of debt securities. For purposes of this hypothetical, assume that no other regulations (e.g., environmental regulations) govern the conduct of the parties.

[169]Of course, under the hypothetical as posited, the corporation may well choose not to dissolve because any judgment against the corporation will go unsatisfied.

The hypothetical raises another related question. If the directors elect dissolution pursuant to §§ 280-282, are their judgments pre- and post-dissolution protected by a presumption of good faith and non-liability or are their decisions subject to the court's strict scrutiny of the entire fairness of those judgments?

[170]DEL. CODE ANN. tit. 8, § 280(a), (c) (1994).

[171]*Id.* § 281(b).

dissolving corporation to make reasonable provisions for pending actions[172] as well as for claims that are likely to arise within five to ten years post-dissolution.[173] Section 281 thereafter mandates the *payment* of "mature, known and uncontested" claims,[174] the *posting of security* for pending and future unasserted claims,[175] or the making of reasonable provisions for pending and future unknown claims.[176] If the 1994 revisions, by requiring security or provisions for contingent and future unasserted claims, deem our hypothetical corporation to have "insufficient funds" to pay all claims,[177] then the corporation arguably has assumed greater risk at dissolution than at incorporation.[178]

Under the modified language of section 280(c), the corporation has pending claims and can foresee claims that have not arisen but that may arise or become known to the corporation within ten years of the date of dissolution[179] Therefore, our hypothetical corporation has three apparent choices. First, the corporation could defend the suits, win, finance the costs of litigation, and continue the pursuit of its stated business goals. Second, the directors could elect to concede liability, permit all known and contingent claimants to litigate among themselves for rights in the firm's assets, put any judgment creditors to the task of locating corporate assets upon which to execute,[180] and, thereafter, informally terminate all business involving radioactive waste disposal research. Finally, the corporation could defend the suits, lose, and dissolve the corporation under sections 280 and 281 with the intent of legally terminating the enterprise and granting a safeguard from future liability for the firm's founders and directors.

Under the third option, the dissolved corporation's assets are, "in total[,] inadequate to secure full compensation to all foreseeable future

---

[172]*Id.* §§ 280(c)(1), 281(b)(ii).

[173]*Id.* §§ 280(c)(3), 281(b)(iii).

[174]DEL. CODE ANN. tit. 8, § 281(a)(4) (1994).

[175]*Id.* § 281(a)(2)-(3).

[176]*Id.* § 281(b)(ii)-(iii).

[177]Under this scenario, "insufficient funds" existed because the existing, contingent, and future foreseeable claims — in the aggregate — exceeded corporate assets.

[178]Under the 1994 amendments, if the hypothetical corporation elected to dissolve under §§ 280-282, it would be considered to have insufficient funds with which to pay its "claimants," not to mention any employee wages, federal or state taxes, rent, and/or overhead that may be due.

[179]*See id.* § 280(c)(1)-(3).

[180]Of course, the irony of this alternative is that the first one or more judgment creditors who locate firm assets and execute upon same will utterly deplete the corporate estate — effectively defeating all later judgment or contingent creditors or future unknown claimants.

claimants."[181] Management's proposed plan of distribution, therefore, will be subject to the court's determination of fairness, as guided by the policies reflected in the Delaware enactments.

This result seems antithetical to basic corporate jurisprudence which permits, indeed invites, risk-shifting by investors through the mere act of incorporation.[182] For example, assume a research scientist develops a cure for AIDS and, thereafter, forms a corporation for the purpose of producing and marketing the cure. After five years in operation, the curative drug is so successful that AIDS is eradicated and the scientist is a millionaire. Finally, assume that the market for the drug has evaporated due to the disappearance of AIDS. Scientific evidence, however, indicates a nominal likelihood of birth defects in the children born to a small percentage of those treated with the drug. Because the market for the drug no longer exists, the scientist elects to liquidate the business and distribute the remaining monies to herself. In light of the future foreseeable injuries, what dissolution obligations are imposed on the scientist when she elects to liquidate the firm? In particular, may she dissolve under section 280 and, thereafter, distribute income to herself? If not, must she freeze some portion of her earnings for possible payment to future claimants?

On the one hand, the obvious attraction of the corporate form is the transferral of internal and external market risks from the owner/managers to those who elect to conduct business with a corporate entity. To compel greater security for future contract or tort claims — which exist only in actuarial analyses — flies in the face of basic precepts of corporate law.

On the other hand, two points must be weighed if the thrust of the 1994 revisions is that, in equity, certain types of suits (mass products liability claims) against certain categories of corporations (publicly-held enterprises) should receive enhanced guarantees upon a corporate defendant's dissolution. First, current corporate philosophy considers a corporation to be an independent juridical person.[183] The imposition of higher financial burdens at firm dissolution or insolvency, therefore, becomes anomalous to the entity theory of corporate governance. Second, retrospective equity findings by a reviewing court pose planning nightmares for corporate directors who must guide a financially unstable firm through its legal demise.

---

[181] *RegO*, 623 A.2d at 102.

[182] *See supra* notes 166-68 and accompanying text.

[183] Note, *supra* note 9, at 1641.

Under the first point, if a natural person placed toxic chemicals into a public water supply, one may easily predict property damage and personal injury to occur for decades after the individual's misconduct. If the claimants obtained judgments against the defendant, those judgments would represent only the right of the successful plaintiffs to locate assets upon which to execute. If the individual defendant lacked sufficient assets to pay the judgments, the creditors would be without recourse for the amounts that remained unpaid. Further, if the wrongdoer was judgment-proof or was immediately diagnosed with a terminal illness, no principle of American law commands the tortfeasor to fund a trust with present assets or life insurance proceeds to compensate these, as well as all statistically foreseeable, plaintiffs.

If Delaware's 1994 version of sections 280 and 281 seek to interject the societal directive that *corporate persons* be held to a higher standard where contingent claimants and actuarially-possible tort and contract victims may be compromised ten years after the corporation's demise, the statutes require further amendment. One must assume, however, that if the legislature intended such an interpretation, or seeks such an amendment, numerous Delaware corporations will pursue a secure dissolution haven elsewhere. In addition, one must speculate that corporations that remain in Delaware will discover, through creative counsel, alternative dissolution techniques that are not as financially burdensome and that do not subject the directors to personal liability after dissolution.[184] Either result obviously circumvents the utility of the revised Delaware statutes.

On the second point, if the hypothetical corporation chooses to dissolve pursuant to amended sections 280 and 281 and the court of chancery determines that the company has "insufficient funds," section 281 requires that corporation to pay all existing and future claims according to their priority and, among claims of equal priority, ratably.[185] In the hypothetical, therefore, the dissolving corporation must undertake an actuarial analysis of statistically possible claims that must thereafter be prorated against contingent claims.

---

[184]Of course, one basic assumption in the above hypothetical is that if the corporation has insufficient funds with which to pay these claimants, then no distributions would be made to stockholders or directors in derogation of creditor rights. If, however, the corporation were to precede its dissolution with a transfer of all corporate assets to stockholders in anticipation of the impending lawsuits, basic principles of fraud would compel the return of those assets to the corporation for distribution to legitimate claimants.

[185]DEL. CODE ANN. tit. 8, § 281(b) (1994).

In *RegO*, the dissolving company predicted that the imposition of an interim cap on products liability claims would render full payment of ninety to ninety-five percent of all claims within a few years after the corporation's dissolution.[186] Several creditors of RegO disputed the company's interim limit and recommended substitute caps or hypothetical prorating figures.[187] Interestingly, though, no party to the *RegO* litigation seriously maintained that the cap should be abandoned for failure to prorate the creditor interests as required under section 281. In essence, therefore, it seems the *RegO* claimants sought only the right to second-guess management as to an appropriate interim limit. The claimants did not seek the displacement of that limit because the limit represented a fair attempt by the corporation to provide full compensation to present claimants and almost total payment to future claimants. The court, in its "fairness" ruling, however, concluded that a plan that preferred present claimants over unknown or future claimants did not meet the statutory requirements.[188]

The planning impediment which is presented by the court's "fairness" test is that once a corporation is found to have "insufficient funds," section 281's mandate of prorating is invoked. As a consequence, under the plain language of sections 280 and 281, directors would logically presume that a judicial finding of an insufficiency of corporate assets under section 280 necessarily requires judicial imposition of prorating. Yet, in *RegO*, the court simultaneously *found the corporation to have "insufficient funds"* to pay all claims, *adopted* the company's concept of an interim limit, and with the vision of judicial hindsight, *modified* the dollar cap.[189] To the court, this result was "fair" under the circumstances of the case.[190]

Yet, if corporations are to utilize sections 280 through 282 as director and creditor safe harbors, then some degree of prospective certainty and management protection must be evident. From a planning perspective, therefore, *post hoc* fairness determinations result in retrospective judicial determinations of directorial mistakes — liability which directors can ill afford. As a result, in the absence of judicial deference to directorial decisions and management presumptions of good faith and non-liability,

---

[186]*See RegO*, 623 A.2d at 110. The claims which would not be paid were those which became manifest after the termination of the trust. *Id.*

[187]*Id.* at 109.

[188]*Id.* at 106.

[189]*Id.* at 110.

[190]*RegO*, 623 A.2d at 105.

corporate directors likely will ignore sections 280 through 282 and, instead, pursue predictable techniques for corporate termination.

Further, in her report, the master noted the realistic obstacle of imposing a duty on a dissolved corporation to marshall non-existent assets for the purpose of providing future insurance to contingent and statistically predictable plaintiffs. Specifically, Master Stilson referred to the failure of section 280 to stay all creditor actions against a financially unstable enterprise.[191] The practical consequence of failing to stay these actions is the *ability* and *right* of judgment creditors to defeat the section 280 rights of contingent or future foreseeable claimants. In the absence of such a stay, it seems that sections 280 through 282 do not empower a Delaware court to curtail or compromise the legitimate commercial law rights of liquidated creditors for the benefit of statistically possible claimants.

Instead, the master suggested that the Delaware amendments were intended to set forth a *notice procedure* for dissolving corporations. Through this procedure, a complying corporation may accelerate its duties to all known and reasonably foreseeable future claimants, placing limits on future liability for distributions by management to stockholders or directors. This notice procedure, however, should not entitle contingent or long-tail claimants to security for full payment of their claims for up to ten years post-dissolution. Rather, the notice procedure should simply close the previous gap in corporate law that afforded no mechanism for corporate directors and stockholders to dissolve and wind up the enterprise without indefinitely fearing accountability to succeeding plaintiffs. Further, implementation of a notice process within a corporate dissolution statute would permit, for the first time, the appointment of a *guardian ad litem* to represent the interests of prospective plaintiffs.

In sum, a "notice interpretation" of sections 280 through 282 aligns more readily with commercial reality than one that creates present rights in contingent and unknown, statistically foreseeable, plaintiffs. The reasons are threefold. First, the Delaware enactments impose no automatic stay analogous to section 362 of the Bankruptcy Reform Act of 1978.[192] Such a stay would be necessary to preserve corporate assets for future distributions to delay-occurrence plaintiffs. Second, current corporate philosophy considers a corporation to be a juridical person, independent from its owners. The corporation, therefore, is independently liable for its contract and tort obligations. Finally, the imposition of a more exacting duty upon directors at firm dissolution would have at least

---

[191] *RegO*, Master's Final Report at 32-33.

[192] 11 U.S.C. § 362 (1988 & Supp. 1994).

two deleterious consequences. One, the enhanced duty would dissuade corporate management from notifying creditors of the financial status of the business (and the impending legal termination of same through dissolution). Two, this higher duty would encourage corporate directors to relegate present and future creditors to their common, contract, or commercial law privileges. These rights, by necessity, would be pursued against the business after its financial, if not legal, death. Stated differently, creditors would pursue these claims after the period in which they could have sought a hearing under section 280 or could have attempted a stay of sales or transfers of corporate assets.

A few final thoughts: if the 1994 amendments or the *RegO* opinion intimate that creditor payment protections vest only upon *dissolution*, directors must question whether these statutory duties may be circumvented by the full payment of all creditor debts as they come due, until the moment at which all corporate assets are dissipated. On the other hand, if the *RegO* opinion proposes that directors have a corporate *fiduciary duty to creditors to dissolve the firm* and, thereafter, to comply with the distribution procedures of section 281, one must question at what moment this duty arises. Additionally, courts must determine what precept of corporate law justifies creation of this "duty to dissolve." Finally, this interpretation of *RegO* will require the courts to consider the relationship of this duty to the historic directorial duties to stockholders that arise under the traditional fiduciary paradigm of corporate governance.[193]

2. What is the Effect of the Legislature's Imposition of a Ten Year Bar Date on Future Foreseeable Claims?

In *RegO*, the guardian posited that section 280(c) compelled a dissolving Delaware corporation to post security for long-tail products liability claimants for whatever time period the dissolved firm, by its own actuarial analysis, could anticipate the claims would arise.[194] In *RegO*, those claims were predicted to continue for thirty-six to forty-four years after the company's dissolution.[195] The basis for the guardian's "long-view" of section 280 was the statutory directive that a corporation provide sufficient security for claims that have not arisen but that, based upon

---

[193]For a discussion of the theoretical issues concerning directorial duties to creditors which *RegO* left unanswered, see *infra* notes 234-35 and accompanying text.

[194]*See* Transcript of Hearing at 75-77, *In re* RegO (Hearing Before the Master *Pro Hac Vice*, Feb. 14, 1992).

[195]*Id.* at 76.

facts known to the corporation, are likely to arise before applicable statutes of limitation expire.[196] According to the guardian, section 280 required RegO to make adequate provision for future foreseeable claimants, recognizing that those individuals represented a class of imminent creditors who lacked a present remedy for their anticipated injuries.[197]

In 1994, sections 280 and 281 were amended to limit the guardian's interpretation of "applicable statutes of limitation." Specifically, the statutes now require a plan of liquidation to

> make such provision as will be reasonably likely to be sufficient to provide compensation for claims that have not been made known to the corporation or that have not arisen but that, based on facts known to the corporation . . ., are likely to arise or to become known . . . *within 10 years after the date of dissolution.*[198]

The 1994 amendments have statutorily imposed a ten-year bar date for the assertion of future foreseeable claims.[199] One difficulty with such a date is its seeming arbitrariness. Recognizing that any bar date suffers from the same infirmity, a second point requires observation: statutory imposition of a limitations period is subject to equity tolling in appropriate circumstances.[200] For example, if the Delaware Legislature intended to provide certainty for judicial dissolutions pursuant to sections 280 through 282, then substantial progress has been achieved with the deletion of "applicable statutes of limitation" in favor of a ten-year limitations period. Unfortunately, the arbitrariness of the selected interval and the fact that such an interval is subject to equity tolling will permit claimants to litigate the equity considerations and potentially to modify this interval. The obvious disadvantage of equity tolling as applied to the

---

[196] *Id.* at 75; *see* DEL. CODE ANN. tit. 8, § 280(c)(2) (1991).

[197] Transcript of Hearing at 73-74, *In re* RegO (Hearing Before the Master *Pro Hac Vice*, Feb. 14, 1992).

[198] DEL. CODE ANN. tit. 8, § 281(b)(iii) (1994) (emphasis added); *see also id.* § 280(c)(3) (limiting the court of chancery's ability to extend the period for which security is required).

[199] DEL. CODE ANN. tit. 8, § 281(b)(iii) (1994) (emphasis added); *see also id.* § 280(c)(3) (limiting the court of chancery's ability to extend the period for which security is required).

[200] *See, e.g.*, Halpern v. Barran, 313 A.2d 139, 143 (Del. Ch. 1973) (tolling a statute of limitations because of fraudulent concealment). *See also* 3 MODEL BUSINESS CORP. ACT § 14.07 (1994) (imposing a five-year limitations period). *See also infra* notes 306-29 and accompanying text (discussing the distinction between a survival or limitation dissolution statute).

ten-year bar date is its crippling effect on managers who must devise a fair plan of liquidation based upon facts known at the time of dissolution.

An alternative to a statutory limitations period is the judicial imposition of a post-dissolution "claims assertion date." Such a date would be ascertained after judicial consideration of the nature of the firm's anticipated liabilities and examination of the statutes of limitations in the jurisdictions in which such claims would likely arise. A claims assertion date alternative permits the efficient redeployment of capital to the market in a reasonable time post-dissolution, yet curtails legitimate tort and contract claims that arise subsequent to the bar date. For example, in the hypothetical, if a claims assertion date is judicially imposed after notice to parties in interest and a subsequent hearing, firm assets will be placed within the capital markets at a specific, reasonable time after dissolution. This method would provide certainty and predictability of distributions to creditors who hold claims against the defunct entity by barring litigation of those claims that arise subsequent to the claims assertion date. Moreover, because the "equities" of the case previously were resolved,[201] the claims assertion date ostensibly would prevent the appointment of a receiver to undertake such litigation. Accordingly, this option judicially balances the privileges of known and existing claimants as against future unknown plaintiffs.

Conversely, the option adopted by the 1994 amendments provides a bright line for purposes of directorial planning. Its disadvantage is the retention of uncertainty due to retroactive applications of equity principles for determinations of tolling. For instance, if the same corporation were to dissolve pursuant to section 14.07 of the Model Business Corporation Act (MBCA) (which imposes a five-year bar date for future unknown claims), directors may purchase insurance to cover those injuries that may arise in the five-year post-dissolution interval. Once this insurance is purchased, the directors may distribute the remaining corporate assets to present creditors or stockholders. Claimants who are injured after the five-year limitations period arguably are without a remedy in light of the statutory termination date. Nevertheless, MBCA-like legislation generally is considered to impose a statute of limitation and, therefore, is subject to equitable tolling in suitable circumstances.[202] The ability of

---

[201]This alternative contemplates the continued provision in § 280(c)(2) for the appointment of a *guardian ad litem* to represent the interests of future foreseeable claimants.

[202]*See infra* notes 306-29 and accompanying text (discussing the differences between survival and limitation dissolution statutes). Appropriate circumstances for equitable tolling may include material after-discovered evidence, recent scientific discoveries or techniques for discovery, or the difficulty of predicting future injuries due to the unique nature of the accident

prospective creditors to stay, modify, or annul dissolution arrangements after the statutory bar date arguably undercuts the apparent benefit to statutorily-imposed termination times for unknown claims.

It is suggested that the Delaware enactments cannot realistically provide the anticipated market incentive for notice dissolutions unless the alternative option is considered. The recommended amendment should create judicially-imposed bar dates that are established after consideration of all factors pertinent to the case at hand.

Thus, in the hypothetical corporation, if future claims are those that result from radioactive poisoning to persons and property, a reviewing court would examine scientific evidence as to the half-life of the waste that caused the poisoning, the nature of future injuries (e.g., whether radioactive injuries to property differ from those to persons), the likelihood that the original poisoning will result in second-generation injuries (e.g., birth defects manifest in the offspring of the original victims), the jurisdictions in which these injuries will likely occur, and the applicable statutes of limitation in those jurisdictions. The court would also consider the nature of pending claims against the firm and the ranges of judgments sought by the plaintiffs to those actions. Once the factors underlying the pending and future unasserted claims are identified, the reviewing court would weigh this information to calculate what would constitute "sufficient security" under section 280 and to determine the assertion date after which all claims would be barred.

This alternative appears superior to the present legislation for two reasons. First, the court of chancery currently must determine the sufficiency of provisions for pending claims, as well as for future unasserted claims.[203] In the hypothetical, the court would have to determine what amount is "sufficient" for the five pending personal injury suits. On this question, two possibilities arise. The first possibility would require security in the amount of the plaintiff's *ad damnum*. The second option would require directors to post security in an amount equal to the directors' good faith valuation of the claim. The second alternative, unlike the first, retains the corporate principle that directors — not claimants — manage the firm.[204]

Such a solution also furnishes a reasonable degree of predictability for directors in the sense that management may, prior to dissolution, engage in an economic analysis. This analysis would weigh the benefit of preserving corporate assets for legitimate future claimants against the

---

which caused the injuries.

[203]DEL. CODE ANN. tit. 8, § 280(c)(1), (3) (1994).

[204]*See* DEL. CODE ANN. tit. 8, § 141(a) (1991).

desirability of placing corporate assets back within the capital markets for productive use. If corporate management concludes that the payment of pending and future claims outweighs the need for present reimbursement to existing creditors, its plan of distribution and proposed claims assertion date will reflect this decision. Party litigants and the *guardian ad litem* likewise would be able to undertake a similar economic analysis for the court's consideration. In this manner, a reviewing court would consider (1) the nature of contingent and future claims, (2) the number and amount of existing claims, (3) the necessity for further maintenance of a trust or other successor device in favor of contingent and future foreseeable plaintiffs, (4) the interests of current creditors who have expended funds to litigate their rights and who have yet to secure a judgment for those claims, and (5) the costs of creating and administering a successor trust for at least ten years after a firm's dissolution.[205]

Such an amendment would have the obvious disadvantage of imposing upon a dissolving corporation, party litigants, the *guardian ad litem*, and the reviewing court, the significant costs associated with devising a fair claims assertion date. Certainly, if the Delaware enactments are to achieve their market goal, they should minimize the legal expenditures and litigation costs associated with the dissolution process itself. Despite the potential for these costs in the proposed amendments, it is suggested that this refinement to the Delaware statutes provides (1) greater economic certainty for directors (and, hence, an enhanced desire to utilize the Delaware notice procedures); (2) greater potential for preservation of corporate assets for future distributions to creditors and stockholders; and (3) less potential for retroactive equity tolling. Indeed, section 280 presently anticipates some degree of judicial cognizance of pending and future claims. The proposed refinements to the statute simply define the scope of that judicial examination and result in greater predictability for corporate managers and claimants and lower costs for the dissolving firm. The proposals also provide the checks and

---

[205]The costs of maintaining a successor entity include compensation for the trustee, employee wages, litigation costs, attorneys' fees, and charges on supervising investment assets. In *RegO*, if the parties in interest had litigated the company's plan of distribution until each creditor was satisfied, attorneys' fees alone would have depreciated the company's estate to a point that no assets would have remained for distribution to creditors. This problem of litigating all aspects of a corporate or natural person's reorganization or liquidation is presently under consideration by the bankruptcy courts. Clearly one difficulty in the federal and state insolvency process is that attorneys, and other experts necessary to the litigation, receive a priority in payment with the result that lengthy litigation completely depletes a debtor's estate to the detriment of those whom the attorneys represent.

balances necessary to alleviate directorial tension between future claimants and deployment of assets.

3. Do the Statutes Intend to Create Temporal Parity Among All Existing, Contingent and Future Unknown Claimants?

In *RegO*, the court of chancery concluded that the portions of the company's plan and trust agreement that accorded full payment to pre-existing obligations[206] arising during the winding-up period were "not justified" within the factual parameters of the case.[207] As such, the court held that RegO's proposed plan of distribution failed to satisfy the security requirements of section 280(c)(2).[208]

Former section 280(c)(2) compelled a dissolving corporation to petition the court of chancery for a determination of "the amount and form of security which [would] be reasonably likely to be sufficient to provide compensation for" future unknown claimants.[209] Section 280(c)(2) also permitted the appointment of a *guardian ad litem* to represent the interests of the potential future plaintiffs.[210]

A dissolved corporation or successor entity that had pursued the section 280 notice procedure was to pay, or otherwise make provision for, stockholders or claimants as set forth in section 281(a).[211] Section 281(a) also mandated that these claims be paid in full if funds were sufficient to compensate all claims.[212] Conversely, where funds were insufficient, "such claims and obligations [were to] be paid or provided for according to their priority and, among claims of equal priority, ratably."[213]

In the 1994 amendments to sections 280 and 281, the prorating of present, contingent, and future claims as required in *RegO* was apparently abandoned. For instance, revised section 280(a)(1) states that present claimants who receive actual notice of a pending dissolution will be barred from suit if a claim is not presented to the dissolving corporation

---

[206]*See supra* note 80 for a definition of pre-existing obligations.

[207]*RegO*, 623 A.2d at 103.

[208]*Id.* at 106.

[209]DEL. CODE ANN. tit. 8, § 280(c)(2) (1991).

[210]*Id.*

[211]*Id.* § 281(a); *see also supra* text accompanying note 101 (explaining the requirements of § 281(a)).

[212]*Id.*

[213]DEL. CODE ANN. tit. 8, § 281(a) (1991). The term "priority," as defined in § 281(c), "does *not* refer either to the order of payments set forth in subsection (a)(1)-(4) of this section or to the relative times at which any claims mature or are reduced to judgment." *Id.*

within a specified period.[214] Section 281(a)(4) thereafter states that these claims will be remitted by the dissolving corporation (1) if not rejected by the firm[215] or (2) if they are "mature, known and uncontested."[216] On the other hand, pending and future foreseeable claims are subject to a judicial conclusion regarding the amount and form of security reasonably likely to provide compensation to these claimants.[217] Section 281 subsequently requires the posting of security for the amounts determined by the court.[218]

For extrajudicial dissolutions, the amendments set forth three directives. First, a dissolving corporation must "make reasonable provision to pay all claims and obligations," including certain contingent contractual claims identified by the corporation.[219] Second, the directors must make reasonable provision for any claim then pending against the corporation.[220] Finally, the firm must make reasonable provision for compensating future unasserted claims that are likely to arise or become known to the corporation within ten years after the date of dissolution.[221]

To explore the application of the statutory amendments, assume a Delaware corporation has engaged in the research and development of a radioactive waste disposal system for one year. Assume further that, during the testing of a proposed disposal process, a malfunction occurs which results in the leakage of radioactive materials into a local water supply. Within six months of the incident, the following claims are outstanding against the company: (1) $10,000 in employee wages, due immediately; (2) $5,000 in rent, due over the next six months; (3) $35,000 to suppliers, due immediately; (4) $50,000 in mortgage payments, due over the next twelve months; and (5) pending personal injury suits seeking, in the aggregate, $75,000. Assume that, at the time of the accident, firm assets have a present value of $200,000. Because the corporation can logically predict numerous personal injury and property damage claims as a consequence of the malfunction, firm management elects to dissolve the business under sections 280 through 282.

