CORPORATE GOVERNANCE IN CHAPTER 11: THE FIDUCIARY RELATIONSHIP BETWEEN DIRECTORS AND STOCKHOLDERS OF SOLVENT AND INSOLVENT CORPORATIONS

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INTRODUCTION

In 1992 the corporate world witnessed a wave of management upheavals in some of the largest commercial corporations in the United States. As a result of increasing and direct stockholder criticism, public directors are becoming more sensitive to their obligations to the corporation and its stockholders. Dormant management-controlled directors are passing into history as nonmanagement directors have become more objective and comprehensive in evaluating management in an effort to improve corporate performance. This surge of pro-active conduct illustrates an increasing recognition of the fiduciary duties that are imposed upon a corporation's directors.

The applicable principle of law is well-settled. Directors owe certain fiduciary duties, generally the duties of care and loyalty, to the stockholders of a solvent corporation. Basically, the duty of care requires directors to exercise that degree of care that an ordinarily prudent person would exercise under the same or similar circumstances, while the duty of loyalty prohibits self-dealing and the usurpation of corporate opportunities. Upon the occurrence of insolvency, however, the scope of these fiduciary duties expands to include obligations to the corporation's creditors.

The precise nature of the fiduciary duties of directors of an insolvent corporation to the corporation's creditors and stockholders becomes somewhat vague and diaphanous postinsolvency and after the commencement of a bankruptcy case under chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code").[1] Generally, the management of the debtor

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[1] Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1988 & Supp. 1992)).

continues to operate the business and manage the assets of the corporation as a debtor in possession ("DIP"). The DIP acts *qua* trustee under the Bankruptcy Code and is responsible for the preservation and administration of the debtor's estate. Nevertheless, the DIP is the same entity as the debtor and there is no change in the normal rules of corporate governance. The board of directors remains the policymaker and appoints the corporate officers subject to the provisions of the Bankruptcy Code. The directors of the debtor as DIP continue to owe the twin fiduciary duties of care and loyalty to both the creditors and stockholders of the debtor corporation. However, these beneficiaries often have conflicting interests as to the administration of a bankruptcy case, the development of a plan of reorganization, or any alternative. These conflicts become even more aggravated when the corporation is insolvent.

This Article will explore the obligation or appropriateness of boards of directors to negotiate for some consideration for stockholders in a plan of reorganization despite the fact that the debtor is patently insolvent. The concept that a debtor is under an obligation to bargain on behalf of stockholders of an insolvent corporation is implicit in the philosophy and policies underlying the provisions of chapter 11 of the Bankruptcy Code.[2] The process of rehabilitating and reorganizing a debtor under chapter 11 should result in the enhancement of the value of the corporation. During the pendency of a case under chapter 11, a corporation which initially may appear to be insolvent may be rehabilitated to the point that enhanced reorganization value extends to the stockholders. It is the grey area between liquidation value and going concern value which may be realized because of a chapter 11 reorganization that provides a potential interest for existing stockholders. Participation in this realization is consistent with the primary objective of chapter 11 — the achievement of a consensual plan of reorganization. Accordingly, within certain constraints, the directors of a debtor continue to have a fiduciary obligation to cause the management to bargain for some participation in the reorganized entity for stockholders. This conclusion is buttressed by the power of the stockholders, generally, to elect directors notwithstanding the debtor's insolvency.

Part I of this Article explores the scope of the fiduciary obligations of directors of corporations that are outside of bankruptcy. It begins with a discussion of the recent activism in the

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[2] 11 U.S.C. §§ 1101-1174 (1988).

world of corporate governance. It then discusses the scope of the fiduciary obligations that directors of both solvent and insolvent corporations have to the corporation's stockholders and other constituents.

Part II of this Article examines the fiduciary obligations that are owed to the creditors and stockholders of corporations that have commenced cases under chapter 11 of the Bankruptcy Code. It analyzes the debtor's responsibility to benefit the debtor's estate as a whole as well as the manner in which conflicts between the duties owed to creditors and stockholders are resolved. It then compares the role of the debtor in the perspective of solvency and insolvency. This Part rejects the view that stockholders of an insolvent debtor are no longer real parties in interest because it is contrary to the scheme and purposes integral to the application of the reorganization provisions of the Bankruptcy Code.

Part III of this Article explores the right of stockholders to cause a change in the board of directors of a chapter 11 debtor. It begins with a discussion of the judicial treatment of stockholders' requests to compel a meeting to elect directors. Despite the pendency of a reorganization case, stockholders do retain many rights relating to corporate governance, including the right to elect directors. Stockholders' requests to convene a meeting to elect directors may be denied, however, if the policies of the Bankruptcy Code would be undermined. This Part then argues that normal corporate governance should prevail during a chapter 11 case, inclusive of the right to cause stockholders' meetings to be held, irrespective of insolvency, unless the exercise of normal corporate governance rights would impair or destroy the ability to achieve the objectives of chapter 11. Finally, this Part concludes with an analysis of the right of preferred stockholders to elect directors. Unlike common stockholders, preferred stockholders usually only may elect directors upon a prescribed default in the payment of preferred dividends. This Part argues that the exercise by preferred stockholders of the right to elect directors, which is triggered by monetary default and continues only so long as the default is extant, is a violation of the automatic stay because it is an action to exercise control over property of, and to recover on a claim against, the debtor.

I. Role of the Board of Directors

The business and affairs of a corporation are managed by or

under the control of its board of directors.[3] The existence and exercise of this power carries with it certain fundamental fiduciary duties. These duties, however, do not exist in the abstract. Rather they must be considered in relation to specific beneficiaries. A director of a solvent corporation owes certain fiduciary duties, namely the duties of care and loyalty, to the corporation and its stockholders. Upon the occurrence of insolvency, however, this duty expands to benefit the corporation's creditors as well. As stockholders have realized their prerogative to directly challenge underperforming management, directors have become more sensitive to their fiduciary duties. As a result, the performance of management has been subjected to greater scrutiny.

A. *Activism in Corporate Governance*

This past year, "events have moved at lightening speed for the world of corporate governance."[4] Since early 1992, corporate America has gone through a record number of basically involuntary senior management changes initiated by growing stockholder dissatisfaction and executed by responsive nonmanagement directors. Chief executives at General Motors, American Express, and IBM who fought in vain to keep their offices ended up being replaced in an atmosphere of director independence fueled by stockholder pressure.

In the past, individual stockholders who were dissatisfied with corporate performance usually did not approach boards of directors. Rather, they would sell their stock. However, large institutions, such as pension funds or money managers, have recently replaced individuals as the predominant owners of corporate stock.[5] These institutional investors have accrued significant power. It has been projected that by the year 2000, the twenty largest pension funds combined with the ten largest money managers will own between 22 and 29 percent of the outstanding equity of the ten largest corporations in the United States.[6] This

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3 *See, e.g.*, DEL. CODE. ANN. tit. 8, § 141 (1991); N.Y. BUS. CORP. LAW § 701 (McKinney 1986).

4 Ira M. Millstein, Corporate Governance in the 1990's: Focus on the Board, Distinguished Lecture in International Business & Trade Law, University of Toronto, Toronto, Ontario, at 2 (Feb. 4, 1993) (unpublished manuscript, on file with the *Seton Hall Law Review*) [hereinafter Millstein].

5 *See, e.g.*, William Power, *Small Investor Continues to Give Up Control of Stocks*, WALL ST. J., May 11, 1992, at C1 (direct stock holdings by individuals dropped from 84.1% of the market in 1965 to 53.5% of the market in 1991).

6 *See* Carolyn K. Brancato, Concentration of Equity Holdings in the Top 10 Corporations by the Largest Pension Funds and Money Managers: 1985 to 1989,

change in stock ownership has resulted in a change in the focus of corporate performance from the stock market to the corporate governance structure of existing corporations.[7]

The new concentration of ownership in the form of institutional investors has caused a heightened corporate discipline. The existence of organized stockholder groups has had significant impact on corporate governance. These stockholders have increasingly demanded that directors discharge their fiduciary obligations to them by revamping a corporation's management when necessary in order to improve corporate performance and increase value for stockholders. Concomitantly, boards of directors have begun to recognize that they must monitor management's performance more comprehensively and objectively in the interests of stockholders.[8] In many situations, chief executive officers no longer exercise dominant influence over the actions of directors.

Activists have been advocating the reformation of the governance structure of existing corporations by improving the function of the board of directors. Their goal is to make the board of directors "what it is supposed to be — a real monitor, on behalf of the shareholders, of corporate performance by corporate managers."[9]

One of the most innovative changes in corporate governance that has been advocated involves the concept of separating leadership of the board of directors from the position of chief executive officer. This innovation recently came to fruition as a result of the board action at General Motors Corporation ("GM"), the world's largest corporation. On March 28, 1992, the outside directors of GM told Chairman of the Board and Chief Executive Officer ("CEO") Robert C. Stempel that two senior executives should be discharged and that he should resign as chairman of GM's executive committee.[10] GM's institutional investors demanded that a new model of corporate governance be installed at GM. The directors of GM were advised to split the duties of

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with Projections to the Year 2000, Columbia Institutional Investor Project, Center for Law and Economics Studies, Columbia University School of Law (1990) (unpublished manuscript, on file with the *Seton Hall Law Review*).

[7] *See* Millstein, *supra* note 4, at 18.

[8] *See id.* at 5 (boards of directors are responding to a culture change in boardrooms in which directors who are motivated by their reputations, pride, and self-respect are acting because they see their responsibilities more clearly).

[9] *Id.* at 20.

[10] *See* Joseph B. White & Paul Ingrassia, *Behind Revolt at GM, Lawyer Ira Millstein Helped Call the Shots*, WALL ST. J., Apr. 13, 1992, at A1.

CEO and chairman of the board, and it was suggested that a nonmanagement person become chairman of the board to oversee management.[11] Although the CEO is in charge of running the corporation, the CEO is accountable to the corporation's directors, who are accountable to the corporation's stockholders. In that perspective, the natural conclusion was that separation of board leadership from operational management is in the best interests of the corporation and its stockholders.

The activism of the GM board of directors has led to increased boards of directors initiatives at a growing number of corporations, including Compaq Computer Co. and Sears.[12] The GM board's action has been characterized as a " 'milestone that other boards can refer to and use to take comfort in being a little more activist in their own regard.' "[13] In addition, nonmanagement directors have become increasingly aware of their obligations to the corporation's stockholders to ensure management performance that will preserve and enhance stockholder values.[14]

B. *Fiduciary Duties of Directors of a Solvent Corporation Outside of Bankruptcy*

1. Directors as Fiduciaries

The directors of a corporation stand in a fiduciary relationship with the corporation and its stockholders. One who is a fiduciary occupies a special relation of trust, and is thus obligated to protect the interests of others as carefully as, if not more carefully than, one cares for one's own interest. The concept of the special obligations imposed upon a fiduciary was described in

11 *See* Joseph B. White, *Corporate Lawyer Is General in Battle For Separation of Powers at Top of GM*, WALL ST. J., Oct. 29, 1992, at B1.

12 *Id.* at B10.

13 Allison Leigh Cowan, *The High-Energy Board Room*, N.Y. TIMES, Oct. 28, 1992, at D1 (quoting statement of James Kristie, the editor of *Directors and Boards*).

14 *See generally* Dennis J. Block & Jonathan M. Hoff, *Corporate Governance Reform And Directors' Duty of Care*, N.Y.L.J., May 20, 1993, at 5, which discusses whether corporate governance reform proposals which advocate increased activism among outside directors will result in better corporate economic performance. The authors note that "[i]ncreasing the role and function of outside directors to become more involved in management decision-making may . . . have the unintended result of effectively transforming outside directors into insiders, thus blurring the distinction between management and independent directors." *Id.* at 6. In addition, the authors conclude that the "increased emphasis on the monitoring function does not result in the imposition of new legal standards (or a novel interpretation of existing standards) which have the effect of increasing directors' legal exposure." *Id.* at 10.

Meinhard v. Salmon[15] by Chief Judge Benjamin Cardozo as follows:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.[16]

This relationship of trust between directors and the corporation and its stockholders[17] "springs from the fact that directors have the control and guidance of corporate business affairs and property and hence of the property interests of the stockholders. Equity recognizes that stockholders are the proprietors of the corporate interest and are ultimately the only beneficiaries thereof."[18] Accordingly, in equity, a director of a corporation

> owes the corporation complete loyalty, honesty, and good faith. That duty is owed the corporation and its shareholders whenever the actions of the director concern matters affecting the general well-being of the corporation. Thus, as a fiduciary in this sense, a director's first duty is to act in all things of trust wholly for the benefit of the corporation.[19]

Because directors do not hold legal title to the assets of the corporation, however, they are considered to be "implied trustees."[20]

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15 164 N.E. 545 (N.Y. 1928).

16 *Id.* at 546 (citations omitted).

