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ARTICLE

THE TECHNOLOGY OF CREDITOR PROTECTION

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Contract is the primary means through which creditors control a firm's debt–equity conflict. There is an irony here, however. Actions that may render a debtor insolvent are the events against which creditors contract. Yet when a breach of contract yields a debtor's insolvency, the debtor cannot fully satisfy its creditors. Thus, a general creditor's contractual remedy against a debtor cannot be fully effective, and anticipation of this shortcoming may increase a debtor's cost of capital. A solution to this conundrum, proposed here, would permit creditors and debtors to contract for creditor remedies against third parties—other creditors, shareholders, and corporate affiliates—who may have benefitted from a debtor's breach, provided that the creditor gave actual or constructive notice of its right to seek such remedies. This solution would offer creditors protection akin to that now

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afforded contractually through secured credit and now afforded by legal rule through the laws of voidable preference and fraudulent conveyance. Because the proposed protection would be contractually based, it could be tailored to the needs of individual firms and could thus improve, and to some extent obviate the need for, the protections now provided by law.

INTRODUCTION

Almost four decades ago, Michael Jensen and William Meckling wrote *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, which sets out to combine "elements from the theory of agency, the theory of property rights and the theory of finance to develop a theory of the ownership structure of the firm."[1] They focused on dueling conflicts among a firm's constituents: on the one hand, conflict between a firm's investors and its managers; and on the other, conflict between a firm's debtholders and its shareholders. Debt itself serves as a tool to control the investor–manager conflict but also generates a new conflict, between shareholders and creditors. Whenever ownership and control are separated, agency costs cannot be wholly eliminated, but they can be minimized. Since the publication of

[1] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305 (1976).

Jensen and Meckling's seminal article, there has been an evolution in the theory of how to accomplish such minimization.

As one of us has argued in earlier work,[2] the agency costs between a firm's shareholders and its managers have recently declined. Reasons for the decline include the greater use of incentive compensation, the growth and increased activism of institutional shareholders, the rise of hedge funds, regulatory changes, and the increased independence of outside directors.[3] Where debt persists despite the reduction in equity agency costs, such reduction increases the relative importance of the relationship between a firm's creditors and its managers, a relationship that encompasses the conflict between a firm's creditors and its shareholders to the extent that managers represent shareholders.[4]

As we discuss below, financial creditors rely principally on contracts to protect their interests, though legally supplied rights offer some additional protections. We generally favor this reliance on contractual rights and, with one important exception, we are skeptical about the need and desirability of additional legal protections for financial creditors. The exception, and this Article's central theme, is this: where a creditor *does* achieve contractual protection against exploitation, the terms of such protection should, subject to some limits, be enforceable against third parties.

By endorsing contractual remedies that run against third parties—those who are not parties to the contract at issue—our proposal is conceptually related to the literature on property rights.[5] Like the remedies we are

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2 *See* Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1051 (2010) (tracing the reduction of shareholder–manager agency costs as power "has shifted notably in the last decade away from CEOs towards outside directors and shareholders").

3 *See id.* at 995-1037; *see also* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1029-42 (2007) (discussing hedge fund activism); Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 896-97 (2002) (discussing the rise of incentive compensation and independent directors as adaptive responses to Delaware hostile takeover law).

4 *See* Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1928 (2013) ("[I]ncreasing the alignment of managers and shareholders can have a significant effect on bondholders.").

5 *See, e.g.*, Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The* Numerus Clausus *Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. S373, S378 (2002) ("[T]he attribute that distinguishes a property right from a contract right is that a property right is enforceable, not just against the original grantor of the right, but also against other persons . . . ."); Michael A. Heller, *The Boundaries of Private Property*, 108 YALE L.J. 1163, 1178 n.73 (1999) (discussing whether a trust grants a property or contract right); Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The* Numerus Clausus *Principle*, 110 YALE L.J. 1, 3 (2000) (distinguishing property and contract rights).

proposing, property rights do not require the assent of all those against whom such rights are asserted.

The legal reform recommended here expands and elaborates on a suggestion made by one of us that a firm's public pledge to abjure debt should be enforceable against subsequent creditors that obtain an interest in violation of such pledge.[6] In this Article, we apply the intuition behind this proposal to a wider set of contractual terms; we also root the proposal in a more general theory of contract and property rights and integrate it into a theory of agency cost and firm ownership.

I. TYPOLOGY OF CREDITOR PROTECTION

In examining the regime of creditor protection, one can distinguish types of creditor protection along two dimensions. The first dimension relates to the person in whom incentives are imbued or against whom remedies are imposed. The second dimension relates to the source and scope of these incentives and remedies.

Regarding the person, most basically, it is the debtor that can be motivated or obligated to perform. When a debtor incurs an obligation, it has reputational and other incentives to fulfill that obligation. And if these incentives are insufficient, the debtor's legal obligation means that a creditor may enforce compliance to the extent the debtor is able to comply. These incentives do not always ensure that a debtor will perform on all of its promises. For example, the Argentine Republic has refused to pay some of its sovereign debt obligations while it continues to pay others. Its incentive to repay proved insufficient and, against sovereign debtors, a party's means of enforcement are limited.[7] Nevertheless, a creditor's reliance on performance by or recovery from a debtor is central to creditor protection.

In addition to the debtor itself, incentives can be instilled in—or remedies imposed on—a number of other persons: subsidiaries of the debtor, shareholders of the debtor as well as entities owned by these shareholders, directors and officers of the debtor, and certain other creditors of the

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6 *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993) [hereinafter Adler, *Financial and Political Theories*]; *see also* Barry E. Adler, *Secured Credit Contracts* [hereinafter Adler, *Secured Credit*] (describing potential efficiency benefits of negative pledges), *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 405, 408 (Peter Newman ed., 1998); Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property and Perfection*, 84 CORNELL L. REV. 305, 347 (1999) (seeking "to strengthen negative pledge covenants by making them enforceable against subsequent secured creditors").

7 *See Argentina's Debt Default: Gauchos and Gadflies*, ECONOMIST, Oct. 22, 2011, at 91 (reviewing creditors' difficulties collecting on Argentinian debt).

debtor.[8] These other persons can be influenced in their individual capacities, and not just as persons that have an interest in or control over the debtor. Examples of devices bearing on these other persons are parent and subsidiary guarantees, which make the guarantor liable for the debt of the principal obligor; the doctrine of veil piercing, which can make a shareholder liable for the debts of a company she controls; and the bankruptcy provisions governing preferences and equitable subordination, which provide for the return of certain payments made to creditors and the subordination of certain debts, respectively, in each case for the benefit of other creditors. These devices can serve a creditor's interest by helping deter a breach of contract in the first place (such as where a guarantor in control of a debtor induces the debtor to repay rather than default on a loan) or by compensating a creditor after a breach (such as where the guarantor pays after a debtor's default).

The second dimension of creditor protection, regarding the source and scope of incentives and remedies, can be provided through two mechanisms: legal rules and contracts with creditors. Legal rules that provide incentives and remedies include, in addition to those mentioned above, rules on fraudulent conveyance law and lender liability as well as legal capital rules and fiduciary duties to creditors. Contractually supplied incentives and remedies include, among other provisions typically found in debt agreements, provisions on maturity and default interest, financial ratio covenants, restrictions on the issuance of additional or secured debt, restrictions on the payment of dividends, change of control provisions, and agreements to subordinate some debts to other debts.[9]

It is worth noting that these creditor-protection incentives and remedies operate against a background of other fundamental structures. Of these, first and foremost is the shareholders' economic interest in the firm. Such interest engenders in the shareholders an incentive to create firm value and to provide corresponding incentives for officers and directors to create such value. Although the interests of shareholders and those of creditors sometimes conflict, and while such conflict is the subject of our discussion below, it is

8 This list is not exhaustive. Any purchaser from a debtor might be influenced, for example, by potential liability under fraudulent conveyance laws, discussed *infra* Section III.B. We limit our discussion, though, to the individuals and entities we perceive as the most relevant to our analysis.

9 For an overview of contractual provisions found in public debt and private placements, see, for example, Marcel Kahan & Bruce Tuckman, *Private Versus Public Lending: Evidence from Covenants*, *in* THE YEARBOOK OF FIXED INCOME INVESTING 1995, at 253, 253-74 (John D. Finnerty & Martin S. Fridson eds., 1995). For sample covenants in debt contracts, see Comm. on Trust Indentures & Indenture Trs., ABA Section of Business Law, *Model Negotiated Covenants and Related Definitions*, 61 BUS. LAW. 1439, 1500-35 (2006).

important not to forget that shareholder and creditor interests are broadly aligned with respect to a wide set of decisions: both shareholders and creditors want the company to be well run and profitable.

In the United States, contractual provisions are the most significant component of the creditor-protection regime. These are supplemented by the legal rules identified above and, in some cases, described more fully below.

II. The Promise and Limits of Contractual Creditor Protection

In our view, it is sensible that creditors in the United States rely on contracts instead of legal rules for protection. Contractual protections have some general advantages over legal rules. Contracts afford the parties the ability to determine for themselves the terms that will govern their relationship and enable different debtors and different creditors to agree on different terms. Moreover, contracts can be changed more easily than laws as circumstances change. This is especially true for contracts with finite duration, such as contracts with creditors. Even if these contracts cannot be easily amended, they expire at some point, and debtors and creditors enter into new contracts to govern their relationship.[10]

These arguments are especially forceful in the context of the relationship between a company and its financial creditors. Financial creditors include mostly banks, private-placement lenders, and bondholders. These creditors are predominantly financial institutions in the business of lending money or holding debt securities.[11] They tend to be large, sophisticated, and repeat players. Loan agreements between firms and financial creditors are often lengthy and contain detailed provisions designed to protect the interests of creditors.[12] In short, financial creditors are the kinds of parties that can easily look out for their own interests.[13]

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[10] As Mike Klausner and one of us have noted elsewhere, legal rules may generate network externalities. *See* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 725-27 (1997). But boilerplate contract terms generate similar externalities; in any case, network externalities generally do not justify mandatory legal rules. *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 834-37 (1995) ("The presence of network externalities offers a slim basis for the use of mandatory rules in corporate law.").

[11] *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS THIRD QUARTER 2012, at 100 tbl.L.212 (2012), *available at* http://www.federalreserve.gov/releases/z1/20121206/z1.pdf (showing holdings of corporate and foreign bonds by type of holder).

[12] Although we use the term "loan agreements" generically, contracts between debtors and banks are usually called *credit agreements*; contracts related to publicly issued corporate bonds are

Of course, not all creditors of a company fall into this category. Some creditors are involuntary and thus have no ability to protect themselves by contract. Others are small, unsophisticated, or short-term creditors for which negotiating detailed protections may make little sense. We discuss in Section IV.C how these groups of creditors could be handled. At this point, though, it is sufficient to say that these groups generally do not account for the bulk of corporate liabilities.[14]

Even for financial creditors, the benefits of contractual protections are limited. Such protections may not generate significant incentives for—and do not necessarily impose liability on—persons other than the debtor. Under current law these other persons typically are not liable unless they are parties to the contract. This privity, of course, is not uncommon. In particular, we observe contractual guarantees by corporate affiliates of a debtor—such as a parent or subsidiary—for the debtor's obligations. We also observe contractual subordination provisions where one set of creditors agrees to have its claims subordinated to those of another set of creditors,[15] and we observe intercreditor agreements among secured creditors. But while it may often be feasible to bind existing affiliates and creditors through such contracts, it is much harder to bind *future* ones.[16]

This limitation matters. Monetary contractual liability is only as good as the breaching party's ability to pay. Whenever one enters into a contract with another party, it is possible that the other party will *both* breach the contract *and* become insolvent and thus will not be able to pay damages. For most contracts, breach and inability to pay are distinct events that may be unrelated. Take, for example, a contract for the sale of goods: the seller may fail to deliver the goods as promised, and thus breach the contract, but be able to pay damages. Of course, it is also possible that the supplier both breaches the contract and is insolvent. However, unless the contract constitutes a large part of the supplier's business, these two contingencies may not be closely connected. By contrast, it is in the nature of a loan covenant that

typically called *indentures*; and contracts governing privately placed debt are generally called *note purchase agreements*.