---

[214]DEL. CODE ANN. § 280(a)(1)(d), (a)(2), (a)(4) (1994).

[215]DEL. CODE ANN. tit. 8, § 281(a)(1) (1994).

[216]*Id.* § 281(a)(4).

[217]*Id.* § 280(c)(1), (c)(3).

[218]*Id.* § 281(a)(3).

[219]DEL. CODE ANN. tit. 8, § 281(b)(i)-(ii).

[220]*Id.*

[221]*Id.* § 281(b)(iii).

If the future foreseeable claims are valued at approximately $10 million, management must interpret the directives of section 281(a) to adopt a plan of distribution that will satisfy the firm's statutory obligations to present, contingent, and future claimants. Accordingly, the directors must determine what form of security arrangement preserves corporate assets for distribution to contingent and future claimants, yet does not compromise or extinguish existing contract and commercial rights of present creditors.

In the foregoing hypothetical, five facts are obvious. First, the company has assets with a present value of $200,000. Second, *liquidated* claims against the corporation equal $45,000. Third, *uncontested* claims that will mature within one year of dissolution total $55,000. Fourth, *contingent*, disputed claims that may mature during the three-year post-dissolution interval equal $130,000. Finally, *future foreseeable* claims total approximately $10 million.

Paragraphs (1) and (2) of section 281(a) require the corporation to pay all liquidated and uncontested claims and section 281(a)(3) mandates the posting of security for pending and future unasserted claims. Applying the facts to section 281(a), it seems indisputable that the $45,000 of liquidated claims are fully compensable under the statute. If so, complete remittance of the liquidated obligations reduces to $155,000 the corporate assets available for distribution subsequent to the firm's dissolution. Next, the $55,000 of uncontested claims that will mature within one year of the company's dissolution are entitled to full remittance as claims that, although not mature, are determined by corporate management to be legitimate obligations of the company. Under section 281(a), therefore, both mature (the employee wages and supplier debts) and unmature (the rent and mortgage obligations) claims will receive identical treatment at dissolution despite their temporal distinction. As such, firm assets are further reduced such that $100,000 remains for distribution to pending and future unknown claimants.

Assume that two plaintiffs thereafter sue the dissolved firm for personal injuries arising from the accident. Plaintiff A receives a $1 million trial court judgment within the statutory winding-up period. Plaintiff B (who is seeking $5 million against the corporation for injuries arising out of the same accident as plaintiff A) has yet to come to trial at the close of the three-year survival interval. What is required of the dissolving corporation vis-à-vis these plaintiffs under section 281(a)?

The *RegO* court interpreted the former statute to require equal treatment of plaintiffs A and B.[222] The ostensible justification for this conclusion was the term "priority" and its definition in section 281(e) that specifically rejects any reference "to the relative times at which any claims mature or are reduced to judgment."[223] By emphasizing the definition of priority under section 281(e), rather than the payment directives of section 281(a), the court concluded that section 281 required a dissolved corporation that "cannot both pay its present creditors and make adequate provision for contingent and future claims"[224] not to compensate its existing creditors in full, but to pay them ratably with its future claimants.[225] The court stated, however, that sections 281(a) and (e) did "not direct directors of a dissolved corporation to pay existing creditors only ratably when they have reason to know that the corporation will not be able fully to secure the payment of compensation to all foreseeable future claimants."[226]

After the court's conflicting signals regarding temporal priority among competing claimants, the question persists whether directors may, subject to the court's subsequent "fairness" review, adopt a security

---

[222] *RegO*, 623 A.2d at 106.

[223] *See id.* (citing DEL. CODE ANN. tit. 8, § 281(e) (1991)).

[224] *Id.*

[225] *Id.*

[226] *RegO*, 623 A.2d at 108. According to RegO's plan and trust agreement, all firm assets were to be transferred to a trust for distribution to existing and future claimants. *Id.* at 100. Under the plan, a $500,000 interim limit capped both contingent and future products liability claims as well as certain other claims. *Id.* at 101. Administrative expenses were to be paid in full as a priority. *Id.* at 101 n.22. Pre-existing claims which were reduced to a judgment before the effective date of the trust, but which remained unremitted as of that date, were to be paid in full. *Id.*

Further, RegO statistics indicated that without an interim limit on contingent and future products liability claims, available funds would be exhausted in the year 1996. *Id.* at 100. On the other hand, with an interim limit, products claims arising out of more than 90% of all occurrences were projected to be paid as if no limit existed. *RegO*, Master's Final Report at 37-38. In addition, with an interim limit, funds were predicted to be available for the payment of products liability obligations up to the interim limit until the year 2000. *RegO*, 623 A.2d at 100.

Interestingly, the guardian supported an interim limit and a priority for administrative expenses but objected to any "priority" being given to pre-existing judgment creditors. *RegO*, Master's Final Report at 25-26. This position was interesting for three reasons. First, it sought to enforce the definition of "priority" in § 281(e), while explicitly rejecting the mandate of § 281(a) that RegO "prorate" its claims. Second, it endorsed a priority for administrative expenses (which, of course, included the guardian's attorneys' fees and costs) but not the full payment of claims held by existing judgment creditors. Finally, it advanced the guardian's personal economic interest in the case to the obvious detriment of existing creditors as well as the class of claimants the guardian was appointed to represent.

scheme that fully compensates liquidated debts at the expense of contingent and future foreseeable claims. The reasonable answer seems to be one that permits the greatest flexibility to directorial decisions that are made in good faith and in an informed manner in the post-dissolution interval.

In the preceding hypothetical, therefore, if the corporation elects not to appeal the $1 million judgment in favor of A, then the remaining $100,000 should be available for payment to A as partial satisfaction of that debt, notwithstanding that such a decision by the directors will consume all corporate assets. In the alternative, the corporate directors should retain the discretion to negotiate a settlement with A if management considers such an option to be in the best interest of legitimate claimants and the dissolving entity. An alternative that retains directorial discretion regarding payment of liquidated debts effectuates the reimbursement requirements of section 281(a) and also fulfills the contract expectations of the liquidated and undisputed, contingent contract creditors.

By contrast, in the foregoing hypothetical, if a court were to require protection of A's and B's claims, the court, in essence, would be divesting assets from a liquidated claimant in favor of preserving a *potential* claim of a contingent or future claimant. This analysis would be in direct conflict with commercial and contract law. Further, directors of the dissolving entity would be compelled to undertake a costly economic analysis of a "fair" scheme for prorating the various claims against the corporation. This analysis requires as its predicate a determination of the total amount owed to creditors, which amount can then be prorated among claimants.[227] Although this method of obtaining "security" for future distribution might seem appealing in principle, three factors illustrate the inherent uncertainty of eliciting the requisite total claims' value and, thus, the unreliability of the methodology of prorating contingent or anticipated claims.

First, any prorating formula must ascertain for what period security must be provided for all potential, future claimants.[228] Second, a prorating formula assumes total claims to be quantifiable — an endeavor

---

[227]One claimant in the *RegO* litigation proposed the following prorating formula:

$$\text{Claims} \times \frac{\text{(Total Assets - Administrative Claims)}}{\text{Expected Total Value}}$$

See RegO, Master's Final Report at 49-50.

[228]In Delaware, this depends upon the court of chancery's selection of some interval between five and ten years post-dissolution.

that is intrinsically refutable. Third, a prorating formula assumes a requirement of ratable payment of *all* claims, with the possible exception of administrative obligations.[229]

If, as the court intimated in *RegO*, the pro rata condition is not absolute, the court must resolve the seeming friction between the payment mandates of section 281(a) and the "priority" language of section 281(e). If the term priority in section 281(e) is interpreted to prohibit the creation of priorities *within the same class of claims*, then sections 281 (a) and (e) are congruous.

For example, in the hypothetical, the liquidated and uncontested contingent claims were contractual obligations of the corporation that pre-dated the firm's accident. These obligations were fully negotiated and voluntarily assumed by the contracting parties. Under a contractual analysis, therefore, it is unsound to assume that the parties to the subject commitments[230] accepted the risk of non-payment of services or capital as a consequence of an environmental accident by the firm. Consequently, this interpretation of "priority" — applicable *only within corresponding categories of claims* — is ostensibly buttressed by the payment divisions of section 281(a) that differentiate between contract and all other classifications of corporate claims.

Further, if the innovation to sections 280 through 282 lies in the posting of reasonable security for pending and future unknown tort claimants, then "prioritizing" according to the "relative times at which any claims mature or are reduced to judgment" achieves the legislative purpose of the enactments. On the other hand, to extend the definition of priority beyond the parameters of a particular class of claimants' compromises the bargained-for commitments of pre-existing creditors to the unfair advantage of claimants who exist in statistical analysis only.

In short, a suggested interpretation of present sections 281(a) and (e) is one that construes "priority" to require equal treatment among the same or similar groups of claimants, not temporal parity for mature debts and contingent or future unknown claims. Such a construction balances the directives of section 281(a) and the definition of priority in section 281(e) with the competing interests of contract and tort victims of corporate negligence or misconduct. This interpretation also reduces the incentive for existing creditors to seek the appointment of a receiver[231] that would

---

[229]Again, this position directly conflicts with basic tenets of contract and commercial law.

[230]These parties would include employees, suppliers, and landlords or mortgagees.

[231]*See* DEL. CODE ANN. tit. 8, § 279 (1991) (permitting the appointment of a trustee or receiver for a dissolved corporation "on application of any creditor, stockholder or director of the corporation, or any other person who shows good cause therefor"); *id.* § 291 (permitting

undermine the effectiveness of the intended safe harbor of sections 280 through 282.

In the hypothetical, therefore, directors should be free to set aside the remaining firm assets for (1) full payment to A, (2) partial payment to A, and apportioned amounts for future payment to B and the other claimants, or (3) any other rational distribution plan that is adopted in an informed and good faith manner. Creditors who consider this directorial discretion to be disadvantageous may petition the court of chancery for the appointment of a receiver.

b. *Other Concerns*

In *RegO*, claimants raised a series of objections to the company's proposed plan and trust agreement. For the most part, the claimants' objections sought to replace post-dissolution directorial judgments with the claimants' retrospective considerations.[232] That is, the claimants desired to substitute their opinions of the disputed trust terms for those of RegO's directors.[233]

The claimants' objections raised two underlying and entwined legal issues. First, to what extent do traditional principles of corporate governance protect directorial decisions post-dissolution? Second, to what extent does a section 280(c)(2) hearing on "reasonable security" entail factual determinations of each challenged term in a proposed plan of security?

1. Theoretical Concerns

As to the former theoretical issue, the court in *RegO* held that "[w]hen directors of a dissolved Delaware corporation are, during the course of winding-up corporate affairs, required to make decisions affecting various classes of interest holders, they are protected from liability in doing so, so long as they act disinterestedly, with due care and in good faith."[234] As articulated, directorial judgments made during dissolution ostensibly are protected by the traditional business judgment rule.

---

the appointment of a receiver for an insolvent corporation "on the application of any creditor or stockholder").

[232] *RegO*, Master's Final Report at 38-39.

[233] *Id.*

[234] *RegO*, 623 A.2d at 109 n.35.

Interestingly, section 281(a) references a similar standard for the review of directorial judgments that involve the payment of "mature, known and uncontested" claims.[235] Section 281(a)(4), however, is silent concerning director decisions that implicate pending or future unknown claimants. Because no viable reason exists for placing a greater burden of review upon directors of dissolving entities that have mature, pending, and future foreseeable claims, section 281(a) should be amended to provide business judgment-like protection for all corporate decisions executed at or during dissolution. Such managerial protection should, however, be accorded to directors without conferring legitimacy to any "duty to creditors." In essence, dissolution should place all claimants to the firm in a creditor-like category with the recognition that stockholder/creditor interests will be compensated only after outside creditor interests are paid or considered.

What remains unresolved is whether good faith directorial decision making should be presumed during an insolvency that pre-dates dissolution. Because insolvency is not a voluntary or fixed state of economic being, creditors could argue that a presumption of validity is not warranted. The fallacy of such a position is its apparent reliance on the alleged "duty to creditors" at insolvency and the conflict that such a duty has with traditional notions of corporate governance. If courts abandon the duty to creditors in favor of contractual protections for corporate claimants, then the directorial obligations of care and loyalty would apply at insolvency in the same manner as they would during firm viability.[236]

2. Procedural Concerns

A recurring theme in the *RegO* proceedings was the allegation by certain claimants that RegO illegally transferred its assets to a related entity for less than fair market value.[237] An initial inquiry, therefore, is the extent to which a section 280 hearing should be subject to factual

---

[235]DEL. CODE ANN. tit. 8, § 281(a) (1994). Section 281(a) states: "In the absence of actual fraud, the judgment of the directors of the dissolved corporation or the governing persons of such successor entity as to the provision made for the payment of all obligations under paragraph (4) of this subsection [regarding payment of mature, known and uncontested claims] shall be conclusive." *Id.*

[236]*See infra* notes 505-29 and accompanying text (discussing the theoretical aspects of abandoning the corporate duty to creditors).

[237]*RegO*, 623 A.2d at 103.

resolutions of complex contractual, commercial, or tort allegations by interested claimants.[238]

For example, consider a publicly-held Delaware corporation which manufactures and nationally distributes a fungicide that is later determined to cause crop damage. Due to anticipated litigation costs, firm management elects to dissolve the business under Delaware sections 280 through 282. At the time of dissolution, the firm has three categories of liabilities: (1) state tax liability; (2) general, undisputed trade liabilities that will mature within weeks of the corporation's dissolution; and (3) products liability claims either for occurrences that arose pre-dissolution or will arise during the three-year post-dissolution interval, *or* that may arise subsequent to that period. Further assume that, in the aggregate, all claims against the dissolved entity exceed present or projected corporate assets and that the company challenges all liability ensuing from the products suits.

The procedural dilemma presented to the court of chancery under current section 280(c)(2) is two-fold: (1) whether the court must undertake factual hearings on each contested products claim where such claims have been initiated in a foreign jurisdiction and, pursuant to principles of conflicts of law, are to be decided under the substantive law of that forum; and (2) whether the court is required to accord full faith and credit to foreign judgments in such suits where those judgments eliminate all security for future distributions to contingent or anticipated products claimants in contravention of the apparent purpose of Delaware's dissolution statutes.

Two alternative resolutions are possible. First, in 1994, section 280(c) was amended to require dissolving corporations to petition the court of chancery for a determination of the amount and form of security reasonably likely to provide compensation for pending claims and for claims that foreseeably will arise in a five-to-ten year interval post-dissolution.[239] In the hypothetical, therefore, the court of chancery must resolve at least two security issues: (1) the quantity and form of security for the claims which arose pre-dissolution but which have not been reduced to judgment, and (2) the quantity and form of security for the future unasserted claims.

As to the pending claims, the court could simply require security in the amount for which plaintiffs have sued. The obvious attractiveness of

---

[238]Intertwined in this query are the principles of conflicts of law and full faith and credit. Resolution of this inquiry is essential if court and attorney costs are to be confined within reasonable boundaries in order to preserve corporate property for distribution to creditors.

[239]DEL. CODE ANN. tit. 8, § 280(c) (1994).

this option is that the corporation, the claimants, and the court are not obliged to present or hear extensive evidence regarding disputes that are external to the dissolution. It is also appealing for its simplistic application.

Such an alternative should be rejected, however, because it permits litigation-inspired plaintiffs' counsel to usurp the legitimate decision-making responsibility of directors. It also ignores, and militates against, the value of negotiated settlements of claims. Instead, it is suggested that the legislature amend sections 280 and 281 to clarify that the hearing on security will weigh certain limited evidence. These hearings will be cost-effective if they also permit testimony on the proposed claims assertion date amendment.[240] By marginally expanding the security hearings, the court is better able to tailor the amount and form of security for particular corporations.

In sum, the Delaware enactments should be amended to clarify that sections 280 through 282 are intended to be summary dissolution actions. Accordingly, absent a showing of overt illegality, actual fraud, bad faith, or compensable injury to a stockholder, issues considered in the dissolution will be narrowed to those involving the sufficiency of security.[241] In this manner, lengthy and costly fact-findings are avoided because dissolution actions arguably are concerned with the administration of corporate assets and affect individual interests only incidentally.

Another alternative is that which requires the court of chancery to hear and decide all factual disputes that tangentially affect a claimant's contention over a provision of a proposed security arrangement. The clear disadvantage to this alternative is its depletion of the corporate estate through attorneys' fees and court costs in a preliminary stage of a firm's dissolution.

Because the latter alternative appears economically wasteful, the former is that recommended for future section 280 proceedings. An obvious flaw to this alternative, however, arises in the case where, as in the hypothetical, the dissolving entity disputes all liability for future or contingent claims — a position that, if accurate, would render the corporation solvent and thus free to ignore the section 281 mandate for

---

[240] *See supra* note 201 and accompanying text.

[241] In this sense, §§ 280-282 would be interpreted similarly to § 273 which permits a summary dissolution of a joint venture having two stockholders. *See* DEL. CODE ANN. tit. 8, § 273 (1991). *See also In re* Southern One-Stop, Inc., No. 7500, 1986 WL 13978, at *1 (Del. Ch. Dec. 3, 1986), *reprinted in* 12 DEL. J. CORP. L. 1208, 1210 (1987) (stating that petitioner could not pursue a claim of diversion of a corporate opportunity in a § 273 action).

ratable payments where funds are insufficient to compensate all creditors fully. Because this scenario will occur in more circumstances than where the dissolved enterprise concedes liability or damages, two observations are warranted.

First, if section 280(c)(2) is amended to provide that "claims" and "obligations," as referred to in that statute, do not include statistically probable or provable claims, then a dissolving corporation only must challenge those claims that are pending and contested. Admittedly, this amendment might encourage directors to contest all contingent claims and thereby create additional procedural ordeals for a reviewing court. Accordingly, a second observation is required.

If section 280(c)(1) and (3) are narrowly interpreted to exclude all testimony on the merits of foreign suits and to permit only expert testimony as to the statistical probability of plaintiffs' success (both substantively and economically) in contingent suits, the market efficiency and predictability purposes of sections 280 through 282 will be fulfilled. In this regard, the recommended amendment would permit interested parties (including the *guardian ad litem*) to introduce only that expert evidence that bears directly upon the question of the sufficiency and fairness of security under section 280. Such judicial efficiency is, however, not achieved at the expense of due process.

Three distinct benefits follow from this interpretation. First, summary dissolution under section 280 reduces the debilitating litigation costs associated with adversarial hearings on issues tangential to a corporate dissolution. Thus, the statute conserves corporate assets for distribution to legitimate claimants. Second, the recommendation sustains, in the reviewing court, the right to set aside an approved plan of distribution where critical expert testimony is later adduced to be incomplete or inaccurate. Third, directorial discretion is retained for managers who oversee corporate dissolutions. The sole disadvantage of the suggested interpretation is its lack of finality once a security arrangement has proceeded through a section 280 hearing. This disadvantage, however, is more imagined than real given the right of certain creditors to seek the appointment of a receiver notwithstanding a section 280 dissolution. Certainly, any interpretation which allows mini-trials within a section 280 proceeding contravenes any tort reform policy inherent in Delaware's dissolution amendments.[242]

---

[242]One conflicts of law dilemma that is not resolved by the recommended construction is that in which a claimant in a foreign jurisdiction seeks to impose the *dissolution law* of the forum wherein the alleged tort or breach of contract occurred. Certainly, the internal affairs doctrine encourages the application of the dissolution law of the corporate defendant's state of

As to the procedural quandary of full faith and credit in the circumstance of a section 280(c) proceeding, two primary scenarios must be considered. First, what happens when a foreign creditor obtains a judgment against a dissolved Delaware corporation that, if honored in its entirety in Delaware, would deplete all corporate assets available for distribution to other creditors? Principles of full faith and credit seem to suggest that Delaware is powerless to adopt a statute that curtails the existing rights of the foreign creditor. In *RegO*, however, the court intimated that full faith and credit, while conclusively establishing the amount of liability in the foreign judgment, does not prevent a "valid state law" from precluding a foreign judgment "from being paid by a dissolved corporation under certain conditions."[243]

Two comments follow from the court's statement regarding full faith and credit. In the first instance, one can only hypothesize on the nature of the "valid state law" to which the court refers. In particular, the question is posed whether Delaware is empowered, through its insolvency or dissolution statutes, to implement indirectly an automatic stay of all foreign judgments against a Delaware corporation in light of the pre-existing contractual and commercial rights of those claimants. Certainly, one must seriously doubt Delaware's power to enact a statute that limits the rights of *Delaware* stockholders and creditors (as opposed to creditors of Delaware firms with foreign judgments)[244] to assets of a dissolved *Delaware* corporation after appropriate notice. To suggest, however, that the enactment of a statute would terminate recognized rights in foreign claimants seems to have no basis in the law. Indeed, it seems ironic that a "valid state law" could be enacted so as to diminish the rights of a class of judgment creditors for the ostensible benefit of a class of future unasserted claimants. This becomes all the more ironic when, as in *RegO*, the corporation surrenders all its assets to a trust and, thus, retains

---

incorporation. *See* McDermott Inc. v. Lewis, 531 A.2d 206, 215 (Del. 1987). Unfortunately, however, no interpretation of Delaware's dissolution legislation prevents a sister-state court from applying *its dissolution law* where the reviewing court concludes that such an application serves the public policy of the foreign forum.

[243] *RegO*, 623 A.2d at 107 n.32. The court thereafter continued: "It is the law governing corporate dissolution that in this context would be entitled to Full Faith and Credit in those sister-state jurisdictions in which execution of a judgment against a dissolved corporation was sought." *Id.*

[244] One must also seriously consider the implications of any Delaware law which attempts to compromise contract and commercial law rights of Delaware creditors of Delaware corporate defendants as opposed to compromising the same rights of foreign creditors of Delaware corporations. In short, any attempt by the Delaware Legislature to fractionalize Delaware corporate assets among resident versus non-resident plaintiffs seems suspect and at direct odds with rudimentary principles of comity and full faith and credit.

no interest in the disposition of its assets. If the latter circumstance is plausible, then a second observation is warranted.

If a sister-state elected to apply the dissolution law of the forum wherein the disputed tort or contract claim arose, is such an election not an issue of conflicts of law? For example, if full faith and credit permits Delaware to enact legislation that compromises or otherwise eliminates a claimant's foreign judgment, then what court in a sister-state would not reject the dissolution law of Delaware in favor of the dissolution statutes of the foreign forum? Clearly courts have, under the auspices of public policy and the fact of the presence of a foreign corporation within their territorial boundaries, refused to implement the dissolution statutes of a corporate defendant's state of incorporation.[245] If these opinions represent a viable alternative to the application of a dissolution statute that compromises or terminates rights of foreign claimants, then traditional constructions of full faith and credit and conflicts of law are substantially eroded.

A more practical full faith and credit interpretation of section 281(a) would obligate a dissolving corporation to pay these judgments in full, recognizing, of course, that execution of such judgments may prevent distributions to contingent or future claimants. On the other hand, contingent claimants who will be harmed by the first execution upon corporate assets may seek the appointment of a receiver. Such appointment not only vests legal title to firm assets in the receiver for equal distribution to legitimate creditors, but also divests corporate directors of the power to distribute corporate property other than upon an equivalent basis. Interestingly, however, such receiverships neither disturb nor interfere with existing liens against corporate assets,[246] nor vest legal title in the receiver to real estate located outside the entity's state of incorporation.[247]

---

[245]*See, e.g.* Western Airlines, Inc. v. Sobieski, 12 Cal. Rptr. 719, 727 (Cal. Ct. App. 1961).

[246]McGlinn v. Wilson Line, Inc., 174 A. 365, 367 (Del. Ch. 1934).

[247]DEL. CODE ANN. tit. 8, § 292(a) (1991). *See also* Stockbridge v. Beckwith, 33 A. 620, 620 (Del. Ch. 1887) (limiting a "receiver's right to the possession of the debtor's property . . . to the jurisdiction of his appointment").

B. *Query: If a Corporation Chooses to Dissolve Without Complying With the Judicially Supervised Notice Procedures of Section 280(c), Do the Firm's Directors Owe a Fiduciary Duty to Creditors?*

Recall that the hypothetical corporation desired to terminate its business, liquidate its assets, and invest remaining funds in a new Delaware venture. If the firm's managers consider Delaware sections 280 and 281 too burdensome and ambiguous in application, may they undertake a sale of company assets at public auction, use the proceeds therefrom to pay uncontested creditor claims, invest remaining monies in a new venture, and permit the former corporation simply to languish until that moment at which its charter is lost for failure to pay franchise taxes? In the alternative, does Delaware law interpose a directorial duty to unpaid creditors to pursue statutory dissolution and winding up of the business under section 280 or section 281?

1. Traditional Corporate Articulations of Management Duties Owed to Creditors

The lack of clarity in present corporate jurisprudence on directorial duties to creditors is poignantly illustrated by cases addressing corporate bondholder privileges. Currently, two rights-enforcement techniques are available to corporate debt holders. First, debt owners may find protection in the contractual duty of good faith in the performance and execution of indenture agreements.[248] This remedy derives from the axiom that bondholders are creditors of the firm and, therefore, must bargain for their own protection.[249] If bondholders fail to negotiate bondholder-protective covenants, or the indenture agreement is silent regarding specific creditor rights, debt holders must rely upon general contract avoidance doctrines to set aside or interpret indenture language resulting in unfairness, oppression, or unconscionability.[250]

An alternative available to debt owners is the imposition upon corporate issuers and controlling shareholders of the firm of a fiduciary duty *to bondholders* where the interests of the debt owners conflict with

---

[248]Ann E. Stilson, *"De-Leveraging" the Leveraged Buyouts of the 1980s: A Prisoner's Dilemma for Unsecured Corporate Bondholders in the 1990s*, 68 DENV. U. L. REV. 331, 368 (1991).