17 *See* 3 FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 838, at 177 (perm. ed. rev. vol. 1986) ("[I]t is universally recognized that courts of equity treat the relationship of director and stockholders as a trusteeship, in order to determine the rights, duties and liabilities of the directors . . . .") (citations omitted) [hereinafter FLETCHER]; *see also* Ashman v. Miller, 101 F.2d 85, 90-91 (6th Cir. 1939) ("A director of a corporation occupies a fiduciary relation to it and its stockholders. His position is one of trust and he is frequently denominated a trustee and so held accountable in equity.").

18 *Ashman*, 101 F.2d at 91.

19 3 FLETCHER, *supra* note 17, § 838, at 178.

20 *See id.* at 179; *cf.* Stephen H. Case, *Fiduciary Duty of Corporate Directors and Officers, Resolution of Conflicts Between Creditors and Shareholders, and Removal of Directors by Dissident Shareholders in Chapter 11 Cases* 13 *in* C371 ALI-ABA 1, 17 (Study Materials for ALI-ABA's Williamsburg Conference on Bankruptcy, Oct. 17-19, 1988) ("The role of the directors of the corporation is similar to that of the trustee under the

The trustee theory is not the only view as to the nature of the fiduciary relationship between directors and stockholders. Some courts refer to directors as agents, while other courts refer to them as agents as well as trustees.[21]

Regardless of which theory is followed, directors remain the focal component of corporate governance. In carrying out its managerial role, a corporate director is charged with unyielding fiduciary duties of care and loyalty, among others, to the corporation and its stockholders.[22] These fiduciary duties are the foundation of the law of corporate governance.[23]

2. Duty of Care

The duty of care requires a director, as a corporate fiduciary, to exercise that degree of care that an ordinarily careful and prudent person would exercise under the same or similar circumstances.[24] A number of states have codified this standard of conduct for directors in their statutory corporate law.[25]

will. They 'hold' property (*i.e.*, corporate assets) for the benefit of others (*i.e.*, shareholders) who are impeded from protecting themselves (*e.g.*, because . . . their economic stake is too small to justify personal attention).").

21 *See* 3 FLETCHER, *supra* note 17, § 838, at 179-80; Anna Y. Chou, *Corporate Governance In Chapter 11: Electing A New Board*, 65 AM. BANKR. L.J. 559, 562 (1991).

22 *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

23 *See e.g.*, Revlon Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 179 (Del. 1986); Guth v. Loft, 5 A.2d 503 (Del. 1939).

Directors and officers also have the duty of obedience, which prohibits activities that are beyond the scope of power conferred by the articles of incorporation and bylaws. However, this duty is not discussed in this Article.

24 *See, e.g.*, Meyers v. Moody, 693 F.2d 1196, 1209 (5th Cir. 1982) (" 'Due care' is that degree of care which a person of ordinary prudence would exercise under the same or similar circumstances."); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) ("[D]irectors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances.").

A minority of courts require directors to exercise that amount of care that an ordinarily prudent person would exercise in his personal affairs. *See, e.g.*, Dykema v. Muskegon Piston Ring Co., 82 N.W.2d 467, 471 (Mich. 1957) (directors must answer for ordinary neglect, which is "understood to be omission of that care which every man of common prudence takes in regard to his own affairs"); FMA Acceptance Co. v. Leatherby Ins. Co., 594 P.2d 1332, 1334 (Utah 1979) (in exercising due care, directors must give the business such attention as an ordinarily discreet businessman would give to his own concerns under similar circumstances).

25 This standard is also contained in § 8.30(a) of the Model Business Corporation Act, which provides:

> A director shall discharge his duties as a director, including his duties as a member of a committee:
> (1) in good faith;
> (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

In evaluating this duty, courts have adhered to the business judgment rule, which has been the primary means of reviewing a director's decisions for over 150 years.[26] The business judgment rule is a presumption that directors who made a business decision acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation.[27] To invoke the protection of the business judgment rule, directors have a duty to inform themselves of all material information reasonably available to them before making a business decision. After becoming so informed, directors are required to act with the requisite care in discharging their duties.[28] If a director takes or approves an action that is detrimental to the corporation without an adequate independent basis, however, the duty of care is breached.[29] Thus, when directors make decisions, the duty of care requires that such decisions be made:

- in good faith
- in the best interests of the corporation
- with the care that an ordinarily prudent person would extend.

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(3) in a manner he reasonably believes to be in the best interests of the corporation.

Model Business Corp. Act § 8.30(a) (1991).

Although Delaware does not statutorily codify the duty of care, the case law in that jurisdiction sets forth the same standard as most of the state statutes. *See Graham*, 188 A.2d at 130.

26 *See* DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 3 (3d ed. 1989) [hereinafter BLOCK].

27 *See, e.g.*, Levine v. Smith, 591 A.2d 194, 207 (Del. 1991); Spiegel v. Buntrock, 571 A.2d 767, 774 (Del. 1990); Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also* BLOCK, *supra* note 26, at 29 ("The business judgment rule both shields directors from liability when its five elements — a business decision, disinterestedness, due care, good faith and no abuse of discretion — are present and creates a presumption in favor of the directors that each of these elements has been satisfied.").

28 *See Aronson*, 473 A.2d at 812.

29 *See, e.g.*, Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 274-75 (2d Cir. 1986) ("Directors may be liable to shareholders for failing reasonably to obtain material information or to make a reasonable inquiry into material matters."); *see also* CAL. CORP. CODE § 309(a) (West 1990) (requiring good faith and the care of an ordinarily prudent person).

Courts differ in their articulation of the standard of culpability (*i.e.*, ordinary negligence, gross negligence, or recklessness) that is required in order to impose liability for breaching the duty of care. *See generally* BLOCK, *supra* note 26, at 35-40 (discussing various standards). A number of courts impose liability only for conduct that amounts to gross negligence. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); *Aronson*, 473 A.2d at 812; *see also* Block & Hoff, *supra* note 14, at 6 (in practice, courts impose liability only for conduct rising to the level of gross negligence).

In addition, such decisions should be based upon the best information available and such professional advice as is appropriate.[30]

3. Duty of Loyalty

A corporate director also has a duty of loyalty to the corporation and its stockholders. The duty of loyalty prohibits self-dealing or the usurpation of corporate opportunities.[31] The basic concept underlying this duty is that a director should not use his or her position in a corporation to obtain a personal advantage. The landmark decision of *Guth v. Loft, Inc.*[32] described this duty as follows:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. . . . A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty . . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[33]

The duty of loyalty is derived form the bar against self-dealing that is inherent in a fiduciary relationship. By assuming office, a director "commits allegiance to the enterprise and acknowledges that the best interests of the corporation and its shareholders must prevail over any individual interest of his own."[34]

Unlike the duty of care, good faith does not preclude a finding that the duty of loyalty has been breached. Thus, a self-dealing transaction will be sustained only if such transaction is objectively or intrinsically fair.[35]

4. Scope of Fiduciary Duties of Care and Loyalty

The primary obligations of the directors of a solvent corporation are to the stockholders of the corporation. The stockholders are the proprietors of the corporation and are ultimately the

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30 *See* BLOCK, *supra* note 26, at 48-66.

31 *See, e.g.*, Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984) (duty of loyalty derives from the prohibition against self-dealing that inheres in the fiduciary relationship).

32 5 A.2d 503 (Del. 1939).

33 *Id.* at 510.

34 Corporate Director's Guidebook, 33 BUS. LAW. 1595, 1599 (1978).

35 *See, e.g.*, AC Acquisition Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 115 (Del. Ch. 1986).

beneficiaries of its growth and increased value.[36] Stockholders have the right to expect that a director will cause the adoption of appropriate policies and practices for the corporation, and that the corporation's officers and management will execute such policies and practices in a professional and competent fashion.

In contrast, a director generally has no fiduciary obligations to the creditors of a solvent corporation.[37] Directors are not trustees for a corporation's creditors. As one court aptly stated:

> [I]t is difficult to perceive upon what principle a director of a corporation can be considered a trustee to its creditors. He is selected by the shareholders, not by creditors; he has no contractual relation with the latter; he represents a distinct entity, the corporation; and his relations to its creditors is exactly the same as the agent of an individual bears to creditors of such individual; and it is not pretended that in the latter case the agent would be the trustee of the creditors of his principal. . . . [B]y the great weight of authority such trust relation is distinctly repudiated, when the corporation is a going concern.[38]

In fact, favoring creditors over stockholders may result in liability of the directors to the affected stockholders.[39]

Creditors are only entitled to the protection afforded by the terms of their contracts with the corporation. This principle was aptly set forth in *Simons v. Cogan*,[40] which held that a corporation that issued convertible debentures did not owe any fiduciary duty to the holders of such debentures. The court began its analysis by explaining that a debenture is a credit instrument that does not devolve upon its holder an equity interest in the issuing corporation,

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36 *See* Ashman v. Miller, 101 F.2d 85, 91 (6th Cir. 1939).

37 *See, e.g.*, C-T of Va., Inc. v. Barrett, 124 B.R. 689 (W.D. Va. 1990); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989); Simons v. Cogan, 549 A.2d 300 (Del. 1988). Thus, one court has stated that while a board of directors

> may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders, . . . such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.

Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

38 Webb v. Cash, 250 P. 1, 8 (Wyo. 1926).

39 *See Revlon*, 506 A.2d at 182-84 (board of directors breached its primary fiduciary duties when it entered into lockup agreement with potential buyer on basis of impermissible considerations of noteholders' interests at expense of interests of stockholders).

40 549 A.2d 300 (Del. 1988).

and that the convertibility feature does not impart an equity element until the debenture is in fact converted.[41] A convertible debenture thus "represents a contractual entitlement to the repayment of a debt and does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties."[42] Before such a fiduciary duty arises, "an existing property right or equitable interest supporting such a duty must exist."[43] Until the debenture is converted into stock, the convertible debenture holder remains a creditor of the corporation whose interests are only protected by the contractual terms of the indenture.[44]

Although directors generally do not owe fiduciary duties to the creditors of a solvent corporation, there are certain instances in which directors do owe fiduciary duties to creditors and other third parties. For example, directors of banking institutions owe fiduciary duties to depositors.[45] A number of cases have held that directors are trustees for such creditors.[46] Similarly, directors of nonbanking corporations that hold funds in trust owe fiduciary duties to the owners of such funds by characterizing the status of the beneficiaries of the trust as similar to those of bank depositors.[47] The trust relationship thus gives rise to a fiduciary duty to guard the trust funds with fidelity and in good faith.[48]

Finally, in response to the wave of takeovers during the 1980's, many states enacted "constituency" statutes in order to give directors leeway to consider constituencies other than stockholders.[49]

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41 *Id.* at 303.

42 *Id.*

43 *Id.* at 304.

44 *Id.*

45 *See, e.g.*, Irving Bank Corp. v. Board of Governors of the Fed. Reserve Sys., 845 F.2d 1035, 1039 (D.C. Cir. 1988) (fiduciary duty to protect stockholders and depositors).

46 *See, e.g.*, Masi v. Ford City Bank & Trust Co., 779 F.2d 397, 401 (7th Cir. 1985) (IRAs are "special deposits that constitute a trust relationship wherein the Bank owes a fiduciary duty to the depositor"); Commercial Cotton Co. v. United Cal. Bank, 209 Cal. Rptr. 551, 554 (Cal. Ct. App. 1985) ("A depositor in a noninterest-bearing checking account . . . is totally dependent on the banking institution to which it entrusts deposited funds and depends on the bank's honesty and expertise to protect them. . . . The relationship of bank to depositor is at least quasi-fiduciary . . . .").

47 *See, e.g.*, Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981) (director of reinsurance brokerage corporation found negligent in not noticing or trying to prevent other directors' misappropriation of funds held by corporation in implied trust).

48 *See id.* at 825.

49 Statutes enacted in Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Il-

These statutes permit or require directors responding to takeover bids to consider the interests of creditors, suppliers, employees, consumers, and, in some states, the local and national economies as well as society in general.[50] Generally, these statutes are precatory; it is not compulsory that directors consider the interests of such constituencies.[51] In fact, some constituency statutes expressly state that they do not "create any duties owed by any director to any person or entity to consider or afford any particular weight" to any nonstockholder constituents.[52]

C. Fiduciary Duties of Directors of an Insolvent Corporation Not Subject to a Case Under the Bankruptcy Code

Although corporate directors have fiduciary obligations to the stockholders, rather than the creditors, of a solvent corporation, upon the occurrence of the corporation's insolvency there is imposed upon the directors the additional burden of fiduciary responsibilities to creditors of the corporation. This expansion of the scope of a director's fiduciary duties raises the question at what point does a corporation become insolvent so that the enlarged scope of responsibility imposed by the law becomes effective. Additionally, the nature and extent of the fiduciary duties of directors to creditors of an insolvent corporation is unclear.