13 *See generally* Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565 (1995).

14 *See* BD. OF GOVERNORS, *supra* note 11, at 70 tbl.L.102 (showing that credit market instruments account for about 60% of total liabilities; foreign direct investment in United States for about 17%; trade debt for about 14%; and taxes and pension obligations for less than 1% each).

15 The senior creditors are generally third-party beneficiaries to the subordination contract.

16 To be sure, loan agreements often obligate the debtor to, inter alia, obtain guarantees from future subsidiaries. But until such guarantees are executed, future subsidiaries are not contractually liable.

there is typically a tight relationship between breach of a loan agreement and a debtor's insolvency.

Unlike a run-of-the-mill contractual obligor, which may breach inadvertently or because it is efficient to do so and then pay damages in full, the typical debtor that breaches—that is, fails to pay—does so simply because it lacks the resources to perform. Put simply, when the obligation is the payment of cash, a merely inadvertent breach can be corrected by payment, and the notion of efficient breach is generally inapposite. Breach of a money obligation typically implies a lack of cash, which impairs any nominal damages remedy.

To address the inadequacy of damages, loan agreements often include additional provisions—so-called covenants—that are designed either to deter the debtor from taking actions that increase the risk of default or to provide an early warning signal to creditors of an incipient insolvency so that they may seek repayment while the company is still (if only barely) solvent. Such covenants include, among others, limitations on the company's indebtedness, restrictions on dividends and share repurchases, restrictions on the incurrence of debt or of secured debt, requirements that asset sale proceeds be used to repay debt, and net worth requirements.[17] Violation of these covenants generally triggers a right of creditors to accelerate, that is, to seek immediate repayment of the amount owed to them.[18]

This structure poses a peculiar problem for financial creditors. If, as a result of a covenant violation (or after the violation and prior to the enforcement of any acceleration), the company has already become insolvent, the acceleration remedy may not be fully effective. Covenants, therefore, must be set more tightly and must be monitored more intensely than would be necessary were creditors to have an effective remedy for breach regardless of solvency. And sometimes even tighter triggers and extensive monitoring will be insufficient to provide a pre-insolvency remedy. The costs of tighter covenants, increased monitoring, and the residual risk of nonrepayment are ultimately borne by debtors, whether in the form of reduced flexibility, increased risk of acceleration, higher interest rates, or reduced availability of credit.

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17 *See, e.g.*, Kahan & Tuckman, *supra* note 9, at 253-74 (presenting an overview of covenants in public and private debt).

18 *See, e.g.*, Ad Hoc Comm. for Revision of the 1983 Model Simplified Indenture et al., Am. Bar Ass'n, *Revised Model Simplified Indenture*, 55 BUS. LAW. 1115, 1136-37 (2000) (providing for the acceleration remedy). Bondholders also have other remedies. *See id.* at 1137 (providing for the pursuit of "any available remedy"). But damage remedies are rarely pursued because it is difficult to prove and quantify damages from a covenant violation.

The link between debtor breach and insolvency, together with the difficulty of contracting with persons other than the debtor, suggest there could be benefits from a legal rule that permitted a debtor and its creditors to create contract obligations enforceable against third parties. The obligations we have in mind could be imposed on third parties who engaged in or benefitted from violations of a loan agreement. In Part IV, we discuss such a rule in greater detail. But next we discuss more fully the rationales for remedies against third parties, and we address, but largely reject, other additional remedies imposed by law and not by contract.

III. Remedies Against Third Parties

In principle, the argument for remedies against a non (third) party to a contract can be based on one of two rationales. The first rationale, the control rationale, is that the third party (or the third party's agent) has some control over whether certain actions take place and that imposing liability will improve the third party's (or its agent's) incentives with respect to such actions. In addition to the guarantor illustration provided above, a classic example is the securities laws' imposition of liability on underwriters for false statements made by the company in a registration statement. The second rationale, the improper benefit rationale, is that the third party derived some undue benefit from an action at the expense of others. The undue benefit rationale is, in part, merely an ex post aspect of the control rationale, relevant when an illicit action occurs despite the disincentive created by the remedy. There is more to the rationale, however. A third party may receive an undue benefit as a result of an action over which it has no control. As an example, consider a sole shareholder who causes an insolvent company to make a gift to his children. Such a gift could be recovered by the company as a fraudulent conveyance regardless of whether the children were in any way at fault.

To the extent that it is desirable to impose remedies against third parties to a credit contract, how should such remedies be designed? As we discussed in Part I, remedies running against third parties could be imposed on directors or officers, on shareholders (controlling or other), or on other creditors. As we explain below, we do not believe that the expansion of remedies against directors and officers would provide a net benefit, though we would have no objection to such remedies if rooted in contract. As we also explain, we find current legal remedies against shareholders and creditors adequate but favor laws that would permit a contractual expansion (and, for that matter, contraction) of such remedies.

A. *Remedies Against Directors and Officers*

Remedies against directors as third parties could, in principle, fit primarily under the control rationale, though a remedy to address self-dealing would come under the improper benefit rationale as well. Directors have the right to manage the affairs of the corporation. As such, they have significant control over corporate actions.

The problem with director liability to creditors, however, is that such liability would be unlikely to improve directors' overall incentives. In publicly held companies with dispersed shareholdings, directors may derive only small personal benefits from most managerial decisions, including decisions that benefit shareholders at the expense of creditors. The prospect of personal liability to creditors for such decisions would thus act as a perhaps excessively strong deterrent. Similar reasons caution against imposing liability on officers.

To elaborate, when the law is clear and penalizes directors only for actions that reduce overall firm value, strong deterrence is desirable, but problems arise if the law is overbroad, unpredictable, or ambiguous. In those cases, the prospect of personal liability would tend to make directors excessively cautious. Why, after all, should directors risk the chance, however small, of personal liability to creditors by, for example, delaying a bankruptcy filing, declaring a dividend, or approving a leveraged buyout? Such excessive caution could result in two types of costs. First, directors could induce companies to expend excessive corporate resources on professional advice. Such advice would include legal opinions on the directors' obligations as well as expert financial or accounting advice, such as solvency and fairness opinions. Second, directors could become highly conservative and refuse to take actions that would increase overall firm value unless, given the advice obtained, it were clear that they faced little or no risk of personal liability.[19]

Importantly, the imposition of liability to creditors for excessive risk-taking would skew incentives if, as under current law, directors faced no equivalent risk of personal liability to shareholders for excessive caution. Several features of corporate law now insulate directors from liability to shareholders if they run corporations conservatively. First, under the business judgment rule, a court will not second-guess a board judgment if the board was informed, independent, disinterested, and acted in good faith.[20] In Delaware, the most important jurisdiction for publicly traded

19 *See generally* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992) (collecting early sources).

20 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

companies,[21] provisions such as sections 141(e)[22] and 172[23] of the General Corporation Law protect directors if they rely in good faith on the records of the corporation or on reports prepared by officers and other professionals. Moreover, section 102(b)(7) permits companies to eliminate personal liability of directors unless they derive an improper personal benefit, breach their fiduciary duty of loyalty, or act in bad faith,[24] an option exercised by almost every publicly traded Delaware company.[25] Finally, directors have great leeway to have the corporation obtain professional advice. Consequently, if faced with broad liability to creditors, directors would have both the incentives and the ability to run the firm in an excessively cautious manner, and thereby minimize the threat of personal liability, whether to creditors or shareholders. And, as far as we know, no one has proposed that such incentive be addressed through the punishment of caution, which could create its own perverse incentives.[26]

Consistent with this normative analysis, legal rights against directors are not a significant component of the creditor protection regime in the United States. Two doctrinal strands in Delaware's corporation law address creditor protection: fiduciary duty law and statutory provisions on capital. But as we next explain, these doctrines afford limited substantive protection and impose no material risk of monetary liability unless the directors misbehave egregiously.

Regarding the first sort of legally imposed creditor protection, under Delaware law, directors owe a notional fiduciary duty to creditors if the corporation is insolvent.[27] Practically, however, this merely means that

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21 For data that describe the predominance of Delaware incorporations, see, for example, Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1571 (2002). Although our discussion in this Part focuses on Delaware law, the general principles we describe are common to other jurisdictions.

22 DEL. CODE ANN. tit. 8, § 141(e) (2011).

23 *Id.* § 172.

24 *Id.* § 102(b)(7).

25 *See* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990) (noting that over 90% of Delaware companies adopted a provision limiting liability within one year after the statute permitting such provisions was enacted).

26 One might imagine a restoration of balance if, along with the broad imposition of liability to creditors for excessive risk, the law imposed on directors liability to shareholders for excessive caution. But the likely result would be directors paralyzed by fear of action or inaction, and a reluctance to serve at all.

27 *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007); Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992) ("[W]hen the insolvency exception [to the general rule that directors do not owe creditors duties beyond the relevant contractual terms] does arise, it creates fiduciary duties for directors for the benefit of creditors."). The Delaware Supreme Court has recently clarified that these duties arise only upon insolvency, and not earlier when the corporation enters a zone of insolvency. *Gheewalla*, 930 A.2d at 101. In an

creditors obtain standing to assert breaches of fiduciary duties in a derivative action.[28] Directors of insolvent corporations enjoy the protections of the business judgment rule and of any exculpatory provisions under section 102(b)(7) to the same extent as directors of solvent corporations in a shareholder derivative action.[29] Thus, directors are largely insulated from the threat of personal liability unless they self-deal or intentionally violate their duties, and a claim that directors chose an unduly risky course for the benefit of shareholders would not likely cross this line.[30] Importantly,

earlier case, the Delaware Chancery Court had suggested that even in the zone of insolvency, a board may take actions that benefit creditors at the expense of shareholders. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commcn's Corp., Civ. A. No. 12150, 1991 WL 277613, at *1155-57 (Del. Ch. Dec. 30, 1991) ("[W]here a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.").

28 *See Gheewalla*, 930 A.2d at 101-02; Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 792 (Del. Ch. 2004) ("[W]hen a director of an insolvent corporation, through a breach of fiduciary duty, injures the firm itself, the claim against the director is still one belonging to the corporation."), *overruled in part by Gheewalla*, 930 A.2d 92. Thus, creditors can, for instance, pursue a claim based on self-dealing in breach of a duty of loyalty. *See, e.g.*, Shandler v. DLJ Merch. Banking, Inc., C.A. No. 4797-VCS, 2010 Del. Ch. LEXIS 154, at *41-42 (Del. Ch. July 26, 2010).

29 *See Shandler*, 2010 Del. Ch. LEXIS 154, at *56; *Prod. Res.*, 863 A.2d at 792, 794 ("The kind of claims that an insolvent firm could press against its directors would, one would think, be at most coextensive with, and certainly not superior to, the claims that a solvent firm itself could bring against its directors.").

30 The duties that directors of an insolvent firm owe to creditors may resemble the duties that directors of any corporation owe to preferred shareholders. While preferred shareholders have standing to assert derivatively rights shared equally with common shareholders, they generally cannot challenge a board's decision to further the interests of common shareholders at the expense of preferred shareholders. *See* HB Korenvaes Invs., L.P. v. Marriott Corp., Civ. A. No. 12922, 1993 WL 257422, at *772 (Del. Ch. July 1, 1993); Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 593-95 (Del. Ch. 1986); *see generally* RGC Int'l Investors, LDC v. Greka Energy Corp., C.A. No. 17674, 2000 Del. Ch. LEXIS 157, at *54 (Del. Ch. Nov. 6, 2000) ("[D]irectors do not owe preferred stockholders the broad fiduciary duties belonging to common stockholders.").