[249]*Id.*

[250]*Id.*

those of the stockholders.[251] This option abandons the traditional corporate characterization of bonds as "debt" to be regulated exclusively by contract.[252]

During the late 1980s, the decline of corporate takeovers in state corporate courts revisited the demarcation of equity and debt and the doctrinal regimes of corporate and contract law as applied to non-equity securities. The resulting judicial response to the imposition of a corporate fiduciary duty was a resounding negative.[253] This result primarily ensued from the unresolvable conflict between the financial expectations of stockholders and bondholders. Secondarily, the response was a product of the contractual nature of the creditor interest.[254] In an instructive case

---

[251] *Id.*

[252] Stilson, *supra* note 248, at 368.

[253] *See, e.g.*, Katz v. Oak Indus., 508 A.2d 873, 878-79 (Del. Ch. 1986) (holding that bondholders stood in contractual relationship with corporation).

[254] *Id.* at 879. The right of a creditor to sue corporate management for breach of a fiduciary duty was a primary issue during the late 1980s. Those cases were raised despite the precedent against the imposition of such a duty. Apparently bondholders revisited the creation of such a duty in the 1980s since the takeovers of that period raised the important theoretical question of the nature of the publicly-held corporation and the relationship of corporate management to all constituents who provide capital to the firm.

Two early decisions on creditor rights against management were Wolfensohn v. Madison Fund, Inc., 253 A.2d 72 (Del. 1969), and Harff v. Kerkorian, 324 A.2d 215 (Del. Ch. 1974), *aff'd in part, rev'd in part on other grounds*, 347 A.2d 133 (Del. 1975). In *Wolfensohn*, plaintiffs sought to enjoin an exchange offer by a holding company for 97% of the target company's stock. *Wolfensohn*, 253 A.2d at 74. According to plaintiffs, the exchange offer effected a reorganization which transferred corporate income from bondholders to stockholders in the event of a liquidation and otherwise placed plaintiff bondholders in an inferior position. *Id.* at 75. Plaintiffs were denied relief because debt holders were deemed to be creditors of the corporation. *Id.* Consequently, no fiduciary duty was owed and the exchange offer impaired no contractual rights owed to the plaintiff bondholders. *Id.*

A similar result was obtained in *Harff*. In *Harff*, plaintiffs brought a combined derivative and class action suit challenging the declaration and payment of a dividend for the controlling shareholders' benefit. *Harff*, 324 A.2d at 216-17. Plaintiffs were the holders of 5% convertible debentures due in 1993. *Id.* at 217. They alleged the classic conflict of interest between stockholders and bondholders in the declaration of a cash dividend that impairs the value of conversion features and causes a decline in the market value of the underlying bonds. *Id.* The Delaware Court of Chancery dismissed the derivative cause of action for lack of standing. *Id.* at 220. Citing the *Wolfensohn* decision, the court found that convertible bondholders do not gain stockholder status until exercise of the option. *Id.* at 219. As to the class action, plaintiffs claimed that defendant directors breached the indenture agreement by violating their fiduciary duties to refrain from acting in self-interest. *Id.* at 221. The court dismissed the class action for failure to show any fiduciary duty existing between the defendants and bondholders. *Id.* at 222. Chancellor Quillen noted, however, that in future cases creditors can maintain an action against management upon proof of fraud, insolvency, or a violation of an independent statute. *Id.* Chancellor Quillen did not address the theoretical basis for any exception which arises upon insolvency.

of that era, *Katz v. Oak Industries Inc.*,[255] the Delaware Court of Chancery revisited the relationship of bondholders to management of the corporate issuer.

In *Katz*, the plaintiffs were owners of long-term debt securities issued by Oak Industries, Inc. (Oak).[256] Oak announced an exchange offer and consent solicitation that would effect a reorganization of the firm.[257] Plaintiffs alleged that the offer was "coercive" and forced bondholders to tender and consent.[258] The argument asserted that by conditioning the offer on consent, management breached their contractual obligation to act in good faith.[259]

The court of chancery denied plaintiffs' application for a preliminary injunction on both direct and indirect grounds.[260] As to the latter, the court found that plaintiffs failed to present the issue of whether a fiduciary duty was owed by corporate management to the holders of debt securities.[261] Consequently, the court found no "cognizable legal wrong" from directorial action that benefitted shareholder interests at the bondholders' expense.[262] The court based its conclusion upon existing Delaware law, and the law generally, which defines the relationship between a corporation and its bondholders (including owners of convertible debentures) to be contractual in nature.[263] The opinion in *Katz* outlined a bondholder's rights and interests as against the issuing firm:

> Arrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the *contractual relationship agreed to and not broad concepts such as fairness* define the corporation's obligation to its bondholders.[264]

---

[255]508 A.2d 873 (Del. Ch. 1986).

[256]*Id.* at 875.

[257]*Id.*

[258]*Id.* at 878.

[259]*Katz*, 508 A.2d at 878.

[260]*Id.* at 878-82.

[261]*Id.* at 879.

[262]*Id.*

[263]*Katz*, 508 A.2d at 879.

[264]*Id.* (emphasis added) (footnote omitted). The court did note, however, the application of implied covenants of good faith and fair dealing as a matter of contract law. *Id.* at 879 n.7. Further noted by the court was the impact of the challenged transaction — that is, the transfer

Notwithstanding existing Delaware law, the court acknowledged that the impact of the proposed restructuring was to transfer the risk of economic loss to bondholders and thus remove wealth from owners of debt to owners of equity.[265] The court, however, refused to impose duties in the absence of either legislative directives safeguarding bondholder interests or indenture terms granting creditor self-protection.[266]

In accordance with modern contract principles, the court reasoned that a party to an indenture owes a duty of good faith and fair dealing in the performance and execution of a contract.[267] The contract obligation of the corporate issuer was found to be different from the duty of loyalty required of a director in the exercise of her duties to the corporation or its shareholders.[268] In *Katz*, the court set forth the test for breach of contract based upon a claim of "coercion" in the structure of a corporate transaction. Under this test, the court determines whether

> [i]t [was] clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith — had they thought to negotiate with respect to that matter. If the answer to this question is yes, then, in my opinion, a court is justified in concluding that such act constitutes a breach of the implied covenant of good faith.[269]

---

of wealth from stockholders to bondholders. *Id.* at 879.

[265] *Id.* at 879.

[266] *Id.*

[267] *Katz*, 508 A.2d at 880.

[268] *Id.* at 879 n.7. The court did not, in the *Katz* opinion, specifically address the difference between a corporate duty of loyalty which demands that directors not act in *their own self-interest at the expense of stockholders* or the corporation and the contractual duty of good faith and *fair dealing which applies equally to the parties to the contract.* Certainly the requirement of fair dealing under contract law would prevent interested transactions by directors to the detriment of stockholders and bondholders. *See, e.g.*, Brown v. McLanahan, 148 F.2d 703, 706 (4th Cir. 1945) (holding that a director-trustee under a voting trust agreement cannot modify a trust indenture to prefer a bondholder interest over that of beneficial owners of voting trust certificates). However, the issue presented in *Katz* was a management preference for stockholder interests over those of bondholders. *Katz*, 508 A.2d at 877. In this sense, it seems logical that the duty of fair dealing in contract law is analogous to the corporate duty of loyalty.

[269] *Katz*, 508 A.2d at 880 (citations omitted). Two questions arise from the court's formulation of "coercion" as a matter of contract law. First, is the concept of "coercion" different in a contract, as opposed to a corporate, regime? If not, is the appropriate legal test then one of "fairness" as determined in an equitable proceeding by the reviewing court? If so, then do not the same equitable principles require fair treatment to all parties who seek redress

Since *Katz*, the law in Delaware has remained that directors owe no fiduciary duties to creditors.[270] What remains unclear, however, is whether the negative statement of this precept excludes the creation of such a duty at *insolvency* or *dissolution* and whether, in any event, the common law contractual duty referred to in *Katz* is co-extensive with any corporate fiduciary obligation to creditors. These concerns immediately raise four questions.

---

in a court of equity, notwithstanding the nature of their economic or financial interests in the alleged wrongdoing? Second, if the test of contractual good faith is what the issuer and creditor "would have agreed to," what creditor protections will ever be implied when to do so is to breach a corporate duty owed by directors to their shareholders? To what extent is this good faith analysis transformed upon a corporation's insolvency or dissolution? Does the timing of an alleged breach by a corporate issuer alter the duty of good faith in terms of a contractual analysis? Certainly, the contract obligation of good faith and fair dealing does not attach to the negotiation process which is arguably the exact juncture at which the interests of stockholders, bondholders, or other creditors diverge. If the covenant of good faith does not attach to the bargaining process, how will a creditor ever prove a breach of good faith in the performance of the indenture?

[270]*See Geyer*, 621 A.2d at 787 (stating that "the general rule is that directors do not owe creditors duties beyond the relevant contractual terms"). Another Delaware case which addressed the rights of creditors as against corporate management was *Harff v. Kerkorian*. In *Harff*, the court of chancery held that unless extraordinary circumstances such as fraud, insolvency, or a violation of a statute were alleged, the rights of debenture holders are determined by the terms of the indenture agreement, and thus, no fiduciary duty existed between the issuing corporation and the holders of its debt obligations. *Id.* at 222. The Delaware Supreme Court reversed, holding that a claim of fraud had clearly been established such that creditors were free to seek relief outside the terms of the indenture agreement. *Harff*, 347 A.2d at 134. *See also* Norte & Co. v. Manor Healthcare Corp., Nos. 6827 & 6831, 1985 WL 44684, at *5 (Del. Ch. Nov. 21, 1985), *reprinted in* 11 DEL. J. CORP. L. 959, 966 (1986) (noting that in reversing *Harff*, the supreme court's language "strongly suggests that it was not disturbing the trial court's holding that convertible debenture holders may not state a claim for breach of fiduciary duty"); Continental Ill. Nat'l Bank & Trust Co. v. Hunt Int'l Resources Corp., No. 7888, 1987 WL 55826, at *4 (Del. Ch. Feb. 27, 1987), *reprinted in* 13 DEL. J. CORP. L. 255, 264 (1988) (concurring with interpretation of *Harff* in *Norte & Co.*, "that a debenture holder may not maintain a claim for breach of fiduciary duty . . . against the issuing corporation and its directors"). Of course the supreme court's opinion in *Harff* did not establish the existence of a fiduciary duty to creditors, only that other relief is available where a claimant can establish fraud — a remedy widely recognized in contract law. *See also* Shenandoah Life Ins. Co. v. Valero Energy Corp., No. 9032, 1988 Del. Ch. LEXIS 84, at *4 (Del. Ch. June 21, 1988), *reprinted in* 14 DEL. J. CORP. L. 396, 400 (1989) (holding that neither a corporation nor its directors owe fiduciary duties to holders of the corporation's debt instruments and that an implied covenant of good faith cannot create rights in debenture holders which are inconsistent with those rights articulated in the indenture agreement); Kass v. Eastern Air Lines, Inc., Nos. 8700, 8701, & 8711 (Del. Ch. Nov. 14, 1986), *reprinted in* 12 DEL. J. CORP. L. 1074, 1081-82 (1987) (holding a corporation's duties to its debt holders are delineated by the commercial relationship of the parties as evidenced by the parties' indenture agreement).

First, if the duty is created only at insolvency or dissolution, what principle of *corporate* law justifies the transformation? That is, are not contractual and commercial rights and priorities sufficient to safeguard creditors against management decisions which prefer stockholder expectancies at the interval of firm distress or demise? Are not bondholders, creditors, lenders, and trade suppliers entitled to negotiate such creditor self-protection provisions in indenture and other contractual arrangements with the corporation? If not, are the holding and *dicta* of *Katz* limited only to *bondholder* contracts or, more specifically, bondholder commitments disputed *outside of* insolvency or dissolution? If the former provides the explanation, then an unresolvable disparity exists between the classification of bondholders, as owners of financial interests which are solely contractual (and thus owed no fiduciary duties), and the financial interests of all other creditors of the corporation.[271] Certainly, any argument that equity furnishes the predicate for the "duty to creditors" at insolvency or dissolution is not defendable in light of modern dissolution reform.[272]

Second, because *insolvency* is a reversible state of economic existence, corporate duties to creditors which may arise at *dissolution* (an identifiable act of death for the corporate entity) are not justifiably analogous.

Third, if the present duty to creditors is co-extensive with the contractual obligations of good faith and fair dealing, a contractual duty alone preserves whatever priority creditors seek during firm distress. An independent corporate duty to creditors is extraneous and needlessly confusing to traditional applications of the fiduciary model of corporate governance.

Finally, since the imposition of a directorial obligation to creditors raises the specter of personal liability to managers, legitimate decision making is clouded by potential economic waste resulting from defensive management. One might speculate that restrained decision making by directors during the post-dissolution and pre-liquidation interval seriously compromises the preservation of corporate wealth and subsequent distribution of firm property. Such a compromise to wealth preservation necessarily diminishes the value of distributions to competing constituents of corporate assets.

---

[271]Examples of "other corporate creditors" include banks, trade suppliers, employees, and officers. Likewise, bondholders are indispensable to the firm from the standpoint of providing necessary capital for corporate research, development or expansion. Therefore, it seems illogical to draw a distinction between "other creditors" and bondholders.

[272]*See infra* text accompanying notes 306-420.

2. Directorial Duties to Creditors at Insolvency

A stated exception to the "no-duty-to-creditors" rule is that at insolvency such an obligation arises.[273] Two recent Delaware decisions illustrate the modern application of this exception. In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*,[274] the Delaware Court of Chancery addressed directorial duties where a corporation was operating "in the vicinity of insolvency."[275] In *Geyer v. Ingersoll Publications Co.*, the court defined insolvency to be "insolvency in fact."[276] The former decision is significant for its apparent expansion of managerial duties to the pre-dissolution period. The second is insightful for its delineation of the economic condition of insolvency.

In *Credit Lyonnais*, the court, in a footnote to the opinion, set out a hypothetical problem which represented a conflict between stockholder and creditor interests.[277] The hypothetical assumed a corporation with $12 million of debt and a single asset represented by a $51 million judgment against a solvent debtor.[278] Assuming a twenty-five percent success rate on appeal, a seventy percent chance of modification on appeal, and a five percent likelihood of reversal, the court inquired whether the directors should settle the claim resulting in the judgment and, if so, for what amount.[279] The court concluded that the directors should settle the suit for any offer in excess of $15.5 million which reflected the "expected value" of the judgment on appeal.[280] The opinion noted, however, that settling for this amount would result in a residual equity value of $3.5 million while prosecution of an appeal by the corporation, though risky, would likely result in a residual equity value of $9.75 million.[281] According to the court, whether directors should litigate the claim to maximize residual equity for all constituents, or settle and be guaranteed limited residual equity, depended upon the board's

---

[273]*Geyer*, 621 A.2d at 787; *Harff*, 324 A.2d at 222.

[274]No. 12,150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 DEL. J. CORP. L. 1099 (1992).

[275]*See id.* at *108, *reprinted in* 17 DEL. J. CORP. L. at 1155.

[276]*See Geyer*, 621 A.2d at 787.

[277]*Credit Lyonnais*, No. 12,150, 1991 Del. Ch. LEXIS 215, at *108 n.55, *reprinted in* 17 DEL. J. CORP. L. at 1155 n.55.

[278]*Id.*

[279]*Id.*

[280]*Id.*

[281]*Credit Lyonnais*, No. 12,150, 1991 Del. Ch. LEXIS 215, at *108 n.55, *reprinted in* 17 DEL. J. CORP. L. at 1156 n.55.

duties where the corporation was operating in the vicinity of insolvency.[282] The court stated that

> [i]f we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than $15.55 million . . . . But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.[283]

Three points should be noted regarding the *Credit Lyonnais* opinion. First, imposing a directorial duty to maximize a corporation's "community of interests" where the board is managing a "nearly insolvent" corporation provides fertile ground for Monday-morning quarterbacking by competing corporate constituencies. This concept conflicts with traditional corporate governance principles. Second, there was no reference to the availability of the business judgment rule for managerial protection from such perfect hindsight in *Credit Lyonnais*. Third, market efficiencies militate against imposing earlier, more uncertain, decision-making burdens on directors who must attempt to guide a financially-distressed corporation either towards solvency or liquidation.

Clearly, abuses by management could occur where the shift in directorial duties is defined to exist at the moment of insolvency in fact. No one can seriously argue, however, that fraud, bad faith, or gross abuse by management operating at an interval just short of insolvency cannot be addressed in equity. A contrary rule would presume that a majority of corporate directors attempt to abuse non-shareholder constituents during the twilight zone before actual insolvency.

In June of 1992, the Delaware Court of Chancery again considered the question of directorial duties to creditors in the context of firm

---

[282] *Id.*

[283] *Id.*

insolvency. In *Geyer*, the court addressed the issue of whether a fiduciary duty to creditors arises under Delaware law upon insolvency "in fact" or only at the institution of statutory insolvency proceedings.[284] The court concluded that Delaware case law[285] and the ordinary meaning of the term insolvency[286] required the imposition of the duty at the moment of actual insolvency (insolvency in fact).[287]

The difficulties in articulating a duty to creditors upon insolvency, the vicinity of insolvency, or insolvency in fact are poignantly illustrated by bankruptcy cases examining directorial duties. For example, the issue of fiduciary duties owed by directors has recently become acute in the bankruptcy courts. This stems from the imposition, by the Bankruptcy Act, of a directorial obligation to creditors prior to the filing of a petition in bankruptcy.[288] The basis for decreeing such a pre-filing fiduciary duty is the trust fund doctrine.[289]

The issue of whether a corporate director stands in a fiduciary relationship with creditors *prior* to the filing of a bankruptcy petition or prior to the existence of an actual or technical trust is currently unresolved. Some courts have concluded that the term "fiduciary capacity" in the Bankruptcy Act is more restrictive than the term "fiduciary duty" in state corporate law.[290] Other courts have concluded that the fiduciary duty arises at a point prior to the existence of an actual or technical trust or have interpreted the requirement of such a trust broadly.[291]

---

[284]*Geyer*, 621 A.2d at 787.

[285]*Id.* at 787-89.

[286]*Id.* at 789.

[287]*Id. See also In re* Martin, 154 B.R. 490, 494 (Bankr. C.D. Ill. 1993) (citing Geyer v. Ingersoll Publications Co., 621 A.2d 784 (Del. Ch. 1992)) (concluding that the fiduciary relationship between an insolvent corporate debtor's directors and creditors is created at the point of insolvency rather than the creation of an express or technical trust).

[288]*In re* Mortgageamerica, 714 F.2d 1266, 1268-74 (5th Cir. 1983).

[289]*Id. See also infra* text accompanying notes 359-420 (discussing the trust fund doctrine).

[290]*See, e.g., In re* Baird, 114 B.R. 198, 202 (Bankr. 9th Cir. 1990) (stating that "[t]he broad general definition of a fiduciary relationship — one involving confidence, trust and good faith — is inapplicable in the dischargeability context"); *In re* Hutton, 117 B.R. 1009, 1010 (Bankr. N.D. Okla. 1990) (holding that "fiduciary capacity" is construed more narrowly under the Bankruptcy Code than "fiduciary relationship" is construed under state law); *In re* Nayee, 99 B.R. 90, 92 (Bankr. M.D. Fla. 1989) (noting that an officer's obligation to creditors does not "rise to the level of an independent fiduciary relationship contemplated by § 523(a)(4)").

[291]*See, e.g., In re* Bruning, 143 B.R. 253, 255 (D. Colo. 1992) (noting that "express or technical trusts" must have existed prior to the creation of the debt in controversy); *In re* Winden, 120 B.R. 570, 574 (Bankr. D. Colo. 1990) (requiring a trust be created prior to the act of wrongdoing); *In re* Schiraldi, 116 B.R. 359, 361 (Bankr. D. Conn. 1990) (noting that the trust relationship must exist prior to the act which created the debt); *In re* Galbreath, 112

More disturbing than the creation of a federal pre-insolvency fiduciary duty is the current trend in bankruptcy jurisprudence in which courts "federalize" the test of director liability for failed financial institutions.[292] For example, in *FDIC v. Canfield*,[293] the Tenth Circuit allowed the FDIC, acting on behalf of a bank and its stockholders, to sue the directors of a bank under an applicable state standard of simple negligence.[294] The court allowed the suit notwithstanding the language of section 1821(k) of FIRREA which provides:

> A director or officer of an insured depository institution may be held personally liable for monetary damages . . . for *gross negligence*, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined . . . under applicable State law. Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law.[295]

As a corollary, the *Canfield* opinion stated that if state law protects directors by mandating more than gross negligence for liability, FIRREA would preempt state law and thus impose personal liability for gross negligence alone.[296] Consequently, directors in a *Canfield* jurisdiction are placed in a no-win situation. If the FDIC is unable to prove its case under a gross negligence standard, it may proceed under a lesser state standard. On the other hand, if the state imposes a greater test of

---

B.R. 892, 898-900 (Bankr. S.D. Ohio 1990) (interpreting the requirements of a trust broadly); *In re* Thorsen & Co., 98 B.R. 527, 529 (Bankr. D. Colo. 1989) (holding that the fiduciary relationship must result from an express or technical trust which must have been created prior to the debt in controversy).

[292]*See* FDIC v. Canfield, 967 F.2d 443, 446-48 (10th Cir. 1992), *cert. dismissed*, 113 S. Ct. 516 (1992) (holding that § 1821(k) of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), 12 U.S.C. §§ 1811-1932 (1988 & Supp. 1989), does not preempt state law imposing a standard of culpability for simple negligence, but rather the statute preempts only those state laws requiring a higher degree of culpability than gross negligence). *See also* FDIC v. Swager, 773 F. Supp. 1244, 1248 (D. Minn. 1991) (holding that state law is partially preempted in the area of director culpability). *But cf.* Gaff v. FDIC, 919 F.2d 384, 391 (6th Cir. 1990) (noting that local law is referred to for purposes of defining "gross negligence").

[293]967 F.2d 443 (10th Cir. 1992), *cert. dismissed*, 113 S. Ct. 516 (1992).

[294]*Id.* at 446.

[295]12 U.S.C. § 1821(k) (Supp. 1989) (emphasis added).

[296]*Canfield*, 967 F.2d at 448.

culpability, the FDIC may proceed under the lesser FIRREA requirement of gross negligence.

To further complicate the issue of director duties in insolvency, the Third Circuit in *Moody v. Security Pacific Business Credit, Inc.*,[297] adopted a "foreseeability" test of insolvency.[298] In *Moody*, the court did not focus on the bankruptcy definition of insolvency. Instead, the court evaluated the foreseeability of the defendant's insolvency, including the reasonableness of asset and cash flow projections prepared and relied upon by the parties, to the leveraged transaction in question.[299]

3. Directorial Duties at Dissolution

At the common law, corporate debts abated immediately upon a corporation's demise, i.e., dissolution.[300] As a result of the corporation's death, its power to hold firm property was lost and equitable title to all corporate assets was transferred to its shareholders.[301] Whereas shareholders received equitable title to corporate property, the entity's directors were entrusted with the assets and invested with the fiduciary obligations of trustees in the liquidation and disposition of the corporate property.[302]

a. *Creditor Rights Upon Corporate Dissolution*

1. Claims Against Dissolved Corporations — Survival and Limitations Statutes

States reacted to the harsh effects of the common law by enacting modern dissolution statutes which permitted corporations to retain title in firm property for the limited purpose of winding up corporate affairs.[303] The statutes also eliminated the imposition of a trusteeship upon directors

---

[297] 971 F.2d 1056 (3d Cir. 1992).

[298] *Id.* at 1073.

[299] *Moody*, 971 F.2d at 1073.

[300] *See* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 10.16, at 10.50-.51 (2d ed. Supp. 1995).

[301] *See* Comment to 2 MODEL BUSINESS CORP. ACT §§ 85-87 (1971) (stating that "[h]istorically corporate dissolution resulted in realty reverting to the grantor, personalty escheating to the sovereign and choses in action extinguished with the death of the corporation").

[302] *See* Official Comment to 3 MODEL BUSINESS CORP. ACT § 14.05(a) (1994) (comparing § 14.05 to the common law).

[303] *See infra* note 316.

of a dissolved corporation.[304] Although these legislative enactments allowed corporations to continue to hold their property during the winding-up interval post-dissolution, the statutes did not curtail the fiduciary obligations of directors. Indeed, some statutes clearly imposed personal liability upon directors for authorizing distributions to shareholders upon dissolution before paying, or making adequate provision for, unpaid creditor claims.[305]

The common law doctrine of dissolution terminated a corporation's right to hold and use its property. As a result, the corporation also lost its right to sue once dissolution occurred.[306] Similarly, all creditor claims which were pending against the firm at the time of its "death" died with the defunct corporation.[307] Under the common law, therefore, a corporation could legitimately dissolve for the sole purpose of eliminating its existing, contingent, and future foreseeable creditor obligations.[308]

Reacting to the incentive provided by dissolution, states enacted legislation which preserved creditor claims by or against the dissolved firm. For the most part, these statutes extended the corporate life for a specific period post-dissolution for the purpose of prosecuting and defending suits.[309] Upon expiration of the statutory "survival" period, however, corporations were generally held to be defunct at least in the absence of a statutory or a constitutional provision to the contrary.[310]

The statutory responses to the common law contrasted in purpose between limitations statutes and survival statutes. Limitations statutes generally create a post-dissolution period after which creditor claims are

---

[304]Some states have, however, retained the mandate that directors assume the obligations of trustees upon dissolution. *See, e.g.*, ME. REV. STAT. ANN. tit. 13-A, § 1122(1) (West 1981); NEV. REV. STAT. § 78.585 (1991). In these jurisdictions, directors are held to a higher fiduciary standard.