1. Definition of Insolvency

Insolvency " 'is a most important and material fact [and] the mere fact of its existence may change radically and materially [a corporation's] rights and obligations.' "[53] The term "insolvent" has been defined in various ways. The Bankruptcy Code and state law definitions involve different variations of formulas that compare assets and liabilities. For example, the Bankruptcy Code defines the term "insolvent" as follows:

(A) with reference to an entity other than a partnership

linois, Indiana, Iowa, Kentucky, Louisiana, Maine, Massachusetts, Missouri, Minnesota, Nebraska, New Jersey, New Mexico, New York, Ohio, Oregon, Pennsylvania, Tennessee, Wisconsin, and Wyoming explicitly permit or require consideration of nonshareholder constituencies or long-term corporate interests, either generally or with respect to contests for control of the corporation.

50 *See* BLOCK, *supra* note 26, at 171-72.

51 *But see* CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1992) (with regard to sales of all or substantially all of a corporation's assets, a director is required to consider the interests of the corporation's creditors).

52 *See, e.g.*, N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1993).

53 Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 357 (1985) (quoting McDonald v. Williams, 174 U.S. 397, 404 (1899)).

> and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of —
>
> (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and
>
> (ii) property that may be exempted from property of the estate under section 522 of this title . . . .[54]

Similarly, the Uniform Fraudulent Transfer Act provides that a debtor is insolvent "if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation," and presumes that a debtor "who is generally not paying his [or her] debts as they become due" is insolvent.[55] A different definition of the term "insolvent" is found in New York Debtor and Creditor Law, which provides that a debtor is insolvent "when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."[56] The statutes span the historical dichotomy of "equitable insolvency"[57] and "bankruptcy" or "balance sheet insolvency."[58]

The issue of when a corporation is insolvent for purposes of defining the fiduciary duties of directors was recently considered in two decisions of the Delaware Court of Chancery. In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*,[59] the court concluded that a corporation may be insolvent for purposes of enlarging the directors' fiduciary responsibilities before the corporation commences formal bankruptcy proceedings: "At least where a corporation is operating in the *vicinity of insolvency*, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."[60] The court explained that when directors manage a solvent corporation

> in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group inter-

54 11 U.S.C. § 101(32) (1988).

55 Unif. Fraudulent Transfer Act § 2(a),(b), 7A U.L.A. 648 (1985).

56 N.Y. DEBT. & CRED. LAW § 271 (McKinney 1990).

57 Equitable insolvency is defined as the inability to pay one's debts as they mature irrespective of balance sheet reporting of asset values in excess of reported liabilities.

58 Bankruptcy or balance sheet insolvency is defined as balance sheet negative net worth, *i.e.*, the book value of assets is less than reported liabilities.

59 No. CIV.A.12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

60 *Id.* at *34 (emphasis added).

ested in the corporation) would make if given the opportunity to act.[61]

The same court reached a similar conclusion in *Geyer v. Ingersoll Publications Co.*[62] In *Geyer*, the plaintiff instituted an action against Ingersoll Publications Co. ("IPCO") and Ralph Ingersoll II ("Ingersoll"), the President, Chairman of the Board, and controlling stockholder of IPCO, alleging, *inter alia*, breaches of fiduciary duties, fraudulent conveyances, and the right to a judgment on a promissory note. Ingersoll moved to dismiss all of the plaintiff's claims and to stay discovery pending resolution of his motion. In connection with this motion, Ingersoll asserted that fiduciary duties to creditors do not arise until a formal insolvency proceeding is commenced under state or federal bankruptcy law. The issue revolved around Ingersoll's claim that he was not subject to the jurisdiction of Delaware since his only contacts with that state were as a consequence of serving as a director of IPCO. In that capacity, Ingersoll alleged that his only fiduciary responsibilities extended to stockholders under Delaware law and that his implicit appointment of the Secretary of State as agent for process was only available to the stockholders of IPCO. Accordingly, Ingersoll argued that he owed no obligation to creditors beyond the relevant contractual terms, absent fraud, insolvency, or the violation of a statute.

The court disagreed and determined that "insolvency in fact" gives rise to fiduciary duties of directors in favor of creditors. In defining insolvency for the purpose of determining when fiduciary duties to creditors arise, the court noted that " '[t]he fact which creates the trust [for the benefit of creditors] is the insolvency, and when that fact is established, the trust arises, and the legality of the acts thereafter performed will be decided by very different principles than in the case of solvency.' "[63] The court also relied on the ordinary meaning of the term "insolvency" in reaching its conclusion:

> [According to Webster's Dictionary, an] entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business. That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held. Although there may be other definitions of insolvency that are slightly different, [this court is] not aware of any authority which indicates that the ordinary meaning of the word insol-

61 *Id.* at *36 n.55.

62 621 A.2d 784 (Del. Ch. 1992).

63 *Id.* at 787 (quoting Bovay v. H.M. Byllesby & Co., 38 A.2d 808, 813 (Del. Super. Ct. 1944)) (alteration in original).

vency means the institution of statutory proceedings.[64]

The court emphasized the policy concerns involved in its interpretation of determining when a corporation should be considered insolvent:

> [I]t is efficient and fair to cause the insolvency exception to arise at the moment of insolvency in fact rather than waiting for the institution of statutory proceedings. The existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when shareholders' wishes should not be the directors' only concern.[65]

Thus, under recent case law, the ordinary meaning of the term "insolvency" as well as policy considerations lead to the conclusion that it is the fact of insolvency, rather than the institution of statutory proceedings, that causes the fiduciary duties to creditors to arise.

2. The Expansion of Fiduciary Duties to Creditors

Whatever measure is used to determine the point at which a corporation becomes insolvent, the fiduciary duties of directors are deemed to have significantly expanded to include a responsibility to creditors.[66] When the point of insolvency is reached, the directors are sometimes deemed trustees for the benefit of corporate creditors.[67]

While the law clearly indicates that directors of insolvent corporations owe fiduciary duties to creditors, the courts are split with respect to whether such directors continue to owe fiduciary duties to stockholders as well. A number of courts have stated

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64 *Id.* at 789. Note that the court, in effect, has merged in one succinct paragraph the equitable and bankruptcy definitions of insolvency to support its conclusions and the rationale that Ingersoll's fiduciary duties extended to IPCO's creditors.

65 *Id.* (citations omitted).

66 *See, e.g.*, Unsecured Creditors Comm. of STN Enters., Inc. v. Noyes (*In re* STN Enters.), 779 F.2d 901, 904 (2d Cir. 1985) ("although in most states directors of a *solvent* corporation do not owe a fiduciary duty to creditors, quite the reverse is true when the corporation becomes insolvent").

67 *See, e.g.*, Automatic Canteen Co. v. Wharton (*In re* Continental Vending Mach. Corp.), 358 F.2d 587, 590 (2d Cir. 1966); Bank Leumi-Le-Israel, B.M. v. Sunbelt Indus., Inc., 485 F. Supp. 556, 559 (S.D. Ga. 1980) ("In the case of an insolvent corporation, the directors and officers stand as trustees of corporate properties for the benefit of creditors first and stockholders second."); *In re* Jersey Materials Co., 50 F. Supp. 428, 430 (D.N.J. 1943) (director "had the responsibility of a fiduciary or quasi fiduciary to the stockholders of his company during its solvency and when it became insolvent this responsibility was extended to its creditors").

that when a corporation becomes insolvent, its directors no longer represent the stockholders.[68] Thus, at the point of insolvency, the fiduciary obligations of the directors "shift[ ] from the stockholders to the creditors."[69]

In contrast, other courts have concluded that directors of an insolvent corporation owe fiduciary duties to both creditors and stockholders.[70] Because of their position as fiduciaries, directors of an insolvent corporation are characterized as trustees of corporate properties for the benefit of creditors first and stockholders second.[71]

All courts are in agreement, however, that when a corporation becomes insolvent, its directors owe fiduciary duties to creditors. Several rationales have been used to support this rule. The majority view is that when a corporation becomes insolvent, a creditor's interest becomes an equitable interest in the assets of the corporation:

> The law by the great weight of authority seems to be settled that when a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders, but by the fact of insolvency, become trustees for the creditors, and that they cannot by transfer of its property or payment of cash, prefer themselves over other creditors . . . .[72]

Other jurisdictions, however, employ a trust fund theory. This doctrine does not involve the application of an actual "trust," but rather provides that a court will administer the assets of an insolvent corporation among its creditors first and thereafter among its stockholders.[73] After describing this theory as a "source of confusion," one court explained the trust fund doctrine as follows:

> When a court of equity does take into its possession the assets

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[68] *See, e.g.*, FDIC v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982), *cert. denied*, 461 U.S. 928 (1983).

[69] *Id.*

[70] *See, e.g.*, Sanford Fork & Tool Co. v. Howe Brown & Co., 157 U.S. 312 (1895) (directors of insolvent corporation, which was still a going concern intending to continue its business, stand in a fiduciary relation to both stockholders and creditors); Committee of Creditors of Xonics Medical Sys., Inc. v. Haverty (*In re* Xonics, Inc.), 99 B.R. 870, 872 (Bankr. N.D. Ill. 1989) ("When a corporation is insolvent its officers and directors stand in a position of trust not only to the corporation and its shareholders, but also to its creditors.").

[71] *See, e.g.*, *Bank Leumi-Le-Israel*, 485 F. Supp. at 559.

[72] *Sea Pines Co.*, 692 F.2d at 977 (quoting Davis v. Woolf, 147 F.2d 629, 633 (4th Cir. 1945)).

[73] *See* WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS & DIRECTORS § 5.05, at 167 (4th ed. 1988).

> of an insolvent corporation, it will administer them on the theory that they in equity belong to the creditors and stockholders rather than to the corporation itself. In other words, and that is the idea which underlies all these expressions in reference to "trust" in connection with the property of a corporation, the corporation is an entity, distinct from its stockholders as from its creditors. Solvent, it holds its property as any individual holds his, free from the touch of a creditor who has acquired no lien; free also from the touch of a stockholder who, though equitably interested in, has no legal right to, the property. Becoming insolvent, the equitable interest of the stockholders in the property, together with their conditional liability to the creditors, places the property in a condition of trust, first, for the creditors, *and then for the stockholders.* Whatever of trust there is arises from the peculiar and diverse equitable rights of the stockholders as against the corporation in its property and their conditional liability to its creditors. It is rather a trust in the administration of the assets after possession by a court of equity than a trust attaching to the property, as such, for the direct benefit of either creditor or stockholder.[74]

A third theory that explains why fiduciary duties are owed to creditors of an insolvent corporation was recently enunciated in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*[75] The court observed that creditors of a corporation that is approaching insolvency are exposed to high-risk strategies in order to enhance earnings: "The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors."[76] The court concluded that the directors of a corporation that is in the vicinity of insolvency should view the corporation as a "community of interests." Thus, rather than choosing to take a riskier action for the benefit of stock-

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74 American Nat'l Bank v. MortgageAmerica Corp. (*In re* MortgageAmerica Corp.), 714 F.2d 1266, 1269 (5th Cir. 1983) (quoting Hollins v. Brierfield Coal & Iron Co., 150 U.S. 371, 383 (1893)).

Other courts have described the trust fund theory somewhat differently:

> Quasi trustees must be held to accountability for the performance of obligations thrust upon them by circumstances. The safety and protection of the trust *res* is of primary significance. If the assets — the trust fund of the creditors — were actually improvidently wasted or depleted as a result of defendants' unilateral action the plaintiff is entitled to recover the amount of the loss thus sustained.

New York Credit Men's Adjustment Bureau, Inc. v. Weiss, 110 N.E.2d 397, 400 (N.Y. 1953).

75 No. CIV.A.12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

76 *Id.* at *36 n.55.

holders, directors should be "capable of conceiving of the corporation as a legal and economic entity" by considering the "community of interests that the corporation represents."[77]

Regardless of which rationale is used, directors of insolvent corporations owe undefined fiduciary duties to the corporation's creditors the way that directors of solvent corporations owe fiduciary duties to the corporation's stockholders. For example, the business judgment rule continues to be the standard for reviewing the conduct of directors of an insolvent corporation.[78] The rationale for continuing to use this standard of review for insolvent corporations is that courts "must be able to rely on officers' and directors' actions, even for an insolvent corporation unless those seeking damages show that such actions are venal. To require less in assessing breach of fiduciary duty . . . would constrain the commercial world in developing means to aid the floundering corporation."[79] Whether the fiduciary duties require disregard of the interests of the corporation as an entity and its stockholders in the pursuit of a paramount objective to satisfy the claims of creditors is undetermined. Similarly, whether the fiduciary duties imposed are limited to preventing unfair or unequal distributions to creditors of the same rank is ambiguous. The only clear and undisputable principle is that insolvency of the corporation triggers an expanded responsibility upon directors. It adds to the beneficiary classes that have a right to call a director their "fiduciary." This appellation, in turn, serves to raise the consciousness and sensitivities of the directors in dealing with the corporation's business and interested parties.