Thus, in *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997), the court found that a company unable to satisfy its liquidation preferences did not violate its duty to preferred shareholders when, rather than liquidate, it raised additional debt that gave it more time to continue development of promising technologies with an upside potential gain that would accrue to the common shareholders. *Id.* at 1041, 1053. The court concluded that the board did not violate its fiduciary duties by acting in this manner to advance the interest of the common shareholders at the expense of the preferred shareholders. *Id.* at 1058-59; *see also* Quadrangle Offshore (Cayman) LLC v. Kenetech Corp., C.A. No. 16362, 1999 Del Ch. LEXIS 213, at *24 (Del. Ch. Oct. 13, 1999) (finding that a board's action to retain value for common shareholders by persuading noteholders not to place company in bankruptcy and thereby trigger liquidation preference of preferred shareholders was not a breach of duty), *aff'd*, 751 A.2d 878 (Del. 2000). Under Delaware law, we do not believe creditors in a case such as *Equity-Linked Investors* would have greater rights than those afforded to preferred shareholders. By the same token, we also do not believe that the directors in that case would have faced liability if the board had decided to liquidate rather than raise debt and buy additional time. *See infra* text accompanying note 32.

creditors may not press any direct claims against directors (based on a theory that a board decision harmed some or all creditors directly, as opposed to a board decision that harmed the corporation, and harmed creditors only indirectly).[31] Fiduciary duties to creditors thus are principally a shield to insulate directors from shareholder claims that the board subordinated shareholder interests to those of creditors; such duties are less a sword held by creditors who want to force the board to take actions that benefit creditors at the shareholders' expense.[32]

The second strand of legally imposed creditor protection is based on legal capital rules that restrict dividends and share repurchases. Under these rules, a corporation may pay dividends only out of surplus—defined under Delaware law as total assets less total liabilities less legal capital[33]—or out of the net profits of the current or the preceding fiscal year.[34] Similar restrictions apply to share repurchases.[35] Directors are personally liable for negligent or willful violations of these rules.[36] That said, although violations of these provisions are neither protected by the business judgment rule nor exculpated by section 102(b)(7), as a source of director liability, they lack bite. The limit on dividends and share repurchases is extremely lax and significantly less restrictive than limitations commonly found in loan agreements.[37] Moreover, directors face no prospect of liability as long as they rely in good faith upon the records of the corporation, upon any information or reports of its employees, or upon the advice of professionals.[38] The combination of the lax substantive standard and this safe harbor means that

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31 *See Gheewalla*, 930 A.2d at 103 ("Accordingly, we hold that individual *creditors* of an *insolvent* corporation have *no right to assert direct* claims for breach of fiduciary duty against corporate directors.").

32 *See Prod. Res.*, 863 A.2d at 788 (discussing *Credit Lyonnais*); *see also* Blackmore Partners, L.P. v. Link Energy LLC, C.A. No. 454-N, 2005 Del. Ch. LEXIS 155, at *23 (Del. Ch. Oct. 14, 2005) (granting motion for summary judgment because company was insolvent and board was permitted "to take into account the interests of creditors at the apparent expense of stockholders").

33 DEL. CODE ANN. tit. 8, § 154 (2011).

34 *Id.* § 170.

35 *Id.* § 160(a).

36 *Id.* § 174.

37 *See* Kahan & Tuckman, *supra* note 9, at 260 (showing that dividend covenants typically limit dividends to a fraction of earnings and require retention of the initial reservoir). Moreover, under legal capital requirements, companies are permitted to revalue assets to their current market value in determining the amount available for these payments, see *Klang v. Smith's Food & Drug Centers, Inc.*, 702 A.2d 150, 154-55 (Del. 1997) (en banc), whereas loan agreements require that earnings be calculated based on generally accepted accounting practices or accounting rules specifically set forth in the agreement.

38 Tit. 8, § 172.

the legal capital rules pose no significant liability risk for directors interested in serving shareholders even at the expense of creditors.[39]

Delaware law, including the provision of potential liability to creditors, thus imposes little risk of personal liability unless directors personally benefit from wrongdoing.[40] As suggested above, the reluctance of Delaware's corporate law to impose liability on directors is an essential complement to their functional role.[41] Most directors of publicly traded corporations are not full-time employees, must rely on information provided to them by insiders, and own a relatively small equity stake. Even directors who are executives of the company, and are thus better informed with, perhaps, a larger equity share,

[39] It is possible that the legal capital rules in some states have a more significant impact on directors than those in Delaware. *See* Sattar A. Mansi et al., *Creditor Protection Laws and the Cost of Debt*, 52 J.L. & ECON. 701, 705, 713 (2009) (finding that non-Delaware firms from states with stricter legal capital rules have better credit ratings and significantly lower yield spreads than Delaware firms).

[40] Creditor rights against directors appear to be greater under the law of some jurisdictions outside the United States. Under English law, for example, a director faces liability if she "knew or ought to have concluded that there was no reasonable prospect that [her] company would avoid going into insolvent liquidation" unless, from that point on, she "took every step with a view to minimising the potential loss to the company's creditors." Insolvency Act, 1986, c. 45, § 214 (U.K.). Similarly, under German law, the members of the management board (Vorstand) of a Stock Corporation are subject to liability if they do not file for bankruptcy once the company has become over-indebted (liabilities exceed assets) or unable to pay its debts. *See* Insolvenzordnung [InsO] [German Insolvency Act], Oct. 5, 1994, BUNDESGESETZBLATT, TEIL I [BGBL. I] at 2866, last amended by Gesetz [G], Dec. 20, 2011, BGBL. I at 2854, § 15(2) (Ger.), *translated in* GERMAN INSOLVENCY ACT: GERMAN-ENGLISH TEXT 40-41 (Joachim Gres & Michael C. Frege trans., 2002) (creating an obligation to file); BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], Aug. 18, 1896, BGBL. I at 1600, as amended, § 823(2) (Ger.), *translated in* THE GERMAN CIVIL CODE: REVISED EDITION (AS AMENDED TO JANUARY 1, 1992) 153 (Simon L. Goren trans., 1994) (imposing civil liability for violations). Such liability extends both to persons who were already creditors when the duty to file arose and to persons who subsequently became creditors. *See* MÜNCHENER KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH § 823 Rn. 397 (Ger.); *see also* Rock, *supra* note 4, at 1977-79 (reviewing U.K. and other law). While, based on this doctrinal description, directors seem subject to greater duties under U.K. or German law than under U.S. law, we are not sure whether, taking into account both the way these laws are interpreted and differences in the enforcement regime (e.g., lack of an active plaintiff's bar, differences in damage measures), directors of U.K. and German corporations are subject to a materially higher threat of personal liability than directors of U.S. corporations.

[41] Even assuming that broad creditor rights against directors and officers would be efficient, and thus, ex ante, benefit shareholders through a lower cost of capital, ex post, a legally imposed expansion of creditors' rights would favor creditors over shareholders and directors. Consequently, such expansion would bestow a windfall benefit on creditors in the large stock of existing Delaware incorporations at the expense of shareholders. Both the directors and shareholders of these corporations might therefore benefit from reincorporating the firm in a different state (one that grants fewer rights to creditors), and creditors may be unable to stop a reincorporation. Consequently, an expansion of creditors' rights under state corporate law would not only be of questionable merit, but, unless enforced uniformly across jurisdictions, would also be of questionable efficacy.

would be reluctant to risk their personal wealth in service of a limited investment in the company. Delaware judges and lawmakers apparently realize that the prospect of personal liability—whether to shareholders or creditors—would make directors excessively cautious if liability attached to activities less flagrant, or less clearly proscribed, than unauthorized self-dealing.[42] Significantly, investors also take this view: loan agreements give no indication that companies and creditors would want to impose liability on directors.[43]

For these reasons, we are skeptical about a legally imposed expansion of creditor remedies against directors.[44] And although our analysis here has

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[42] There are cases in which directors faced a significant prospect of monetary liability despite the absence of a wrongful personal benefit. The best known of these cases is *Smith v. Van Gorkom*, 488 A.2d 858, 863-64 (Del. 1985). There are even instances of such cases after the adoption of section 102(b)(7), a director-protection provision prompted by *Van Gorkom*. *See, e.g.*, Ryan v. Gifford, 918 A.2d 341, 357-58 (Del. Ch. 2007) (finding that directors who approved the backdating of stock options may face liability regardless of whether they received backdated options); *In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ.A. 16415, 2004 WL 1305745, at *39 (Del. Ch. 2004) (refusing to exculpate outside director who did not act in good faith even though he did not directly benefit from unfair transaction). These cases, however, represent exceptions that prove the rule. As noted, *Van Gorkom* was effectively overturned by legislation; *Ryan* involved egregious facts and quasi-criminal conduct; and *Emerging Communications* exhibited an erroneous litigation strategy and pertained to a board member who benefited monetarily from his association with a controlling shareholder who did obtain a direct wrongful benefit. In other cases that presented the prospect of a director's personal liability despite the absence of self-enrichment, no such liability was ultimately imposed. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 278 (Del. Ch. 2003) (refusing to dismiss breach of fiduciary duty action against board members who did not personally benefit from alleged breach); *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 60-62, 73 (Del. Ch. 2006) (finding that directors did not breach duties). *But see* Rock, *supra* note 4, at subsection IV.A.2 (presenting arguments for how Delaware doctrines could be interpreted to create a more severe risk of liability for directors).

[43] Loan agreements and associated documents sometimes include remedies against the debtor's shareholders, subsidiaries, and other creditors, each of whom contractually consent to such liability. Examples of such provisions include upstream guarantees, downstream guarantees, subordination clauses, and intercreditor agreements. But loan agreements do not contain equivalent provisions with respect to directors and officers. To the contrary, bond indentures regularly contain provisions similar to the following:

> No director, officer, employee, incorporator, member, partner or stockholder of the Company or any Guarantor, as such, shall have any liability for any obligations of the Company or the Guarantors under the Securities, this Indenture, the Subsidiary Guarantees, any Registration Rights Agreement or for any claim based on, in respect of or by reason of such obligations or their creation. By accepting a Security, each Holder waives and releases all such liability. The waiver and release shall be part of the consideration for the issue of the Securities.

Petrohawk Energy Corp., Indenture (Form 8-K), at exhibit 4.1, § 11.9 (Aug. 20, 2010).

[44] For commentators advocating expanded creditor rights against directors, see, for example, Albert H. Barkey, *The Financial Articulation of a Fiduciary Duty to Bondholders with Fiduciary Duties to Stockholders of the Corporation*, 20 CREIGHTON L. REV. 47, 68-69 (1986) (advocating a duty to

been largely confined to directors, the same reasoning makes us reluctant to endorse a legally imposed expansion of creditor remedies against officers.[45]

B. *Remedies Against Shareholders and Corporate Affiliates*

Noncontractual third-party remedies against shareholders or corporate affiliates could be justified either under the control rationale or the improper benefit rationale. At present, third-party remedies against shareholders or affiliates principally arise under the rubrics of piercing the corporate veil and fraudulent conveyance.[46]

To pierce the corporate veil (and thus hold a shareholder liable for corporate debts), generally, a creditor must show that the shareholder was in control of the corporation and sought benefit through fraud or some other wrong.[47] By contrast, remedies for fraudulent conveyance against a shareholder

maximize current market value of stocks and bonds and to compensate bondholders for any wealth appropriations); Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 449-50 (1986) (contending that directors' "[f]iduciary duties to bondholders should implement the Pareto principle of welfare economics"); Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 307-09 (1988) (suggesting a fiduciary duty to maximize firm value); Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1224 (1990) (arguing for a director's duty not to take any actions inconsistent with reasonable expectations of bondholders unless required by a legitimate business purpose that cannot otherwise be reasonably achieved); *see also* Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1869-72 (1992) (advocating for an enhanced duty of good faith); Martin Riger, *The Trust Indenture as Bargained Contract: The Persistence of Myth*, 16 J. CORP. L. 211, 243 (1991) (calling for governmental intervention to strengthen bondholder rights generally). *But see* Kahan, *supra* note 13, at 616-17 (arguing that creditor protection should be based on contract).

