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Behavioral Approach to Analyzing Corporate Failures

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A BEHAVIORAL APPROACH TO ANALYZING CORPORATE FAILURES

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Recent corporate failures indicate that existing laws fail to give boards of directors adequate incentives to acknowledge that some financially troubled firms simply cannot be salvaged. Relying primarily on insights from law and behavioral science literature, this Article notes that directors have a natural tendency to underestimate risks and overestimate their ability to save an insolvent or near insolvent firm. This Article urges the imposition of a duty to file a timely bankruptcy petition because such a duty will encourage directors to consider the interests of all the firms' constituents, including workers, creditors, and the local community, when making decisions for

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a financially troubled firm. This Article argues that directors of insolvent firms that fail to protect firms by placing them under the protection of federal bankruptcy laws should be sanctioned in the firm's subsequent bankruptcy.

I. INTRODUCTION

Many businesses that file for bankruptcy are hopelessly insolvent, i.e., dead-on-arrival ("DOA"), before they even reach the bankruptcy court.[1] This is not surprising, as boards of directors of businesses seem reluctant to admit that they lack the ability to save a financially troubled business. The magnitude of the recent corporate financial scandals[2] and the likelihood that the questionable business practices the managers and directors of those firms used are more common than originally assumed caused Congress to enact sweeping corporate fraud legislation that

1. *See* NAT'L BANKR. REVIEW COMM'N, REPORT OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION, BANKRUPTCY: THE NEXT TWENTY YEARS 308 (1997) [hereinafter REPORT] (acknowledging that "Chapter 11 also attracts some 'dead-on-arrival' businesses . . . ").

2. Recent large corporate financial debacles include Enron, WorldCom, Kmart, Conseco, and Adelphia. Enron was the seventh largest corporation in the United States before it filed for protection under Chapter 11 on December 2, 2001. Richard A. Oppel, Jr. & Andrew Ross Sorkin, *Enron Corp. Files Largest U.S. Claim for Bankruptcy*, N.Y. TIMES, Dec. 3, 2001, at A1. It was at that time the largest filing in U.S. history. *Id.* The July 21, 2002 bankruptcy filing of WorldCom surpassed it as the largest filing. Simon Romero & Riva D. Atlas, *Extra Level of Scrutiny in WorldCom Bankruptcy*, N.Y. TIMES, July 23, 2002, at C1. Both WorldCom and Adelphia executives have been arrested on fraud charges. Kurt Eichenwald, *2 Ex-Officials at WorldCom Are Charged in Huge Fraud*, N.Y. TIMES, Aug. 2, 2002, at A1. Kmart executives misreported earnings, acquired two new planes for themselves, and created a "retention loan" program (then fabricated the true scope of the program to the board) that gave almost twenty-nine million dollars to executives who left or were discharged from the company. *See* Jennifer Dixon, *Subsidiary Bought 2 Planes, Purchase Came Just Before Cash Ran Out*, DETROIT FREE-PRESS, June 20, 2002, at A6; Amy Merrick, *Kmart Studied Executive Conduct as a Focus of Its Internal Probe*, WALL ST. J., Jan. 27, 2003, at A3. Conseco filed for bankruptcy while it was facing a federal investigation of its accounting practices. *See* Jane Hoback & Gil Rudawsky, *Former Conseco Exec Confident Firm Will Climb Out of Chapter 11*, ROCKY MOUNTAIN NEWS, Jan. 4, 2003, at C6. Finally, the trial, conviction, and ultimate demise of Arthur Andersen is a fallout of the Enron debacle. *See* Kurt Eichenwald, *Andersen Guilty in Effort to Block Inquiry on Enron*, N.Y. TIMES, June 16, 2002, at A1 (discussing conviction "for impeding an investigation by securities regulators into the financial debacle at Enron" and announcing that Andersen "would cease auditing public companies").

accomplishes the following: (1) tightens federal securities disclosure rules; (2) regulates the consulting relationships that audit companies have with businesses they audit; (3) increases the duties of audit committees of boards of directors; (4) prohibits certain insider trading; (5) enhances penalties for the destruction of documents needed in federal investigations or bankruptcy proceedings; and, (6) prevents corporate executives from using bankruptcy laws to avoid securities fraud liabilities.[3]

This legislation is a good first step. However, while the proponents of the legislation may be correct in assuming that greater disclosures would have prevented the scandals associated with the Enron and WorldCom bankruptcies, it is unlikely that greater disclosures necessarily would have prevented the firms' financial difficulties. Since insolvency is inevitable for some firms, the question that remains to be answered is how (or whether) laws should encourage directors to place businesses under the protection of federal bankruptcy laws once they realize that the business is facing a financial crisis.