II. Fiduciary Duties of Directors of a Corporation in Chapter 11

A. *Fiduciary Duties of Debtors in Possession*

As in the case of an insolvent corporation independent of bankruptcy, the directors of a corporation in a chapter 11 bankruptcy case have fiduciary duties to the multiple constituencies usually involved in such cases. The Supreme Court described these fiduciary duties as follows:

> [Directors are fiduciaries whose] powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with

[77] *Id.*

[78] *See, e.g.*, Committee of Creditors of Xonics Medical Sys., Inc. v. Haverty (*In re* Xonics, Inc.), 99 B.R. 870, 876 (Bankr. N.D. Ill. 1989).

[79] *Id.*

> the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside. While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation — creditors as well as stockholders.[80]

Upon the filing of a chapter 11 case, the board of directors, through the management of the debtor corporation, continues to operate the business and manage the assets as a DIP.[81] A DIP acts *qua* trustee under the Bankruptcy Code.[82] It has primary responsibility for the administration and protection of the debtor's estate unless a trustee is appointed. Nevertheless, the DIP is the debtor and, as such, is subject to the normal rules of corporate governance as limited by the provisions of the Bankruptcy Code. Consequently, the directors of the debtor continue to have fiduciary obligations to the debtor's creditors, other constituencies, and the entity, which are further enlarged by the duties and obligations imposed by the Bankruptcy Code.[83]

The Supreme Court established the applicable principle of law in *Wolf v. Weinstein*,[84] which involved a proceeding under Chapter X of the former Bankruptcy Act.[85] In that case, in which a trustee was not appointed, the Court held, *inter alia*, that the district court correctly concluded that the debtor's President and General Manager were "fiduciaries" within the meaning of § 249 of the former Bankruptcy Act and that, as the officers of the debtor in possession performing those functions that would otherwise be performed by a

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80 Pepper v. Litton, 308 U.S. 295, 306-07 (1939) (citations omitted).

81 *See* 11 U.S.C. § 1108 (1988).

82 *See, e.g.*, Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKR. DEV. J. 1, 21 (1989) ("the DIP is most closely associated with the *management* of the business: the officers, directors, retained professionals, and business managers") [hereinafter Nimmer & Feinberg].

83 *See, e.g.*, MARTIN J. BIENENSTOCK, BANKRUPTCY REORGANIZATION 72-76 (4th ed. 1987).

84 372 U.S. 633 (1963).

85 Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (repealed 1978).

disinterested trustee, they held similar responsibilities and obligations to the debtor's creditors and stockholders:

> [S]o long as the Debtor remains in possession, it is clear that the *corporation* bears essentially the same fiduciary obligation to the creditors as does the trustee for the Debtor out of possession. . . . [I]n practice these fiduciary responsibilities fall not upon the inanimate corporation, but upon the officers and managing employees who must conduct the Debtor's affairs under the surveillance of the court.[86]

The Court explained that the concept of allowing a debtor to remain in possession is "premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee."[87]

This principle remains applicable to a case under chapter 11 of the Bankruptcy Code. Section 1107 of the Bankruptcy Code provides that a DIP "shall perform all the functions and duties . . . of a trustee serving in a case under" chapter 11, with certain exceptions.[88] In addition, the Supreme Court continued to follow its *Wolf v. Weinstein* rationale in *Commodity Futures Trading Commission v. Weintraub*.[89] In *Weintraub*, the Court held that the trustee of a debtor corporation has the power to waive the corporation's attorney-client privilege with respect to prebankruptcy communications. By looking at the "roles played by the various actors of a corporation in bankruptcy to determine which is most analogous to the role played by the management of a solvent corporation," the Court concluded that the trustee is the party that is most analogous to that of a solvent corporation's management and thus controls the attorney-client privilege.[90] Citing *Wolf v. Weinstein*, the Court reaffirmed that "if a debtor remains in possession — that is, if a trustee is not appointed — the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession."[91]

Thus, a DIP, which encompasses the board of directors, is required to act as a fiduciary for both the creditors and stockholders of the corporation and perhaps other interests within the "community of interests" in the debtor corporation. The courts have recognized that a DIP owes the twin duties of care and loyalty to its creditors

86 *Wolf*, 372 U.S. at 649-50 (citations omitted).
87 *Id.* at 651.
88 11 U.S.C. § 1107(a) (1988).
89 471 U.S. 343 (1985).
90 *Id.* at 351-53.
91 *Id.* at 355.

and stockholders. These standards are similar to the standards that are used with respect to directors of corporations operating outside of bankruptcy. The business judgment rule continues to be the applicable standard for reviewing the actions of the DIP. Similarly, the courts have recognized that a DIP owes the duty of loyalty to its creditors and stockholders.[92]

B. *Balancing Fiduciary Duties in Insolvent Chapter 11 Corporations*

A chapter 11 debtor clearly has fiduciary duties to the involved constituents, including secured creditors, senior and junior unsecured creditors, and stockholders.[93] These constituents often have conflicting interests and often disagree with each other as to the desirability of reorganization and rehabilitation, the management of assets, the conduct of the debtor's business, and the provisions of a plan of reorganization.[94] In that context, the "fiduciary duty notion seems to direct management to do the best it can in a difficult situation."[95]

The Bankruptcy Code does not clearly resolve this tension. It provides that the debtor as a DIP represents the estate.[96] As a result, the DIP must act to benefit the estate as a whole:

> Once a corporation becomes a debtor under [c]hapter 11, its directors are no longer allowed to pursue parochial interests but have broader fiduciary obligations which encompass all aspects of the reorganization. . . . These directors are

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92 *See, e.g.*, Wolf v. Weinstein, 372 U.S. 633, 647 (1963); Fulton State Bank v. Schipper (*In re* Schipper), 112 B.R. 917, 919 (N.D. Ill. 1990), *aff'd*, 933 F.2d 513 (7th Cir. 1991).

93 *See, e.g.*, Martin J. Bienenstock, *Conflicts Between Management and the Debtor in Possession's Fiduciary Duties*, 61 CINCINNATI L. REV. 543 (1992), which described the complexity of these duties as follows:

> In the context of Chapter 11, the formulation of the debtor in possession's fiduciary duties is complex because the debtor in possession must act on behalf of numerous other parties having conflicting interests, such as creditors holding secured claims, senior unsecured claims, and junior unsecured claims, in addition to, shareholders, customers, and the public interest, in some situations. To determine a debtor in possession's fiduciary duties is at least as complex as simultaneously solving multiple equations for as many variables as there are different categories of parties in interest.

Id. at 543 n.2.

94 *See, e.g.*, Nimmer & Feinberg, *supra* note 82, at 36 ("In Chapter 11, . . . cases often arise where the interests of unsecured creditors conflict with those of secured creditors, while the interests of both creditors conflict with those of the owners.").

95 Christopher W. Frost, *Running the Asylum: Governance Problems in Bankruptcy Reorganization*, 34 ARIZ. L. REV. 89, 119 (1992).

96 11 U.S.C. §§ 323(a); 1107(a) (1988).

> bound to act in the best interest of the corporation, in good faith, and are answerable for their actions.[97]

A fortiorari, during the administration of a chapter 11 case, the directors of a debtor corporation are bound to act as fiduciaries for the various constituencies and serve the best interests of the entity.[98] The debtor in discharge of its fiduciary responsibilities must devise a means to deal with the diverse interests of the different constituencies so that the purposes of the Bankruptcy Code are achieved without charges of favoritism or breach of fiduciary duties.[99]

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97 Manville Corp. v. Equity Sec. Holders Comm. (*In re* Johns-Manville Corp.), 52 B.R. 879, 885 (Bankr. S.D.N.Y. 1985), *aff'd*, 60 B.R. 841 (S.D.N.Y.), *rev'd*, 801 F.2d 60 (2d Cir.), *on remand*, 66 B.R. 517 (Bankr. S.D.N.Y. 1986) (citations omitted).

98 *See, e.g.*, *In re* Central Ice Cream Co., 836 F.2d 1068 (7th Cir. 1987), which involved an appeal of the trustee's application to approve a settlement agreement. In that case, the debtor won a $52 million verdict in state court in a suit against McDonald's Corp. This suit was the estate's principal asset. McDonald's filed post-trial motions but offered a settlement of $15.5 million if the debtor accepted before the trial court acted. The debtor's board of directors accepted and the bankruptcy court approved the settlement. The stockholders appealed this decision. The district court dismissed the stockholders' appeal and awarded sanctions against their attorneys. The United States Court of Appeals for the Seventh Circuit held that the appeal of the bankruptcy court's approval of the settlement was not frivolous so as to warrant imposition of sanctions. In reaching this decision, the court declared the following:

> The trustee preferred the creditors over the shareholders. The trustee's counsel . . . testified that in negotiating the settlement he "did not consider the interest of shareholders." This is an unusual posture for a trustee, whose duty is to maximize the value of the estate, not of a particular group of claimants. Central Ice Cream had assets sufficient to pay all creditors. This made the shareholders the residual claimants; each additional dollar would go to them. It is true . . . that spurning the settlement would expose the creditors to risk, but this parallels the risk creditors face outside of the bankruptcy process as firms try to maximize the expected value of the enterprise. The bankruptcy court should try to implement, rather than alter, nonbankruptcy entitlements. Both shareholders and creditors have such entitlements.

Id. at 1072 (citations omitted).

In a footnote, however, the court noted that the stockholders could have purchased the debtor so that the stockholders would be risking their own money, rather than the creditor's money: "Any risk to the creditors could have been eliminated by putting the firm up for sale. The sale would have produced a pot of cash from which claims would have been satisfied. . . . The potential buyers in a case like this include . . . the putative stockholders." *Id.* at 1072 n.3. Thus, the court attempted to address the conflict between the debtor's creditors and stockholders without resolving the issue.

99 *See, e.g.*, Nimmer & Feinberg, *supra* note 82, at 34, which described the DIP's fiduciary duties as follows:

> The fiduciary obligations of the [debtor's] officers and directors require that they structure their actions and choices in a way that reflects an honest and reasoned effort to balance the competing inter-

This tension is exacerbated in those situations in which the debtor unequivocally is insolvent, with little hope of enhancing values to attain solvency. Because the Bankruptcy Code provides that creditors have priority over stockholders in the hierarchy of dividends and distributions of consideration, the argument may be made that an insolvent debtor should pursue actions that further the interests of creditors despite the potentially negative effect on its stockholders. Because stockholders of an insolvent debtor are entitled to no distribution under a plan of reorganization if the absolute priority rule is applied, the argument may be made that stockholders of an insolvent corporation in chapter 11 have no pecuniary interest in the case and should not have any standing to be heard to impede the progress of the case. This conclusion is suggested by the United States Court of Appeals for the Second Circuit in a footnote in *Manville Corp. v. Equity Security Holders Committee (In re Johns-Manville Corp.)*.[100] In the context of a corporate governance dispute as to the election of directors, the court commented that if Manville were determined to be insolvent, so that the stockholders lacked any equity interest in the corporation, it might be proper to reject the demand on their part to call a stockholders' meeting because they "would no longer be real parties in interest."[101]

The view that a debtor owes no duties to the stockholders of an insolvent corporation in chapter 11 is, however, contrary to the scheme and purposes underlying the chapter 11 reorganization provisions of the Bankruptcy Code. The legislative history indicates that Congress intended stockholders to have a role in a debtor's reorganization:

> In a large public company, whose interests are diverse and complex, the most vulnerable today are public investors who own subordinated debt or equity securities. The bill . . . is designed to counteract the natural tendency of a debtor in distress to pacify large creditors with whom the debtor would expect to do business, at the expense of small and scattered public investors . . . .
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> . . . .
>
> [I]t should be emphasized that investor protection is most

ests present in a chapter 11 case. These obligations do not require that the [debtor] elevate one interest to the exclusion of the other, nor do they require that each be evenly balanced against the other. The choices the [debtor] makes reflect the character of the insolvency proceedings, the causes of the bankruptcy, and the probable future of the business.

100 801 F.2d 60 (2d Cir. 1986). *See infra* notes 146-61 and accompanying text.

101 *In re Johns-Manville Corp.*, 801 F.2d at 65 n.6.

> critical when the company in which the public invested is in financial difficulties and is forced to seek relief under the bankruptcy laws.[102]

Chapter 11 of the Bankruptcy Code is devoid of any indication that stockholders of an insolvent corporation are stripped of corporate governance rights available under applicable nonbankruptcy law absent a direct conflict with the bankruptcy law. Unlike the provisions of Chapter X of the Bankruptcy Act, which provided that stockholders of an insolvent debtor had no right to vote for or against a plan,[103] the Bankruptcy Code makes no distinction between solvent and insolvent corporations as to the right to participate in the formulation and acceptance of a plan of reorganization and in the consideration to be distributed under the plan.[104] Indeed, one objective of chapter 11 is the confirmation of a consensual plan of reorganization without regard to solvency.[105]

The Bankruptcy Code contemplates that, initially at least, the debtor will lead the plan formulation process. Section 1121(b) of the Bankruptcy Code gives the debtor the exclusive right to propose a plan for 120 days from the outset of a chapter 11 case.[106] This

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102 S. REP. No. 989, 95th Cong., 2d Sess. 10 (1978), *reprinted in* 1978 U.S.C. C.A.N. 5787, 5796.