[305]*See, e.g.*, Gateway Structures, Inc. v. Carpenters' 46 N. Cal. Counties Conference Bd., 681 F. Supp. 1437, 1443-44 (N.D. Cal. 1987) (applying CAL. CORP. CODE § 316(a)(2) (Deering 1977)). Of course, it is quite likely that personal liability would be imposed upon directors for a breach of their fiduciary duties in the absence of such a statute. However, if one argued that directors only owed duties to shareholders, this duty may not extend to creditors. This result seems highly implausible given the contractual relationship of the corporation to its creditors and the common law contractual duties of good faith and fair dealing which would appear to preclude the subordination of creditor interests to those of equity owners.

[306]FLETCHER CYCLOPEDIA, *supra* note 3, § 8142.

[307]*Id.*

[308]This "dissolution incentive" is discussed at *supra* note 27.

[309]*See infra* note 316.

[310]16A FLETCHER, *supra* note 3, § 8144.

said to be "barred" against a dissolved corporation.[311] These statutes provide that dissolution does not obstruct the commencement of a proceeding by or against a dissolved firm in its corporate name or toll a suit which is pending by or against the corporation on the effective date of dissolution.[312] Unlike strict "survival" legislation, these limitations statutes specify the post-dissolution interval after which creditor claims abate or are otherwise absolutely precluded from remedy. For example, under the MBCA's five-year limitations statute[313] and Delaware's amended five-to-ten year statute,[314] individuals who are injured five years and two months after a firm's dissolution are forever restrained from redress for those injuries. The policy behind such a limitation statute is its expedient re-deployment of corporate assets at a foreseeable time post-dissolution.[315] In addition, limitations statutes ostensibly curtail directorial and shareholder liability after the statutory cut-off date.[316]

Survival statutes, like limitations statutes, reverse the common law effect of dissolution by providing for the "survival" of the corporate

---

[311]*See, e.g.*, 3 MODEL BUSINESS CORP. ACT § 14.07 (1994) (repealed 1994) (five-year limitations period).

[312]*See, e.g.*, 3 MODEL BUSINESS CORP. ACT § 14.07 (1984); ALA. CODE § 10-2A-203 (1994); ARK. CODE ANN. § 4-27-1407 (Michie 1991); CAL. CORP. CODE §§ 2005, 2010, 2011 (West 1990 & Supp. 1995); COLO. REV. STAT. ANN. § 7-8-122 (West 1990) (repealed 1994); CONN. GEN. STAT. ANN. § 33-379(c) (West Supp. 1994); D.C. CODE ANN. § 29-397 (1991); GA. CODE ANN. §§ 14-2-1403.1, 14-2-1407 (1994); HAW. REV. STAT. § 415-105 (1993); IDAHO CODE § 30-1-105 (Supp. 1994); ILL. REV. STAT. ch. 805, para. 5/12.80 (1993); IND. CODE ANN. § 23-1-45-7 (Burns Supp. 1994); IOWA CODE ANN. § 490.1407 (1991); KY. REV. STAT. ANN. § 271B.14-070 (Baldwin 1994); ME. REV. STAT. ANN. tit. 13-A, § 1122(1) (West 1981); MISS. CODE ANN. § 79-4-14.07 (Supp. 1994); MO. ANN. STAT. § 351.482 (Vernon 1991); NEB. REV. STAT. § 21-20,104 (1991); NEV. REV. STAT. § 78.585 (1991); N.H. REV. STAT. ANN. § 293-A:14.07 (Supp. 1994); N.C. GEN. STAT. §§ 55-14-07, 55-14-08 (1993); OR. REV. STAT. § 60.644 (Supp. 1994); R.I. GEN. LAWS § 7-1.1-98 (1992); S.C. CODE ANN. § 33-14-107 (Law. Co-op 1990); TENN. CODE ANN. § 48-24-107 (1988); VT. STAT. ANN. tit. 11, § 2075 (1984) (repealed); WASH. REV. CODE ANN. § 23B.14.340 (West 1994); W. VA. CODE § 31-1-48 (1988); WIS. STAT. ANN. § 180-1407 (West 1992 & Supp. 1994); WYO. STAT. § 17-16-1407 (1989).

[313]3 MODEL BUSINESS CORP. ACT § 14.07 (1994).

[314]DEL. CODE ANN. tit. 8, § 280(c)(3) (1994).

[315]*See* 3 MODEL BUSINESS CORP. ACT § 14.07 cmt. (1994).

[316]*But see id.* § 14.07(d)(2). This section states that a claim may be enforced against a dissolved corporation

> if the assets have been distributed in liquidation, *against a shareholder of the dissolved corporation to the extent of his pro rata share of the claim or the corporate assets distributed to him in liquidation*, whichever is less, but a shareholder's total liability for all claims under this section may not exceed the total amount of assets distributed to him.

Id. (emphasis added).

persona for some interval post-dissolution.[317] In contrast to strict limitations enactments, however, survival statutes permit the corporation to sue, or to be sued, in the winding-up interval without expressly setting a bar date for these claims.[318] In certain jurisdictions, the statutory period for survival may be extended by court order or otherwise continued until all judgments are fully executed against the dissolved entity.[319] Additionally, federal law may supersede state survival statutes in situations where Congress considers an augmented survival term to be necessary.[320]

The immediate consequence of characterizing a dissolution statute as a "limitations statute" or a "survival statute" is that a survival period is not subject to tolling in the same manner as a statute of limitations.[321] In addition, equitable estoppel does not preclude a defendant, sued by a dissolved corporation after the expiration of the stated survival period, from asserting that the argument is barred due to the plaintiff's dissolution.[322] The apparent explanation for the distinction between the enactments is that statutes of limitations are directed to the prevention of

---

[317]*See, e.g.*, DEL. CODE ANN. tit. 8, § 278 (1991) (providing a three-year survival period post-dissolution).

[318]*In re* Citadel Indus., Inc., 423 A.2d 500, 507 (Del. Ch. 1980).

[319]*See, e.g.*, DEL. CODE ANN. tit. 8, § 278 (permitting extension of the three-year winding-up period by court order under appropriate circumstances and continuance of corporate persona beyond the three-year interval for the sole purpose of allowing execution of all judgments against the dissolved entity). *See generally In re* Citadel Indus., Inc., 423 A.2d 500 (Del. Ch. 1980) (interpreting § 278); Patterson v. Missouri Valley Steel, Inc., 625 P.2d 483 (Kan. 1981) (interpreting Kansas statute based on § 278).

[320]The most common example of federal intervention in the area of dissolution is for environmental cleanup costs pursuant to the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA). 42 U.S.C. §§ 9601-9657 (1980).

[321]*See, e.g.*, Canadian Ace Brewing Co. v. Joseph Schlitz Brewing Co., 629 F.2d 1183, 1188-89 (7th Cir. 1980) (holding that ILL. REV. STAT. ch. 32, § 157.94 (1975) was a survival statute and thus not subject to tolling as a limitations statute would be and likewise was not subject to the doctrine of equitable estoppel).

[322]*See Canadian Ace Brewing Co.*, 629 F.2d at 1189 ("'The operation of the doctrine of estoppel is limited in several respects involving the person or persons affected. . . . Estoppel cannot . . . be the means of successfully avoiding the requirements of legislation enacted for the protection of a public interest. It does not operate to defeat positive law or public policy.'") (quoting 38 AM. JUR. 2D *Estoppel and Waiver* § 34, at 638 (1966)). *See also* Indiana Nat'l Bank v. Churchman, 564 N.E.2d 340, 343 (Ind. Ct. App. 1990) (finding that an action against a former shareholder was subject to the same doctrines as those applicable to a dissolved corporation).

fraud and fraud is not affected unless the statute is tolled under appropriate circumstances.[323]

Quite apart from the characterization of a particular dissolution statute is the consideration of the extraterritorial effect of a voluntary dissolution on the rights of claimants to corporate assets.[324] In general, jurisdictions are at liberty to apply choice-of-law principles which entail selection between the dissolution law of the state of incorporation for the defunct entity or the dissolution law of the state with the greatest number of contacts to the transaction or incident which resulted in the cause of action.[325] Traditional corporate dogma adheres to the "internal affairs doctrine," a choice-of-law principle favoring the dissolution law of the jurisdiction which incorporated the entity.[326]

---

[323]*See* Canadian Ace Brewing Co. v. Anheuser-Busch, Inc., 448 F. Supp. 769, 772 (N.D. Ill. 1978), *aff'd*, 601 F.2d 593 (7th Cir. 1979), *cert. denied*, 444 U.S. 884 (1979). The court stated:

> The former [statutes of limitation] "were enacted to prevent frauds; to prevent parties from asserting rights after the lapse of time had destroyed or impaired the evidence which would show that such rights never existed, or had been satisfied, transferred or extinguished, if they ever did exist. To hold that by concealing a fraud, or by committing a fraud in a manner that it concealed itself until such time as the party committing the fraud could plead the statute of limitations to protect it, is to make the law which was designed to protect fraud the means by which it is made successful and secure."

Id. (quoting Bailey v. Glover, 88 U.S. (21 Wall.) 342, 349 (1874)).

The dichotomy between survival and limitations statutes is not always recognized by reviewing courts. *See, e.g.*, Moore v. Nick's Finer Foods, Inc., 460 N.E.2d 420, 421 (Ill. App. Ct. 1984); Russell v. First York Sav. Co., 352 N.W.2d 871, 873-74 (Neb. 1984).

[324]*But see* North Am. Asbestos Corp. v. Superior Court, 225 Cal. Rptr. 877, 883-84 (Cal. Ct. App. 1986) (Scott, J., dissenting) (stating that he would have held that a California statute, which provided that the California Corporate Code did not generally apply to foreign corporations, would preclude the applications of the California dissolution survival statute to an Illinois corporation which formerly conducted business in California).

[325]*See* Trounstine v. Bauer, Pogue & Co., 44 F. Supp. 767, 770 (S.D.N.Y. 1942) (noting that, although corporations are always subject to the law of their state of incorporation, they are also subject to the laws of the states in which they do business).

[326]In 1982, the United States Supreme Court reaffirmed the strong state interest in regulating the internal affairs of corporations which are incorporated pursuant to their corporate laws:

> The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs — matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders — because otherwise a corporation could be faced with conflicting demands.

Edgar v. Mite Corp., 457 U.S. 624, 645 (1982).

Presently one difficulty in applying corporate dissolution law is the apparent tendency by foreign courts to apply the dissolution law of their home forum (wherein a tort or breach of contract occurred) on the ostensible grounds that the foreign jurisdiction has a greater interest

2. Dissolution Statutes — Known Claims

Most modern dissolution legislation sustains only creditor rights or claims in existence, or liabilities incurred, prior to dissolution.[327] Therefore, these statutes distinguish between claims that are "known"[328] by a corporation at the time of its dissolution and claims that are "unknown,"[329] yet foreseeable, by the dissolving entity. For example, a known claim is mature, or pending, against the corporation and unliquidated at the moment of a firm's demise.[330] An unknown claim is one which is contingent as to liability or damages or which is a claim anticipated to arise years, or even decades, after the corporation's dissolution.[331]

Under current legislation, corporations must provide notice of dissolution to known claimants in order for the dissolution to be effective against the interested parties.[332] Notice requirements often include a

---

in protecting their residents from dissolution by non-resident corporations. In most of these suits, the dissolution law of the dissolving entity's home forum eliminates or drastically modifies the rights of these tort and contract claimants. *See supra* note 35.

[327]*See supra* note 315.

[328]Typically, a known claim is one in which a claimant is entitled to sue immediately. *See supra* note 34 for listing of jurisdictions which regulate only known claims.

[329]Unknown claims are categorized as either unknown as to claimant or unknown as to claim. For example, a known claim, yet unknown claimant, may involve a product manufactured by a dissolved corporation which product contains latent defects which are anticipated to cause injuries to persons and property for several decades after the manufacturer's dissolution. In that circumstance, the claim which is likely to occur in the actuarial period post-dissolution is known but the identity of the claimant is not. On the other hand, a defunct corporation could have negotiated an indemnity agreement during its viability which agreement remains in effect at the time of the firm's demise. If a claim is ultimately pursued on the indemnity contract, the identity of the claimant is known, yet the actual claim is not. *See, e.g.*, MODEL BUSINESS CORP. ACT § 14.06(d) (1984) (providing that the term "'claim' does not include a *contingent liability or a claim based on an event occurring after the effective date of dissolution*") (emphasis added). See *supra* note 34 for a listing of the jurisdictions which regulate unknown claims.

[330]*See* 3 MODEL BUSINESS CORP. ACT § 14.06(d) (1994) ("'claim' does not include contingent liabilities").

[331]*Id.*

[332]*See, e.g.*, *id.* § 14.06. This section provides:

(b) The dissolved corporation shall notify its known claimants in writing of the dissolution at any time after its effective date. The written notice must:

(1) describe information that must be included in a claim;
(2) provide a mailing address where a claim may be sent;
(3) state the deadline, which may not be fewer than 120 days from the effective date of the written notice, by which the dissolved corporation must receive the claim; and
(4) state that the claim will be barred if not received by the deadline.

description of the information which must accompany a claim, a current mailing address for the claimant, the deadline by which the dissolved corporation must receive the claim, and a statement by the corporation that the claim will be barred if not received by the stated deadline.[333] The failure of a dissolving entity to comply with the statutory notice requirements will toll the expiration of the survival interval.[334]

The common law doctrine of abatement apparently precludes assertion of a remedy against a defunct entity for claims arising post-dissolution.[335] This result occurs despite the assertion that the activity causing the alleged liability took place prior to, and was known by the defunct corporation before, dissolution.[336] Whether or not a corporation may be sued for injuries which occurred, and thus were known, after dissolution, but before the expiration of the applicable survival period, is a question of statutory interpretation in each jurisdiction.[337]

3. Dissolution Statutes — Unknown Claims

Modern corporate statutes and policies diverge on the issue of recovery for claimants whose injuries arise post-dissolution. The issue

---

(c) A claim against the dissolved corporation is barred:
  (1) if a claimant who was given written notice under subsection (b) does not deliver the claim to the dissolved corporation by the deadline;
  (2) if a claimant whose claim was rejected by the dissolved corporation does not commence a proceeding to enforce the claim within 90 days from the effective date of the rejection notice.

(d) For purposes of this section, *"claim" does not include a contingent liability or a claim based on an event occurring after the effective date of dissolution.*

Id. (emphasis added).

[333]*See, e.g., id.* (listing the Model Act's notification procedures and informational requirements regarding known claims).

[334]*See* Dr. Hess & Clark, Inc. v. Metalsalts Corp., 119 F. Supp. 427, 429 (D.N.J. 1954) (holding that an Illinois statute which precluded the commencement of a suit against a corporation after two years from the date of its dissolution was inapplicable where a New Jersey statute required foreign corporation doing business within New Jersey to surrender its certificate of incorporation in order to effectively dissolve under New Jersey law).

[335]*See* D. Gilbert Friedlander & P. Anthony Lannie, *Post-Dissolution Liabilities of Shareholders and Directors for Claims Against Dissolved Corporations*, 31 VAND. L. REV. 1363, 1400 (1978) (noting that "[a]t common law, all actions and claims by and against corporations abated upon dissolution").

[336]A common example of pre-dissolution activity which results in a late-maturing injury is the circumstance where a corporation manufactures a product which will foreseeably cause injuries to consumers for years after the corporate manufacturer dissolves.

[337]*See, e.g.*, Penasaquitos, Inc. v. Superior Court, 812 P.2d 154, 156-59 (Cal. 1991) (interpreting the California dissolution statute as allowing post-dissolution suits which are brought within the statutory winding-up interval).

is most often presented as one involving "future unknown claimants."[338] The specific issue is whether the term "claim" or "liability" in dissolution legislation encompasses claims which are not in existence at the time of a corporation's dissolution, or during the statutory winding-up period post-dissolution, but that are anticipated to arise for several decades after the firm's demise.[339] The most common scenario implicating future unknown claims is that of delay-occurrence products liability injuries that are not only foreseeable to a dissolving firm at the time of its death but which also provide the sole impetus for the corporation's dissolution.[340] Indemnity agreements, executed by a dissolving corporation during its viability and that extend into the post-dissolution period, provide another common example of future unknown liability. Presently, future unknown claimants are generally denied relief under dissolution statutes for two reasons: (1) the potential claimants lack standing to contest any proposed plan of distribution in liquidation; and (2) the claims, when manifest, arise subsequent to the statutory survival period.[341]

Proponents of dissolution reform have suggested amendments to the early enactments that would require dissolving corporations to provide, prior to effectuating liquidating distributions, adequate protection for all known and foreseeable claimants[342] to the same extent as if the firm had not dissolved.[343] Those who criticize the inclusion of tort reformist measures within corporate dissolution law urge finality in the dissolution process. Particularly, they argue that ambiguity in the interpretation of survival statutes raises practical enforcement problems[344] as well as the unconscionable specter of personal liability against

---

[338]*See, e.g.*, Rosemary R. Schnall, *Extending Protection to Foreseeable Future Claimants Through Delaware's Innovative Corporate Dissolution Scheme* — In re RegO Co., 19 DEL. J. CORP. L. 141 (1994).

[339]*See* 3 MODEL BUSINESS CORP. ACT § 14.06(d) (1994) (defining the term "claim" to not include contingent liabilities or claims which may arise in the future).

[340]*See generally* Mark J. Roe, *Corporate Strategic Reaction to Mass Tort*, 72 VA. L. REV. 1, 7-39 (1986) (discussing preemptive liquidation as a means of avoiding mass tort liability and why such liquidation is an unlikely option for a large public corporation).

[341]Sarlitto, *supra* note 27, at 1050.

[342]*See* Green, *supra* note 27, at 49-60 (discussing the superiority of statutory reform to remedy the issue of late-maturing products liability claims).

[343]*Id.*

[344]Some examples of practical enforcement problems are: For what period are these claims cognizable? How much insurance must be secured to provide for these claims? May distributions be made to shareholders post-dissolution without the attachment of liability? Who manages these assets and what liability results if claimants allege mismanagement of property? What investment schemes will not result in liability to managers of post-dissolution corporate property?

shareholder/distributees for an indefinite period post-dissolution. Reformists posit that absolute bar dates ignore the public nature of many dissolved corporate entities[345] and the propensity of those companies' products to cause personal injury or property damage for years, even decades, into the future.[346]

The MBCA and similar statutes specifically address unknown claims post-dissolution.[347] Section 14.07 of the MBCA sets forth a notice procedure whereby corporations may advertise an impending dissolution and request that persons with claims against the corporation present them in accordance with the notice.[348] Once the dissolved corporation publishes the section 14.07 notice, certain claims are barred unless the claimant commences a proceeding to enforce the claim against the dissolved firm within five years after the date of publication.[349] The MBCA allows two types of claims to proceed despite the five-year bar date: (1) claims against undistributed assets,[350] and (2) claims against a shareholder of the dissolved corporation. The latter claims are available to the extent that the shareholder received a distribution in liquidation, and then only to the extent of the shareholder's pro rata share of the claim or the corporate assets so distributed, whichever is less.[351]

In non-MBCA jurisdictions, the issue remains whether a future unknown claimant has standing to challenge a plan of liquidation incident to a dissolution. Currently, future tort and contract victims are without

---

[345]Arguably, large publicly-held corporations have a greater duty to protect consumers against latent product defects because consumers are not only unable to discern the defects, but also because the corporation has often engaged in a publicity blitz to increase purchase of its products. A short-lived survival statute encourages the creation of shell corporations which may be dissolved once a defect is discovered.

[346]*See, e.g.*, Nuhn, *supra* note 27, at 1241-44 (suggesting that the California legislature extend liability to corporations or its formal shareholders for post-dissolution injuries caused by the products they market).

[347]3 MODEL BUSINESS CORP. ACT § 14.07 (1994); DEL. CODE ANN. tit. 8, §§ 280(c)(3), 281(b)(iii) (1994).

[348]3 MODEL BUSINESS CORP. ACT § 14.07(a) (1994).

[349]*Id.* § 14.07(c). The classes of claimants who are barred after the five-year limitations period are:

> (1) known claimants who did not receive written notice;
>
> (2) claimants whose claims were forwarded to the corporation in a timely manner but which were not acted upon by the corporation; and
>
> (3) claimants whose claims are contingent or are based upon events occurring after the effective date of the corporation's dissolution.

Id.

[350]*Id.* § 14.07(d)(1).

[351]*Id.* § 14.07(d)(2) (limiting a shareholder's liability, in any event, to the total amount of assets distributed to said shareholder in the liquidation).

a statutory remedy for injuries that arise subsequent to stated corporate survival periods. As a result, courts have resorted to alternative theories of recovery including the trust fund doctrine, successor liability, and fraudulent conveyance statutes.[352] Only Delaware and Florida have

---

[352]As a consequence of the incentive to dissolve, courts have considered alternative theories to provide a remedy for foreseeable future claimants to corporate assets. At least four theories have gained widespread acceptance: (1) successor liability, (2) the trust fund doctrine, (3) fraudulent conveyance statutes, and (4) corporate statutory reform. A brief description of these theories follows.

First, successor liability bypasses traditional corporate law protections which attach to a sale of assets by one corporation to another corporation where the selling company's assets, by contract, are to remain with the seller. *See, e.g.*, DEL. CODE ANN. tit. 8, § 275 (1974) (stating that the sale of assets which has been approved by the requisite board and shareholder vote will transfer assets only). For example, if a corporate defendant in multiple personal injury suits were to elect to terminate its tort liability tail through corporate law, corporate directors may, as part of the termination process, authorize a sale of the company's assets to a successor entity, use the proceeds from the sale to pay business debts, and then distribute remaining monies to its shareholders. Such a sale of assets, according to traditional corporate law, extinguishes all rights of future claimants against the dissolved entity to recover for subsequent injuries. Corporate law mandates this result for two reasons: (1) the plaintiff's injury was not manifest within the statutory winding up period, and (2) the plaintiff's claim is against a now-defunct corporation which has liquidated its assets. Limited exceptions to this result are recognized in corporate law. *See* Jerry J. Phillips, *Product Line Continuity and Successor Corporation Liability*, 58 N.Y.U. L. REV. 906, 909 (1983). The sale of assets will transfer the seller's liabilities to the purchasing entity where the transaction amounts to a "de facto" merger. The "de facto" merger exception requires (1) continuity of shareholders before and after the transaction, (2) timely dissolution of the selling corproation, and (3) assumption by the transferee corporation of the seller's ordinary business obligations. *Id.*

Successor liability allows claims against the transferor corporation, which has either dissolved or is in the process thereof, to be pursued instead against the transferee corporation. Successor liability is predicated upon the contractual relationship between the transferor and transferee corporations. *See generally* Green, *supra* note 27, at 28-40; Sarlitto, *supra* note 27, at 1053-55.

Second, the common law trust fund doctrine deems shareholders to hold post-dissolution distributions in trust for certain creditors of the dissolved corporation. *See generally* Joseph J. Norton, *Relationship of Shareholders to Corporate Creditors upon Dissolution: Nature and Implications of the "Trust Fund" Doctrine of Corporate Assets*, 30 BUS. LAW. 1061, 1075-76 (1975). *See also* Gonzales v. Progressive Tool & Die Co., 463 F. Supp. 117, 119 (E.D.N.Y. 1979) (holding plaintiff whose claim had not matured at the time of dissolution may not recover under trust fund doctrine); City of Newark v. Hollander, 42 A.2d 872, 876-77 (N.J. 1945) (allowing claim against shareholders for foreseeable rights on guarantee); Asmussen v. Quaker City Corp., 156 A. 180, 181 (Del. Ch. 1931) (holding that creditors have a prior right to assets of dissolved corporation which, if distributed to shareholders, constitutes a "trust fund" for creditors).

Fraudulent conveyance statutes permit recovery to foreseeable tort claimants where plaintiffs are able to show a "fraudulent" transfer by the corporate defendant to shareholders. Fraud as to future creditors is defined in § 7 of the Uniform Fraudulent Conveyance Act. 7A U.L.A. 509 (1985). Section 7 provides: "Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or

statutes which have ostensibly been "tort" reformed to address the academic proposals of tort modifications within dissolution statutes.[353] Unfortunately, all recent legislative enactments that address the dilemma of contingent or future foreseeable liabilities are rife with ambiguities and procedural hurdles impeding their productive use.[354] In addition, these attempts at legislative reform fail to explicitly reject certain equitable theories of recovery which developed as alternatives to perceived inadequacies in dissolution statutes. The most viable theory is the trust fund theory.[355] The following discussion serves as the antecedent for the rejection of this doctrine in twentieth century corporate jurisprudence in light of the statutory reform examined above.

b. *Creditor Rights Upon Corporate Dissolution Under the Trust Fund Doctrine*

The trust fund doctrine resulted from concern by early American jurists of creditor rights upon the *dissolution* of a corporation.[356] This concern was the apparent outgrowth of attributing a legal personality to the corporation along with the recognition that state corporate legislation protected the relationship of the corporation to its stockholders — not the corporation to its creditors. Consequently, early case law considered the duties and obligations of a corporation to its creditors as simply one between an individual (the corporation) and its creditors.[357]

---

defraud either present or *future* creditors, is fraudulent as to both present and *future* creditors." *Id.* (emphasis added).

Finally, attempts were made at statutory reform. For example, § 14.07 of the MBCA proposed a five-year limitations period for claims against a dissolved corporation and its shareholders. 3 MODEL BUSINESS CORP. ACT § 14.07 (1994). Although § 14.07 is facially appealing for its certainty, it is of limited utility where products manifest a defect after the limitations period.

[353]*See* DEL. CODE ANN. tit. 8, §§ 280-282 (1994); FLA. STAT. ANN. § 607.1406 (West 1990 & Supp. 1994).

[354]*See supra* text accompanying notes 154-247 (discussing the substantive and procedural difficulties of the Delaware "unknown" claims statutes).

[355]This article will focus only upon the equitable trust fund doctrine because this principle served as the corporate predicate for the present directorial duty to creditors. The other alternative theories for creditor recovery are more specific to fraudulent transfers or their analogy and thus are beyond the scope of this article.