Current corporate and bankruptcy laws give directors no incentive to timely place a firm in bankruptcy and fail to sanction directors who place a DOA firm in a Chapter 11 reorganization proceeding. Given the well-established behavioral tendency for actors to be overconfident about the risk that bad things will happen,[4] it is somewhat predictable that directors will be unwilling to place firms in bankruptcy since doing so acknowledges that they lack the ability to save the business or, even worse, may have made decisions that contributed to the firm's financial crisis. This Article argues that bankruptcy laws should encourage directors to place firms under the protection of the bankruptcy laws before the firm is hopelessly insolvent and that directors who fail to do so should be fined in any subsequent bankruptcy proceeding.[5]

Part II of the Article relies on insights from law and behavioral science literature to explain why some directors might not admit that they lack the ability to save a financially troubled firm until it is too late for even the protections afforded by bankruptcy laws to

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3. Sarbanes-Oxley Act of 2002, H.R. 3763, 107th Cong. §§ 103, 301, 306, 402, 802-03 (2002).

4. *See* discussion *infra* Part II.

5. This Article does not consider the usefulness or efficiency of bankruptcy laws in general. Specifically, in arguing for a duty to file a timely bankruptcy petition I assume that bankruptcy laws will continue to allow firms to attempt to reorganize. I do not consider whether state law remedies are superior to those provided in the Federal Bankruptcy Code or whether unsecured creditors would fare better under applicable state law. I do, however, briefly discuss the arguments concerning Chapter 11's efficiency *infra* Part IV.A.3.

save it. This Part argues that the unwillingness of directors to admit defeat is consistent with a well-established behavioral trait: the overconfidence bias. I suggest that this bias will prevent some directors from filing timely bankruptcy petitions for their firms because placing the firm in bankruptcy would force them to publicly admit that they either made bad decisions in the past or that they simply lack the capacity to save the firm. This Part indicates that the tendency to make risky decisions based on a good faith (though misinformed) belief that those decisions will not harm the firm is natural and well-established and, in most cases, does not reflect any ill intent on the part of directors.

Part III of this Article considers whether existing legal rules or market controls already give directors incentives to prevent DOA filings. The first section discusses the fiduciary duties directors of solvent firms owe shareholders and creditors and argues that those duties fail to give directors any incentives to avoid DOA filings. Indeed, this section suggests that the ambiguous nature of directors' duties once a firm is approaching insolvency gives directors an additional incentive to avoid early filings. This Part then demonstrates that current market controls fail to curb directors' tendencies to make decisions that allow them to continue to believe that their prior decisions are still valid. I suggest that these controls are particularly ineffective once directors either know the firm cannot be saved or conclude that they can make substantial financial gains by delaying the filing.

The Article concludes by arguing that the law needs to impose sanctions to encourage directors to develop a more realistic expectation of their ability to resuscitate a financially troubled firm. Specifically, I argue that directors should have a "duty to timely file" and that they breach that duty if they fail to place firms in bankruptcy within thirty days of the time either the directors knew that the firm would be unable to pay its probable liability on its existing debts as they matured or when they knew (or should have known) that the firm's current liabilities exceeded the fair market value of its current tangible assets.

II. BEHAVIORAL INFLUENCES ON DIRECTOR DECISION-MAKING

It is worth saying as an initial matter that it is unrealistic (and unfair) to suggest that most directors are either intentionally corrupt or serve on boards with the single goal of looting the firm. Most directors intend to act in the best interest of the firm but may fail to do so for reasons completely unrelated to any desire to intentionally harm the firm. Certain behavioral traits may, in fact, prevent directors from acting in the best interests of their firms.[6]

Overconfidence is a common human tendency, and highly successful people in particular have a tendency to overestimate their ability to control their environments and to avoid harm.[7] The problem of the "overconfidence bias" is well-documented and recently has been discussed in the law and behavioral science literature.[8] An actor is susceptible to this bias if she believes that the probability of a negative event happening to her is less than the likelihood of the event happening to someone else or, conversely, that it is more likely that a positive event will happen to her than the likelihood that a negative event will happen to her.[9] This bias purportedly exists even if the actor is an expert and even if she knows the actual probability distribution of any particular event.[10] Likewise, behavioral studies suggest that people, especially successful ones, have an enhanced sense of their abilities to control events in their lives and that they will likely attribute positive outcomes to their own decision-making abilities.[11] These tendencies combine to encourage people to accept too many risks based on their belief that adverse risks are unlikely to occur and that, in any event, they can prevent harm from occurring.[12]

Behavioral studies also suggest that choices people make are "path-dependent."[13] That is, people will be over committed to decisions they made, will often ignore or discount new information

6. I am not suggesting that all directors have psychological biases. Instead, I suggest that the law should at least consider the possibility that certain psychological biases may cause directors unconsciously to make decisions that harm the business and that a stronger legal sanction may be needed to help directors overcome those biases.