103 *See* § 179 of the Bankruptcy Act, which provided:

> After a plan has been accepted . . . by or on behalf of creditors holding two-thirds in amount of the claims filed and allowed of each class, and, if the debtor has not been found to be insolvent, by or on behalf of stockholders holding the majority of stock . . . of each class . . . the judge shall fix a hearing . . . for the consideration of the confirmation of the plan . . . .

Bankruptcy Act of 1898, as amended by the Chandler Act of 1938, ch. 575, § 179, 52 Stat. 840, 892 (repealed 1978).

104 *See, e.g.*, 11 U.S.C. § 1103(c) (1988) (equity committee may participate in the formulation of a plan; no distinction between solvent and insolvent debtor); *id.* § 1126 (stockholder may accept or reject plan; no distinction between solvent and insolvent debtor).

105 *See, e.g.*, H.R. REP. No. 595, 95th Cong., 1st Sess. 221 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6180, which states that

> [t]he purpose of the reorganization . . . case is to formulate and have confirmed a plan of reorganization . . . .
>
> In addition to certain other requirements, the Bankruptcy Act requires that the plan be accepted by a certain percentage of affected creditors and stockholders before it may be confirmed and put into operation. The consent requirement necessitates negotiation among management, creditors and stockholders. . . . The result of the negotiations, the plan, is sent to all affected creditors and stockholders for consent. If they agree, and if all of the other requirements of the law are met, the court confirms the plan, and the debtor comes out of the case as a reorganized company.

106 11 U.S.C. § 1121(b).

period of exclusivity may be extended or contracted for cause.[107] During this period of exclusivity, creditors and other parties in interest are not allowed to formally propose and file a competing reorganization plan. By granting this period of exclusivity, the Bankruptcy Code gives the debtor a level of leverage to establish bargaining parity with the involved constituencies to negotiate a consensual plan of reorganization that will provide for the treatment and consideration to be distributed in respect of creditor claims and stockholder interests. This result is encouraged by the Bankruptcy Code despite issues of solvency. In order to further the concept of a consensual plan, § 1126(g) of the Bankruptcy Code provides that the failure of a plan to entitle a class of stockholders to receive or retain any property under the plan on account of their interest shall be deemed a rejection of the plan by that class.[108] Such rejection would prevent confirmation unless resort is made to the cramdown power under § 1129(b) of the Bankruptcy Code.[109]

Consistent with the objective of achieving a consensual plan of reorganization is the provision allowing a class of prior claimants to waive or relax the right to absolute priority in distributions under the plan. The absolute priority rule requires each class of creditors to be paid in full in cash or securities prior to the receipt or retention by any junior class of creditors or stockholders of any property or interest in the reorganized enterprise.[110] By relaxing the absolute priority rule, the Bankruptcy Code enables senior classes to relinquish value to junior classes in order to effectuate a negotiated consensual plan of reorganization. This major innovation of the Bankruptcy Code provides a basis for the duty of a debtor to negotiate for some consideration for the stockholders of an insolvent corporation in the pursuit of a consensual plan of reorganization. This duty must be tempered by the needs of the particular case and should not impair the accomplishment of an effective and expeditious reorganization.

The use of the "cramdown" power provides an alternative confirmation standard.[111] It is called into play only at the option of the proponent of a plan of reorganization. Section 1129(b) of the Bankruptcy Code permits a court to confirm a plan of reorganization if it "does not discriminate unfairly, and is fair and equitable, with re-

[107] *Id.* § 1121(d) (providing that courts may grant extensions on request of a party in interest).
[108] *Id.* § 1126(g).
[109] *Id.* § 1129(b).
[110] The absolute priority rule is codified at 11 U.S.C.§ 1129(b).
[111] *See* 11 U.S.C. § 1129.

spect to each class of claims or interests that is impaired under, and has not accepted, the plan."[112] If a class of interests is impaired, the court is required to value the business enterprise in order to determine the value of the interest of the stockholders.[113]

The cramdown power is a fallback provision intended to operate only in the event of a breakdown in negotiations for a consensual plan.[114] If a debtor were under no obligation to negotiate for some recovery for stockholders when the debtor is insolvent, and the deemed rejection of § 1126(g) of the Bankruptcy Code occurred, then cramdown would be the only means by which a plan could be confirmed. This result would be contrary to one of the main objectives of the Bankruptcy Code — the confirmation of a consensual plan of reorganization. Manifestly, the notion that a debtor has a duty to bargain for some recovery on behalf of stockholders of an insolvent debtor is implicit in the Bankruptcy Code.

The Bankruptcy Code provides further indication that a debtor may properly negotiate plan treatment on behalf of stockholders despite the insolvency of the debtor. Chapter 11 of the Bankruptcy Code contemplates a difference between liquidation value and going concern value. The continuation of the business operations of an enterprise under chapter 11 is based on the assumption that maintaining the productive assets of a debtor's business will preserve going concern values that may not be obtained by dismemberment or liquidation.[115]

Chapter 11 is premised upon the policy of rehabilitation. This policy is predicated on the assumption that going concern value is

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[112] *Id.* § 1129(b)(1).

[113] Section 1129(b)(2) provides, in pertinent part:

> For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> . . . .
>
> (C) With respect to a class of interests —
>
> (i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; or
>
> (ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.

Id. § 1129(b)(2).

[114] *See, e.g.*, Frost, *supra* note 95, at 96.

[115] *See generally* Chaim J. Fortgang & Thomas M. Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1063-65 (1985).

higher than liquidation value.[116] Because going concern evaluation requires an evaluation of future operations, it is not always clear whether a corporation is in fact insolvent for the purpose of establishing "reorganization value" for plan purposes.[117] While a corporation may appear to be insolvent on a balance-sheet-test basis, the difference between liquidation value and going concern value may not be crystal clear. It is this unknown area of value, which is dependent upon future operations, that provides the basis for participation by stockholders or, sometimes, junior creditors in the reorganized entity. For a reasonable period of time, particularly in the absence of an appointed representative committee of stockholders to represent stockholder interests pursuant to § 1102 of the Bankruptcy Code,[118] a debtor and its directors legitimately may seek to negotiate for some recovery or retention of an interest by stockholders.

The achievement of rehabilitation as contemplated by chapter 11 should lead to an increase in the value of the debtor, albeit in the future. Nevertheless, this enhanced value might result in the stockholders' retaining some of the equity in the reorganized entity. In fact, stockholders typically manage to keep a small percentage of the equity of a corporation that has been reorganized under chapter 11. While it may appear that stockholders no longer have any economic interest in the debtor corporation, the policy of chapter 11 reorganization supports the proposition that stockholders retain some interest as part of the consensual process.[119] The notion that

[116] *See* H.R. REP. No. 595, 95th Cong., 1st Sess. 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179 ("The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.").

[117] *See, e.g.*, Steven R. Gross et al., *Directors Face Risks in Workout; Shifting Duties*, NAT'L L.J., Apr. 15, 1991, at 19 ("Because a going-concern valuation uses techniques that are necessarily imprecise and involve forecasting possibly unpredictable future events, one cannot always determine with certainty whether or not a struggling company is insolvent.").

[118] 11 U.S.C. § 1102.

[119] *See, e.g.*, Mark E. Budnitz, *Chapter 11 Business Reorganizations and Shareholder Meetings: Will the Meeting Please Come to Order, or Should the Meeting be Cancelled Altogether?*, 58 GEO. WASH. L. REV. 1214 (1990), which states that the provisions of the Bankruptcy Code indicate that

> Congress intended to make it clear that, even if insolvency may render the shareholders' continued economic interests in the corporation problematical, shareholders nevertheless retain their ownership interest. Therefore, it would be anomalous to interpret the Bankruptcy Code to mean that once a corporation is insolvent directors no longer owe any fiduciary duty to shareholders.

Id. at 1249.

stockholders of an insolvent debtor are no longer real parties in interest for purposes of reorganization is thus not well-founded.[120]

It is worth noting that stockholders are often an unrepresented class in negotiating a plan of reorganization and thus must look to the debtor to represent their interests. While the Bankruptcy Code provides for the mandatory appointment of a creditors' committee,[121] it gives the court discretion to decide whether it is appropriate to appoint an equity security holders' or stockholders' committee.[122]

The Bankruptcy Code expressly authorizes committees to participate in the formulation of a plan of reorganization.[123] The legislative history states that equity security holders' committees are to serve as "the primary negotiating bodies for the formulation of the plan of reorganization. They will represent the . . . equity security holders from which they were selected. They will also provide supervision of the debtor in possession and of the trustee, *and will protect their constituents' interests*."[124]

Thus, if a court decides to appoint an equity security holders' committee, the interests of the stockholders will be represented in the process of plan negotiations. Notwithstanding the existence of an equity security holders' committee, however, directors continue to have fiduciary obligations to the stockholders of a debtor corporation.[125] There is no dispute that directors of a debtor owe fiduci-

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120 *See generally* Raymond T. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009 (1987), which states that

> a rule that disenfranchises shareholders based merely on the insolvency of the company reaches too broadly. It eliminates virtually any protection for what are often cumulatively large investments and does this based on an appraisal of assets indicating insolvency. Even if a company is insolvent, the shareholder investment and resulting loss are real and substantial. Describing the shareholders as no longer real parties in interest is sophistry.

Id. at 1064.

121 11 U.S.C. § 1102(a)(1).

122 Section 1102(a)(1) of the Bankruptcy Code provides that "the United States trustee . . . may appoint additional committees . . . of equity security holders as the United States trustee deems appropriate." *Id.*

123 *Id.* § 1103(c)(3).

124 H.R. REP. No. 595, 95th Cong., 1st Sess. 401 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6357 (emphasis added).

125 *See, e.g.*, Anna Y. Chou, *Corporate Governance In Chapter 11: Electing A New Board*, 65 AMER. BANKR. L.J. 559, 580 n.181 (1991) ("[T]here is a good argument that, notwithstanding the existence of [an] equity holders' committee, the fiduciary obligations to the constituents represented by such a committee continue. Committees accord the represented group additional protection and rights under § 1103 of the Code and do not detract from protection by the fiduciary.").

ary obligations to creditors, despite their being represented by the mandatory creditors' committee. The same standard should apply with respect to stockholders who are represented by an equity security holders' committee.[126]

Courts frequently refuse the appointment of an equity security holders' committee because of the expense involved and the often clear case of insolvency. The absence of such a committee puts stockholders at a disadvantage because they will not be singularly represented during the process of negotiating a plan of reorganization. Such circumstances require the directors to cause the debtor's representatives to attempt to negotiate some recovery on behalf of the stockholders.

There may come a point of departure in the case, however, when the debtor and its directors must recognize their responsibility to the case as a whole and cease negotiating on behalf of stockholders if such negotiations would be unproductive. The directors would be in danger of breaching their fiduciary duties to the debtor and the other constituencies if they prolonged and frustrated the reorganization case by fruitless negotiations for stockholders who may not have any real equity interest in the corporation.

It is difficult to determine exactly when a director should desist from causing continued negotiations for stockholders and still discharge their fiduciary obligations. However, it seems that when the financial condition of a corporation is "hopelessly" insolvent, such that there is little or no chance that stockholders would have any equity interest in the corporation, a debtor's directors no longer have any duty to pursue actions that may prejudice the debtor, its business, and the interests of senior classes.[127] Thus, it has been

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126 *See, e.g.*, *In re* Evans Prods. Co., 58 B.R. 572 (S.D. Fla. 1985), in which the court held that

> [n]owhere in the Bankruptcy Code is it suggested that a committee whose appointment is mandatory pursuant to Section 1102(a)(1) has any greater or different rights or duties than a committee whose appointment is precatory pursuant to Section 1102(a)(2). Once appointed, their rights and responsibilities clearly are the same. The rights and fiduciary duties of the Equity Committee are no different from those of any committee appointed pursuant to Section 1102 in these cases.

Id. at 575.

127 *See generally* Michael A. Gerber, *The Election of Directors and Chapter 11 — The Second Circuit Tells Stockholders To Walk Softly and Carry A Big Lever*, 53 BROOK. L. REV. 295, 354 (1987) ("[T]he debtor's financial condition should not be completely disregarded. . . . There will be cases in which a debtor is so obviously and hopelessly insolvent that experts can agree that stockholders have no equity in the company and no prospect of ever having any.").

determined that when a debtor is insolvent beyond any real prospect of achieving solvency, the appointment of an equity security holders' committee is unwarranted because "neither the debtor nor the creditors should have to bear the expense of negotiating over the terms of what is in essence a gift."[128] Once it is clear that the corporation's insolvency is immutable, any value the stockholders would have been able to retain is eliminated and totally dependent upon the creditors' willingness to relinquish value in pursuit of the objective of the confirmation of a consensual plan. The occurrence of such a factual situation limits the obligation and responsibility of the directors to continue negotiations on behalf of stockholders.