[356]*See* Wood v. Dummer, 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17, 944).

[357]*See, e.g.*, Catlin v. Eagle Bank, 6 Conn. 233, 238 (1826) (agreeing that a corporation's relationship with its creditors is "ordinarily the same" to the relationship between any individual and a creditor).

In general terms, the trust fund principle permits a court in equity to create a "trust fund" upon the assets of a corporation for the benefit of stockholders or creditors.[358] In the event of dissolution, the trust fund theory imposes a "constructive trust"[359] or "equitable lien"[360] upon corporate assets in order to guarantee the *absolute priority* of payment to creditors before any distribution to stockholders. In early corporate jurisprudence, the absolute priority rule was essentially one concerned

---

[358]*See generally* 2 VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS §§ 1031-1035 (2d ed. 1886) (examining the historical development of the trust fund theory).

[359]The "constructive trust" is a remedial device utilized by the judiciary to afford specific restitution of any benefit unjustly received by one party to the detriment of another. Roscoe Pound, *The Progress of the Law 1918-19 — Equity*, 33 HARV. L. REV. 420, 420-21 (1920). Unlike an express trust, the constructive trust is not recognized because of the subject parties' intention to do so; indeed, the opposite is typically the case — the parties have no intention of creating a fiduciary relationship between or among themselves. In this sense, the constructive trust is *not* a fiduciary relation although the existence of a fiduciary obligation may give rise to the imposition of such a trust in equity. *See, e.g.*, 2 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE, AS ADMINISTERED IN ENGLAND AND AMERICA 604 (13th ed. 1886) (examining the operation of constructive trusts not created by parties' intent). Consequently, the constructive trust is an equitable device to achieve fair results where fraud, unjust enrichment, mistake, or breach of a fiduciary relation exists. *See, e.g.*, Anderson v. Lybeck, 154 N.E.2d 259, 262 (Ill. 1958).

[360]An "equitable lien" is defined as follows:

> A right, not existing at law, to have specific property applied in whole or in part to payment of a particular debt or class of debts. An equitable lien arises either from a written contract which shows an intention to charge some particular property with a debt or obligation or is implied and declared by a court of equity out of general considerations of right and justice as applied to relations of the parties and circumstances of their dealings.

BLACK'S LAW DICTIONARY 483 (5th ed. 1979) (citations omitted). *See also* Caldwell v. Armstrong, 342 F.2d 485, 490 (10th Cir. 1965) (stating that an equitable lien is a "creature of equity" and may be imposed because of "general considerations of right and justice as applied to the relationship of the parties"); First Nat'l Bank v. Conner, 320 S.W.2d 391, 394 (Tex. Civ. App. 1959) (holding that an equitable lien may arise implicitly from consideration of all parties and circumstances involved in the alleged dispute).

An equitable lien is distinguishable from a constructive trust in the sense that an equitable lien is a security interest in the property of the corporate debtor only. As to whether the "trust fund" articulated in the original *Wood v. Dummer* opinion was a lien or constructive trust, Justice Story, in his treatise on Equity stated:

> Perhaps to this same head of implied trusts . . . we may refer that class of cases where the stock and other property of private corporations is deemed a trust fund for the payment of the debts of the corporation; so that the creditors have a *lien or right of priority of payment on it*, in preference to any of the stockholders in the corporation.

2 STORY, *supra* note 362, at 602 (emphasis added). *See also* Berwick v. Associated Gas & Elec. Co., 174 A. 122, 123 (Del. Ch. 1934) (stating that under the trust fund doctrine, a creditor may be entitled to a lien on assets improperly distributed to stockholders).

with fairness and the prevention of fraud or unjust enrichment. In other words, by *contracting* with a creditor, a corporation undertook a contractual duty to perform the payment terms of the contract in good faith, including the contractual duty not to make liquidating distributions to *equity holders* at dissolution where unpaid balances were owed to creditors.[361] Therefore, early corporate jurisprudence protected creditors' contractual rights in equity.[362] The original directorial duty to creditors was thus born out of contract, yet protected in equity.

Notwithstanding the seeming fairness and simplicity of the trust fund theory, courts have extended the application of the original equitable principle beyond its historical and theoretical predicate. As a result, present corporate law is inconsistent and confusing as to the principle's application to insolvent corporations or those corporations pursuing statutory dissolution. What follows is an examination of the historical advent of the trust fund concept and its illogical application to current insolvency and dissolution decisions.

c. *The Historical Development of the Trust Fund Doctrine*

The inception of the trust fund theory can be traced to the decision of *Wood v. Dummer* in 1824.[363] In *Wood*, a bill in equity was filed against a bank chartered in Massachusetts. The charter was to expire in 1812.[364] By an act of the Massachusetts legislature, however, the charter was extended for the purpose of permitting an orderly dissolution and winding up of the bank's business affairs.[365] In the year following the charter extension, the stockholders of the bank voted to distribute among themselves approximately seventy-five percent of the bank's paid-in capital.[366] The evidence at trial indicated that the stockholder votes were

---

[361]*See* Norwood P. Beveridge, Jr., *Does a Corporation's Board of Directors Owe a Fiduciary Duty to its Creditors?*, 25 ST. MARY'S L.J. 589, 603 (1994).

[362]This doctrine of priority to creditors at a firm's demise has been cited as "universal" to corporate dogma. *See* Wewoka Petroleum Corp. v. Gilmore, 319 P.2d 285, 289 (Okla. 1957).

[363]30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944).

[364]*Id.* at 436.

[365]*Id.*

[366]*Id.* At the time of the *Wood* opinion, it was common practice in corporate law to require corporations doing business as banks to pay in a considerable sum of start-up capital. *Id.* Requirements for initial capitalization are virtually non-existent in present corporate law. To the extent that states require initial paid-in capital, the amounts typically are nominal — e.g., $1,000, $500, or $300. *See generally* ROBERT HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 167-68 (3d ed. 1986) (discussing initial capital requirements which many states no longer enforce).

taken despite clear knowledge that at least $90,000 in unsecured debts remained to be paid by the corporation and that any capital distribution to stockholders would seriously impugn the bank's ability to fulfill its contractual duty to pay its noteholders.[367]

The court in *Wood* specifically addressed the issue of "whether the capital stock in the hands of the *stockholders* is liable to the payment of the debts of the bank."[368] It was apparent from the facts that the bank's stockholders attempted, through the exercise of their franchise prior to the legal dissolution of the bank, to place themselves in a better position than they would have obtained had the noteholders been compensated and the bank thereafter dissolved.[369] The plaintiff's bill, however, failed to allege either a fraudulent conveyance by the stockholders or a resulting insolvency of the corporation.[370]

Despite the plaintiff's failure to set forth a prima facie case for relief, Judge Story, cognizant of the inequitable intent of the stockholders' vote, determined by "inference and intendment and exposition of the charter" the fact of insolvency and dissolution of the bank as a consequence of the stockholders' actions.[371] To reach this equitable result, Judge Story needed only to apply the well-established *contractual* principle that distributions on *dissolution* require absolute priority to creditors over stockholders.[372] Unfortunately, Judge Story did not so limit his ruling. Instead, Judge Story theorized that capital which is paid into a corporation by subscriptions or stock sales constitutes a "trust fund" for

---

[367] *Wood*, 30 F. Cas. at 439.

[368] *Id.* at 436 (emphasis added). It should be noted that the decision in *Wood* is limited to the question of liability of *shareholders* to repay sums distributed in insolvency or dissolution to the detriment of creditors and in no way articulates a fiduciary duty by the corporation or its directors toward the firm's creditors.

[369] *Id.*

[370] Either of these two claims could have allowed relief to the plaintiff under existing equitable and contractual principles. Indeed, the plaintiff's complaint in *Wood* was grossly deficient regarding allegations of fraud and/or insolvency. *Id.* at 436-37.

[371] *Wood*, 30 F. Cas. at 438. The fact that the defendant in *Wood* was a bank, and with a public nature, seemed to weigh heavily in Judge Story's opinion:

> It appears to me very clear upon general principles, as well as the legislative intention, that the capital stock of *banks* is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank. The *public*, as well as the legislature, have always supposed this to be a fund appropriated for such purpose. The individual stockholders are not liable for the debts of the bank in their private capacities. The charter relieves them from personal responsibility, and substitutes the capital stock in its stead. Credit is universally given to this fund by the *public*, as the only means of repayment.

Id. at 436 (emphasis added).

[372] *Id.* at 436.

the benefit of creditors. The result is that corporate distributions of capital must be limited to payments from surplus, rather than paid-in capital, accounts.[373]

The articulation of the "trust fund" theory by Judge Story was unfortunate for two reasons. First, the parameters of the trust fund principle as articulated in *Wood*, although not entirely clear from the opinion, were apparently broader than the existing equitable doctrine of absolute priority. Second, the creation of such a broad equitable principle, predicated mainly upon public policy and implied legislative intent,[374] created uncertainty in early American corporate law and was entirely unnecessary to the ruling in *Wood*. Indeed, the precise limits of the trust on paid-in capital was so ambiguous that it seemed to approach the creation of an equitable lien against corporate assets that could not be modified or compromised without creditor consent or full satisfaction of creditor debts.[375]

An obvious difficulty with Judge Story's extension of the existent rule on priority of payments upon dissolution is that *in fact* no trust relationship exists either between a stockholder and a corporation's assets or between a creditor and the same assets. In other words, stockholders, as well as creditors who choose to contract with corporate entities, take with notice that the legal person with whom they are contracting is the *corporation* and that corporate property is therefore owned solely by the corporate persona.[376] Corporate assets are thus not held in trust because the requisite duality of estates, or interests — one equitable and one legal — simply do not exist in the corporate context. Stated another way, the capital of a corporation is the exclusive property of that juridical person

---

[373]*Id.* at 436-37.

[374]In creating the trust fund theory, it has been supposed that Judge Story was concerned about the "public" nature of the American corporation in the early 1800s, i.e., that corporations were in their infancy and were, therefore, viewed with great distrust by the public as well as state legislators. *See generally* E. MERRICK DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860 (1954) (examining the historical advent of modern American corporate law). Also, it is noteworthy that the corporation in *Wood* was a *bank* which could only operate after having secured a special and limited legislative concession from the State. *Wood*, 30 F. Cas. at 436. Because these factors apparently provided the impetus for the original articulation of the trust principle, it is logical that the theory should either be so limited in its application today or, at a minimum, be re-examined in light of its historical genesis.

[375]*Wood*, 30 F. Cas. at 436-37. See *supra* note 363 for Judge Story's characterization of the "trust" imposed in *Wood* as a "lien" against corporate property.

[376]*See Wood*, 30 F. Cas. at 437.

with the result that the corporation possesses both the legal and beneficial title to its capital.[377]

d. *A Nineteenth Century Application of the Trust Fund Doctrine*

If the genesis of the trust fund theory in *Wood* resulted from the insolvency and dissolution of a *bank* — a special form of public corporation — and the failure of plaintiff's counsel to properly plead for relief which could be granted in a court of law, the doctrine becomes understandable in light of the equitable nature of the case. Subsequent courts, however, did not so confine their application of the theory.

For example, in the 1853 opinion in *Curran v. Arkansas*,[378] the Supreme Court, in *dicta*, imposed a trust on all corporate assets for the benefit of creditors.[379] As in *Wood*, the defendant in the *Curran* case was an insolvent bank.[380] Unlike the trust articulated in *Wood*, the *Curran* Court implied that a general trust springs into existence at the moment of incorporation. The trust included *all corporate assets* in addition to paid-in capital by equity holders.[381]

This extension of *Wood* was unwarranted on the facts, and it substantially broadened the jurisdiction of the trust fund theory. Indeed, the "trust" in *Curran* appears more like an express trust than the constructive trust or equitable lien remedies envisioned in *Wood*. Yet, as in *Wood*, the *Curran* Court was apparently concerned about the insolvency of a quasi-public institution such as a bank.[382] The more circumspect course would have applied the existent contractual doctrine of absolute priority. This decision would have protected the bank's creditors against unfair distributions to equity holders upon insolvency or distributions resulting in insolvency. Of course, the *Curran* modification

---

[377]Although the original trust fund doctrine does not appear to allow the creation of a device approaching an express trust, either a constructive trust or an equitable lien may have been intended. *See supra* notes 362-63 and accompanying text. The obvious difference between the express trust and either the constructive trust or equitable lien is that the latter two devices emanate from *equity administration of corporate assets* only. *Id.*

[378]56 U.S. (15 How.) 304 (1853).

[379]*Id.* at 307.

[380]*Id.* at 306. Again, as in *Wood*, the bank in *Curran* was subject to a substantial capitalization requirement due to the public nature of the corporation. *Id.* at 305.

[381]*Id.* at 307.

[382]*See Curran*, 56 U.S. (15 How.) at 315.

permitted attachment of virtually all corporate assets for the payment of creditor claims.[383]

In 1873, the Supreme Court once again augmented the trust fund doctrine. In *Sawyer v. Hoag*,[384] the Court considered an allegation of fraud in the circumstance of unpaid stock subscriptions by certain equityholders.[385] The defendant in *Sawyer* was an insolvent insurance corporation (a quasi-public enterprise) which, like the banks in *Wood* and *Curran*, was operating under a special state concession requiring a capital stock account of $100,000.[386] The alleged "fraud" in *Sawyer* was the non-payment of $90,000 of the requisite capitalization which, upon insolvency of the firm, shifted all business risks from the equity holders to the creditors of the company.[387] Apparently, the Court in *Sawyer* considered an enlargement of the trust fund doctrine necessary since the theory, as broadened in *Curran*, only attached to assets *paid in* to the corporation and not those which had been *wrongfully excluded* from the corporate coffers.[388] This extension to unpaid stock subscriptions was upheld two years later in the Supreme Court opinion of *Sanger v.*

---

[383]*Id.* at 307. From a public policy as well as a contractual perspective, however, a question arises as to what degree creditors of banks can rely upon bank assets for payment as opposed to relying on paid-in capital. Also, it seems that the extended application of the trust fund theory in *Curran* places all contracting risks on the bank retroactive to the date of contracting rather than permitting the allocation of risks by free bargaining by the parties to the agreement.

[384]84 U.S. (17 Wall.) 610 (1873).

[385]*Id.* In early American corporate law, a common method for raising capital for a new enterprise was through the issuance of pre-incorporation stock subscriptions. *See, e.g., id.* at 610-11. In a stock subscription, persons agree to purchase a certain number of corporate shares for a specified sum contingent upon sufficient start-up capital being raised. *Id.* The common law of subscriptions focused primarily upon three legal issues: (1) the revocability of subscriptions prior to acceptance by the corporation; (2) what enforcement rights vested in the corporation upon the non-payment of subscription proceeds; and (3) what call rights attached to the subscriptions. *See, e.g.*, REVISED MODEL BUSINESS CORP. ACT § 6.20 (1984) (detailing the rights and obligations resulting from the subscription for shares prior to incorporation); DEL. CODE ANN. tit. 8, § 162 (1974) (providing liability of subscriber for stock not paid in full); *id.* § 165 (providing revocability of preincorporation subscriptions); *id.* § 166 (providing formalities required of stock subscriptions).

[386]*Sawyer*, 84 U.S. (17 Wall.) at 610. It is worth noting that each of the early cases interpreting the trust fund doctrine involved "public" companies which, under state corporate law, were subject to stringent initial capitalization requirements. If the defendants in these cases had been private corporations, it is arguable that the trust theory would never have developed in light of the alternative theories available for recovery.

[387]*Id.* at 613.

[388]*Id.* at 615-18.

Upton.[389] In *Sanger*, the Court granted an equitable lien on the unpaid capital stock of the corporation for the payment of creditor claims.[390]

One issue which remained unresolved after *Wood* and its immediate progeny was whether the trust principle *applied only in the context of insolvency or whether the trust also attached to a solvent corporation.* In 1880, the Supreme Court in *Graham v. Railroad Co.*[391] held that in the absence of fraud, a solvent corporation exercised "supreme dominion" over its assets subject only to a fiduciary duty to its *stockholders*.[392] In 1898, the Court reaffirmed this view of corporate dominion over firm property:

> When a corporation is solvent, the theory that its capital is a trust fund upon which there is any lien for the payment of its debts has in fact very little foundation. No general creditor has any lien upon the fund under such circumstances, and the right of the corporation to deal with its property is absolute so long as it does not violate its charter or the law applicable to such corporation.[393]

The final blow to the "insolvency" prerequisite for the equitable imposition of a trust on corporate assets occurred in 1893 when the Supreme Court decided the case of *Hollins v. Brierfield Coal & Iron Co.*[394] In *Hollins*, plaintiffs were mere contract creditors of the corporation who had not reduced their claims to a judgment.[395] As such, the creditors had no recognizable lien or deed of trust to corporate property.[396] According to plaintiffs, creditors were permitted, in equity, to seize firm property for the satisfaction of debts pursuant to the well-established trust fund doctrine.[397] The Court refused to allow the

---

[389]91 U.S. 56 (1875).

[390]*Id.* at 60-61.

[391]102 U.S. 148 (1880).

[392]*Id.* at 160-61. Implicit in the Court's ruling is that *corporate* law governs the rights of shareholders as against the corporation and its directors. It is also apparent that *equity, absent fraud, is unnecessary* to redress alleged wrongs to creditors unless insolvency or dissolution placed payments to creditors at risk. In short, corporate law considered creditors' rights to be contractual in nature such that creditors were free to contract well or contract poorly regarding possible business risks to the corporation or security for future payments by the corporate debtor.

[393]McDonald v. Williams, 174 U.S. 397, 401 (1898).

[394]150 U.S. 371 (1893).

[395]*Id.* at 378.

[396]*Id.* at 378-79.

[397]*Id.* at 379.

imposition of an equitable lien on corporate assets because the claims were not in the form of a judgment and, therefore, plaintiffs failed to exhaust their remedies at law.[398]

The Court's opinion in *Hollins* is insightful for two reasons. First, the Court explicitly rejected the previously asserted argument that the "trust" on corporate property occurred upon a firm's inception. The Court elaborated:

> While it is true language has been frequently used to the effect that the assets of a corporation are a trust fund held by a corporation for the benefit of creditors, this has not been to convey the idea that there is a direct and express trust attached to the property . . . .
>
> . . . .
>
> We do not concur in this view [that a corporation is a mere trustee, holding its property for the benefit of its stockholders and creditors]. It is at war with the notions which we derive from the English law with regard to the nature of corporate bodies. A corporation is a distinct entity. Its affairs are necessarily managed by officers and agents, it is true; but, in law, it is as distinct a being as an individual is, and is entitled to hold property (if not contrary to its charter) as absolutely as an individual can hold it. Its estate is the same, its interest is the same, its possession is the same. Its stockholders may call the officers to account, and may prevent any malversation of funds, or fraudulent disposal of property on their part. But that is done in the exercise of their corporate rights, not adverse to the corporate interests, but coincident with them.[399]

By this specific language, the Court in *Hollins* clarified its interpretation of the trust fund doctrine, indicating that although the "trust" is equitable in nature, it arises from *contract*, rather than corporate, principles.[400] It seems clear from this standpoint that a corporation does

---

[398] *Hollins*, 150 U.S. at 386-87.

[399] *Id.* at 381-82.

[400] In particular, the Court reaffirmed the language of *Sanger*:

> The capital stock of an incorporated company is a fund set apart for the payment of its debts. It is a substitute for the personal liability which subsists in private copartnerships. When debts are incurred, a *contract* arises with the creditors that it shall not be withdrawn or applied, otherwise than upon their demands, until such demands are satisfied.

Sanger, 91 U.S. at 60 (emphasis added).

not hold its assets "in trust, or subject to a lien in [the creditors'] favor, in any other sense than does an individual debtor" absent fraud or other equitable circumstances meriting the imposition of the equity jurisdiction of a reviewing court.[401]

The second insight provided by *Hollins* was its clarification of the use of the trust theory upon a company's insolvency, solvency, or dissolution. Despite the recurrence in each of the prior trust fund opinions of an "equity" presumption which apparently attached upon a direct or indirect finding of a corporate defendant's insolvency, the Court stated that "[w]hatever of trust there is arises from the peculiar and diverse *equitable* rights of the *stockholders* as against the corporation in its property and their *conditional liability to its creditors*."[402] In other words, the Court implicitly acknowledged that upon a firm's *liquidation*, stockholders, like creditors, are entitled to be paid distributions of corporate assets. Therefore, according to the Court, liquidation, in essence, transforms a stockholder's previous equity interest into a creditor expectation, albeit one which is subordinate to all other creditor interests. On the other hand, where a corporate liquidation follows from insolvency, stockholders, although creditors in theory, will not share in a liquidating distribution to the exclusion of bona fide creditors because corporate liabilities exceed firm assets and stockholder claims comprise the last tier of creditor obligations. According to the *Hollins* Court, a corporation and its stockholders remained the sole owners and risk-bearers who could dispose of corporate property as against non-judgment creditors notwithstanding an insolvency of the business.[403] In other words,

---

If one recognizes the theoretical predicate of the trust fund theory, its application to modern publicly-held corporations becomes strained. For example, the common law of contracts imposes a duty of good faith and fair dealing which is, at a minimum, co-extensive with the contract referred to in *Sanger* and *Brierfield*. The contractual obligation of good faith would thus seemingly grant the identical priority of distributions to creditors over stockholders where unpaid balances remain. It is, therefore, redundant to create a broad *corporate* remedy such as the trust lien on corporate assets based upon the same contractual duty. Theoretically, it seems more sound to recognize the nature of the contractual relationship between individual creditors and the corporate creditor and to allow those parties to bargain against event risks which are foreseeable in the administration of and course of dealings with a corporate person.

[401] *Hollins*, 150 U.S. at 385.

[402] *Id.* at 383 (emphasis added). Indeed, the Court further elaborated that any trust imposed upon corporate assets was one in "*the administration of the assets after possession by a court of equity [rather] than a trust attaching to the property, as such, for the direct benefit of either creditor or stockholder.*" *Id.* (emphasis added).

[403] Although corporate dogma allows stockholders to compromise creditor claims in certain instances, to the extent that a creditor is not willing to have its interests so modified, state corporate law permits these creditors to petition the courts for the appointment of a receiver.

insolvency was not the *sine qua non* of equitable relief masquerading as a trust on corporate assets.[404]

As to the applicability of the trust theory upon a corporate dissolution, the *Hollins* Court simply stated that dissolution may provide an exception to the general requirement that a creditor must exhaust all legal remedies before equitable relief may be asserted.[405] The Court made clear, however, that if such an exception existed "it is upon the ground that the assets of the corporation constitute a trust fund which will be *administered by a court of equity* in the absence of a trustee; the principle being that equity will not permit a trust to fail for want of a trustee."[406] With this statement, the Court reaffirmed two longstanding corporate precepts: first, dissolution results in the death of the corporate persona

---

See, e.g., DEL. CODE ANN. tit. 8, § 291 (1974). Section 291 permits the appointment of a receiver, "on the application of any creditor or stockholder thereof," who will

> take charge of [the corporation's] assets, estate, effects, business and affairs, and to collect the outstanding debts, claims, and property due and belonging to the corporation, with power to prosecute and defend, in the name of the corporation or otherwise, all claims or suits . . . which might be done by the corporation and which may be necessary or proper.

Id.

Unlike the actions by directors, which are generally directed to the management of the corporation for the benefit of its equity owners and thus governed by the presumption of the business judgment rule, receivers are officers of the appointing court and thus are required to act for the benefit of all interested parties as opposed to the interest of the corporation. *See, e.g.*, Jones v. Maxwell Motor Co., 115 A. 312, 314-15 (Del. Ch. 1921) (holding that a receiver is not appointed in the interest of the corporation); Stockbridge v. Beckwith, 33 A. 620 (Del. Ch. 1887) (stating that a "receiver is an officer of the court"); Hannigan v. Italo Petroleum Corp. of Am., 181 A. 4, 5 (Del. Super. Ct. 1935) (noting that the appointment of receiver is for all interested parties).

[404]Since insolvency created no expectation interest on behalf of non-judgment creditors to seize corporate property for distribution, it seemed clear that no equitable trust could be imposed upon the assets of a solvent corporation. Indeed, the Court in *Hollins* expressly stated that "[s]olvent, [the corporation] holds its property as any individual holds his, free from the touch of a creditor who has acquired no lien; free also from the touch of a stockholder who, though equitably interested in, has no legal right to, the property." *Hollins*, 150 U.S. at 383.

[405]*Id.* at 381. In particular, the Court in *Hollins* noted that "there are some exceptions [to the rule of exhaustion of legal remedies]; and we are not prepared to say that a creditor of a dissolved corporation may not, under certain circumstances, claim to be exempted from its operation." *Id.*

The exception implied in *Hollins* for dissolution is understandable in light of the legal impact of a corporate dissolution at early common law. Under common law, dissolution resulted in the death of the corporate persona and thus the demise of all claims against that person.

[406]*Id.* (emphasis added). Of course, the trust to which the *Hollins* Court refers is the *constructive trust* which is created only by court order once the reviewing court has assumed jurisdiction over corporate assets.

which, without the imposition of an administrative trust, would preclude trust-like distributions in equity; and second, the precise nature of the corporation and its separate juridical existence from its owners necessitates disposition of corporate disputes in equity.[407]

e. *Reflections on the Trust Fund Doctrine in the Twentieth Century*

The development of the trust fund doctrine was unfortunate in the history of corporate law. Two observations are offered in support of this conclusion. First, creation of the doctrine was superfluous to the resolution of the creditors' dilemmas in *Wood* and its nineteenth century progeny.[408] For instance, in each of the early opinions, creditors could have recovered for unpaid debts on two different grounds. They could have asserted that a fraud was committed in the conveyance of corporate property to stockholders which occurred at, or resulted in, the firm's insolvency. They also could have recovered based on the argument that the corporation breached its common law contractual duty to accord absolute priority to creditors in the payment of liquidating distributions. In addition, the imposition of a broad remedial device created significant confusion in the early jurisprudence of corporations. The remedial device was characterized as either an equitable lien or a constructive trust upon corporate assets. Such liens or trusts were apparently unbounded other than by judicial discretion.