45 Officers presently face minimal risk of liability to shareholders unless they engage in unauthorized transactions from which they derive a financial benefit at the expense of shareholders at large. To be sure, under Delaware law, officers owe fiduciary duties to shareholders. *See* Gantler v. Stephens, 965 A.2d 695, 708 (Del. 2009) (holding that fiduciary duties of officers are the same as those of directors). Furthermore, unlike directors, officers cannot be exculpated from breaches of their fiduciary duty of care under section 102(b)(7). In principle, officers can thus be liable for decisions taken in their capacity as officers. But to establish a breach of duty of care against an officer, the plaintiff must show that the officer was uninformed, which is difficult in a case against corporate employees. Moreover, officers can be protected by a firm's directors. Unless the board wishes to bring an action, a breach of fiduciary duty suit against an officer would be a derivative claim, and a shareholder-plaintiff cannot ordinarily pursue a derivative suit against officers (whether for breach of duty of care or of loyalty) because such an action would not satisfy the demand futility requirement. *See* Blasband v. Rales, 971 F.2d 1034, 1047-49 (3d Cir. 1992).

46 If a firm is insolvent, creditors can also bring a derivative lawsuit against a controlling shareholder for self-dealing or similar breaches of fiduciary duties. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101-02 (Del. 2007). Shareholders may also be obligated to return a dividend paid in violation of the dividend restrictions imposed by corporate law. DEL. CODE ANN. tit. 8, § 174(c) (2011).

47 *See* Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479, 506-14 (2001) (describing the doctrine of veil piercing).

or affiliate are not explicitly premised on control of the corporation or on a wrongful act.

In the shareholder context, the basis for these remedies against third parties is not merely that shareholders were unjustly, if innocently, enriched by a corporate action. Shareholders, in the aggregate, control the corporation. To be sure, in companies with dispersed shareholdings, no individual shareholder exercises control. And in companies with a controlling shareholder, minority shareholders do not exercise control. Still, in order to reduce the agency costs of equity that result from the separation of ownership and control, the corporate structure is set up to align the incentives of the corporate decisionmakers (directors and officers) with those of shareholders. Shareholders thus elect directors, who owe fiduciary duties to the corporation and to shareholders, and officers receive incentive compensation designed to align their interests with those of shareholders. It is, therefore, not a coincidence when directors approve actions—such as an increase in leverage or payment of dividends—that benefit shareholders but harm creditors. Even though shareholders do not control the transaction—in fact, they may not have any direct say in the transaction—the directors act as their agents (in the economic sense) and for their benefit. To the extent that third-party remedies against shareholders disgorge improper benefits, directors have reduced incentives to bestow such benefits on shareholders. Thus, third-party remedies do not merely, ex post, force shareholders to return improper benefits; they also create ex ante incentives for corporate decisionmakers not to generate such benefits from the outset.

From this perspective, remedies against shareholders as third parties serve as a proper response to a concern that the incentives of directors (and officers) are too closely aligned with those of shareholders.[48] Indeed, remedies against shareholders have a significant advantage over remedies against directors: the former are less likely to result in excessive caution by directors, as both the full benefits of the corporate action and the full cost of a potential remedy accrue to shareholders.

The challenge is to define what benefits must be returned (i.e., those that constitute improper benefits). Veil-piercing remedies are not problematic at least to the extent a controlling shareholder can avoid them through honest behavior and routine adherence to corporate formalities.[49] Fraudulent conveyance law is more complicated. For instance, under fraudulent

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[48] *Cf.* Rock, *supra* note 4, at Part IV (discussing legal solutions to the shareholder–manager agency cost problem).

[49] *See* Bainbridge, *supra* note 47, at 521 (observing a "well-nigh universal refusal to treat undercapitalization, standing alone, as dispositive" in a determination to pierce the corporate veil).

conveyance principles, a dividend paid, or an amount paid by a corporation to purchase its own shares, is a (constructive) fraudulent conveyance if the company is insolvent, is thereby rendered insolvent, or is left with unreasonably small capital.[50] The baseline established by fraudulent conveyance law—insolvency or unreasonably small capital—is legislative, rather than contractual. This might be of little concern because the insolvency baseline is sufficiently lax that one can reasonably assume it does not impose unwanted terms on contractual relationships. As we explain more fully immediately below, however,[51] the baseline of unreasonably small capital is more difficult to defend at least because it is imprecise. In any case, our intuitions about what investors prefer matter little to our analysis. In Part IV, we suggest that the law permit contractually created remedies against shareholders as third parties; such remedies could be set to different standards and could be more clearly defined than provisions under current law.

Just as a debtor's shareholders can improperly benefit at the expense of creditors, so can a debtor's corporate affiliates, which may be directly or indirectly controlled by a debtor's shareholders. Consequently, veil-piercing and fraudulent conveyance laws provide remedies against corporate affiliates as well, and in our view, are generally appropriate to the same extent.[52]

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50 Though specific provisions and some terminology differ, these fraudulent conveyance principles are common to federal bankruptcy law and state law. For federal bankruptcy purposes, however, section 546(e) of the Bankruptcy Code, 11 U.S.C. § 546(e) (2006), has been interpreted to bar recovery of payments to shareholders made through financial intermediaries. *See* Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329 (2d Cir. 2011); *see generally* Rock, *supra* note 4, at subsection IV.A.1 (discussing bankruptcy law in the context of failed leveraged buyouts).

Corporate law rules generally have similar or weaker standards for unlawful dividends and stock repurchases. In most states other than Delaware, dividends and share repurchases are unlawful if the company is or is rendered thereby insolvent or has no surplus. *See, e.g.*, N.Y. BUS. CORP. LAW § 510 (Consol. 2012). As described above, in Delaware, even companies with no surplus may pay any dividends out of current profits or out of the combined profits of the current and the prior fiscal year. DEL. CODE ANN. tit. 8, § 170. Shareholders who had knowledge of facts indicating that the dividend or purchase was unlawful are required to return the amounts received. *Id.* § 174(c); N.Y. BUS. CORP. LAW § 719(d).

51 We discuss fraudulent conveyance law again below. *See infra* text accompanying note 59.

52 This is not to say that every remedy against a shareholder would be equally justifiable against a corporate affiliate. For example, it might be fully appropriate for a creditor to pierce a subsidiary's corporate veil and reach assets of a controlling shareholder, while at the same time wholly inappropriate for a creditor to reach assets of the subsidiary's sibling corporation at the expense of the sibling's creditors. We discuss the issue of corporate affiliate liability again in Part IV, *infra*.

C. *Remedies Against Other Creditors*

A third-party claim can also be asserted against other creditors. Under present law, such remedies against creditors are based on both the control and improper benefit rationales. For present purposes, we discuss two existing types of remedies: those that relate to voidable preferences and those that relate to fraudulent conveyances in the context of a leveraged buyout.

Under federal bankruptcy law, certain payments made to other creditors prior to a bankruptcy filing are recoverable as voidable preferences. Generally, a payment is recoverable if it is made within ninety days of a bankruptcy filing, while the debtor was insolvent, and resulted in a recovery greater than the repaid claim would have received in the debtor's liquidation had the payment not been made.[53] The standard rationale is not merely equitable, or ex post; that is, the standard rationale is not merely the notion that it is improper for creditors who get paid shortly before a bankruptcy to end up in a better position than similarly situated creditors who did not get paid. Deterrence is an additional component to the classical preference story. The idea is that if a creditor anticipates that it will have to return any collection made on the eve of a bankruptcy filing, it will have a diminished incentive to monitor the debtor wastefully in preparation for a race to assets as well as a diminished incentive to conduct the race and collect prior to bankruptcy—perhaps dismembering a viable debtor in the process. But this standard explanation is wanting; it is static, as it incorrectly imagines that a creditor's bankruptcy filing is preordained rather than dependent on the creditors' collection efforts. Despite the prospect of avoidance, because bankruptcy may not be imminent, creditors may have an incentive to collect even when collection costs are positive.[54]

Still, preference law has consequences that may well protect creditors. The prospect that a bankruptcy trustee will later recover a collection may induce some creditors to investigate, and perhaps declare a default against, a debtor earlier in the debtor's financial decline.[55] The creditors may thus protect themselves and other creditors who are not in a position to monitor the debtor directly, but who might react to the early withdrawal.[56] Moreover,

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[53] 11 U.S.C. § 547 (2006). Different rules apply if a payment is made to or for the benefit of an insider. *Id.*

[54] *See* Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575, 581 (1995) (discussing the deterrent effects of preference law).

[55] *See* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, 1094-96 (1995).

[56] *See id.* (explaining how voidable preferences encourage better lender monitoring efforts).

because a bankruptcy trustee may reverse an eve-of-bankruptcy debt collection, or grant of a security interest, a lender may be hesitant to finance a debtor's continuation, and continuous decline, with the promise of early maturity on a new loan or security on an existing one.[57] Such reluctance might lead a failed debtor to an earlier bankruptcy, and perhaps an efficient liquidation, thus benefiting creditors that would have suffered from continuation.[58]

A second, related third-party remedy against creditors is based on fraudulent conveyance in the context of a leveraged buyout (LBO).[59] There are multiple ways that an LBO can be structured. One typical structure involves the creation of an acquisition vehicle, "Acquisition Corp.," that obtains some equity contributions from the ultimate purchaser and borrows a much greater amount of additional funds. Acquisition Corp. then acquires the stock of the target corporation and merges with it. Whether structured in this or some other fashion, when the dust settles, the former shareholders of the target corporation are cashed out and the target corporation is owned, directly or indirectly, by the ultimate purchaser who contributed only a fraction of the purchase price to the acquisition. The remainder of the purchase price consists of debt, typically secured by the target's assets, and, as a result of a merger or otherwise, the target corporation becomes obligated to pay the debt incurred in the LBO.

From the perspective of the target corporation and its creditors, an LBO results in more debt (often of higher priority), new owners, and not necessarily any benefits. To be sure, LBO proponents may claim that new management and a concentrated equity ownership will promote productive business innovation and unprecedented diligence. And this claim may be correct, but it may not be. Because some of the costs of an LBO are borne by pre-LBO creditors, equity's option value on the highly leveraged firm may be hugely valuable even while that value is fed by, and promotes, inefficient overinvestment in risky projects, with ruin a significant possibility.

Courts, therefore, may be on solid ground when they use fraudulent conveyance law to devalue claims held by lenders who finance an LBO. Even though these lenders contribute real money, this money ends up in the hands of the shareholders of the target corporation, not in the target corporation itself. Courts have reasoned, therefore, that if the target

[57] Adler, *supra* note 54, at 597-98.

[58] *See id*.

[59] We do not here discuss lender liability and deepening insolvency, which are actions that bear a family resemblance to fraudulent conveyances. Our proposed contract-based third-party remedy, described below in connection with these doctrines, would permit parties to fashion their own versions of such actions.

corporation is insolvent after the LBO, or if it is left unreasonably undercapitalized, the obligations to the creditors that finance the LBO are voidable as fraudulent transfers.[60] In effect, avoidance subordinates the LBO lenders' claims or, if a court avoids just the security interest, reduces those claims to the same level of priority as other claims.

The application of fraudulent conveyance law to LBO lenders can be defended if it encourages those who finance an LBO to assure that the debt incurred in the LBO does not render the company insolvent or nearly so, at least unless such financial instability is justified by the upside of the transactions. LBO lenders are an integral party to the LBO transaction; they are, through their lending decisions, in a position to control whether the LBO occurs and how much debt is incurred. LBO lenders can also derive substantial profits (through fees and interest income) from a successful LBO. Thus, when LBO lenders face a risk of reduced priority for the debts owed to them, they may appropriately exercise more caution in their lending decisions. That is, fraudulent conveyance rules may usefully force an LBO lender to internalize the costs the lender imposes.