III. The Right of Stockholders to Change the Board of Directors During a Chapter 11 Proceeding

Stockholders of a corporation reorganizing under chapter 11 are not powerless to challenge the actions of directors that may result in harm to the corporation. To the contrary, stockholders retain rights under applicable nonbankruptcy law to elect and remove directors despite the pendency of a bankruptcy or reorganization case.[129] However, courts have refused to grant requests for stockholders' meetings if such meetings would conflict with the policies and purposes of the Bankruptcy Code or jeopardize the reorganization of the debtor.

A. *Judicial Treatment of the Right to Compel a Stockholders' Meeting*

Several tests have been used by courts in order to determine whether to grant a stockholder's request for a stockholders' meeting. One of the most commonly used tests is the "clear abuse" test. This test was established over fifty years ago by the United States Court of Appeals for the Second Circuit in the landmark case of *In re J.P. Linahan, Inc.*[130] In *Linahan*, the court approved an involuntary petition for Chapter X relief under the former Bankruptcy Act. The debtor was allowed to remain in possession. A majority stockholder and creditor of the debtor filed an answer in opposition, charging that the petition was not filed in good faith and that adequate relief could be obtained under Chapter XI of such Act. The stockholder subsequently

[128] *In re* Emons Indus., Inc., 50 B.R. 692, 694 (Bankr. S.D.N.Y. 1985).
[129] *See, e.g.*, *In re* Bush Terminal Co., 78 F.2d 662, 664 (2d Cir. 1935); Lionel Corp. v. Committee of Equity Sec. Holders of Lionel Corp. (*In re* Lionel Corp.), 30 B.R. 327, 330 (Bankr. S.D.N.Y. 1983).
[130] 111 F.2d 590 (2d Cir. 1940).

asked the court to require the debtor to hold the regular annual meeting of stockholders in order to elect directors, alleging that the directors had not acted in the interests of the debtor or the stockholders in consenting to the proceeding under Chapter X. The stockholder also requested a special meeting of stockholders in order to adopt a resolution that a proceeding under Chapter XI, rather than Chapter X, should be filed by the debtor.

The Second Circuit held that the lower courts were in error in denying leave to hold the annual stockholders' meeting and in staying the special meeting:

> It is the court's concern that the management of the business does not pass into the hands of incompetent or untrustworthy persons. The debtor has other parts to pay [sic], however, in a proceeding for reorganization or for arrangement, parts not directly concerned with management of the property during the period of court control, such as submission to involuntary proceeding and filing of plan, and over these the court ordinarily exercises no restraint. *As to such matters the right of the majority of stockholders to be represented by directors of their own choice and thus to control corporate policy is paramount and will not be disturbed unless a clear case of abuse is made out.*[131]

With respect to their choice of the type of reorganization plan, "the stockholders are entitled to elect directors who will abide by their wishes, provided of course the directors chosen are not persons who will injure the honest and efficient management of the corporate property."[132] The court, however, did not explain how to identify the circumstances under which a clear case of abuse would exist.

The Second Circuit continued to use this standard in *In re Potter Instrument Co.*[133] In *Potter*, a major stockholder sought to compel a special stockholders' meeting in order to elect a new board of directors who would contest an arrangement under Chapter XI of the former Bankruptcy Act that reduced the interests of stockholders in favor of a Chapter X proceeding. The lower courts rejected the stockholder's request on the ground that such a meeting would preclude confirmation of the plan, jeopardizing the rehabilitation of the debtor:

> Here, we have a situation of a disgruntled stockholder who is frustrated in his efforts to smash the Companies which he brought into being because he has been ousted from management and control.

131 *Id.* at 592 (emphasis added).
132 *Id.*
133 593 F.2d 470 (2d Cir. 1979).

> . . . .
>
> [T]o permit Potter to control the Debtors through the election of a majority of the Board of Directors would sound the death knell to the Debtors. His objection to the issuance of stock to secured and unsecured creditors would require an Amended Plan, new notice to creditors and new acceptances solicited. There is no showing that interested parties would approve a plan without the issuance of stock.[134]

Based on the equitable powers of the bankruptcy court, the Second Circuit held that, under the clear abuse standard, the lower courts were justified in denying the request for a special meeting to elect new directors because "such an election might result in unsatisfactory management and would probably jeopardize both [the Debtor's] rehabilitation and the rights of creditors and stockholders — sounding the 'death knell' to the debtor as well as to [the stockholder] himself."[135]

The clear abuse test has continued to be the standard used by courts in deciding cases under the Bankruptcy Code. For example, in *Lionel Corp. v. Committee of Equity Security Holders of Lionel Corp. (In re Lionel Corp.)*,[136] a chapter 11 debtor brought an adversary proceeding in order to enjoin the committee of equity security holders from prosecuting a state court action seeking an order compelling the debtor and its board of directors to call and hold the debtor's 1982 and 1983 annual meetings of stockholders for the election of directors. The court refused to enjoin the state court action and refrained form deciding the merits of a "strictly corporate governance controversy."[137] It found nothing in the record that demonstrated that holding an annual meeting would impede reorganization, noting that if a new board were elected, the reorganization might "take an entirely different turn."[138] The court went on to state that there is

> no demonstrable reason for denying shareholders their right to an annual meeting despite the pendency of a reorganization proceeding, and it would be an abuse of this Court's power to preclude defendants-respondents herein from resorting, as they have, to all available legal remedies including the state court proceeding as a vehicle for asserting their fundamental rights against Lionel, a New York Corporation, and its Board

134 *Id.* at 474.
135 *Id.* at 475.
136 30 B.R. 327 (Bankr. S.D.N.Y. 1983).
137 *Id.* at 329.
138 *Id.* at 330.

of Directors.[139]

In a recent bench ruling involving the chapter 11 case of Fairmont Communications Corporation,[140] the bankruptcy court for the Southern District of New York denied the request of a creditor/stockholder to exercise its right to elect directors under a proxy that was triggered by, *inter alia*, the nonpayment of notes. The court determined that the stockholder's remote financial interest in the debtor because of its clear insolvency, coupled with the possible economic harm to the debtor if a director was appointed in potential violation of FCC regulations, constituted grounds for invoking the clear abuse exception to the general rules of corporate governance.

Although most courts follow the clear abuse test, several other courts have chosen to utilize a type of balancing test. For example, in *Saxon Industries, Inc. v. NKFW Partners*,[141] a stockholder, both individually and on behalf of the equity security holders' committee, brought an action to compel an annual meeting in order to elect directors notwithstanding the debtor's reorganization under chapter 11. The Delaware Supreme Court held that the alleged adverse effect of such a meeting did not overcome the right to compel the election of directors. In reaching this decision, the court attempted to strike a balance between Delaware's state corporation law and the Bankruptcy Code. The court declared that the right of stockholders to have a meeting to elect directors under section 211 of Delaware's General Corporation Law is "virtually absolute."[142] Because Delaware law does not presume that stockholders act contrary to their own best interests, the stockholders' motive to increase the payment they would receive in the reorganization was irrelevant and thus did not preclude their right to seek relief under section 211.[143] In addition, the court held that insolvency did not divest the stockholders

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139 *Id.* The state court ultimately ordered the board of directors to call the annual meetings:

> [During bankruptcy] it is more important than in less turbulent and more normal times that the shareholders have a voice in the crucial decisions affecting their company's destiny. A period of crisis does not justify officeholders retaining their positions indefinitely. Democracy, whether political or industrial, is capable of dealing with difficulty and crisis, and is not to be suspended on the pretext of exigency.

Committee of Equity Sec. Holders of the Lionel Corp. v. Lionel Corp., N.Y.L.J., June 28, 1983, at 6.

140 *In re* Fairmont Communications Corp., No. 92 B 44861 (Bankr. S.D.N.Y. Mar. 3, 1993), *appeal docketed*, No. 93 Civ. 2388 (S.D.N.Y. Apr. 14, 1993). For a detailed discussion of the facts of this case, see *infra* notes 193-95 and accompanying text.

141 488 A.2d 1298 (Del. 1984).

142 *Id.* at 1301.

143 *Id.*

of their right to elect directors because the debtor remained in control of its affairs.[144] The court also rejected the debtor's affirmative defenses of a potential proxy fight, the loss of an acquiring company's offer, the loss of valued sales employees, and the curtailment of the debtor's trade credit as too speculative. The court thus concluded that the scales tipped in favor of holding the meeting because of the "strong Delaware policy behind the free exercise of a stockholder's right to elect directors, and the absence of that focus in the pending bankruptcy proceedings . . . ."[145]

B. The Manville Decisions

The most comprehensive decision concerning the right of stockholders to change the board of directors during the pendency of a chapter 11 case involved the long-running chapter 11 reorganization of Johns-Manville Corporation ("Manville").[146] On August 26, 1982, Manville, a leading manufacturer of asbestos, and twenty of its subsidiaries and affiliates filed for reorganization under chapter 11 as a result of Manville's actual and contingent liabilities to thousands of persons who were exposed to Manville products containing asbestos. Because of the long latency period for asbestos-related injuries, Manville anticipated that thousands of new lawsuits would be filed against it during the next twenty to thirty years. Manville was also a defendant in several lawsuits seeking recoveries for asbestos-related property damage potentially resulting in hundreds of millions of dollars in liability. In addition to the committees that were appointed to represent the interests of Manville's creditors and equity security holders, the court appointed a committee to represent the interests of asbestos health claimants and a legal representative with the powers of a committee to represent the future claimants, but without power to bind such persons (the "Legal Representative").

For the next several years, the bankruptcy court extended the period during which Manville retained the exclusive right to file a reorganization plan. Manville experienced a great deal of difficulty in formulating an acceptable plan of reorganization until August 2, 1985, when Manville announced that its board of

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144 *Id.* at 1302.
145 *Id.*
146 Manville Corp. v. Equity Sec. Holders Comm. (*In re* Johns-Manville Corp.), 52 B.R. 879 (Bankr. S.D.N.Y. 1985), *aff'd*, 60 B.R. 841 (S.D.N.Y.), *rev'd*, 801 F.2d 60 (2d Cir.), *on remand*, 66 B.R. 517 (Bankr. S.D.N.Y. 1986).

directors and the Legal Representative approved an agreement on principal elements of a reorganization plan (the "Principal Elements Agreement"), which would earmark billions of dollars for payment to present and future asbestosis victims as well as to others damaged by the asbestos products that Manville once manufactured.

The committee of equity security holders (the "Equity Committee") did not voluntarily participate in the negotiations between Manville and the Legal Representative and was dissatisfied with the Principal Elements Agreement, which would have resulted in a 90 percent dilution of existing stockholders' interests. Viewing this prospect as evidence of the board's abdication of its responsibilities to stockholders, on August 16, 1985, the Equity Committee and Lion Dubin ("Dubin"), a Manville stockholder and member of the Equity Committee, brought an action in the Delaware Chancery Court seeking to compel a meeting of Manville's stockholders pursuant to section 211(c) of Delaware's General Corporation Law (the "Delaware Action") so that new directors might be elected to reconsider the proposed plan. In response, Manville brought an action in the bankruptcy court to enjoin the Delaware Action.

The bankruptcy court enjoined the Equity Committee and Dubin from prosecuting the Delaware Action on the ground that holding a stockholders' meeting would obstruct Manville's reorganization.[147] After describing the general reluctance of courts to enjoin meetings of stockholders, the court stated that "[t]he right to compel a shareholder's meeting is not absolute and the existence of various circumstances, including the parties' progress in plan negotiations, can militate against allowing the meeting."[148] The circumstances justifying the injunction included the recent progress in plan negotiations, the jeopardy that a meeting posed to the process of reorganization, and the conduct of the Equity Committee.[149]

The district court affirmed the decision of the bankruptcy court.[150] The court found that the bankruptcy court did not enjoin the proceeding solely because of the possibility that a stockholders' meeting might delay or alter the course of the reor-

[147] *Id.*

[148] *Id.* at 887.

[149] *Id.* at 887-88.

[150] *In re* Johns-Manville Corp., 60 B.R. 842 (S.D.N.Y.), *rev'd*, 801 F.2d 60 (2d Cir. 1986).

ganization. Rather, the bankruptcy court found that holding a meeting at this point in the reorganization process would seriously jeopardize any attempt at successfully reorganizing Manville. In addition, the district court found the requisite clear case of abuse in the motivation of the stockholders to either destroy any prospect for a successful reorganization or strengthen its bargaining position.