Notwithstanding the theoretical deficiencies in continued adherence to the original trust fund doctrine, courts persist in recognizing a duty to creditors attended by the puzzlement the doctrine's application spawned in 1824.[409] Cases in this century addressing the relationship of the trust

---

[407] *See supra* text accompanying notes 359-65 (discussing creditors rights upon dissolution under the trust fund doctrine).

[408] In the companion case of Vose v. Grant, 15 Mass. 505, 522-23 (1819), the court considered the application of existing principles of law and equity sufficient to redress the creditor's claim against the defunct corporate defendant. *Id.*

[409] *See, e.g.*, *In re* STN Enterprises, 779 F.2d 901, 904 (2d Cir. 1985) (adopting the "New York" interpretation of the trust fund doctrine); Reconstruction Fin. Co. v. Teter, 117 F.2d 716, 726-27 (7th Cir. 1941) (refusing to apply trust fund theory to tort claim which arose after the corporate defendant's dissolution and after the expiration of the statutory survival period post-dissolution); MacKenzie Oil Co. v. Omar Oil & Gas Co., 120 A. 852, 858 (Del. Ch. 1923) (refusing to apply the trust fund doctrine solely on the basis of corporate insolvency); Asmussen v. Quaker City Corp., 156 A. 180, 182-83 (Del. Ch. 1931) (refusing to apply doctrine solely upon insolvency or as a remedy for claims by creditors *inter sese*); Blankenship v. Demmler Mfg. Co., 411 N.E.2d 1153, 1155-56 (Ill. App. Ct. 1980) (refusing to apply trust fund doctrine to claim which arose eight years after the corporation's dissolution in violation of Illinois' survival statute); New York Credit Men's Adjustment Bureau, Inc. v. Weiss, 110

fund theory to non-public[410] corporations primarily fall into three categories: (1) application of the trust fund theory solely upon a finding of corporate insolvency or dissolution without regard for the nature of the claim or claimants to corporate assets,[411] (2) rejection of the doctrine where the applicable jurisdiction has adopted a post-dissolution survival

---

N.E.2d 397, 398 (N.Y. 1953) (applying trust fund doctrine upon insolvency of corporation); People v. Metropolitan Surety Co., 98 N.E. 412, 413-15 (N.Y. 1912) (applying trust fund doctrine upon insolvency); Hunter v. Fort Worth Capital Corp., 620 S.W.2d 547, 548, 551 (Tex. 1981) (trust fund theory not applicable to claim by tort victim which claim arose 11 years after the corporate defendant's dissolution and thus in violation of the Texas survival of claims statute).

[410]The term "non-public" in this circumstance is intended to apply to corporations which are not vested with a quasi-public character. In this sense, a "public" corporation would include banks, insurance companies, or other similar entities which use or invest public funds.

[411]The cases which apply the trust theory broadly arise most often in New York. *See, e.g.*, New York Credit Men's Adjustment Bureau, Inc. v. Weiss, 110 N.E.2d 397 (N.Y. 1953); People v. Metropolitan Surety Co., 98 N.E. 412 (N.Y. 1912); Heaney v. Riddle, 23 A.2d 456 (Pa. 1942). *But see* Gonzales v. Progressive Tool & Die Co., 463 F. Supp. 117 (E.D.N.Y. 1979) (trust fund not applicable to claim which had not accrued at the time of dissolution).

A typical case which employed the trust device in its broadest sense is *New York Credit Men's Adjustment Bureau, Inc. v. Weiss*. In *Weiss*, a corporation which was experiencing financial difficulty elected to liquidate its assets via a public auction for the ostensible purpose of paying its outstanding debts and then dissolving. *Weiss*, 110 N.E.2d at 398. At the time of the auction, the company's balance sheet indicated an excess of assets over liabilities, despite the firm's inability to meet its obligations as they became due. *Id.* The estimated value of the corporation's inventory was approximately $73,500; the inventory was carried at a cost value of $60,000; and the creditors' claims in the aggregate, approximated $52,000. *Id.* at 399. The proceeds from the auction netted, after expenses for labor, advertising, and the auctioneer's commission, a mere $19,900. *Id.* Three days after the auction, an involuntary petition in bankruptcy was filed against the corporation and a trustee appointed to take charge of the proceeds from the liquidation sale. *Id.*

The issue decided by the *Weiss* court was whether the corporate officers and directors breached their duties to creditors by allowing a public auction and thus indirectly compromising the corporate *res*. *Id.* at 399. The court concluded that despite the absence of fraud, bad faith, self-dealing, diversion of assets, or allegations of the violation of any statute by the defendants, defendants were "quasi-trustees" who were accountable for the safety and protection of the "trust fund" for creditors. *Id.* at 400. In affirming a judgment for a new trial on the issue of plaintiff's damages, the court stated that the burden was upon the defendants to show that their actions in liquidating corporate assets in a public forum "resulted in obtaining full value" for the assets and did not, therefore, constitute an improper depletion of the trust *res*. *Id.*

The court's decision in *Weiss* is an example of twentieth century augmentation of the trust theory without regard to its historical genesis or the inconsistencies such an application imposes on traditional corporate principles. *But see* People v. Metropolitan Surety Co., 98 N.E. 412, 413 (N.Y. 1912) (disallowing *contingent* claim against an insolvent surety company since the claim did not mature at the time "[w]hen the corporate assets constituting [the] trust fund [were] to be marshalled, equities adjusted, and claims allowed").

statute curtailing creditor claims,[412] and (3) application of the doctrine only where the petitioning creditor seeks the appointment of a statutory receiver to administer corporate assets upon insolvency or dissolution.[413]

---

[412]*See, e.g.*, Reconstruction Fin. Co. v. Teter, 117 F.2d 716 (7th Cir. 1941); Blankenship v. Demmler Mfg. Co., 411 N.E.2d 1153 (Ill. App. Ct. 1980); Hunter v. Fort Worth Capital Corp., 620 S.W.2d 547 (Tex. 1981).

An example of a recent decision rejecting the use of the trust fund theory in the presence of an express legislative policy to restrict application of the doctrine to pre-dissolution claims is Hunter v. Fort Worth Capital Corp., 620 S.W.2d 547 (Tex. 1981). In *Hunter*, plaintiff was permanently injured when an elevator fell while plaintiff was working at the bottom of an elevator shaft. *Id.* at 548. Plaintiff sued the former shareholders of the corporation which had installed, inspected, and serviced the elevator. *Id.* The injuries and the subsequent suit were brought more than eleven years after the subject company had dissolved. *Id.* The applicable dissolution statute, Article 7.12 of the Texas Business Corporation Act, provided that "any right or claim existing, or any liability incurred, *prior to such dissolution*" must be brought within three years after the date of the corporation's dissolution. *Id.* at 549 (quoting 3A TEX. BUSINESS CORP. ACT, art. 7.12 (West 1994) (emphasis added)).

In response to plaintiff's plea for recovery, the Texas Supreme Court held that Article 7.12 provided a statutory remedy for pre-dissolution claims only and that the Article was in the nature of a survival enactment. *Hunter*, 620 S.W.2d at 549. As such, the court concluded that plaintiff could not maintain a cause of action against the former shareholders of the corporation because the injury occurred after the company's dissolution. *Id.* According to plaintiff, however, tort recovery could be granted under the trust fund doctrine. *Id.* The Texas court responded by stating that "Article 7.12 expresses a legislative policy to restrict the use of the trust fund theory to pre-dissolution claims, and to protect shareholders, officers and directors of a dissolved corporation from prolonged and uncertain liability." *Id.* at 551 (quoting Bishop v. Schield Bantam Co., 293 F. Supp. 94, 95 (N.D. Iowa 1968)). At least two other courts have likewise rejected the application of the trust fund theory to claims occurring after the expiration of relevant survival periods. *See* Reconstruction Fin. Co. v. Teter, 117 F.2d 716 (7th Cir. 1949); Blankenship v. Demmler Mfg. Co., 411 N.E.2d 1153 (Ill. App. Ct. 1980). In those jurisdictions which have yet to address this issue, the exclusivity of statutory remedies is all but certain.

[413]*See, e.g.*, Asmussen v. Quaker City Corp., 156 A. 180 (Del. Ch. 1931); MacKenzie Oil Co. v. Omar Oil & Gas Co., 120 A. 852 (Del. Ch. 1923).

For a case rejecting the trust fund doctrine, see Asmussen v. Quaker City Corp., 156 A. 180 (Del. Ch. 1931). In *Asmussen*, directors of an insolvent corporation paid certain of its unsecured creditors in preference to others (not including the officers, directors or stockholders of the firm). *Id.* The issue before the court was whether the trust fund doctrine extended to disputes *among creditors*, or whether the theory only protected *creditors from stockholders*. *Id.* at 181. The court concluded that the "trust fund" was not a rule preventing directors of insolvent corporations from preferring certain creditors over others:

> While the trust fund doctrine is supported by the overwhelming weight of authority in cases where the conflict is between creditors on the one hand and stockholders on the other, and also in cases where the corporate assets have been drawn within the administrative power of courts or statutory agencies for liquidation and distribution, yet the weight of authority favors the view that as among creditors, no trust exists which prevents the directors of an insolvent corporation from preferring some over others, notwithstanding the corporation is in failing circumstances and manifestly headed for disaster.

From these twentieth century interpretations of the trust fund principle, it is apparent that substantial inconsistencies exist in modern corporate law regarding the rights of creditors to corporate assets and the conjectural bases for those rights. These inconsistencies are intensified in those circumstances where foreign courts refuse to apply the law of the corporate defendant's state of incorporation. Such refusal creates confusion for corporate directors regarding managerial decisions rendered pre- or post-dissolution.

Ironically, though, Delaware law permits managers to eliminate liability for a breach of the directorial duty of care[414] or to modify or restrict their liability as members or managers of Delaware limited partnerships[415] or limited liability companies.[416] Yet, because these contractual amendments to liability are predicated upon proper classification of the duty to be relieved, Delaware managers must divine the appropriate characterization of the historic duty to creditors.

Beyond the issue of proper classification, it is irrefutable that equity gave birth to the doctrine which first announced the directorial duty to creditors. As a consequence of its *equitable* predicate, the trust theory should *not* be utilized to resolve corporate disputes between creditors and stockholders in the absence of exceptionally compelling facts which warrant the abdication of explicit dissolution legislation or alternative legal remedies.[417] In addition, it appears that a duty to creditors should be delimited to the context of an *equitable and judicial administration* of

---

Id.

The court in *Asmussen* noted that creditors not wishing to entrust the payment of their debts to the discretion of directors were free to seek the appointment of a receiver charged by the appointing court with the administration of the corporation's estate on the basis of equality among all claimants of the same priority. *Id.* at 182 (noting "there is nothing novel about the magic of judicial interference by way of receivership as a transforming agency by which assets that before were freed from a trust are turned into a trust fund to be administered on a basis of equality"). *Id. See also* MacKenzie Oil Co. v. Omar Oil & Gas Co., 120 A. 852, 858 (Del. Ch. 1923) (stating that the existence of a *receivership statute* in Delaware allowed standing to a non-judgment creditor for claims against an insolvent corporation).

[414]*See* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1993).

[415]*See* DEL. CODE ANN. tit. 6, § 17-1101(d) (1993).

[416]*See id.* § 18-1101(c)(2).

[417]The factual considerations which apparently compelled the early courts to utilize the doctrine include: (1) corporate defendants with a public character — e.g., banks, insurance companies, and railroads; (2) corporations which required substantial initial capitalization (but from which capitalization was not forthcoming by equity participants) to protect the public investors who deposited their funds with the defendant firms; (3) distributions to stockholders in preference to unpaid creditors at the moment of insolvency or dissolution of the corporation; and (4) disputes which focused solely upon creditors as against stockholders and not disputes among creditors *inter sese*. *See supra* notes 366-410 and accompanying text.

corporate assets where no dispute exists regarding the court's jurisdiction over those assets. In essence, the creditor duty should be viewed as a contractual responsibility which is subject to modification or elimination as adjudged under such *equitable principles of contract law* as unconscionability, fraud, or duress. In short, the creditor duty should be rejected in favor of contractual enforcement techniques or fraudulent conveyance or common law fraud actions. Correspondingly, the trust fund doctrine should be rejected in those jurisdictions which provide statutory dissolution procedures and which permit survival of corporate actions post-dissolution.

C. *Rejoinder to the Hypothetical: A Summation*

1. A General Summation

Parts A and B surveyed the equitable predicate for the directorial duty to creditors as well as the statutory and judicial responses to equity's actions. The author concludes that corporate law presently reflects both a defect in legal reasoning and a threat to creditor and equity holder expectations.

The defect in existing corporate law is the judicial conclusion that the actuality or expectation of contingent and/or future foreseeable claims renders a firm insolvent. Such an interpretation upends the traditional fiduciary duty to stockholders in favor of the equitable duty to creditors. This metamorphosis results in the inability of directors to take risks with corporate assets for the purpose of extinguishing or minimizing the firm's temporary financial distress. Stated simply, the mere presence and/or anticipation of contingent and future unknown claimants shift the directors from an active management mode to one of passive asset-preservation.

The threat of current law is its bifurcated incongruity. For example, stockholders voluntarily enter into a contractual relationship with the corporation (through direct or indirect stock purchase) in order to receive voting rights, dividends, rights to inspect books and records, rights to distributions on liquidation, and rights to sell, assign, or pledge these interests in contractual or commercial transactions. Stockholders, by contracting in this manner, relinquish direct control over the firm. Instead, control resides in corporate directors who must manage the firm according to their fiduciary duties of care and loyalty. Stockholders thus limit themselves to equitable remedies where directors breach their fiduciary responsibilities.

Creditors, on the other hand, experience only a contractual relationship with the corporation. In other words, their rights and duties vis-à-vis the firm are negotiated through arm's-length bargaining and are typically memorialized in a written agreement drafted by attorneys. Creditors who fear insolvency or dissolution of the corporation may negotiate a security interest in unencumbered corporate assets, seek limited proxy rights, or negotiate representation on the board for the term of their contract.

The paradox results when corporate courts subordinate stockholders' equitable rights to creditors' contract rights at insolvency or dissolution. Subordination of stockholder interests at this juncture defies the precise expectations which formed the basis of the stockholders' and creditors' relationship with the firm. Creditors thus receive a windfall at the expense of stockholders.

In addition, the benefit which creditors received in the above scenario is subsequently extinguished by judicial decisions which require equal treatment of existing, contingent, and future unasserted claimants at corporate insolvency and dissolution. For example, commercial law entitles judgment creditors to execute their judgments against available corporate assets notwithstanding the insolvency of a corporate debtor. Creditors with pending and/or contingent claims may prevent execution by seeking the appointment of a receiver or by petitioning for an involuntary bankruptcy of the firm. The *RegO* opinion unfortunately ignored these rudimentary principles of commercial law and instead, in the name of equity, compromised the ability of a judgment creditor to receive full satisfaction of an unpaid debt — contrary to the creditors' contractual rights and expectations.

In sum, bargained-for business and contract risks are being transferred, through equity, from contingent and unknown claimants to firm assets to existing creditors, corporate directors, and stockholders. This risk-transference thus provides both a windfall and a disadvantage to creditors who are able to safeguard their interests through contract and commercial law. Realigning contract risks via equity also paralyzes legitimate stockholder expectations of productive use of corporate assets.

To correct the present law, the author makes the following suggestions. First and foremost, the duty to creditors should be rejected as an anachronism of our law that has outlived its mission. Creditor security should instead remain within the realm of contract and commercial law or actions for fraud.

In the alternative, states should adjust their corporate law according to commercial and contractual reality. In particular, states should amend their corporate codes to clearly characterize dissolution legislation as

either survival or limitations statutes. Second, dissolution statutes should explicitly supersede the trust fund doctrine. Delaware, in particular, should amend sections 280 through 282 to conform to commercial expectations. Third, dissolution statutes should make clear that contingent and future unknown claims are not "liabilities" for the purpose of defining insolvency. Rather, such claims only become significant in the *judicial administration and distribution* of the debtor's estate post-dissolution.

2. Application to the Hypothetical

The author suggests that the duty to creditors should be rejected in order to keep creditor security within the arena of contract and commercial law or fraud actions.

First, if the founders elect to dissolve the corporation under Delaware sections 280 through 282, the $1 million in supplier debts and $1 million property judgment may be remitted to the appropriate claimants. The remaining company assets should be preserved until the court of chancery is able to determine the amount and form of security necessary to satisfy the five pending personal injury claims and the future foreseeable claims. Firm assets should not be distributed to stockholders on the eve of dissolution if an *actual insolvency* would result.

The founders, however, will retain the discretion to negotiate appropriate settlements with pending claimants and to implement a distribution scheme for unknown claimants according to their good faith business judgment. Creditors who object to directorial discretion during dissolution may seek the appointment of a receiver or pursue involuntary bankruptcy in appropriate situations. In addition, because the contingent and future unasserted claims would not be considered "liabilities" of the corporation for the purpose of determining insolvency, the founders will be free to negotiate an arm's-length sale of firm assets prior to dissolution. The proceeds from the sale will be available for the payment of legitimate claims and final distribution to equity holders.

Second, if the founders pursue a pre-dissolution sale of assets to a newly-formed limited partnership or limited liability company of which they are the owners, equity should not unwind the transaction based upon any "duty to creditors." This conclusion follows for five reasons. First, the firm was neither "insolvent" nor "operating in the vicinity of insolvency" at the time of the sale. Second, the asset sale resulted from arm's-length bargaining and provided liquidity to the corporate enterprise and its stockholders. Third, creditors contract with corporations with full knowledge that collection of unpaid debts may be compromised by the

debtor's insolvency, dissolution, or bankruptcy. Commercial and contract law license creditor protection in these eventualities. Creditors who wish recourse against *specific* corporate property may bargain for a security interest in that property. Fourth, by permitting creditors to sue the purchasing enterprise, equity dispenses a windfall to creditors for which they did not bargain. In addition, the purchasing entity likely did not base its acquisition price on the assumption of the seller's liabilities. Fifth, in the absence of bad faith, fraud, or self-interest by the founders, corporate directors should retain the flexibility to manage the firm during its viability and its demise. Actions for fraud or fraudulent conveyances are available to preserve corporate assets in the exceptional case.

Finally, the founders should be under no duty to dissolve the company despite the existence of contingent and/or future foreseeable liabilities which, in the aggregate, exceed the firm's present assets. Simply put, the corporation, through its managers, should be empowered to exist until that moment when the last judgment creditor executes upon the last corporate asset. For creditors who challenge such fatalistic management, state receiverships and involuntary bankruptcies furnish existing and sufficient creditor relief without the interference of inappropriately applied equitable principles which cause significant harm to commercial and contractual expectations.

IV. A THEORETICAL PERSPECTIVE ON DIRECTORIAL OBLIGATIONS TO CREDITORS

The *RegO* opinion was a landmark not only for its initial construction of a novel dissolution statute, but also for its failure to consider, or resolve, fundamental theoretical questions regarding corporate governance in the circumstance of enterprise dissolution or insolvency. The following sections confront those undecided issues which necessarily provide the foundation for virtually all prospective insolvency or dissolution litigation. The section begins by returning to the hypothetical of Part One. The discussion then proceeds to an exposition of the nature of the modern publicly-held corporation and the impact of the development of such entity on the law of corporate governance in the twentieth century. The materials then examine the traditionalist and contractarian theories of directorial obligations as they apply to managerial duties to creditors at insolvency or dissolution. Finally, Part Three concludes with three recommendations: (1) because contractarian doctrine more readily reflects modern corporate entities, that doctrine should be embraced by contemporary business courts; (2) as a result, whatever duty to creditors remains should be subject to complete

modification by contract; and (3) any corporate obligation to firm claimants should be abandoned in favor of principles of freedom of contract and the corresponding contractual duties of good faith and fair dealing.

A. *Posing the Hypothetical*

1. The Hypothetical

Return to the hypothetical corporation at Part One. Recall that corporate directors wished to take funds that remained after firm dissolution and to invest them in a new Delaware venture. Assume that money is available. Assume further that three Delaware business forms are under consideration: (1) a corporation, (2) a limited partnership, and (3) a limited liability company. Recall also that the former directors wish to utilize any recent Delaware "law" which will curtail managerial duties to creditors.

If the corporate form is adopted, the founders contemplate the use of DGCL section 102(b)(7) in their new charter to eliminate directorial obligations to creditors. The founders cite section 102(b)(7), which provides:

> (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:
>
> > (7) A provision *eliminating* or limiting the *personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director*, provided that such provision shall not eliminate or limit the liability of a director:
> >
> > > (i) For any breach of the director's duty of loyalty to the corporation or its stockholders;
> > >
> > > (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law;
> > >
> > > . . . .

> (iv) for any transaction from which the director derived an improper personal benefit.[418]

The founders wish to draft a provision for the new certificate of incorporation which maximizes application of section 102(b)(7). They are uncertain, however, whether such a provision will eliminate directorial liability to *creditors* — especially at insolvency or dissolution.[419] Specifically, they are unsure whether the duty to creditors is in the nature of a duty of care, duty of loyalty, duty of disclosure, contract obligation, trust obligation, or tort obligation.[420]

In the alternative, the founders are considering the formation of a Delaware limited partnership. Currently the founders anticipate creating a limited partnership controlled by a Delaware corporation, i.e., the general partner will be incorporated as a Delaware entity. The founders are aware, however, of the 1991 court of chancery opinion of *In re USACafes, L.P. Litigation*.[421] In *USACafes*, the chancery court recognized a fiduciary obligation of directors of a corporate general partner to the limited partners of the partnership.[422] The founders thus ponder drafting two provisions for inclusion in the limited partnership agreement which will exactly track the language of sections 1101(c) and (d) of the Delaware Revised Uniform Limited Partnership Act (DRULPA). Recall that sections 1101(c) and (d) state:

> (c) It is the *policy of this chapter to give maximum effect to the principle of freedom of contract* and to the enforceability of partnership agreements.
>
> (d) To the extent that, at law or in equity, a partner has duties (including fiduciary duties) and liabilities relating thereto to a limited partnership or to another partner, . . . (2) *the partner's duties and liabilities may be expanded or restricted by provisions in a partnership agreement*.[423]

---

[418]DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1993) (emphasis added).

[419]They presume the application of these provisions only where director actions do not fall within § 102(b)(7)(ii) or (iv).

[420]*See supra* notes 11-13 and accompanying text.

[421]600 A.2d 43 (Del. Ch. 1991).

[422]*Id.* at 48-49. *See also* Litman v. Prudential-Bache Properties, Inc., 611 A.2d 12, 16 (Del. Ch. 1992) (distinguishing *USACafes*).

[423]DEL. CODE ANN. tit. 6, § 17-1101(d) (1993) (emphasis added).

The founders note two aspects of section 1101. First, they mention that section 1101(c) specifically states a legislative policy effectuating freedom of contract[424] — a policy that is starkly absent in DGCL section 102(b)(7). Second, they comment that section 1101 seems to permit only contractual reduction of liabilities — not elimination as set forth in section 102(b)(7).[425] As a consequence, the founders ruminate as to whether the creation of a corporate general partner whose charter traces section 102(b)(7) and a partnership agreement which tracks section 1101 will result in the elimination of their duty to *creditors*. Specifically, they ponder which contract provision will govern the issue of limited liability to creditors — the corporate charter of the general partner or the limited partnership agreement. It is their hope that the "freedom of contract" language of section 1101(c) includes any corporate obligation to creditors, but they are concerned that the "restriction" language of section 1101(d) will not allow elimination of liability as expressly permitted in section 102(b)(7). They also speculate on the impact of *USACafes* on these contractual provisions.

The third alternative that the founders are considering is the creation of a Delaware limited liability company. Due to the fact that Delaware's Limited Liability Company Act[426] has an analogous section 1101[427] and because managers of Delaware limited liability companies arguably can be formed as Delaware corporations, the founders ponder the same combination of contractual provisions as stated in the limited partnership alternative.

Finally, the founders speculate about the effect of the possible adoption by Delaware of a contractarian perspective of business organizations (as opposed to Delaware's present adherence to traditional principles of corporate governance). In particular, the founders consider whether, if Delaware embraced a contractarian paradigm, incorporating the new business would fulfill their needs. The founders reason that the new corporation could insert a charter provision which expressly eliminated all liability to pending and future foreseeable creditors. Such a provision would be self-executing under a contractarian regime notwithstanding the absence of any applicable corporate statutory authority.

---

[424] *Id.* § 17-1101(c).

[425] *Id.* § 17-1101(d)(2).

[426] *Id.* § 18-1102.

[427] DEL. CODE ANN. tit. 6, § 18-1101 (1993).

2. A General Commentary

Three theoretical concerns are presented by the hypothetical. The first issue involves the nature of the duty to creditors. For example, DGCL section 102(b)(7) permits contractual elimination of the duty of care, but not the duty of loyalty. If firm managers wish to utilize section 102(b)(7), the question is raised whether the duty to creditors is more akin to the duty of care (modifiable by contract) or the duty of loyalty (not subject to contract modification). Further, section 102(b)(7) makes no reference to a corporate duty of disclosure, a duty to creditors, tort obligations to stockholders, trust duties to equity holders, or contract obligations in corporate entities. All of these issues have been addressed in recent Delaware business decisions. Therefore, if the duty to creditors is neither a duty of care nor a duty of loyalty, the creditor obligation is apparently not subject to revision under section 102(b)(7). Additionally, section 102(b)(7) is inapplicable to director conduct which is in bad faith or involves intentional misconduct. If a breach of the duty to creditors is an act "not in good faith," then section 102(b)(7) again provides no directorial safeguard through contract. Ironically, however, if a *breach* of a duty to creditors constitutes bad faith, creditor relief lies in *contract* for a breach of the duty to act "in good faith." In other words, the section 102(b)(7) prohibition for bad faith conduct is superfluous in light of existing contractual demands for good faith performance and execution of contract terms. The foregoing inquiries thus expose the ambiguity in the application of section 102(b)(7). Part Three addresses this ambiguity.