Beyond theory, though, and as intimated above, a determination that a debtor is insolvent or *too* thinly capitalized is as much art as science.[61] The risk of a court finding, after the fact, that an LBO unduly subjected early, unsecured creditors to risk may well make potential LBO lenders excessively cautious, perhaps deterring LBOs that could, through the replacement of management or the elimination of free cash flows, enhance the target's value.

In the next Part, we suggest an expansion of remedies against creditors that are not parties to contracts breached by debtors. As in the case of fraudulent conveyance law, the rationale for imposing such remedy is that creditors are, through their lending decisions, in a position of control and can be expected to exercise such control more appropriately if they are forced to internalize the costs of the transactions they finance. However, unlike fraudulent conveyance law, the remedy we propose is optional and

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60 *See, e.g.*, United States v. Gleneagles Inv. Co., 565 F. Supp. 556 (M.D. Pa. 1983), *aff'd sub nom.* United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986) (applying fraudulent conveyance law to a leveraged buyout on both actual and constructive fraud theories); *see also* 11 U.S.C. §§ 544, 548 (2006) (providing for application of fraudulent conveyance law in bankruptcy). We do not endorse any particular doctrinal analysis. Rather, we recognize the potential efficacy of a rule that holds a lender liable, as an LBO participant, for the negative consequences, borne by early creditors, of the transactions it finances. Even so, as we explain below, we favor early creditor self-protection over fraudulent conveyance rules that provide untailored, and perhaps unwanted, protection.

61 *See, e.g.*, Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1072-73 (3d Cir. 1992) (holding that "the test for unreasonably small capital is reasonable foreseeability," which in *Moody* hinged on whether "the parties' projections were reasonable").

based on contractual principles. Consequently, the baseline for imposing the remedy would be determined by the parties and would apply only to the extent that a company and its pre-existing creditors agreed. Thus, if a company were concerned that the possibility of a third-party remedy against future creditors would unduly impede its ability to obtain future credit, it would be free not to opt in to such a remedy. As we explain below, we would extend this option to permit a firm's retreat from current fraudulent conveyance standards, allowing financial creditors to fend for themselves without any ability to undermine an LBO financier's rights.[62]

IV. LEGAL RULES IN THE AID OF CONTRACTS: A PROPOSAL FOR LEGAL RULES THAT CREATE OPTIONAL THIRD-PARTY REMEDIES FOR CREDITORS

As we explained in Part II, among contractual parties, lenders face an atypical problem. Unless fully secured, lenders know from the outset that they cannot confidently rely on standard breach-of-contract remedies when a debtor breaches a protective covenant, one designed to reduce the risk of nonpayment. If the breach of such a covenant results in insolvency and nonpayment, then damages from breach may not be recoverable. As a result, remedies against third parties with respect to breaches of these covenants may be more important than for other types of breaches. Yet, given the difficulty of contracting with third parties—because their identities may not be known at the time creditors lend funds or because the number of such parties may be large—imposing such remedies directly, through contract, may be costly or impracticable.

Put another way, creditor remedies matter most when a debtor is insolvent (i.e., unable to satisfy all obligations), but when a debtor is insolvent, a remedy exclusively against the debtor may prove meaningless. We therefore suggest that the law create a mechanism for the enforcement of contractually based remedies against third parties. Importantly, this mechanism would be optional. Remedies against third parties would be created only if, and only to the extent, a loan agreement or a provision in the debtor's corporate

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62 Douglas Baird and Thomas Jackson have criticized the application of fraudulent conveyance law to leveraged buyouts and, as we do here, have argued that, if creditors want protection of that sort, it could be supplied by contract. *See* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 854 (1985) (concluding that the "fraudulent conveyance remedy is far easier to contract into than it is to contract out of"). Creditors could not opt into a fraudulent conveyance regime, however, unless, as we recommend in this Article, the law permitted the imposition of third-party liability. It is not clear whether Baird and Jackson had such legal reform in mind.

charter[63] so provided. Optionality is a crucial element of the mechanism we propose. Although there are theoretical reasons to believe that third-party liability *may* be efficient, and that transactions costs prevent the direct contractual imposition of such liability, this does not imply that any particular type of remedy against third parties, or for that matter any at all, is in fact

63 It might prove impracticable to impose third-party liability through corporate charter provisions. For one reason, it is unclear to what extent the corporate charter can impose liability on shareholders (especially noncontrolling shareholders) or creditors of a corporation. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b) (2011) (setting forth provisions that may be contained in the charter). Specifically, it is not clear whether a provision imposing liability would be regarded as a provision "for the management of the business and for the conduct of the affairs of the corporation" or as a provision "creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders." *Id.* § 102(b)(1). Also, while the charter may contain "[a] provision imposing personal liability for the debts of the corporation on its stockholders to a specified extent and upon specified conditions," see *id.* § 102(b)(6), this statutory provision would not permit imposition of liability on creditors, and it is unclear whether this provision would permit imposition of liability on any former shareholder. Second, given choice-of-law and jurisdiction principles, it may be difficult to enforce third-party liability provisions even if they are valid under the law of the firm's domicile. Delaware generally could not exercise personal jurisdiction over parties merely because they are shareholders or creditors of a firm incorporated in Delaware. *See* Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945) (requiring that a person have minimum contacts within a state for that state's courts to exercise personal jurisdiction). And while states generally look to the laws of the state of incorporation to govern the internal affairs of a firm, it is not clear whether remedies by creditors against other creditors or shareholders would be considered to fall within the scope of the internal affairs doctrine. *See* Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 DEL. J. CORP. L. 57, 68 (2009) ("Within corporate law, 'internal affairs' encompasses the statutory and judicial standards defining the corporation's legal personhood, rules for . . . effectuating mergers and acquisitions, charter and bylaw amendments, procedures for shareholder and board voting and meetings, and the rights and responsibilities of shareholders, officers, and directors."). Third, any charter provision would have to be approved by the company's shareholders. Tit. 8, § 242(b). The process of creating third-party remedies through a charter provision would thus be more cumbersome than the process we are proposing. Fourth, under general rules of corporate law, the charter may be changed with the approval of the board of directors and the shareholders. *Id.* Under the general rules, therefore, charter provisions would offer only weak protection because they could be changed without creditor approval. To be sure, this problem could be overcome as the charter could confer limited voting rights on creditors to give them veto power over the respective charter provision and further require that, upon a merger or consolidation, the surviving entity retain equivalent charter provisions. *See id.* § 221. But such voting rights may give excessive protection to creditors, for example, by giving them veto power over a reincorporation into a state that does not recognize such a charter provision. Fifth, a charter is best suited for the provision of global rules, and the remedies we have in mind might be specific to individual contracts—the protection, for example, of one bond issue but not another—and so the charter may not be an ideal repository of covenants to be enforced against third parties. Similar limitations would apply to the use of by-laws as a source of third-party liability.

All this said, we are not opposed to the idea of the corporate charter as the source of remedies against third parties. As we explain below, we believe that for a contract to impose third-party liability there should be public notice of that remedy, and a charter is a reasonable location for public notice. Thus, we would favor legal reform that would make charter provisions enforceable against third parties.

desirable.[64] By making the imposition of third-party liability optional, we would leave the ultimate determination to the contracting parties.

Our proposal builds on a suggestion by one of us that a firm and a subset of its investors should be permitted generally to enter contractual arrangements that bind investors who are not parties to the contract.[65] The context of this original proposal was a thought experiment in which a firm minimized its cost of capital through the abjuration of all traditional debt and the replacement of such debt with a special type of preferred equity (referred to as "Chameleon Equity").[66] Such a firm could exist in the real world only if it could effectively bind itself, either in its corporate charter or through public recordation, to the renunciation of debt at the time of incorporation and in the future.[67] The initial proposal, which is conceptually related to ours here, is to provide a mechanism through which a firm could reliably bind itself not to take certain actions so that any purported issuance of a right in violation of a contract would be *unenforceable* against the firm, and not merely give rise to a breach of contract claim against the firm.

Subsequent development of this idea gave rise to additional proposals closely related to the topic we address here. As discussed earlier, a possible role of voidable preference rules is to discourage a distressed debtor's inefficient investment financed by later creditors at the expense of earlier creditors. The preference rules, however, are limited to the repayment of loans, or the issuance of a security interest, within a short period prior to bankruptcy. In response to this limitation, as suggested by one of us, a debtor perhaps should be permitted to adopt an extension of the preference rules such that any loan made during the debtor's insolvency would be unenforceable except on terms no more favorable in maturity or priority than those of debt obligations already issued and outstanding.[68] A further, more prosaic proposal was to extend the secured-credit system so that it

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64 We do not imagine that a debtor would covenant for creditor protection then refuse to opt into third-party liability so that it may later breach without consequence. Rather, because liability may be hard to determine, or damages difficult to measure, depending on the remedy, a debtor might decide that the uncertainty of third-party liability would, beyond the covenant itself, unduly chill the opportunity for later financing.

65 *See* Adler, *Financial and Political Theories*, *supra* note 6, at 336-39.

66 *Id.* at 323-24.

67 *Id.* at 336-39.

68 *See* Barry E. Adler et al., *Value Destruction in the New Era of Chapter 11*, 29 J.L. ECON. & ORG. (forthcoming 2013) (manuscript at 20), *available at* http://jleo.oxfordjournals.org/content/early/2012/02/06/jleo.ewr004.full.pdf+html ("To raise the cost of loans taken by an insolvent debtor, the law could simply deny the loans priority or early maturity regardless of the loans' contractual terms."); *see also* Barry E. Adler, *Accelerated Resolution of Financial Distress*, 76 WASH. U. L.Q. 1169, 1176 (1998) (making the same point).

would enforce against third parties not only security interests, but also negative pledges against the issuance of secured credit.[69]

The common theme here is that certain kinds of legal arrangements between a firm and its creditors are difficult to establish purely through traditional contract. Our proposal here is designed largely to broaden the set of arrangements that parties can devise through private ordering by establishing a mechanism for the contractual creation of remedies against third parties.[70]

To be sure, in the mechanism we propose, it will be the debtor and a creditor that decide on the imposition of any third-party liability. Shareholders, corporate affiliates, and future creditors—the targets of the remedies we envision—do not explicitly consent. However, as we discuss below, the debtor company will have significant incentives to take into account the interests of shareholders, affiliates, and future investors (equityholders or creditors) in deciding whether to agree to the imposition of third-party liability. Significantly, our proposal also includes mechanisms for third-party self-protection. We propose that a creditor could not be made liable as a third party unless, at the time of its investment, it was aware of or on public notice of any rule or remedy that would affect it. Additionally, we would not have the law permit contractual third-party liability against shareholders or corporate affiliates unless a charter provision expressly permitted a firm to enter into contracts that imposed such liability. Thus, a shareholder subject to third-party liability would either invest with actual or constructive knowledge of this prospect or would have an opportunity to vote on a charter amendment that permitted third-party liability. And corporate affiliates would rely on the discretion of their shareholder parents.[71]

This third-party liability proposal follows the secured credit model, which creates a property interest good against past and future creditors but

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69 *See* Adler, *Secured Credit*, *supra* note 6, at 409 (recommending that entry in a public record be sufficient to "make universally enforceable a debtor's commitment to leave some or all of its assets unencumbered" (citation omitted)); *see also generally* Bjerre, *supra* note 6 (usefully expounding the utility of negative pledges). As discussed *infra* Part V, although it is possible under current law to secure a negative pledge, there are inherent limitations in such security.

70 Our focus here is on the operation of the proposed third-party liability mechanism. We do not express an opinion on whether the law that would authorize or facilitate the mechanism should be state or federal (or, for that matter, part of a multinational convention).