On appeal, the United States Court of Appeals for the Second Circuit reversed the decision of the lower courts and remanded to the bankruptcy court.[151] Beginning with the well-established rule that "the right to compel a shareholders' meeting for the purpose of electing a new board subsists during reorganization proceedings," the court stated that the Equity Committee's right to call a meeting would only be impaired if the Equity Committee was guilty of "clear abuse" in its attempt to call one.[152] The court refused to agree that the Equity Committee's desire to attain more bargaining power in the negotiation process, as opposed to a secret desire to destroy all prospects for reorganization, constituted clear abuse: "The law . . . directs that the shareholders' natural wish to participate in this matter of corporate governance be respected."[153] Under this analysis, the court concluded that

> the shareholders' mere intention to exercise bargaining power — whether by actually replacing the directors or by "bargaining away" their chip without replacing the board . . . — cannot without more constitute clear abuse. Unless the Equity Committee were to bargain in bad faith — *e.g.*, to demonstrate a willingness to risk rehabilitation altogether in order to win a larger share for equity — its desire to negotiate for a larger share is protected.[154]

The court noted that the focus of the clear abuse inquiry is whether rehabilitation will be "seriously threatened," rather than merely delayed.[155] The court then stated that an injunction against a stockholders' meeting would be appropriate if there is (1) clear abuse in calling the meeting and (2) irreparable injury resulting from such a meeting.[156] However, the Second Circuit noted in a footnote that

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[151] *In re* Johns-Manville Corp., 801 F.2d 60 (2d Cir.), *on remand*, 66 B.R. 517 (Bankr. S.D.N.Y. 1986).

[152] *Id.* at 64.

[153] *Id.*

[154] *Id.* at 65.

[155] *Id.* at 66.

[156] *Id.* at 68.

the solvency or insolvency of a debtor may be significant in determining whether to restrain stockholders from exercising their voting rights because stockholders of an insolvent debtor would no longer be real parties in interest.[157]

On remand, the bankruptcy court applied the standards sanctioned by the Second Circuit, made findings of fact, and held that Manville was entitled to an injunction prohibiting the Equity Committee from calling the stockholders' meeting.[158] The court concluded that the purpose of electing new directors was to withdraw the existing plan of reorganization, which was the result of a "substantial but fragile consensus" that had been achieved after "four years of often bitter and always arduous struggle."[159] In addition, the court doubted the ability of a new board of directors to achieve a consensual reorganization plan within a reasonable period of time.[160] The court thus concluded that the attempts of the Equity Committee to call a stockholders' meeting constituted clear abuse because such a meeting would "irrevocably injure the reorganization and thereby irreparably injure the parties in interest to this reorganization."[161]

C. *The Right to Demand Stockholders' Meetings When the Debtor Is Insolvent*

As discussed, *supra*, the United States Court of Appeals for the Second Circuit has indicated that the solvency or insolvency of a debtor corporation may be significant in determining whether stockholders should be permitted to exercise their right to require a meeting to elect a new board of directors.[162] In footnote six of its decision in *Manville Corp. v. Equity Security Holders Committee (In re Johns-Manville Corp.)*,[163] the court noted, in dicta, that "if Manville were determined to be insolvent, so that the shareholders lacked equity in the corporation, denial of the right to call a meeting would likely be proper, because the shareholders would no longer be real parties in interest."[164] Upon closer analysis, however, it becomes clear that, within certain con-

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[157] *Id.* at 65 n.6. See *infra* notes 162-71 and accompanying text for a discussion of the effect of insolvency on the right to call a stockholders' meeting.
[158] *In re* Johns-Manville Corp., 66 B.R. 517 (Bankr. S.D.N.Y. 1986).
[159] *Id.* at 536.
[160] *Id.* at 539.
[161] *Id.* at 542.
[162] *See supra* note 157 and accompanying text.
[163] 801 F.2d 60 (2d Cir.), *on remand*, 66 B.R. 517 (Bankr. S.D.N.Y. 1986).
[164] *Id.* at 65 n.6.

straints, the insolvency of a debtor corporation should not prevent the stockholders from exercising their corporate governance rights.

The Bankruptcy Code gives no indication that stockholders of a corporation in chapter 11 have no role to play when a debtor is insolvent.[165] In fact, a number of courts have concluded that the insolvency of a corporation does not divest stockholders of their right to elect a new board of directors.[166] Moreover, prohibiting stockholders from exercising their right to elect a new board of directors would give the incumbent directors in place at the commencement of a chapter 11 case of an insolvent corporation a lack of accountability.[167]

As discussed, *supra*, directors continue to have fiduciary obligations to the stockholders of an insolvent corporation in chapter 11.[168] The legislative history of the Bankruptcy Code indicates that the objective of chapter 11 is to "restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, *and produce a return for its stockholders*."[169] Divesting stockholders of their right to call a meeting and elect directors in every situation would defeat this objective by depriving stockholders of the opportunity to improve their treatment under a plan of reorganization. However, each case should be decided on its facts and in the perspective of the determinative factors established by the appellate courts.

The ability to request a meeting to elect directors may also be used as a bargaining chip in the reorganization process in order to obtain concessions from other parties.[170] Requesting such a meeting need not result in the actual election of new directors. The mere fact that a meeting is requested gives rise to the threat of delaying the progress of a reorganization case. By forbearing from holding a meeting to which they would otherwise be enti-

165 *See supra* notes 102-20 and accompanying text.

166 The leading case espousing this position is *Saxon Industries, Inc. v. NKFW Partners*, which is discussed at *supra* notes 141-45 and accompanying text.

167 *See, e.g.*, Nimmer, *supra* note 120, at 1064 ("if we eliminate all shareholder control, we place far too much power and autonomy in the hands of management").

168 *See supra* notes 102-20 and accompanying text.

169 H.R. REP. No. 595, 95th Cong., 1st Sess. 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179 (emphasis added).

170 *See* Manville Corp. v. Equity Sec. Holders Comm. (*In re* Johns-Manville Corp.), 801 F.2d 60, 65 (2d Cir. 1986) ("the shareholders' mere intention to exercise bargaining power — whether by actually replacing directors or by 'bargaining away' their chip without replacing the board . . . — cannot without more constitute clear abuse").

tled, stockholders may be able to improve their treatment under a plan of reorganization.[171] There is no reason, absent compelling facts and circumstances of imminent prejudice or damage to the entity and senior classes, why stockholders of an insolvent corporation should not retain this bargaining chip to the same extent as do stockholders of a solvent corporation.

D. *The Right of Preferred Stockholders to Elect Directors and the Automatic Stay*

1. The Right of Preferred Stockholders to Elect Directors

Unlike the conventional case in which common stockholders seek to invoke their right to elect directors, preferred stockholders are unique in that their right to elect directors stems from a default in the payment of dividends.[172] Certificates of preferred stock typically provide that if the issuing corporation fails to pay dividends for a specified period of time, the preferred stockholders have the right to elect a certain number of directors to the board.[173]

Graselli Chemical Co. v. Aetna Explosives Co.[174] is an example of an early decision involving an attempt by preferred stockholders to exercise such rights. Decided under the former Bankruptcy Act, *Graselli* involved the election of a new board of directors of a company in receivership by holders of preferred stock whose voting rights were triggered by default in the payment of dividends. The preferred stock was not entitled to any vote, except upon the

[171] *See generally* Gerber, *supra* note 127, at 345 (noting that in *Saxon Industries, Inc. v. NKFW Partners*, 488 A.2d 1298 (Del. 1984), stockholders received slightly better treatment under the plan in exchange for forbearing from holding a meeting; in *Lionel Corp. v. Committee of Equity Security Holders of Lionel Corp.* (*In re Lionel Corp.*), 30 B.R. 327 (Bankr. S.D.N.Y. 1983), the committee of equity security holders was allowed to name several directors to serve on the board for the first year after confirmation in exchange for forbearing from holding a meeting).

[172] *See, e.g.*, SEC v. Liberty Banking Corp., 240 F. 511 (2d Cir. 1957) ("Until five successive annual dividends are paid, the new preferred stockholders . . . may name three out of seven members of the board of directors. After five years, in the event the debtor defaults in payment of 12 quarterly dividends, the preferred will be permitted to elect four of the seven directors . . . ."); Lacos Land Co. v. Lone Star Indus., Inc. (*In re* New York Trap Rock Corp.), 141 B.R. 815 (Bankr. S.D.N.Y. 1992) (preferred stockholders had right to elect four directors due to debtor's nonpayment of dividends).

[173] *See, e.g.*, Resolution Trust Corp. v. Allied Stores Corp. (*In re* Federated Dep't Stores, Inc.), 133 B.R. 886, 888 (S.D. Ohio 1991) ("Preferred Shares provided that if in the event Allied failed to pay dividends for six consecutive quarters, the Preferred Shareholders were to automatically have the right to elect two directors to Allied's Board of Directors.").

[174] 252 F. 456 (2d Cir. 1918).

issue of placing a mortgage upon the company's property. However, when the company increased its common stock, it was provided that in the event there is a default in the payment of dividends of the preferred stock for a period of eight months or more, each share of preferred stock was entitled to nine votes. The dividends on the preferred stock were paid regularly until a receiver was appointed. Because the dividends had not been paid for over eight months since such appointment, the right of the preferred stockholders to vote had accrued.

Several days before the scheduled annual meeting, activity among groups of the stockholders indicated that a contest for control of the corporation was to be waged by the election of a new board of directors and the submission of a plan of readjustment. A group of common stockholders sought to enjoin the meeting, claiming that a meeting to elect directors would "place in control a board of directors who would be unfavorable and unjust to the interests of the common stockholders, and who will assist in the adoption of the readjustment plan," resulting in irreparable injury to the majority of the common stockholders.[175] The United States Court of Appeals for the Second Circuit affirmed the decision of the district court to enjoin the meeting:

> The property is being successfully managed by the receivers; it has very profitable contracts, and is, or will very shortly, be able to pay all its indebtedness . . . . It can pay the arrears of dividends on the preferred stock, and may retire the preferred stock. If the dividends are paid, the right of the preferred stock to vote on the basis of nine for one is eliminated, and, when a meeting is held, the business policy of the corporation can be determined by the will of the majority of common stockholders. Therefore, the right of the preferred stockholders to vote being but temporary, with every prospect of the common stockholders regaining control of the corporation, the court should not lend its aid nor permit a group of preferred stockholders electing a board of directors who would permit this plan of readjustment to be adopted.[176]

Accordingly, because the receivers were about to cure the dividend arrearages which gave the preferred stockholders their voting rights, the court held that the meeting should be stayed.

More recently, preferred stockholders defeated an attempt by the creditors' committee of a chapter 11 debtor to enjoin a stock-

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[175] *Id.* at 459.
[176] *Id.* at 461.

holders' meeting in *In re Allegheny International, Inc.*[177] In that case, the debtor had defaulted on enough dividends on its preferred stock to trigger the right of the holders of such stock to elect directors. As a result, the preferred stockholders mounted a proxy fight. The court stated that the effect of the proxy battle on the 120 day period of exclusivity, the fact that the proxy battle may have been waged by a self-serving election committee, and the costs of the proxy battle did not constitute clear abuse. After discounting the impact of these threats to the reorganization process, the court stated that although

> the interests of the debtor's unsecured creditors would be better served by prompt submission of a reorganization plan, . . . the ability of shareholders to exercise their rights to corporate governance cannot be enjoined simply on the basis that a group of shareholders may be successful in their bid to elect directors whose views concerning a plan of reorganization may differ from those of existing management. The possibility of harm to the interests of the unsecured creditors posed by these contingent events is simply too remote to support the finding of irreparable harm necessary for injunctive relief.[178]

The preferred stockholders eventually elected five out of eleven directors.[179]

2. Preferred Stockholders and the Automatic Stay

As discussed, *supra*, preferred stockholders have the right to elect directors upon a default in the payment of dividends.[180] Under generally accepted accounting principles, preferred stock may be accounted for as debt in certain circumstances.[181] As a result, preferred stockholders who wish to exercise their right to elect directors may be in violation of the automatic stay by attempting to recover on a claim against the debtor.

The automatic stay, which is codified in § 362 of the Bankruptcy Code,[182] is considered to be one of the most fundamental

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177 [1987-1989 Transfer Binder] Bankr. L. Rep. (CCH) ¶ 72,328, at 93,150 (W.D. Pa. May 31, 1988).

178 *Id.* at 93,154.

179 *See* Chaim J. Fortgang & Thomas M. Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 64 (1990) ("Preferred shareholders of Allegheny International Inc. mounted a proxy fight, defeated an attempt by creditors of that chapter 11 debtor to enjoin a shareholders' meeting, and then elected five out of eleven directors.").

180 *See supra* notes 172-79 and accompanying text.

181 *See* Fortgang & Mayer, *supra* note 179, at 72 ("under certain circumstances preferred stock is accounted for as debt under generally accepted accounting principles").

182 11 U.S.C. § 362 (1988).

protections afforded by the bankruptcy laws.[183] It provides that the filing of a petition in bankruptcy automatically stays certain actions directed against the debtor or against the debtor's property.[184] Specifically, § 362(a) provides that the filing of a bankruptcy petition operates as a stay of, *inter alia*,

> the commencement or continuation . . . of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title.[185]

The automatic stay is intended to provide a debtor with a "breath-

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183 *See* Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection, 474 U.S. 494, 503 (1985) ("The automatic stay . . . has been described as 'one of the fundamental debtor protections provided by the bankruptcy laws.' ") (quoting S. REP. No. 95-989, 95th Cong., 2d Sess. 54 (1978); H.R. REP. No. 95-595, 95th Cong., 2d Sess. 340 (1977)).