Second, if business managers choose to avoid the ambiguities of DGCL section 102(b)(7) in favor of section 1101 in both Delaware limited partnership and limited liability company law, the question arises whether "restriction" of duties and liabilities under those statutes includes "elimination" of same. For example, may the founders of such future enterprises draft contractual provisos which restrict managerial liability to a maximum recovery of $100? Or, is such a restriction in essence a prohibited elimination of liability?

In addition, a conflict arises between legitimate corporate contractual amendments that eliminate liability for directorial breaches of the duty of care on the one hand and partnership agreements that modify partner liability on the other where limited partnerships or limited liability companies are formed with corporate managers. In this circumstance, the question becomes, which contractual provisions govern the liability of individual managers, the charter or the partnership agreement?

Finally, the fundamental theoretical inquiry posed by the duty to creditors is whether the modern publicly-traded corporation demonstrates

the same, or similar, potential for abuse by management against equity holders which abuse spawned the creation of the original fiduciary paradigm of corporate governance. In other words, if the logic underpinning the creation of directorial obligations no longer exists, then the traditional construct of governance by fiduciaries should be replaced by the contractarian model of administration. If such a measure were undertaken, the issues presented by section 102(b)(7) and the respective section 1101's would be mooted in favor of contractual freedom among business constituents. Such advancement of principles of contractual independence does not, however, compromise or nullify fiduciary obligations of business managers. Rather, duties to firm constituents would remain intact in the form of the *contractual* obligations of good faith and fair dealing and would be policed by the *contract* techniques of duress, fraud, economic coercion, and unconscionability. The latter theoretical argument thus subsumes the former issues of statutory interpretation. As a result, the following section examines the character of the modern corporation in the traditional and contractarian regime.

3. The Nature of the Modern Publicly-Held Corporation: Contractarian versus Anti-Contractarian Analyses of the Fiduciary Paradigm

The past two decades have witnessed the gradual decline of the traditional fiduciary paradigm for corporate governance.[428] One attack on the fiduciary model is posed by economists who suggest that the modern publicly-held enterprise is merely a series of contracts among the constituents to the corporation. This contractarian view[429] is historically

---

[428]In a corporation, capital investors may own an equity interest in the corporate entity yet retain management rights through the exercise of their voting franchise. Because of the independence of the corporate entity from its owners, corporation law requires a centralized management. As a result of the division of management between corporate directors and the firm's stockholders, corporate law created fiduciary duties of care and loyalty to protect shareholders from the potential mismanagement and greed of directors. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1988) (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)).

[429]Recent versions of the contract theory are voluminous. *See, e.g.*, Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990); Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986); Francis H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Jensen & Meckling, *supra* note 9. This list is by no means intended to be exhaustive on the writings in this area. Instead, these

paradigmatic in the sense that its "nexus of contracts" approach seeks to replace the traditional fiduciary paradigm with a contractual model. To the contractarians, this substitute is necessary since modern corporations are no longer fictional enterprises which operate solely by state largesse.[430] Instead, the contractarians consider these corporations to represent a model of private ordering which serves as a contracting nexus for participants to the private corporation, including shareholders, creditors, suppliers, employees, and consumers.[431]

To contractarians the corporate contract is, at a minimum, a standard form agreement which encompasses state law provisions or, at best, a private contract which delineates the parties' expectations regarding competitive pressures from external[432] and internal[433] market sources.[434] Contracting parties are free to contract well, to contract poorly or not to contract at all regarding event risks which are likely to occur in their association with the firm. Consequently, contractarians consider fiduciary obligations unnecessary to protect the participants from the other's greed and mismanagement.[435] In essence, the contractarians advocate replacing fiduciary principles developed under corporate and trust law with contractual duties which arise from bargained-for terms.[436] To the extent the parties' contract is silent regarding a disputed performance, the contractarians would default into the common law contractual duty of good faith which applies in the performance and execution of all contracts.[437]

The anti-contractarian, or traditionalist, theory, on the other hand, is premised upon the historical advent of the corporation. Early American corporate law was rooted in English business law wherein the corporation originated from a state franchise that invested the newly-formed entity

---

articles are suggested as being representative of the commentaries in the field.

[430]Butler & Ribstein, *supra* note 432, at 8-10.

[431]*Id.* at 7. This view of corporate governance is in direct conflict with the traditionalist view which predicates corporate rules upon the internal relationship of the corporation, i.e., the relationship between the stockholders and their managers. *Id.* at 7 n.14.

[432]*Id.* at 7. External market forces include pressures from capital usages, products manufacture, and marketing and occurrences in the labor forces. *Id.*

[433]*Id.* Internal market forces include, in general, the centralized structure of management and, in particular, pressures from management incentive plans. *Id.*

[434]Butler & Ribstein, *supra* note 434, at 7.

[435]*Id.* at 16.

[436]*Id.* at 13.

[437]*Id.* at 16. *See also* RESTATEMENT (SECOND) CONTRACTS § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.").

with a quasi-public character.[438] Although in this country the franchise or quasi-public character of the corporation became less significant in the late nineteenth and early twentieth centuries, state corporate law continued to require a corporate filing with the state in order to create the corporation and invoke its desired protections of limited liability for the corporation's equity holders.[439] This concession theory of American corporate law was affirmed by the Supreme Court with its 1819 decision in *Trustees of Dartmouth College v. Woodward*.[440] In *Dartmouth*, the Court described the corporation as an "artificial being, . . . existing only in contemplation of law."[441] As recently as 1987, the Supreme Court has quoted with approval the concession theory articulated in *Dartmouth*.[442]

To traditionalists, the fact that the sovereign is a necessary party to the formation of a corporation cannot be cast away in favor of an abstracted contractual paradigm. The traditionalists thus observe the original distrust with which corporations were viewed and the initial reliance of corporate charters upon special acts of the legislature and the filing of private bills with the state legislature.[443] Although traditionalists concede that the formerly particularized bills mandated for incorporations

---

[438]For a discussion of the historical evolution of the corporation, see Henry N. Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGIS. STUD. 129 (1985); Henry N. Butler, *General Incorporation in Nineteenth Century England: Interaction of Common Law and Legislative Process*, 6 INT'L REV. OF L. & ECON. 169 (1986) [hereinafter Butler, *General Incorporation*].

In this sense, early American corporate law was regulatory in focus. Today, most modern corporate statutes are faciliatory in nature and thus substantially unburdened by previous state-imposed regulations. Interestingly, the Russian Federation is currently involved in the drafting of a corporate code and must directly address the issue of for what purpose corporation statutes exist — the *regulation* or *facilitation* of commerce in a market economy. At present, the consensus view on the Russian corporate code is one of regulation. The draft Russian model is, however, reasonable given the absence of any local or national civil code which protects budding Russian entrepreneurs from domestic and foreign greed and corruption. (The author was one of a seven-member Delaware delegation of lawyers, judges, and academics who consulted with their Russian counterparts in Moscow in December of 1993 on matters of business privatization.)

[439]This practice had its origin in English corporation law. *See* Butler, *General Incorporation*, *supra* note 441, at 170-71.

[440]17 U.S. (4 Wheat.) 518 (1819).

[441]*Id.* at 634.

[442]CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 89 (1987). For a recent examination of the concession theory, see William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989).

[443]*See, e.g.*, HENRY W. BALLANTINE, BALLANTINE ON CORPORATIONS § 8a (rev. ed. 1946) (referring to the early practice in corporate law which required a filing of a private bill in the applicable state legislature which then had to pass both houses and be signed by the governor).

were replaced by generalized corporation acts, state confirmation is still required in order to legally effect a corporate structure.[444]

With the historical concept of the corporation being a concession of the state, anti-contractarians consider certain regulatory provisions to be untouchable, that is, these provisions may not be waived or modified by private ordering. The most important of the provisions is the directors' fiduciary obligations to shareholders. In this respect, contractarians and traditionalists are in direct conflict. Perhaps the case which brought this debate into clearest focus was the Delaware Supreme Court's unprecedented opinion in *Smith v. Van Gorkom*.[445] In that case, the court

---

[444]Although state corporate law relaxed the requirements for incorporation, evidence of distrust continued. For example, in Louis K. Liggett Co. v. Lee, 288 U.S. 517, 557 (1933), Justice Brandeis, in referring to the later-enacted general incorporation laws, stated: "The removal by the leading industrial States of the limitations upon the size and powers of business corporations appears to have been due, not to their conviction that maintenance of the restrictions was undesirable in itself, but to the conviction that it was futile to insist upon them." *Id.* at 557 (Brandeis J., dissenting).

Contractarians dispute this line of reasoning for several reasons. For example, contractarians note many limitations upon corporations which have been abolished by modern corporate codes, including former limitations on mergers, limitations on the size of corporations, and the demise of the doctrine of ultra vires. Butler & Ribstein, *supra* note 432, at 9. *See, e.g.*, Act of Mar. 10, 1899, ch. 273, § 54, 21 Del. Laws 445, 461 (requiring a supermajority (two-thirds) for corporations to merge and thus limiting the size of corporations).

Anti-contractarians counter these examples with references to modern statutory restrictions on the payment of dividends and stock repurchases as well as the practical explanation for the decline of the doctrine of ultra vires which focuses upon the lack of necessity for limiting corporate purposes. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 170, 173 (1991 & Supp. 1993) (imposing limits on the payment of dividends and stock repurchases). In addition, anti-contractarians note other "mandatory" corporate provisions, including stockholder voting rights and fiduciary duties. Butler & Ribstein, *supra* note 432, at 10.

As to these latter examples, the contractarians respond that voting rights and, in some circumstances, fiduciary duties are more accurately described as contractual. Butler & Ribstein, *supra* note 432, at 10. For example, if corporation A chooses to merge with corporation B, corporation A could deny voting rights to A's shareholders simply by forming a wholly-owned subsidiary which would effectuate the merger. As to fiduciary duties, contractarians refer to the decision in Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E. 2d 505 (Mass. 1975), in which the Massachusetts Supreme Court granted an "equal opportunity" right to minority stockholders in a close corporation for the repurchase of their shares. Butler & Ribstein, *supra* note 432, at 10-11. Contractarians interpret *Donahue* as recognizing an implied duty on majority stockholders in a small business to not take advantage of minority shareholders through share repurchases where the minority stockholders have no ready market for their stock. *Id.* at 10-11. To the contractarians, imposition of such an implied duty is either consistent with the actual expectations of the majority and minority stockholders or is appropriate judicial drafting where the parties failed to specifically address the transaction in question but would have done so had they considered the dilemma. *Id.* at 11.

[445]488 A.2d 858 (Del. 1985).

found inside and outside directors liable for breaches of their fiduciary duties of care.[446] In response to the *Van Gorkom* opinion, the Delaware legislature amended its corporate code to permit charter amendments which eliminate or limit personal directorial liability in certain situations.[447]

For purposes of this article, the theoretical debate between contractarians and traditionalists is whether the fiduciary duties of corporate managers should be subject to private contract or whether these duties should be mandatory and hence inviolable. Consideration of this debate is significant to the discussions which follow because present insolvency and dissolution law is grossly non-uniform, ambiguous, and replete with common law equity doctrines. As a result, directors and stockholders currently subject to staggering personal liability may, under a contractarian analysis, elect to eliminate their respective liabilities for acts or transactions which, in good faith, are sanctioned during insolvency, dissolution, or liquidation.[448]

B. *Identifying the Competing Constituents to Corporate Assets Upon Insolvency or Dissolution and the Relationship of Corporate Theory to a Reasoned Resolution of the Conflict*

Business and business law focus upon all participants who are necessary to the success of a business. Therefore, the law of business regulates lenders, employees, suppliers, managers, consumers, and owners. Of these indispensable constituents to the business, however, only the owners are protected by traditional corporate law. Yet, upon insolvency or dissolution of the corporate enterprise, owners, as well as

---

[446] *Id.* at 864.

[447] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1993). The § 102(b)(7) charter amendments are not available for the elimination or limitation of director liability where: (1) the breach is of a director's duty of loyalty; (2) the alleged acts or omissions were not in good faith, involved intentional misconduct, or resulted from a knowing violation of law; (3) involved an unlawful payment of dividend or an unlawful stock purchase or redemption; or (4) the director derived an improper personal benefit. *Id.*

Delaware was not the first to draft a limitation upon director liability by charter amendments. In 1982 the American Law Institute (A.L.I.) first proposed a liability limitation in its PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 7.06 (Tentative Draft No. 1, 1982). The current proposal appears in PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.17 (Tentative Draft No. 9, 1989).

[448] The remaining theoretical discussion focuses solely upon the publicly-traded corporation because a legitimate argument could be posed that adoption of a contractarian model does not align itself with corporate governance issues in closely-held corporations.

non-equity participants, compete for rights in business collateral. The following discussion examines the rights of these competing constituents to business assets from contractarian and traditional corporate governance perspectives.

1. A Contractarian Perspective

The contracting parties to corporations typically include lenders, suppliers, employees, managers, consumers, bondholders, and equity holders. An analysis of these general contractual relationships, as viewed from a contractarian position, follows.

a. *Lenders*

Lenders are those parties who extend credit to the corporation in return for a note and security agreement collateralized by corporate assets. These lenders are often first lien holders who take priority over all other creditors. These parties are usually sophisticated lenders who contract with the corporation upon their own terms. From a contractarian perspective, these parties are able to protect themselves through superior bargaining power and negotiation of first liens. Further protection is afforded by the corporation's duty to perform the contract terms in good faith. Consequently, a corporate fiduciary duty adds little to the protections available to lenders via their private agreements with corporations.

b. *Suppliers and Employees*

Suppliers and employees are creditors of the firm who provide services or goods to the business. In most instances these parties sign form contracts or reach agreements with corporations based upon oral understandings[449] or past business practices. In the event of insolvency

---

[449]Of course, contracts for services for more than one year and contracts for the sale of goods for the price of $500 or more are subject to the statute of frauds. *See, e.g.*, U.C.C. § 2-201 (1989). Section 2-201 provides:

> [a] contract for the sale of goods for the price of $500 or more is not enforceable by way of action or defense unless there is some writing sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought or by his authorized agent or broker.

Id. § 2-201(1). But see U.C.C. § 2-201(3) which allows enforceability of a contract which does not satisfy the writing requirement for the statute of frauds in certain circumstances. *See also* RESTATEMENT (SECOND) OF CONTRACTS § 131 (1981) (stating the general requirement for

or dissolution, these parties are considered general unsecured creditors of the firm who take on a pro rata basis after secured creditor claims are satisfied.[450] These parties are contractually protected in the sense that goods and services are being provided to the business on a continual basis and the corporation has undertaken to perform the contract terms in good faith.[451] Where contract terms are silent regarding a disputed performance, commercial codes may provide gap-filling solutions.[452] Under contractarian theory, a corporate fiduciary duty does not advance these parties' interests because the creation of such a duty cannot place these contracting parties ahead of, or in parity with, secured creditors — the only resolution that would secure the employees' and suppliers' expectation of payment.

---

writings); *id.* § 115 (stating the writing requirement for surety agreements); *id.* §§ 125-129 (stating the writing requirement for contracts for the sale of lands, tenements, or any interest therein).

Two well-recognized exceptions to the writing mandate of the statute of frauds are part performance of the contract and promissory estoppel. *See, e.g.*, Hickey v. Green, 442 N.E.2d 37 (Mass. App. Ct. 1983) (applying equitable estoppel exception); Remilong v. Crolla, 576 P.2d 461 (Wyo. 1978) (applying estoppel exception).

[450]*In re* Jeanes Mechanical Contractors Co., 32 B.R. 657, 659 (Bankr. W.D. Ky. 1983).

[451]*See* U.C.C. § 1-203 (1989) (providing "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement"); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) (stating that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement"). Additionally, because employees and suppliers provide a continuous and necessary service and/or benefit to the firm, a corporation in financial distress likely will pay these parties out of operating capital in order to preserve the continuous supply of goods and services which are critical to the life of the corporation.

[452]*See, e.g.*, U.C.C. § 2-305 (1989) (allowing for enforceability of a contract despite an open price term); *id.* § 2-308 (allowing enforceability despite the absence of a specified place for delivery of goods); *id.* § 2-309 (allowing enforceability despite absence of specific time provisions regarding shipment or delivery of goods); *id.* § 2-310 (allowing enforceability despite an open term regarding time for payment or the running of credit).

c. *Corporate Management*

Managers of the business include inside[453] and outside[454] directors as well as non-director officers.[455] Directors obtain their authority to conduct the business affairs of the firm through an annual stockholder vote[456] and serve, therefore, at the discretion of the equity owners.[457] Officers, on the other hand, generally derive their authority either from the corporation's bylaws or resolutions of the board of directors.[458] From a contractarian view, director duties are defined by the firm's certificate of incorporation and bylaws as well as state corporate law.[459] Directors thus take office with notice of the terms of their "contract" with the corporation. Directors directly influence the terms of their contractual arrangement with the firm to the extent that this contract may be modified during a director's tenure through an amendment to the corporation's charter.[460] On the other hand, where charter amendments are proposed by management, such modifications generally take effect only upon an informed stockholder vote.[461] Upon insolvency or dissolution, director obligations are generally considered administrative

---

[453]Inside directors are those who have a personal financial stake in the firm. A common example of an inside director is one who is an officer of the corporation and receives a salary from the business. Another common example is a director who owns a substantial percentage of the outstanding stock of the corporation. In each of these situations, the director is faced with a potential conflict of interest either where a directorship is at stake or where creditors will take priority over equity owners.

[454]Outside directors are those who do not have a personal financial stake in the firm.

[455]Officers are agents of the corporation who are, most often, granted their offices either from the corporation's bylaws or from directorial resolutions. *See, e.g.*, DEL. CODE ANN. tit. 8, § 142 (1991). Non-director officers are responsible for the day-to-day management of the firm and thus are held to the same fiduciary duties as directors. Indeed, corporate common law suggests that the judicial scrutiny accorded to the conduct of officers may be more stringent than that accorded to the conduct of directors. *See* A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 215 (1992).

[456]*See, e.g.*, DEL. CODE ANN. tit. 8, § 211(b) (1991) ("annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the bylaws").

[457]HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 192 (3d ed. 1983).

[458]*Id.* § 219.

[459]*Id.* § 207.

[460]*Id.*

[461]*See, e.g.*, DEL. CODE ANN. tit. 8, § 242 (1991); 3 MODEL BUSINESS CORP. ACT §§ 10.01-.03 (1994). Two common director charter provisions are those which limit or eliminate director liability in some circumstances, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1993), and those which provide indemnification for directors, *id.* § 145.

expenses of the corporation such that director expenses and costs are treated as priorities in the distribution of corporate funds.[462] Some equity limitations will subordinate these debts where appropriate.[463]

Officer contracts are traditionally negotiated by directors and are specific to the nature of the officer's position as well as the officer's business experience.[464] Officer contracts are thus private agreements that reflect greater bargaining among the parties. From a contractarian perspective, officers are protected against greed and arbitrariness by the common law contractual duty of good faith and fair dealing imposed on the performance and execution of their contract.[465] In addition, most officers obtain their office through some personal contact with the appointing directors. As a consequence, officer and director contracts do not reflect typical "creditor" relationships with the firm. In the event of insolvency or dissolution of the corporation, officer liabilities, like director obligations, are considered administrative expenses and thus accorded priority in the scheme of distributions.

A substantial body of empirical evidence on corporate management suggests that the responsibility of long-range planning for the firm should lie with the board of directors while responsibility for day-to-day decision making should be vested in the officers.[466] Ostensibly the purpose for the division of management responsibility is to minimize infighting among managers.[467] In addition, separation of management decision making and implementation of management decisions provides an internal mechanism for monitoring management conduct.[468] According to the contractarian

---

[462]Pepper v. Litton, 308 U.S. 295, 306-08 (1939).

[463]In *Pepper v. Litton*, the United States Supreme Court articulated the "Deep Rock Doctrine" which allows courts, in the exercise of their equity jurisdiction, to subordinate the claims of officers, directors, and stockholders to the claims of outside creditors. *Id.* at 307-09. In an extreme case, the Deep Rock Doctrine permits the disallowance of an otherwise valid inside debt. *Id.* at 309.

[464]Butler & Ribstein, *supra* note 432, at 26-27.

[465]*See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

[466]*See* ALFRED D. CHANDLER, JR., STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF INDUSTRIAL ENTERPRISE (1962); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 281 (1985) (confirming the importance of the multidivisional structure in the success of a corporation); OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 36-54 (1975) (providing a more in-depth analysis of the multidivisional corporate structure). *See also* David J. Teece, *Internal Organization and Economic Performance: An Empirical Analysis of the Profitability of Principal Firms*, 30 J. INDUS. ECON. 173, 173 (1981) (concluding that a decentralized and divisionalized internal structure of a firm has been shown to enhance firm performance).

[467]*See* Butler & Ribstein, *supra* note 432, at 25.

[468]*See, e.g.*, *id.* at 25-26; WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 469, at 281.

theory, management contracts, including executive compensation packages, may be structured to resolve any conflict between management self-interest and stockholder interest.[469] For example, executive incentives may include stock options, stock appreciation rights and bonuses for superior management achievements.[470] In this way, management is compensated according to benefits that accrue directly to equity owners.[471]

d. *Consumers*

Consumers arguably comprise the largest percentage of contractual relationships with the corporate entity and reflect the principal source of profit to the firm.[472] Consumers of corporate products generally contract for the purchase of goods through dealers or other participants in the chain of product distribution.[473] As a result, consumers do not typically contract directly with the corporate manufacturer.[474] The contract which does exist between consumers and manufacturers arises from provisions in the Uniform Commercial Code that impose warranties on contracts for the sale of goods.[475] Although these warranties are subject to

---

[469]*See* Butler & Ribstein, *supra* note 432, at 25.

[470]*See id.* at 26.

[471]Opponents of the contractarian position emphasize studies which indicate that firm performance is not accurately reflected in executive salaries. *See* John C. Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 943-44 (1988) (citing MICHAEL C. JENSEN & KEVIN J. MURPHY, ARE EXECUTIVE COMPENSATION CONTRACTS STRUCTURED PROPERLY? 3-14 (Managerial Economic Research Center, University of Rochester Working Paper, June 1987)). These critics thus minimize, or wholly ignore, a contractual analysis of the role of the management structure in guarding against management misconduct. To these critics, non-director officers are mere pawns of directors and therefore are ineffective to protect shareholder interests. Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1421, 1429, 1430 n.72 (1985).

[472]*See* THE ECONOMIST, GUIDE TO GLOBAL ECONOMIC INDICATORS 42 (1994) (showing that in 1990, the Gross Domestic Product (the leading economic indicator for consumer purchasing power) of the United States was $5.392 trillion).

[473]*See* Bratton, *supra* note 445, at 1488 (discussing briefly the historical origins of the chain of product distribution).

[474]The Uniform Commercial Code addresses, in part, the privity of contract issue in § 2-318. This section only resolves the issue regarding the necessary privity of persons related to the purchaser of the good; however, the issue of privity with the manufacturer through the distribution chain is left to case law. *See* U.C.C. § 2-318 official cmt. 3 (1989).

[475]*See* U.C.C. §§ 2-314 to -315 (1993) (setting forth the implied warrantics of merchantability and fitness for a particular purpose).

modification or elimination in appropriate circumstances,[476] such limitations will be voided if a court finds the limitations to be unconscionable[477] or to fail of their essential purpose.[478] In the situation of insolvency or dissolution of a corporate manufacturer, consumers often find their claims barred either by dissolution statutes of limitation[479] or for lack of standing where the injury is not manifest within the corporate survival interval post-dissolution.[480] The dilemma of late-maturing product defects has thus provided the impetus for dissolution reform because consumers are unprotected by contract once a corporation dissolves or becomes insolvent.[481]

e. *Bondholders*

Bondholders are creditors of the firm who provide financing necessary to the business. They neither vote for the board of directors nor share an equity interest in the firm.[482] Instead, contract law and traditional bond covenants protect bondholder interests.[483] For example, the three basic attributes of bonds — maturity date, interest, and face or par value — are generally set forth in a contract referred to as a "trust

---

[476]*See id.* § 2-316 (setting forth the requirements for the exclusion or modification of warranties).

[477]*See id.* § 2-719(3) ("Consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable. Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable but limitation of damages where the loss is commercial is not.").

[478]*See id.* § 2-719(2) (stating that "[w]here circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act").

[479]*See, e.g.*, 3 MODEL BUSINESS CORP. ACT § 14.07 (1994) (setting forth a five-year statutory bar for claims unknown at the time of dissolution).

[480]*See, e.g.*, DEL. CODE ANN. tit. 8, § 278 (1991) (setting forth a three-year survival period post-dissolution during which claims do not abate against or be abated by the corporation).

[481]Contractual remedies for late-maturing products liability claimants have been proposed by economists and academics. *See, e.g.*, Sarlitto, *supra* note 27 (examining the relationship between successor liability doctrine, legislative reform, and late-maturing products liability claims); Roe, *supra* note 27 (examining the contractual role of successor liability to compensate future unknown claimants to a dissolved corporate manufacturer). *See also* William M. Landes & Richard A. Posner, *Legal Precedent: A Theoretical and Empirical Analysis*, 19 J.L. & ECON. 249, 269-70 (1976) (presenting an economic perspective of the uncertainty inherent in valuing unknown claims).

[482]ROBERT HAMILTON, CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 321-22 (1990).