71 Every investor implicitly agrees to the law that will govern its investment, and so, transition issues aside, every third-party investor in some sense consents to whatever liability the law permits a debtor and creditor to impose by contract. Nevertheless, our view of implicit consent is less tautological. As suggested by the text, we imagine that the law would, for the most part, not allow debtors and creditors to impose liability contractually on a third party unless, at the time of its investment, the third party either had actual or constructive notice of such liability or had chosen to leave itself exposed.

only with notice of such interest. Simply put, we aim to broaden the scope of creditor protection that secured credit now provides in a needlessly narrow fashion. Given this background, we begin a discussion below of our proposal for contractual third-party liability with an analysis of remedies against other creditors. We then turn to related remedies against shareholders and corporate affiliates and make some observations about how our proposal compares with remedies under existing law.[72]

A. *Remedies Against Other Creditors*

As part of our proposal for third-party liability, we suggest the creation of an optional remedy against a creditor (a "new" creditor) who lends on terms that violate a covenant in a loan agreement between a pre-existing creditor (an "early" creditor) and a common debtor. A number of common covenants in loan agreements prohibit specified subsequent agreements with other creditors. These provisions limit, for example, the total amount of debt that a company may incur, the debt of or guarantees by the company's subsidiaries, the right of subsidiaries to restrict dividends, or the ability of the company to grant a security interest to other creditors.

The trigger for remedies against third parties would be contractual in several respects. First, a remedy would be imposed only if an agreement with a new creditor violated a term contained in the agreement with an early creditor. That is, the baseline substantive standard would be based in contract. Second, a remedy would be imposed only if the agreement with an early creditor specifically provided for third-party liability in the event of a breach of a specific term. Third, a remedy would be imposed to benefit only those early creditors that contracted for third-party liability.

To understand how such remedies might operate, consider the following illustration. Debtor has $100 in assets and is subject to $100 in unsecured debt. Under the terms of the unsecured debt contract, Debtor promises not to issue any secured debt and opts into a third-party liability regime. Yet, in violation of this negative pledge covenant, Debtor borrows an additional $100 and pledges all of Debtor's assets as security. Debtor then invests all $200 of its assets—that is, its initial $100 plus the new loan proceeds—in a risky project that fails, inducing Debtor to enter bankruptcy with only $50 in assets. Absent third-party liability, the secured lender, with a lien on all

[72] In principle, our proposal would permit the imposition of liability on other sorts of third parties—purchasers, for example. We limit our analysis to creditors, shareholders, and corporate affiliates, however, because we perceive them as the most likely targets of such liability. *See supra* note 8.

Debtor's assets, would collect the entire $50 estate, and the unsecured lenders would receive no payment and have no remedy for Debtor's breach. It is left to consider, then, the extent of a third-party remedy against the secured lender.

In a third-party liability regime, the unsecured creditors might, at the least, be able to set aside the lien that violated the negative pledge covenant, with the result that they and the secured lender would share Debtor's assets on a pro rata basis (for a recovery of $25 each). This outcome amounts, in essence, to an avoidance of the later lender's security interest with respect to the unsecured creditors that contracted for the negative pledge.[73]

This remedy is modest and easily enforceable, but it is not the only possibility. A more fulsome remedy could perhaps provide the unsecured creditors in this illustration subordination of the new lender's secured claim. This would result in an award of $50 to the unsecured creditors and nothing to the new lender. Moreover, the unsecured creditors in this illustration might argue that, but for the secured loan, Debtor would have been unable to finance the risky project and that, if Debtor had not undertaken the project, the unsecured creditors would have been paid in full. Then, the remedy against the secured lender could be that it relinquish its $50 lien in favor of the unsecured creditors and pay the unsecured creditors an additional $50 in lender liability as consequential damages.[74]

Where an early lender contracts for third-party liability but does not specify the nature of that liability, we would, where possible, limit the remedy to avoidance of the terms that violated the early lender's loan agreement. In this illustration, such a remedy would be avoidance of the later lender's security interest and a $50 recovery for unsecured creditors. We would permit an early lender and debtor to contract for a more extensive remedy, such as subordination or full expectation damages, but only if the loan agreement between the debtor and early lender clearly imposed such remedy. Our caution here is twofold. First, we are concerned that the

[73] In our illustration, all the early creditors contracted for a negative pledge, and the parties opted into a third-party liability regime. By contrast, consistent with the minimal recovery described here, if creditors holding only $50 of early claims had contracted for such provision, only those creditors would obtain the benefit of the remedy, for a pro rata recovery of $12.50. The secured creditor would be entitled to the security interest with respect to the other early creditors and obtain a total recovery of $37.50. The early creditors who did not contract for a negative pledge, or did not contract to have such pledge enforceable against a third party, would receive a $0 recovery. Thus, the remedy described here does not constitute subordination and need not constitute entire avoidance.

[74] As in the case of the more modest remedy described above, we propose that a subordination or expectation remedy would accrue only to the benefit of those early creditors who contracted for such remedy.

parties might prefer not to contract for a more extensive remedy, which might chill later investment or be difficult to calculate, or both. Second, even if such remedy were adequately publicized—a desirable prerequisite of third-party liability to which we turn momentarily—participants in the financial community might be slow to understand the consequences of a change in the law to permit third-party liability. Therefore, we believe that third-party liability should not casually attach. It follows, of course, that we do not recommend that the law permit the parties to contract for third-party liability in excess of full compensation for breach—that is, punitive damages, which are not enforceable under general principles of contract law.

We are mindful that, whatever the merit of our proposal, it would not be costless to implement. Costs to minimize can be divided into two categories: the costs of determining whether a debtor contracted for third-party liability and the costs arising from contracting for such a remedy.

The first set of costs—those relating to *whether* a debtor contracted for third-party liability—would be incurred by creditors of all debtors. Thus, when passed along in the form of higher fees or interest rates, these costs would be borne by all debtors, regardless of whether the debtors contracted for such a remedy. These costs could be significant, not because they would necessarily be large for any particular debtor, but because they are distributed so widely—beyond the debtors who would choose to impose third-party liability.

The second set of costs, those arising from the contracting process itself, would be borne only by debtors who availed themselves of contracts for third-party liability. Such costs would include not only the expense of the debtor and creditor that contract to impose liability, but also the costs to new creditors of investigating the terms and underlying facts of discovered third-party liability agreements between debtors and early creditors. A new creditor would have to determine whether the earlier agreement would be violated and would have to decide whether and on what terms to extend credit. Related costs could arise from the possibility that new creditors might err in this determination and become subject to liability from inadvertent breach. These costs, which would extend beyond the mere determination that third-party liability had been invoked, could be nontrivial because covenants in loan agreements may contain multiple exceptions and carve-outs as well as occasional ambiguities.[75] A detailed analysis both of the

[75] For an example of such covenants, see J.C. Penney Co., Current Report (Form 8-K) (Feb. 4, 2013), *available at* http://www.sec.gov/Archives/edgar/data/1166126/000134100413000151/form_8k.htm, discussed *infra* in text accompanying note 97.

terms of an agreement and of the company's prior use of any exceptions and carve-outs may be necessary to determine whether an agreement would be violated.

All this said, it is easy to overstate the significance of these investigation costs. To begin, new lenders are well positioned to scrutinize a debtor's affairs and have an incentive to do so even absent the prospect of contractually imposed third-party liability. New lenders routinely ask debtors for important documents and other information and attempt to verify whether the information they are provided is complete and accurate. They, of course, also have the power to deny credit if they are not satisfied with the responses they receive. We therefore do not believe that the additional costs for new creditors generated by contracts for third-party liability would be prohibitive.

In this regard, it is noteworthy that, unlike the determination of whether a debtor has contracted for third-party liability, investigation costs given the existence of a contract arise only for debtors that have voluntarily contracted for such liability. Because a new creditor can be expected to recuperate these costs from a debtor through higher fees or higher interest rates, a debtor has incentives to take them into account and incur them only if the benefits to be obtained (from early creditors) as a result of contracting for third-party liability exceed the costs imposed.

The law, moreover, can be designed to minimize both sets of costs we have identified. We offer the following suggestions:

First, we would require a creditor that contracted for third-party liability to file its agreement in a central depository. Failure to file an agreement would render unenforceable any included remedy against a third party. The natural depository would be the office for Uniform Commercial Code (UCC) filings in the debtor company's state of incorporation.[76] Generally, new creditors perform a UCC search in any case to determine whether a company has granted any security interests. To that extent, new creditors could at little or no additional cost discover any loan agreement that contained a third-party liability provision potentially enforceable against them. Even for creditors that would not otherwise conduct a UCC search, the costs of such a search could be low. Thus, even though new creditors would need to search for third-party liability provisions in connection with loans

[76] To the extent that the agreement with the early creditors could be violated by agreements between new creditors and subsidiaries of the company, the agreement would also have to be filed in the office of the subsidiary's state of incorporation.

to debtors who have imposed none, such universal search need not be excessively expensive.[77]

Second, as may be implicit from our analysis, we would limit the right to contract for third-party remedies to legal entities. Accordingly, a new creditor would seldom if ever have difficulty identifying the appropriate depository.

Third, because even a discovered provision for third-party liability may be difficult to interpret in context, we would limit the creation of third-party liability to material new creditors; the materiality threshold could be determined after an analysis of search costs. This amount could be raised or lowered in light of the actual market demand for remedies against third parties. For a relatively mild remedy, such as the disgorgement of a security interest granted to an existing creditor in violation of a negative pledge clause, the materiality threshold could be modest. Ignorance of a mild remedy might not be very costly, just as a creditor's ignorance of the voidable preference rules under current law may not be very costly. If, however, a remedy imposed greater liability, such as an award of consequential or punitive damages (if permitted by law),[78] there likely should be a non-trivial materiality standard.

A materiality threshold would not merely save small, new creditors the cost of investigation. The size limitation would also mitigate a version of the arms-race problem, where creditors too small or insufficiently sophisticated to investigate would assume that they would face liability and would pass along the expected cost of such liability to the debtor.[79] The debtor, in turn, would then have an incentive to impose the paid-for liability, whether or not liability made sense from an efficiency perspective. By contrast, substantial creditors, particularly financial creditors, could relatively easily discover the presence or absence of liability, negotiate for their own rights against other creditors, if desired, and adjust their interest rates accordingly. As discussed further below, because even small or unsophisticated creditors could investigate and act to secure a debtor's disclaimer of third-party

77 A filing requirement would have the further benefit that new creditors would be able to investigate the scope of any third-party liability from an examination of filed agreements.

78 *See* discussion of punitive damages *supra* Section IV.A. Although we noted concerns in that context over a newly created prospect of lender liability, even if provided for in a publicized contract between a debtor and earlier creditors, to the extent that the materiality threshold does its work, the significance of these concerns recedes.

79 This arms-race problem was identified, though in different terms and a somewhat different context, in Lucian Arye Bebchuk and Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996).

liability against them, inefficient investment spawned by an arms race might be limited to the transactions costs of such investigation and action.

The observation that the expected cost of third-party liability would be passed along to the debtor has efficiency implications beyond the materiality standard and arms-race problem just described. The costs of remedies against third parties would make new lenders more reluctant to extend credit and would affect the terms of any credit they extended (e.g., they could demand higher fees or higher interest rates). This behavior, however, is precisely what third-party liability is designed to induce. For the most part, the costs of third-party liability would be borne by the debtors who contract for third-party remedies with early creditors. To the extent that debtors are forced to internalize the costs of third-party remedies imposed on new creditors, they have proper incentives to include such remedies in their agreement with early creditors only to the extent such remedies are efficient. For example, inasmuch as the rationale for third-party liability is that the contractual remedies of debt acceleration and damages against the debtor may not be effective in the event of the debtor's insolvency, the availability of any remedy against new creditors might be conditioned on the debtor's insolvency, as evinced by bankruptcy or a payment default after acceleration. In addition, the parties might limit the remedy to agreements with new creditors that occurred within a reasonably short time span, perhaps one year, prior to bankruptcy initiation or a payment default; such limitation may be a sensible way to encourage useful monitoring, by creditors that would benefit from the imposition of third-party liability, and to provide new creditors with greater certainty. New creditors would be cautious, but we would not expect them to be overly cautious because they would be driven by profit motive to finance efficient projects, even risky ones, provided that the debtor were willing to pay the price. Thus, a debtor would be discouraged from the pursuit of projects that are too risky but might still finance other projects.