184 11 U.S.C. § 362(a).

185 *Id.* § 362(a)(1). Section 362(a) provides in full:

> Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. 78eee(a)(3)), operates as a stay, applicable to all entities, of —
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> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
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> (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
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> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
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> (4) any act to create, perfect, or enforce any lien against property of the estate;
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> (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
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> (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
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> (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
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> (8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

Id. § 362(a).

ing spell" from his creditors and to centralize all disputes concerning property of the estate in the bankruptcy court so that the reorganization can proceed efficiently.[186] Moreover, the automatic stay operates to preserve property of the debtor's estate for the benefit of all creditors.[187]

Recently, the United States Court of Appeals for the Second Circuit expanded the applicability of the automatic stay in *FDIC v. Hirsch (In re Colonial Realty)*.[188] In that case, involuntary bankruptcy petitions were filed against Colonial Realty Company and its general partners, Googel and Sisti. The FDIC, as the receiver of five failed Connecticut banks, brought an action in a Florida district court to avoid the transfer of, and recover, assets that Sisti allegedly had fraudulently conveyed to his wife and other transferees (the "Florida Action"). The Florida Action was brought only against the transferees to recover the funds for the benefit of the estates of the failed banks. The FDIC alleged that Sisti made various fraudulent transfers to the defendants with the intent to hinder, delay, and defraud the FDIC or the five banks. The trustee for the debtors moved for an order determining that the Florida Action violated § 362 of the Bankruptcy Code and enjoining the FDIC from continuing the action.

The Second Circuit affirmed the decision of the lower courts that the Florida Action was subject to the automatic stay. The court analyzed § 362 as staying actions "against the debtor" *or* "to recover a claim against the debtor." The court reasoned that the latter category "must encompass cases in which the debtor is not a defendant; it would otherwise be totally duplicative of the former category and pure surplusage."[189] While the Florida Action was not asserted against any of the debtors, the court held that it should be regarded as an action to recover a claim against the debtor and thus was subject to the automatic stay:

> While a fraudulent transfer action may be an action against a third party, it is also an action "to recover a claim against the debtor." Absent a claim against the debtor, there is no independent basis for the action against the transferee. Moreover, the creditor can only recover property or value thereof

[186] *See, e.g.*, Shugrue v. Air Line Pilots Ass'n, Int'l (*In re* Ionosphere Clubs, Inc.), 922 F.2d 984, 989 (2d Cir. 1990), *cert. denied*, 112 S. Ct. 50 (1991).

[187] Official Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re* Prudential Lines Inc.), 928 F.2d 565, 573 (2d Cir. 1991); Holtkamp v. Littlefield (*In re* Holtkamp), 669 F.2d 505, 508 (7th Cir. 1982).

[188] 980 F.2d 125 (2d Cir. 1992).

[189] *Id.* at 131.

received from the debtor sufficient to satisfy the creditor's claim against the debtor.[190]

The court went on to state that the FDIC's complaint alleged that Sisti is liable to the FDIC as a result of loans made by the failed banks and that the defendants are liable as fraudulent transferees of Sisti.[191] Accordingly, the FDIC was seeking to recover a claim against Sisti and thus was subject to the automatic stay.[192]

In light of this construction of the scope of the automatic stay, it appears that an attempt by preferred stockholders to exercise their right to elect directors may be considered a violation of the automatic stay as an attempt to recover a claim against the debtor. The recent bench ruling in the chapter 11 case of Fairmont Communications Corporation ("Fairmont"), which was set forth in the record of the hearing, sheds light on this important issue.[193] In that case, Price Communications Corporation ("Price"), an unsecured creditor and stockholder, sought an order permitting it to exercise certain irrevocable proxies and appoint an additional director to the board of directors of Fairmont that would have given it control of the board. Fairmont had acquired several companies from Price in a leveraged buy out transaction (the "LBO"), which was funded in part by Price. As a result of this financing, Fairmont was indebted to Price in the amount of $94,800,000, which was evidenced by Series A, B, and C 12.5% subordinated extendible notes with extendible maturing dates from September 30, 1992 to September 30, 1994 (the "Price Notes"). This unsecured indebtedness was junior and subordinate to all of Fairmont's other indebtedness.

In connection with the LBO, Fairmont and its four stockhold-

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190 *Id.* at 132 (quoting *In re* Saunders, 101 B.R. 303, 305-06 (Bankr. N.D. Fla. 1989)).

191 *Id.*

192 *Cf.* Landmark Land Co. v. Resolution Trust Corp. (*In re* Landmark Land Co.), 973 F.2d 283 (4th Cir. 1992). In *In re Landmark Land*, the court held that the district court lacked jurisdiction to enjoin the RTC, acting as conservator, and thus stockholder, of a failed thrift, from assuming control of the thrift's chapter 11 subsidiaries by initiating a stockholders' meeting. The court determined that FIRREA trumped the Bankruptcy Code by reason of its anti-injunction provisions: "The comprehensive scheme of FIRREA indicates Congress' intent to allow the RTC full rein to exercise its statutory authority without injunctive restraints imposed by bankruptcy courts or district courts in other proceedings." *Id.* at 290. Thus, the Fourth Circuit recognized the right of the RTC to exercise its broad powers to reorganize and collect assets by initiating or convening a stockholders' meeting in order to elect directors who would withdraw the thrift from bankruptcy. *Accord* Board of Governors of the Fed. Reserve Sys. v. MCorp Fin., Inc., 112 S. Ct. 459 (1991).

193 *In re* Fairmont Communications Corp., No. 92 B 44861 (Bankr. S.D.N.Y. Mar. 3, 1993), *appeal docketed*, No. 93 Civ. 2388 (S.D.N.Y. Apr. 14, 1993).

ers, including Price, entered into a stockholders' agreement which provided that Fairmont would have a five member board of directors. In addition, the other three stockholders were required to deliver irrevocable proxies to Price, entitling Price to elect up to four additional directors to the board. Price's right to appoint two additional directors could only be exercised after September 30, 1992 if the Price Notes remained unpaid, accrued interest had been unpaid, its preferred stock had not been redeemed, or dividends on the preferred stock were in arrears. If the Price Notes remained unpaid on September 30, 1994, Price had the right to appoint two additional directors, bringing the board up to nine directors.

The court held that the automatic stay barred Price from exercising its rights under the proxies. By attempting to exercise these rights, Price was acting as a creditor because the actions it intended to take were based upon the failure to meet the monetary terms of the Price Notes and calculated to ensure the payment of such notes. The court relied on *In re Briggs*,[194] which held that an action taken by a creditor in the process of seeking voluntary repayment of a prepetition indebtedness violated § 362(a)(6) of the Bankruptcy Code if such action "(1) could reasonably be expected to have a significant impact on the debtor's determination as to whether to repay, and (2) is contrary to what a reasonable person would consider to be fair under the circumstances."[195]

The court also found that § 362(a)(3) barred Price's actions as an attempt to exercise control over property of the estate. By electing a director of Price's choosing, Price, in its capacity as a creditor, would control the board of directors and thus the operations of Fairmont.

A similar result was reached in *In re Bicoastal Corp.*,[196] which involved a leveraged buy out of The Singer Company by the debtor. After obtaining financing for the leveraged buy out from Mesa, the debtor provided Mesa with a junior note and redeemable preferred stock in consideration for such financing. The preferred stock provided Mesa with voting rights to appoint the majority of the board of directors in the event the junior note and preferred stock were not paid on a timely basis and the preferred stock was not redeemed.

After the debtor failed to make the requisite payments, Mesa attempted to exercise its right to designate a majority of the

194 143 B.R. 438 (Bankr. E.D. Mich. 1992).

195 *Id.* at 453.

196 No. 89-8189, 1989 Bankr. LEXIS 2046 (Bankr. M.D. Fla. Nov. 21, 1989).

debtor's board of directors. The court held that the automatic stay barred the actions contemplated by Mesa because Mesa was attempting to indirectly force the repayment of the loan in violation of § 362(a)(1). Furthermore, if Mesa were permitted to control the board of directors, it would obtain, possess, and exercise full control over the operation of the debtor in violation of § 362(a)(3).

It has also been suggested that attempts by preferred stockholders to exercise their right to elect directors might violate the automatic stay as an act to collect a debt. For example, Fortgang and Mayer illustrated this proposition as follows:

> [Consider] a bank which has extended credit secured by a pledge of a controlling stock interest in the debtor. The pledge agreement gives the bank the right to vote the stock after an event of default. Surely no court would allow the bank to enforce such a right and displace the chapter 11 debtor's board. Such an act would clearly violate the automatic stay. Yet it is difficult to see how preferred shareholders, in attempting to elect directors as provided in their contract, have any greater right to control the debtor than does the bank with a pledge of stock.[197]

The motives of preferred stockholders in demanding a meeting to elect directors are significantly different from the motives of common stockholders. Common stockholders seek to elect directors as part of their fundamental right to be heard on corporate governance matters. They are concerned with electing competent directors who will benefit the corporation as a whole. In contrast, preferred stockholders have a far narrower interest. Their sole concern is to elect directors whose first allegiance may be to pursue the parochial interests of preferred stockholders that the dividends that were in arrears are paid. By indirectly seeking to collect on the claims for forcing the payment of dividends, preferred stockholders may be in violation of the automatic stay. In addition, by attempting to enforce the right to elect directors, preferred stockholders, in effect, are attempting to exercise control over the property of the estate based upon a monetary default. Such action necessarily violates the provisions of the automatic stay.

Conclusion

The "institutional integrity of a corporation depends upon the proper discharge" of a director's fiduciary duties.[198] How-

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197 Fortgang & Mayer, *supra* note 179, at 72.

198 Francis v. United Jersey Bank, 432 A.2d 814, 824 (N.J. 1981).

ever, because a chapter 11 debtor represents the entire bankruptcy estate, it has fiduciary obligations to all of the constituents despite their relative conflicting interests. In fulfilling its fiduciary role, the debtor must resolve these conflicts in accordance with its duties and powers under the Bankruptcy Code and its fiduciary responsibilities under applicable nonbankruptcy law to the creditors and stockholders.

This conflict is exacerbated when the debtor corporation is insolvent. Although an argument may be made that a chapter 11 debtor has no fiduciary obligations to stockholders of an insolvent corporation because such stockholders have no pecuniary interest in the debtor, upon closer analysis it becomes evident that a debtor has a responsibility to continue to negotiate plan treatment on behalf of such stockholders subject to the overall constraints imposed by the Bankruptcy Code. The notion that a debtor and its directors cease to have any obligations to stockholders of an insolvent debtor is contrary to the philosophy, policies, and provisions of chapter 11 of the Bankruptcy Code. Chapter 11 is predicated upon the policy of rehabilitation and reorganization, with consequent enhancement of the value of the debtor. Achievement of this objective may provide for participation in the reorganized entity by stockholders despite clear insolvency at the beginning of a chapter 11 case or pursuant to the consent of creditors as contemplated by the Bankruptcy Code. For example, by relaxing the absolute priority rule to allow senior classes of creditors to relinquish value to junior classes, the Bankruptcy Code indicates the congressional intent to encourage consensual reorganizations with participation by all parties in interest, including old stockholders, notwithstanding the insolvency of the debtor. Thus, it is not inappropriate for the debtor to reasonably negotiate for old stockholders of an insolvent corporation to share in the reorganization value.

The philosophy of rehabilitation and reorganization under the Bankruptcy Code enables stockholders to retain an interest in the administration of the debtor until a confirmed plan of reorganization terminates their interests. It follows, then, that stockholders should continue to retain their fundamental and paramount right to be heard on corporate governance matters notwithstanding insolvency so long as those corporate rights do not conflict with the provisions and purposes of the Bankruptcy Code.

Although it is sometimes difficult to determine exactly when

the point of conflict is reached, each case must be determined based upon its facts and the principles enunciated by the appellate courts. The interests of stockholders should not prolong a chapter 11 case when it is patent that there is not, and there will never be, sufficient value to provide any consideration for the stockholders. However, so long as a debtor has a good faith belief that the corporation can be rehabilitated and that going concern value will be preserved and enhanced, the debtor and its directors have a duty to attempt to achieve a consensual plan of reorganization incorporating plan treatment for stockholder interests and junior creditor claims as contemplated by the Bankruptcy Code.

Finally, although the right of common stockholders to elect directors subsists during reorganization, the right of preferred stockholders to elect directors upon a default in the payment of dividends may be in violation of the automatic stay. While common stockholders seek to elect directors as part of their fundamental right to be heard on corporate governance matters, preferred stockholders seek to elect directors in order to cause the corporate governors to pursue actions to cure the monetary dividend defaults and arrearages. In so doing, preferred stockholders may be acting in violation of the automatic stay by seeking to exercise control over the property of the debtor in order to achieve a recovery on their claims.