[483]LARRY RIBSTEIN, BUSINESS ASSOCIATIONS § 11.07 (1990).

indenture."[484] The trust indenture is a standard form contract which contains several covenants to protect bondholder expectations regarding management decision making.[485] The purpose of these covenants is to minimize corporate decisions that tend to transfer wealth from bondholders to stockholders or other creditors.[486] Customary bond covenants include restrictions on future unsecured long-term debt,[487] limitations on the declaration and payment of dividends,[488] and restraints on secured debt (known as a negative pledge clause).[489] Covenants which are uncommon to indenture contracts, but which substantially protect bondholder interests, are constraints on the sale or disposition of assets[490] and restrictions on future investments.[491] In the event of insolvency or dissolution of a corporation, bondholders are considered general unsecured creditors of the firm who take pro rata after claims of secured creditors are satisfied.[492] The contractarian doctrine thus considers bondholder interests to be protected by contract both through express indenture terms regarding rights on default by the debtor firm and by the common law contractual duties of good faith and fair dealing in the performance and execution of those terms.[493]

---

[484]The trust indenture is a contractual relationship between the corporate issuer and a trustee for the benefit of bondholders. *See* ARTHUR S. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 172-75 (5th ed. 1953). The contract sets forth the rights and obligations of the issuer and bondholders and is subject to modification by a majority vote of the bondholders. *Id.*

[485]*See Committee on Developments in Business Financing, ABA Section of Corporation, Banking and Business Law, Model Simplified Indentures*, 38 BUS. LAW. 741-43 (1983).

[486]AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURES 369-70 (1971) [hereinafter COMMENTARIES].

[487]*Id.*

[488]*Id.* at 402.

[489]*Id.* at 350. A negative pledge clause typically limits a company's ability to incur additional mortgage debt. This pledge by the firm assures its unsecured bondholders that no mortgage debt will be created which would obtain priority over the pre-existing unsecured bond obligation. The negative pledge clause, however, only relates to the firm's fixed assets. *See* Stilson, *supra* note 248, at 338-39 & n.34.

[490]COMMENTARIES, *supra* note 489, at 423.

[491]*Id.* at 458. *See* Stilson, *supra* note 248, at 339.

[492]Under federal bankruptcy law, the order of priorities is (1) secured creditors, (2) enumerated priority creditors, (3) unsecured creditors, and (4) equity investors. 11 U.S.C. § 507 (1988). A bondholder whose interest is protected by a mortgage or a lien on specific corporate property would be classified as a secured creditor. Otherwise, the bondholder would be treated as a general unsecured creditor. *See* Stilson, *supra* note 248, at 349-50.

[493]*See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981). *See also* Stilson, *supra* note 248, at 343.

f. *Stockholders*

Stockholders, unlike all the participants to the business discussed above, are investors who provide capital to the corporation in return for an equity position in the firm. These investors, in initial stock offerings, enter contracts whereby the stockholder promises to pay for stock in return for the seller's promise to sell the stock. Under traditional corporate principles, this contract is fully executed upon the receipt of legal consideration for the securities and the delivery of same to the prospective shareholder. Once the purchasing investor becomes an owner of record, she is entitled to all corporate rights accorded by the law of the firm's state of incorporation.

Under a contractarian perspective, the shareholder/corporation relationship is considered contractual in nature as stockholders are entitled to draft mechanisms which will protect against management misconduct.[494] As such, directorial fiduciary duties and remedies for breach of those duties are considered a part of the *contractual* safeguards that shareholders are free to negotiate.[495] Stockholders who purchase their equity interest in the public markets after a waiver of director duties is imposed by first tier investors are protected against managerial abuse by their choice of investing in this, as opposed to another, corporation. The second tier investors also obtain the benefit of lower priced stock where managers are exempt from fiduciary duties.

Although contractarians consider stockholders to be somewhat synonymous with consumers, stockholders remain the risk bearers of the corporate enterprise.[496] Hence, a contractarian analysis ostensibly considers the stockholder/corporation contract to be a promise by the stockholder to pay the specified contract price in return for a promise by the corporation to transfer the owner's name upon the corporate books and to continuously provide the stockholder with all corporate rights which flow from stock ownership.[497] One difficulty of such an analysis is that most investors today do not purchase directly from the corporate issuer. Instead, investors purchase their equity investments on the public markets through underwriters or broker-dealers who often hold the securities in the name of the financial intermediary on behalf of the

---

[494] *See* Butler & Ribstein, *supra* note 432, at 28-32.

[495] *See id.* at 32 (noting that fiduciary duties are fundamentally contractual in nature).

[496] Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U. L. REV. 99, 107 (1989) (stating that "shareholders . . . are the primary risk bearers of the corporation").

[497] *Id.* at 106-08 (explaining contractarian view on the issuance of stock).

customer.[498] In this situation, the corporation has no direct relationship with the stockholder. In fact, the corporation is often unaware of the shareholder's position as a beneficial owner of the company's stock. In this setting, the beneficial stockholder of a publicly-held corporation is not in privity of contract with the issuer and thus is in a situation analogous to a consumer of corporate products. If, however, the stockholder establishes a direct relationship with the issuing corporation by demanding that stock be issued in her name, that stockholder will be paid at dissolution or insolvency only after all other claims are satisfied.

2. A Traditional Corporate Governance Perspective

Under the traditional fiduciary model of corporate governance, directors only owed duties to equity owners.[499] The entity theory of corporate management also recognized the historical concept of the corporation as a concession of the state.[500] Current academic support for the historic model of fiduciary governance is espoused by the traditionalists who consider the modern corporation either not to be a contract at all among the firm's constituents or, at least, to require some *de minimis* governmental regulation in order to protect corporate stockholders from ambitious managers.[501]

Adherence to a traditionalist perspective will require resolution of the concerns introduced in the preceding hypothetical. It will also mandate a reexamination of trust, tort, and contract law theories employed by courts to define the relative rights and liabilities of firm managers. Currently, corporate statutes are inadequate to resolve the issue of contractual modification or elimination of liability for managers of corporations, limited partnerships, and limited liability companies. A *contemporary theory* of business organization must therefore be adopted. The choice is clear — statutory regulation (according to traditionalist theory) or freedom of contract (according to contractarian dogma).

---

[498] *See supra* note 43 for an explanation of the present indirect holding system of corporate securities for publicly-traded corporations. *See also* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1435 (1989) (noting generally that many people hold stocks through third party investors).

[499] *See supra* text accompanying note 9 (discussing briefly the historical development of the corporation and directorial fiduciary duties).

[500] *See supra* text accompanying notes 444-48.

[501] *See supra* text accompanying notes 450-53 (discussing the anti-contractarian theory of corporate governance).

C. *Observations and Commentary on the Conflicting Theoretical Principles of Corporate Governance at Dissolution and Insolvency*

It seems clear that the law of corporate insolvency and dissolution is, at present, director-unfriendly in the sense that corporate management is making decisions during a period of firm distress which may subject the directors to staggering personal liability. This specter of culpability results from ambiguity in the legal definition and consequences of "insolvency" and "dissolution." Present corporate law is vague as to when insolvency occurs, what classes of "claims" or "liabilities" result in insolvency, and whether a fiduciary duty to non-equity constituents is created at the moment of insolvency.

Traditional precepts of corporate governance extend directorial obligations into the post-dissolution winding-up interval. During this period, corporate managers retain possession of firm property. Directors must surmise, however, whether fiduciary duties (as opposed to contractual obligations) are owed to all stakeholders in the firm notwithstanding the nature of the claimants' underlying financial interests. Directors managing a firm in dissolution must also determine which duties gain ascendancy in the event of a conflict in constituent interests. Managers must also foresee *ad hoc* judicial applications of historic equitable doctrines to permit directorial decisions concerning corporate plans for dissolution to be set aside. Moreover, such decisions may result in personal liability. Further uncertainty is created by patchwork judicial interpretations of the internal affairs doctrine.

Generally, stockholders own and indirectly manage the corporation through equity securities of common stock. It is indisputable that direct control of the corporate entity resides in a board of directors.[502] Due to the independence of the corporate enterprise from its owners, corporate law imposes fiduciary obligations upon management to safeguard equity owners from the potential greed and mismanagement of directors. These fiduciary principles arise because the stockholders relinquish direct control over their investment in the corporate entity.[503]

---

[502] *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1991) (providing, in part, that "the business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors).

[503] Partnership law similarly imposes fiduciary obligations on partners who manage partnership property. Whether the fiduciary obligation of general partners presently articulated in case law is a partnership obligation or a contractual duty is somewhat unclear.

In addition to corporate owners and management who supply necessary start-up capital and management expertise for a foundling entity, creditors, employees, lenders, and consumers of the firm are vital to the entity's success. Historically courts regarded consumers as contract creditors and thus persons unprotected by corporate fiduciary obligations. The apparent predicate to this principle is that creditors retain control, directly or indirectly, over the terms of their bargain with a corporation. Stockholders, however, typically abandon their right of control to directors. The general statement of contract versus corporate protection based upon relinquishment of control is not universal.

Present corporate law permits a unity of ownership and management interests in statutory close and membership corporations without a corresponding tail of personal liability.[504] Similarly, closely- and publicly-held corporations may elect to include charter amendments which limit or curtail directorial liability for breaches of fiduciary obligations.[505] Further, modern practices of trading and settling securities transactions in publicly-held corporations create an indirect system of corporate ownership with the consequence that corporate management is not truly acting on behalf of the corporation's owners.[506] Finally, the assumption that contract claimants exercise control in the bargaining process ignores the reality that many suppliers, employees, and consumers are without leverage to bargain on equal terms.

Notwithstanding the contract-corporate composition of a business, corporation law presently allows management to take action that maximizes shareholder interests at the expense of non-constituent interests.[507] At insolvency or dissolution, a conflict between these constituent (equity) and non-constituent (creditor) interests in corporate assets ensues. A clear resolution of the conflict is difficult because both insolvency and dissolution are reversible "events". The directors' dilemma is how to best fulfill their converging corporate and contractual duties. Directorial frustration is exacerbated where the corporate enterprise knows, or has reason to know, of contingent or future unidentifiable claimants.

---

[504] *See, e.g.*, DEL. CODE ANN. tit. 8, § 351 (1991) (providing that "[t]he certificate of incorporation of a close corporation may provide that the business of the corporation shall be managed by the stockholders of the corporation rather than by a board of directors").

[505] *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1993).

[506] *See supra* text accompanying note 503.

[507] The three most common examples of shareholder maximization are dividend payments, investment choices, and the investment of surplus capital. *See* Ileen Malitz, *On Financial Contracting: The Determinants of Bond Covenants*, FIN. MGMT., Summer 1986, at 18.

To date, corporate law has addressed these contrasting expectations through *ad hoc* applications of the equitable trust fund doctrine and through the articulation of a "fiduciary duty" to creditors which trumps that owed to stockholders. Whether this fiduciary duty arises from, and is co-extensive with, the common law contractual duty of good faith and fair dealing *or* whether this duty is an independent corporate fiduciary obligation occurring at dissolution or insolvency is not apparent.

1. A Contract Perspective Regarding the Rights of Creditors to Corporate Assets Upon Firm Distress or Dissolution

Under contract law, every contractual commitment creates an implied duty of good faith and fair dealing in the performance and execution of the parties' agreement.[508] Since the implied duty attaches after contract formation, contract law provides no good faith protection to contract constituents in the bargaining or negotiating process.[509]

In the corporate setting, the contractual duty of good faith inheres in every non-constituent agreement with a corporation. Hence, the duty of good faith attaches to contractual commitments between corporate management and firm suppliers, lenders, consumers, debt holders, employees, and officers. Parties to corporate contracts may well foresee insolvency or dissolution and, therefore, remedies or priorities among claimants are likely terms for negotiation and contract inclusion. Whether the parties to the exchange have equivalent bargaining power regarding insolvency or dissolution protections depends upon the nature of the contractual exchange as well as the relative sophistication of the parties.[510]

The contractarian view of corporate law suggests that the modern publicly-held corporation is but a series of such contracts among the stakeholders of the corporation.[511] Recall that contracting parties are, under contract theorem, competent to contract well, to contract poorly or to not contract at all concerning event risks. As a consequence, contractarians consider corporate fiduciary duties to be redundant in the preservation of stakeholder interests. In the event that stakeholders fail to negotiate a remedy for a disputed performance, contractarians would

---

[508]RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); U.C.C. § 1-203 (1989).

[509]*See, e.g.*, Market St. Assocs., Ltd. Partnership v. Frey, 941 F.2d 588, 593-94 (7th Cir. 1991) (stating that the question of good faith is one of performance and not one of formation).

[510]Certainly contract law presupposes a freedom to contract well, poorly, or not at all. Therefore, to the extent a party considers contract risks to exceed their potential benefits, that party will refrain from a contractual commitment.

[511]*See* Butler & Ribstein, *supra* note 432, at 7.

resolve any contractual impasse within the parameters of the implied contractual duty of good faith and fair dealing. In essence, contractarians reject any argument that a corporate fiduciary duty to creditors or stockholders is either necessary or advantageous given the economics which drive a corporate enterprise.[512]

2. Contract Versus Corporate Duties to Firm Creditors

Notwithstanding the contractarians' disapproval of fiduciary obligations, a contractual duty to creditors appears, on its face, to be co-extensive with the two primary corporate fiduciary obligations, that is, the duties of care and loyalty. If so, continued debate on the source of a creditor duty is moot. If not, further analysis is required. Assuming ambiguity, an examination of the contract-corporate obligations is required.

The traditional duty of care is articulated as an obligation of directors to inform themselves, prior to making a business decision, of material information reasonably available to them which bears upon the matter under consideration to be followed by a management decision which is discharged with requisite care and good faith.[513] The corporate duty of loyalty is articulated as an affirmative obligation by firm management to protect the interests of the corporation and a duty to refrain from conduct that may advantage the directors, either personally or economically, to the detriment of stockholders or the corporate enterprise.[514] Under certain circumstances, the duty of loyalty may include a duty of disclosure by management in good faith.[515]

The contractual duty of good faith seems to provide the analog for the corporate fiduciary obligation of care. For example, a contractual performance executed in good faith comports with the corporate imperative of good faith. Both duties arise subsequent to the formation of the alliance which creates the good faith commitment and each mandates a continued good faith execution of the terms of that relationship. In this sense, stockholders, like suppliers, employees,

---

[512]Economists basically suggest that judicial or regulatory intervention in the private ordering of corporate contracts simply increases agency costs which costs are then transferred to consumers, contract constituents, and stockholders.

[513]Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

[514]Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987).

[515]*See* Hoover Indus. v. Chase, No. 9276, 1988 Del. Ch. LEXIS 98, at *6-7 (Del. Ch. July 13, 1988), *reprinted in* 14 DEL. J. CORP. L. 332, 338 (1989).

lenders, and consumers, freely enter, via contract, into an association which has foreseeable risks and benefits.

Two distinctions between these seemingly parallel duties must, however, be raised. First, the contract which placed equity ownership in stockholders is fully executed upon the settlement of the purchase and sale of the underlying security.[516] As such, any further right which must be performed in good faith by the issuing corporation, its directors, or controlling shareholders in favor of minority stockholders, arises under *corporate* law because of the now existent stockholder-corporate union.[517] Those ensuing rights were not, however, articulated or defined under the original stockholder-corporation *enabling contract*. Non-stockholder contracts, by contrast, arguably delimit the performances which are owed by the contracting parties within the limits of the contractual commitment itself. In addition, non-constituent contracts are often executory for some interval.

Second, the corporate requirement of good faith imposes an obligation that a director inform herself of all material information bearing upon a management decision prior to effecting the requisite good faith investment determination for the firm. By necessity, the corporate duty of information attaches to those continuous management decisions which occur *after a stockholder becomes a record owner* of the issuer's equity securities. Conversely, in contract law, the duty to inform oneself is not a necessary element to a bargained-for contractual *performance* given the likelihood that the parties negotiated contract terms with full or material knowledge of all factors which comprised the contractual duty to be executed. Therefore, it is arguable that the encumbrance of a corporate duty of good faith in favor of creditors provides an additional safeguard of directorial information-gathering after contract formation. Where the corporate-creditor bond arises only upon insolvency or dissolution, however, this additional increment of protection provides no security, or priority, of payment upon distributions of corporate assets. Indeed, the common law duty of absolute priority of creditor interests over those of equity holders affords a fairer guarantee of payment under contractual commitments.

The contractual duty of fair dealing similarly yields an adequate analog to the corporate prohibition on decision making in self-interest. The duty of fair dealing requires some degree of honor and vigilance by the contracting parties in the execution of the terms of the subject

---

[516]U.C.C. § 8-301 (1977).

[517]*Id.*

agreement.[518] Where a party to a contract chooses to deal unfairly or in bad faith vis-à-vis a required performance, the promisee of that performance is entitled to contract relief in the form of damages, specific performance, or other equitable policing techniques.[519] Although the contractual duty of fair dealing may not impose a stringent disclosure mandate upon the parties to the commitment, it provides a similar *remedy* to that of the corporate duty of loyalty.

An argument could be presented that the imposition of a corporate prohibition on self-dealing in favor of creditors provides protections otherwise unavailable under the creditor-corporate contract. Specifically, the respective corporate and contractual duties of loyalty accord protection solely to the contracting parties. The duty arises under corporate law between stockholders and their issuing corporation and under contract law between creditors and the corporate enterprise. If the creation of a corporate duty of loyalty to creditors is interpreted to grant preference to creditor interests over those of stockholders in management decision making, then creditors have indeed acquired an investment maximization which is unwarranted by the allocation of risks evidenced by the creditor-corporation contract.

3. A Contractual Viewpoint of Stockholders and Consumers to Publicly-Held Corporations

Corporate holdings which are not easily compartmentalized within the contractual paradigm are those of consumers and stockholders of publicly-held corporations. Today, sixty to eighty percent of the outstanding stock of all publicly-traded corporations in the United States is held of record by the Depository Trust Corporation (DTC).[520] As such, a vast majority of equity securities in this country are owned of record by one (or a few) institutional investors or by smaller investors who hold their investments through financial intermediaries. The impact of this indirect system of holding, trading, and settling securities transactions and significant stock ownership by a single financial intermediary is the

---

[518]RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); U.C.C. § 1-203 (1989).

[519]*See supra* note 521.

[520]DTC is a limited purpose trust company which is organized pursuant to the laws of the State of New York for the sole purpose of acting as a depository of shares for its clients — some 600 broker-dealers and banks. Of the securities held of record by DTC, one entity, The California Pension Fund, is the single largest shareholder of publicly-traded stock in the United States.

absence of a direct relationship between the "true," or beneficial, owners of stock and the issuing corporation.

From a contract perspective, the contract which established the indirect (or beneficial) ownership of these equity holdings was one negotiated between the purchasing consumer and her broker. The broker thereafter entered into a direct holding relationship with DTC by purchasing, for its client, the requested securities in a contractual transaction with a selling financial intermediary. The entity whose name appears as owner of record of those securities is DTC, not the selling financial intermediary, the purchasing broker, or the ultimate buyer whose acquisition interest in the securities generated the trade. What necessarily results is a tripartite agreement: a commitment between the purchasing client and her broker and a commitment between the broker and the selling financial intermediary. The initial client-broker contract is likely to be established on the broker's terms as reflected in the broker's form contract. To the extent the broker fails to perform the contract, principles of contract law will permit the purchasing client to challenge any unfairness in the form contract.[521] If the financial intermediary fails to perform the requested trade, the broker has a similar contract remedy for non-performance. The obvious difference between the client-broker and broker-financial intermediary contracts is the level of bargaining power and expertise of the parties to the commitments. Like the purchasing consumer, however, the acquiring broker may invoke equitable policing arguments against a non- or mis-performing financial intermediary.[522]

Because stock ownership in this country no longer resembles the direct purchase transactions of the late nineteenth and early twentieth centuries, stockholders, like other non-equity constituents, are without corporate fiduciary security. In this sense, it seems illogical to grant a corporate duty to creditors (whose investment interests are solely contractual) where beneficial owners of stock are left only with contract remedies for breach of their equity investment expectations.[523]

---

[521]U.C.C. § 2-302 (1989). Contract law permits the policing of contractual commitments on the basis of lack of bargaining power in adhesion contracts as well as fundamental precepts of unconscionability. E. ALLAN FARNSWORTH, CONTRACTS § 4.26 (2d ed. 1990).

[522]Of course, in addition to contract protections, consumers, broker-dealers, and financial intermediaries have alternative methods of recovery for non- or mis-feasance by the other party to a securities contract. Those alternatives primarily lie in federal securities regulation — most prominently the trading regulations of the 1934 Securities Exchange Act.

[523]Of course, federal securities laws provide safeguards to stockholders and debt owners which are unavailable to other contract constituents where those constituents cannot characterize their relationship with a corporate entity as an "investment contract." *See* SEC v. Howey, 328 U.S. 293, 298 (1946) (defining an "investment contract" as a contract, transaction, or scheme

The other corporate constituent which is not easily compartmentalized within the contractual paradigm is that of consumers. Consumers, like stockholders, often purchase corporate "goods" through market intermediaries. Where the goods are sold by merchants and a consumer is ultimately injured by the goods or the goods fail to perform as implicitly guaranteed, warranty claims generally provide redress for the aggrieved buyer.[524] Actions against the manufacturer of the goods are also available despite the absence of privity between the consumer and the manufacturer.[525]

The contractual relationship, whether direct or implied, between these parties fails to provide relief for consumers who are injured by defective products placed in the market by a now defunct manufacturer. If the selling merchant is without fault in the ensuing consumer injury, recourse is typically denied against defunct corporate manufacturers. Imposition of a corporate fiduciary duty to these claimants is unavailing in the absence of legislative directives which create present rights in future unknown tort victims.[526] Finally, the sole difference between consumers of goods and consumers of stock in publicly-held corporations lies in the temporal relationship of the consumer vis-à-vis the corporate enterprise.

D. *The Resolution*

It is suggested that states must make a reasoned choice between the two opposing theories of corporate governance. Due to the development of the modern, indirect holding system for securities, a contractual perspective of the corporation more accurately reflects reality. The obvious impact of a contractarian regime on the duty to creditors is that such an obligation would be modifiable by negotiation and enforceable by contract. The issues concerning the parameters of provisions analogous to section 102(b)(7) and the respective 1101 sections would, therefore, be mooted. Likewise, obligations of disclosure, trust duties, and tort and contract responsibilities — articulated in several recent Delaware decisions — would be regulated under the general rubric of

---

which induces a person to (1) invest money, (2) in a common enterprise, (3) with the expectation of receiving profits therefrom, (4) which are to come solely from the efforts of others).

[524]*See* U.C.C. § 2-314 (1993) (granting an implied warranty of merchantability in all contracts for the sale of goods). *But see id.* § 2-316 (permitting the limitation or modification of warranties).

[525]U.C.C. § 2-318 (1989).

[526]Whether present dissolution reform necessarily resolves the dilemma of future unknown claimants is addressed *supra* text accompanying notes 154-93.

contract amendment. *Ad hoc*, uneconomic applications of the trust fund doctrine would also cease. Finally, the abuses of fraud, overreaching, duress, and unconscionability in corporate/consumer contracts would remain under the aegis of contract theorem.

Alternatively, if adherence to traditionalist theory is anticipated, then the corporate duty to creditors must be forsaken for the contract obligations of good faith and fair dealing. The equitable trust fund doctrine must also be rejected as anachronistic. Such a resolution serves five purposes. First, it permits market negotiation between issuers and creditors to the firm without the implicit creation of a corporate windfall to creditors at dissolution or insolvency. Second, it licenses contractual moderation of liability tailored to the needs of the contracting parties that is enforced and policed by contract theorem. Third, it obviates the ambiguity of present dissolution statutes as well as the cases interpreting "corporate insolvency." Fourth, it creates economic savings through predictability in the dissolution process. Fifth, it retains the cardinal corporate principle that directors, not creditors, manage corporate assets. To achieve the clarity and predictability of these goals, however, equitable doctrines such as the trust fund theory must be permitted an honorable demise.

V. CONCLUSION

Presently directors are rendering decisions during corporate demise that affect claimants throughout the country and which subject management to astounding personal liability. Former statutory dissolution law was inadequate to guide directors through the intervals preceding and following a corporation's death. Consequently, states either amended their dissolution legislation to address this inadequacy or created judicial doctrines to resolve competing claims to corporate assets at dissolution or insolvency.

Unfortunately, current statutory reform, in particular Delaware's sections 280 through 282, contains significant obstacles to efficient and predictable corporate terminations. In order to instill greater predictability into the statutes and thus incentive for directorial use, four refinements are necessary: (1) clear legislative direction that statistically possible claims of whatever maturity are not "claims or obligations" in an insolvency sense but present only a class of claimants for whom notice and representation is required for purposes of posting future security for compensation; (2) an independent claims assertion date that would be judicially imposed subsequent to notice to and hearing for interested parties; (3) a scheme of priority among classes of claimants which

abandons rote application of temporal parity for all claimants to corporate assets; and (4) clarification that sections 280 through 282 constitute summary dissolution actions such that issues tangential to a dissolution would be stringently narrowed to those involving sufficiency of security.

In addition, the corporate duty to creditors should be rejected as anachronistic to our law. Creditor protection should thereafter revert to the realm of contractual duties and obligations as well as commercial security devices.

Finally, judicial re-examination of the traditional fiduciary paradigm is necessary to align twentieth century developments in corporate equity ownership with historic concepts of corporate fiduciary duties. In particular, the contractarian model of corporate governance should be embraced as that which most closely aligns with the manner in which corporate enterprises conduct business. Due to the regulatory vestiges of traditional corporate law, however, a fiduciary duty to stockholders alone should be retained throughout the viability and death of the corporate persona. To the extent a contractarian perspective would permit contractual elimination of fiduciary duties, such perspective is recommended as both economically efficient and reflective of present equity holdings in this country. Such a theoretical decision on corporate governance, is, however, one which must be *decided* by the corporate bench and bar and *not left to deduction* on an *ad hoc* basis.