This observation is consonant with accepted finance theory. The debt–equity conflict induces equity to prefer too much risk and creditors to prefer too little. When equity controls management, creditors seek to limit excessive risk, which managers may pursue, despite natural risk aversion, as faithful agents or as the only hope to save their jobs. To combat unjustifiably risky investment, early creditors may contract for priority, typically through the use of secured credit, so that it becomes difficult for equity and a subsequent lender to externalize risk on earlier creditors.[80] As described

[80] *See, e.g.*, Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209 (1989) (calling for first-in-time priority as the general default rule); Clifford W. Smith, Jr. & Jerold B. Warner,

above, both voidable preference and fraudulent conveyance law may similarly induce debtor internalization of risk and thus discourage inefficient investment. To be sure, inhibitions on the externalization of risk may also discourage efficient investment, but the restriction may be worthwhile nonetheless.[81] Our proposal here for third-party creditor liability is in the same vein and allows a firm to balance the benefits and costs of protection for early creditors.

B. *Remedies Against Shareholders and Corporate Affiliates*

In addition to remedies against third-party creditors, we suggest that the law accommodate optional remedies against third-party shareholders. Remedies would be triggered if the company made a payment or distribution to shareholders, purchased stock or other equity securities from shareholders, or entered into a transaction with shareholders that violated a covenant in a loan agreement with early creditors. Loan agreements commonly contain a number of covenants that pertain to shareholders, including provisions restricting the amount of dividends the company may pay and the amount it can expend on purchasing its own shares, provisions requiring the maintenance of a certain net worth, and provisions requiring that any agreement between the company and a controlling shareholder (or its affiliate) be on terms that are fair to the company.

As in the case of remedies against creditors, we propose that remedies against shareholders would be contractual. The remedies would be triggered if the company breached a term contained in a loan agreement with early creditors in a manner that benefited shareholders. The conditions for enforcement would be similar to those for remedies against creditors. To be enforceable against shareholders, the agreement with early creditors would have to specifically impose a third-party remedy for a breach of a specified term. The remedy would benefit only those early creditors that contracted for the imposition of such a remedy; would be limited, where possible, to avoidance of the violation unless a different remedy were contractually

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Bankruptcy, Secured Debt, and Optimal Capital Structure: Comment, 34 J. FIN. 247, 250 (1979) (describing secured credit as a means to avoid asset substitution). There are other uses of secured credit, as a solution to underinvestment, for example. *See, e.g.*, René M. Stulz & Herb Johnson, *An Analysis of Secured Debt*, 14 J. FIN. ECON. 501 (1985) (observing that profitable projects may not be undertaken by firms that can use only unsecured debt to finance them but may be undertaken by firms that can use secured debt).

[81] *See, e.g.*, Elazar Berkovitch & E. Han Kim, *Financial Contracting and Leverage Induced Over- and Under-Investment Incentives*, 45 J. FIN. 765 app. B (1990) (identifying competing concerns); *cf.* Stulz & Johnson, *supra* note 80 (describing efficient investment induced by priority for a later creditor).

specified; and would in any case be limited by the harm from the violation. Also, to be enforceable, the agreement would have to be filed in some central depository.[82] As in the case of remedies against creditors, we imagine that the parties would contract so the availability of any remedy against shareholders would be conditioned on the debtor's insolvency proceeding or a payment default after an acceleration of the early creditors' debt, and we anticipate that the remedy against shareholders would be limited to violations within a reasonably short time prior to such initiation or default.

Remedies against shareholders may be beneficial even if they do not induce the shareholders to intervene in the management of a firm. An additional basis for such remedies, a variant of the control rationale, is that directors and officers of a firm are less likely to authorize a violation of a loan covenant, such as a restriction on the payment of dividends, if shareholders are deprived of profit from that violation. Although the existence of third-party shareholder liability would impose potential costs on shareholders, companies that are run for the benefit of shareholders would be expected to take these costs into account in deciding whether to incorporate such remedies in their loan agreements. Companies would have an incentive to incorporate such a remedy only if it minimized the debtor's cost of capital and were thus efficient.

The question arises whether management's role as the shareholders' agent sufficiently establishes the shareholders' implied consent to third-party shareholder liability. Under current law, through the mere issuance of debt, management can subordinate shareholders' interests in the company's assets to those of creditors. So, in some sense, third-party shareholder liability would not be a radical change. As a matter of caution, though, we would limit the contractual expansion of liability against third-party shareholders to those firms with a charter provision that permits the imposition of such liability. An even more cautious approach would limit liability to shareholders who have invested subsequent to, and with actual or constructive notice of, a contract that seeks to impose liability. Such caution, though, could greatly weaken or slow the efficacy of our proposal because equity shares (unlike debt) are not routinely retired and replaced. Moreover,

[82] Filing of an agreement in a central depository would usefully disseminate information for the benefit of future investors and would thus be useful even if, as we recommend and explain below, third-party liability could be imposed on shareholders who invested prior to the agreement.

because directors and officers owe the same fiduciary duty to all shareholders, this limitation could create problematic conflicts of interest.[83]

Our proposal could accommodate contractual third-party liability against corporate affiliates as well, but this liability could be more problematic than liability against shareholders. While the interests of a debtor's directors and officers may align with those of the debtor's shareholders, the directors' and officers' interests would be less likely to align with those of a corporate affiliate. For example, a debtor's parent corporation might seek to externalize the cost of third-party liability on the debtor's sibling corporation and thus on the sibling's minority shareholders and creditors.[84] We do not deny that the prospect of such externalization would be a cost of our proposal if extended to corporate-affiliate liability. But members of a corporate affiliate are by their nature subject to (and to some extent protected by fiduciary duty from) the risk of self-interested control. We do not believe that adoption of our proposal would seriously exacerbate such risk. Thus we would permit contractual third-party liability against corporate affiliates under the same conditions that would apply to such liability against shareholders.

C. *Short-Term and Nonfinancial Creditors*

Not all creditors would contract for third-party liability. Short-term creditors in particular may have little need to impose such liability. Like the covenants it supports, third-party liability is most useful when a debtor might otherwise freely exploit a creditor's ignorance of or a change in circumstances.[85] Where circumstances are not as a creditor perceived them, a debtor might take advantage of underpriced credit—which permits the externalization of risk—and invest inefficiently at that creditor's expense for

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[83] At least under some circumstances, a firm might be reluctant to impose liability on shareholders who would be reasonably unaware that their actions violated any covenant. For example, a shareholder might inadvertently participate in a violation of a loan covenant against a debtor's stock repurchase when she sells her shares unknowingly to the debtor in an anonymous open market transaction. The prospect of liability for such a breach might chill investment in the debtor's stock, and a firm might reasonably foreswear, in its charter, the option to impose liability in such a situation. This example also highlights a practical difficulty in the imposition of liability triggered by an open market transaction: it may be difficult or impossible to match buyers and sellers. Third-party liability would not attach in this case, or it would apply pro rata to participants in a transaction.

[84] *Cf. supra* note 52 and accompanying text (discussing the imposition of liability on corporate affiliates).

[85] A change in circumstance is a necessary source of exploitation when parties are fully informed because any known condition, including the debtor's current and planned future investments, present at the time of a loan would be priced as part of the loan.

the benefit of equity or other creditors. However, short-term creditors, even large ones, may have little concern about changed circumstances or misinformation as they are largely protected by early maturity, which enables lenders to withdraw funds quickly if they are not satisfied. That is, when changed circumstances come to light, or misinformation is corrected, a debtor has relatively little opportunity to exploit a short-term extension of credit made on the basis of prior assumptions. Short maturity thus acts as at least a partial substitute for covenants: covenants enable creditors to accelerate (i.e., seek to withdraw their funds) contingent on a covenant violation that triggers an event of default, while short maturity enables creditors to withdraw funds at will without significant delay. It follows that short-term creditors, including short-term nonfinancial creditors, may have little need for loan covenants and would thus have little need for third-party liability to enforce loan covenants, or at least no need large enough to justify the transactions costs of loan covenants or their enforcement.

The question then arises whether lenders who do not covenant for protection beyond early maturity should be afforded additional protection by law. The argument in favor of additional protection is that some short-term creditors, such as many trade creditors, hold claims so small that they will not closely investigate the specific financial condition of companies to whom they extend credit.[86] These nonfinancial creditors have been referred to as "nonadjusting" consensual creditors.[87] It has been suggested that legal (as opposed to contractual) protections against exploitation of such creditors would usefully reduce a version of the arms-race problem discussed above. A small (or unsophisticated) short-term creditor, without protection and absent good information about the debtor, may assume the worst and charge an interest rate that compensates it for exploitation, leaving the debtor with an incentive to exploit to the extent possible, efficiency aside.[88]

We are agnostic about the need for extra-contractual protection even of small, nonfinancial creditors. First, we are not convinced that such creditors are in all cases truly uninformed. Even a small trade creditor will usually have some information about the company. At a minimum, the creditor will know whether the company pays the creditor's own bills on time and may deduce additional information from the history and size of the company's orders. The creditor may also have—through its dealings with other industry

86 Even holders of large claims may be insufficiently sophisticated to investigate, but creditors such as these may be rare.

87 *See* Bebchuk & Fried, *supra* note 79, at 864 (noting that such creditors will remain "'rationally uninformed' about the borrower's financial structure").

88 *See id.* at 886.

participants or by virtue of the debtor's public disclosures—some information about the debtor's general payment history, the debtor's ability to tap into a revolving credit facility, and the state of the industry in which the debtor operates. In some cases, the creditor may have read about the company (e.g., that it has undergone a leveraged buyout or is rumored to file soon for bankruptcy). A creditor so informed could react to this information, not necessarily by adjusting the interest rate or negotiating for covenants, but by demanding cash on the barrelhead for a time before extending further credit. Because small, unsophisticated creditors tend to be short term, this option may offer ample protection for the reasons discussed above: a creditor's pre-existing debts would generally become due, and often be paid, before the debtor could exploit the creditor's initial assessment of the debtor's affairs.

Second, even nonfinancial creditors need not be condemned to their plight. Such creditors may obtain a letter of credit—which shifts the risk of exploitation to a sophisticated actor—or a personal guarantee from a shareholder.

Third, we are not sure the problem of nonadjusting creditors, even if unaddressed, is a large one. On the one hand, sophisticated creditors, along with the debtor, may exploit a nonadjusting creditor. But on the other, sophisticated creditors will often contract for self-protection measures, such as a limitation on debt or dividend payments, and thus can incidentally protect nonadjusting creditors.

Fourth, and perhaps most importantly, we are not convinced that it would necessarily be unduly expensive for a debtor, concerned over the interest rate being charged by nonadjusting creditors, to cure any information asymmetry between it and a nonadjusting creditor. A debtor could do so through the offer of contract-based protection—itself enforceable against third parties, ideally—were it efficient to do so.[89]

This leaves consideration of nonconsensual creditors, notably tort victims. Nonconsensual creditors have no ability to protect their interests through contract, no opportunity to ask for a personal guarantee or a letter of credit, and no ability to insist on cash up front. For that reason, and as several commentators have noted, it would be sensible to provide them with strong protection through legislation.[90] A grant of highest priority, ahead of

[89] *See* Adler, *Secured Credit*, *supra* note 6, at 408-09.

[90] *See, e.g.*, Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1905, 1920-21 (1991) (arguing that exposing shareholders to unlimited tort liability for corporate acts would result in the net "gain[] of inducing risky corporations to internalize their full expected tort liability"); *see also* Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. 219, 242-43 (2004) ("Every consideration, therefore,

all investors including all consensual creditors, unsecured or secured, would strike most as fair and would best align the incentives of investors with those of society. Priority for nonconsensual creditors would be efficient because it would force investors more fully to internalize the cost of a firm's activity.[91] Under current law, however, nonconsensual creditors are unsecured, with lower priority than secured creditors and priority on par with other unsecured creditors. Our proposal for contractual enforcement against third parties under specified circumstances would not change this priority perversion. But we would not exacerbate the problem by allowing early creditors to enforce a covenant against later nonconsensual creditors.

V. OUR PROPOSED REMEDIES AND EXISTING LAW

We view contractually based third-party liability as a modest proposal, similar to presently imposed remedies under preference and fraudulent conveyance law. Our remedy differs from current law in a number of important respects: our remedy would not apply unless a company affirmatively adopted it; our remedy would be available only to those creditors that contracted for it; and the baseline for the imposition and amount of our remedy would be determined by the parties.

Compare, for example, a dividend paid by a company that is left with unreasonably small capital with a dividend paid by a company in violation of a covenant in a loan agreement. The former dividend is a fraudulent conveyance and can be recovered for the benefit of all creditors. As to the latter dividend, although the restriction imposed by the loan agreement—the baseline—may well be tighter than the one imposed by fraudulent conveyance law, a third-party remedy against its recipients is available only if specifically provided for in the loan agreement, and recovery is limited to those creditors that have contracted for third-party liability.

Furthermore, legally imposed and contractually imposed liability could differ in risk and uncertainty. To be sure, the contractual third-party liability we suggest would generate some uncertainty for third parties. Shareholders could be surprised when asked to return dividends they have received. New creditors may not expect to have a security interest invalidated. And such uncertainty is qualitatively similar to the uncertainty created by fraudulent conveyance and preference law.[92] But because debtors would have an

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seems to favor nonconsensual-claim priority, which would cause a company's investors to internalize both the cost and the benefit of corporate activity (at least to the full extent of corporate assets).").

91 *See supra* note 90.

92 *See supra* text accompanying notes 53-61.

incentive to reduce uncertainty—so that they could more easily obtain subsequent financing—one might expect contracts for objectively verifiable triggers to third-party liability, such as an insufficiency in specified cash reserves as opposed to "unreasonably small capital," the latter being an inscrutable trigger of fraudulent conveyance law.[93]

This raises an additional point. If our proposal were adopted, firms would, at least in some contexts, have less need for fraudulent conveyance law's imposition of liability on third parties. As discussed above, fraudulent conveyance law has been used to avoid transfers in LBOs. But as noted, LBOs may enhance value as well as destroy value. Thus, although current bankruptcy law does not permit waiver, a debtor should be permitted contractually to foreswear the statutory avoidance of transfers used to finance projects it may wish to pursue.[94] Permitting such a waiver would be particularly appropriate were debtors free to offer contractual protection against transfers, enforceable against third-party recipients. Under these circumstances, each debtor could, if it chose, replicate the legal protection now afforded as a matter of law or alter it as desired, with, for example, a less or more rigorous capitalization standard. Our proposal would allow a debtor to balance competing concerns and obtain only those protections of fraudulent conveyance law that it made sense to retain.

Similarly, other legally imposed remedies against third parties might be altered under our proposal. For example, above we explained how a debtor might contract to extend voidable preference law, but there might well be circumstances under which a firm wishes to curtail the reach of such laws. An enhanced concern about an ability to finance projects comes to mind. The essence of our proposal is that debtors should be permitted, but not required, to create third-party liability in favor of early creditors.

Whatever the merit of our proposed remedies against third parties, one might imagine that such remedies already exist in the form of tortious interference doctrine. Consider, for example, a bond covenant against the issuance of subsequent secured debt. If the debtor violated that covenant

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93 *See supra* note 61.

94 A debtor and early creditor might decide that the excessive cost of later debt as a result of fraudulent conveyance protection might outweigh the savings from greater protection of early debt. A debtor might make this decision, for example, if the debtor and its creditors anticipated little opportunity for the debtor to pursue unduly risky projects and anticipated a significant possibility of underinvestment, that is, of profitable projects that the debtor's equity investors would not pursue unless subsequent finance could be obtained on favorable terms. Note, however, that all else equal in a Coasean bargain, the threat of inefficient underinvestment may be more manageable than that of inefficient overinvestment. One might thus expect a firm to prefer some form of protection for early creditors. *See* Adler, *Secured Credit*, *supra* note 6, at 407-08 (discussing this observation in connection with an early, unpublished version of this Article).

and issued secured debt, the new lender might be liable to the bondholders under tort law for interfering with the covenant. This is plausible, but application of the tortious interference doctrine is uncertain; in this example, a court might reject the doctrine on the ground that its application would undermine the statutory priority established by the UCC.[95] Even where it is undisputed that the tortious interference doctrine applies, the results may be haphazard, as the doctrine applies only when the interference is intentional, a standard that may require not merely knowledge of the breached contract and its terms but also knowledge that the defendant's action violates these terms. Under this standard, in our setting, the burden of any ambiguity likely falls on the early creditors. As a result of due diligence, a subsequent financial creditor may know of a contract with an early creditor and have to concede such knowledge; but the subsequent creditor might too easily evade tortious interference liability if it says it believed, even erroneously, that the contract with the early creditor was not violated.[96] Moreover, the tortious interference standard, were it robust enough to matter, might be evaded by purposeful ignorance of early debt contracts and their terms.

A recent dispute involving J.C. Penney Company, Inc. (JC Penney) illustrates why the tortious interference doctrine does not seem an adequate substitute for contractual third-party liability.[97] On January 29, 2013, holders of a majority of JC Penney's 7.4% debentures sent a notice of default to the company claiming that a credit agreement between the company and a group of banks violated a negative pledge covenant in the indenture pursuant to which the debentures were issued. The credit agreement granted the banks a lien on JC Penney's inventory, and the negative pledge covenant limited liens on "real property and tangible personal property owned by [JC Penney] . . . constituting a part of any store, warehouse or distribution center."[98] In response, JC Penney filed a declaratory judgment action on the

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[95] *Compare* First Wyo. Bank, Casper v. Mudge, 748 P.2d 713, 717 (Wyo. 1988) (applying tortious interference law when a subsequent creditor knew about an earlier restrictive covenant), *with* U.S. Claims, Inc. v. Flomenhaft, 519 F. Supp. 2d 532, 539 n.3 (E.D. Pa. 2007) (describing *Mudge* as "an 'outrageous' and 'unfortunate' example of a court 'mangling' the clear UCC priority rules in the name of fairness and equity" (citing 1 BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 3.14[7]-[8] (rev. ed. 2006))).

[96] If a merely plausible argument can be made that a proposed action does not violate a covenant (and sometimes even if not), subsequent creditors may have little difficulty finding an outside law firm, or inside counsel, to opine that, while the issue is not free from doubt, a court would likely find no violation of the contract with early creditors. Though questionable, such an opinion may in itself enhance a good faith defense.

[97] The facts provided are taken from J.C. Penney Co., Current Report (Form 8-K) (Feb. 4, 2013), *available at* http://www.sec.gov/Archives/edgar/data/1166126/000134100413000151/form_8k.htm.

[98] *Id.* (ellipsis in original).

ground, among others, that inventory is not encompassed within the phrase "tangible personal property . . . constituting a part of any store, warehouse or distribution center."[99]

If the debenture holders prevail and the default is not cured, they will have the right to accelerate the debentures. But even if the debenture holders prevail against JC Penney, they would not necessarily prevail in a tortious interference action against the banks, as the banks could argue that they interpreted the negative pledge clause, in good faith, not to encompass inventory.

As explained above, we propose that remedies against third parties be made effective by public filing; unless the parties so provided, we would not limit the remedy to cases where the third party had actual knowledge of, or intended to breach, the contract. Thus, in the JC Penney case, if the indenture at issue had included a third-party remedy of the type we suggest, the banks' good faith would not be at issue. In that case, regardless of the banks' intent, if a court determined that the liens violated the negative pledge clause and JC Penney did not repay the debentures upon acceleration, the bondholders could assert a claim against the banks.

Whatever the state of, or justification for, tortious interference claims or other tort-based lender-liability claims under current law,[100] the justification would be strengthened if liability were imposed by contract between an early creditor and a debtor, where the debtor chose to incur the burden of higher interest imposed by the prospect of such liability on the debtor's later borrowing. It is a central tenet of our proposal that the debtor, which internalizes its lenders' expected costs, may choose its preferred liability regime.

This brings us to another alternative: the use of the secured credit system as support for loan covenants. Under current law, a debtor can pledge its assets as security for the performance of covenants in a loan agreement and allow the lender to perfect its interest through public recordation.[101] So, for example, a debtor might covenant not to issue new debt, or new secured

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99 *Id.*

100 For recent surveys of lender liability doctrine, see, for example, Gerald L. Blanchard, *Lender Liability Update*, *in* NORTON ANNUAL SURVEY OF BANKRUPTCY LAW 1165 (William L. Norton, Jr. ed., 2010), and Lauren Colasacco, Note, *Where Were the Accountants? Deepening Insolvency as a Means of Ensuring Accountants' Presence when Corporate Turmoil Materializes*, 78 FORDHAM L. REV. 793 (2009).

101 *See* RANDAL C. PICKER, SECURITY INTERESTS IN PERSONAL PROPERTY: CASES, PROBLEMS, AND MATERIALS 234-37 (4th ed. 2009) (describing a secured negative pledge under the UCC, but noting the potential for bankruptcy preference rules to avoid the benefits of such security); *see also, e.g.*, Coast Bank v. Minderhout, 392 P.2d 265 (Cal. 1964) (negative pledge secured by an equitable lien on real estate).

debt, and may grant a creditor a security interest to provide the creditor's claim priority in the event the debtor breaches the covenant. Such an arrangement—created by contract and thus tailored to the debtor's needs—bears a family resemblance to our proposed creditor protection.

There are, however, differences between our proposal and the remedies currently available as part of the secured credit system. Most notably, our proposal would allow a breach victim to collect directly against a third party associated with a breach, including one who is not a creditor, while a security interest in a debtor's assets operates only to alter the priority of claims against the debtor. The value of priority enhancement for a covenant breach is limited to the value of the debtor's assets, and there are circumstances under which a security interest perfected by an early record of public notice, including one held by the victim of a covenant breach, can be trumped by a later interest.[102] Moreover, because a reduction in a claim's priority does not eliminate the claim, a potential third-party creditor may have a relatively low incentive to avoid participation in the debtor's covenant breach.

There is more. As presented here, our proposal is, in essence, a thought experiment. If legislation converted our abstract ideas to concrete law, the result would be a structural framework that could change the way in which creditor protection is perceived. We would expect the law to clarify enforcement ambiguities and to establish reasonable default rules. We would also expect innovation, including the creation of boilerplate provisions on which parties might inexpensively rely. Consider, for example, that under current law there are not, to our knowledge, many instances of a negative pledge secured independently of a payment obligation. That is, we do not believe that many debtors use the secured credit system itself to bond themselves against the issuance of secured debt. The reason may be that debtors do not desire such a bond, but it may be instead that the current technology of creditor protection has not created an environment in which such a bond can develop. Our proposal could usefully alter the environment.

CONCLUSION

The irony of a debtor's covenant against actions that can lead to its insolvency is that when such a covenant is breached, insolvency itself may render the remedy ineffective. For creditors to be protected by such covenants,

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102 *See* PICKER, *supra* note 101, at 237-41 (describing the superpriority of purchase money security interests under sections 9-103 and 9-324 of the UCC).

a solution is enforcement against third parties who may have benefited from such breach. Enforcement against third parties should be limited to cases where the third parties were on actual or constructive notice of a creditor's right to enforcement against them. Under these circumstances, debtors would be forced to internalize more fully the costs of their breaches. This would induce relatively efficient debtor behavior ex post and allow a debtor effectively to promise such behavior ex ante.