7. *See* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 807 (2001).

8. *See* Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1659-61 (1998); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1091-93 (2000).

9. *See* Korobkin & Ulen, *supra* note 8, at 1091.

10. *See* Jolls, *supra* note 8, at 1659 & nn.22-23 (citing studies); Korobkin & Ulen, *supra* note 8, at 1091-93 (citing psychological studies); Jeffrey J. Rachlinski, *The "New" Law and Psychology: A Reply to Critics, Skeptics, and Cautious Supporters*, 85 CORNELL L. REV. 739, 758 (2000).

11. *See* SHELLEY E. TAYLOR, POSITIVE ILLUSIONS: CREATIVE SELF-DECEPTION AND THE HEALTHY MIND 16 (1989); Robert A. Hillman, *The Limits of Behavioral Decision Theory in Legal Analysis: The Case of Liquidated Damages*, 85 CORNELL L. REV. 717, 723 (2000); Robert K. Rasmussen, *Behavioral Economics, the Economic Analysis of Bankruptcy Law and the Pricing of Credit*, 51 VAND. L. REV. 1679, 1689 (1998).

12. *See* Hillman, *supra* note 11, at 723-24.

13. *See* Langevoort, *supra* note 7, at 826.

that contradicts their belief that their prior decisions are correct, and will remain wedded to those decisions even if they later obtain information that should lead them to question the decisions.[14] Because their present decisions and choices are constrained by prior decisions, they will attempt to justify and rationalize the continuing validity of prior decisions even though those decisions might appear questionable to an outsider who did not participate in the earlier decision-making process.[15] Indeed, this tendency will cause them to seek out information that confirms the respectability of their prior decisions,[16] rather than seek information that suggests that those decisions were unwise (or are no longer wise).[17] Even when confronted with potentially harmful information concerning risks, actors tend to interpret information in ways that serve their personal interests or pre-conceived notions.[18]

Finally, behavioral studies indicate that most actors have the tendency to cut corners (but not feel guilty) if they think that their choices are ones reasonable people would make and will ultimately lead to a successful result.[19] Cognitive psychologists refer to this tendency, a form of cognitive dissonance, as the "sunk cost trap" whereby people incrementally make good faith (but overly optimistic) decisions which cause harm to the firm once an unexpected event occurs (such as a downturn in the economy).[20] A director who does not recognize that what he is doing is unreasonable, irrational, or illegal will have little incentive to act consistently with any particular legal rule or duty unless he realizes that he faces significant penalties or the imposition of increased external monitoring.[21]

Directors are probably more likely than the average person to

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14. *See* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 29 (2002); Langevoort, *supra* note 7, at 811; Matthew Rabin, *Psychology and Economics*, 36 J. ECON. LITERATURE 11, 26 (1998).

15. *See* Langevoort, *supra* note 7, at 826; Rabin, *supra* note 14, at 26 (noting that "'fresh' thinkers may be better at seeing solutions to problems than people who have meditated at length on the problems, because the fresh thinkers are not overwhelmed by the 'interference' of old hypotheses"); Rasmussen, *supra* note 11, at 1689-90.

16. Rabin, *supra* note 14, at 26.

17. *See* TAYLOR, *supra* note 11, at 27; Langevoort, *supra* note 7, at 826; Rasmussen, *supra* note 11, at 1689-90.

18. *See* TAYLOR, *supra* note 11, at 28; Korobkin & Ulen, *supra* note 8, at 1093.

19. *See* Donald C. Langevoort, *Seeking Sunlight in* Santa Fe*'s Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 482 (2001).

20. *See id.* at 481-83 (discussing how sunk cost trap and overoptimism bias may affect corporate officers' decision-making process).

21. *Id.*

be overconfident about their abilities to make correct decisions. Unfortunately, directors who are susceptible to the overconfidence bias will be less likely to admit that they cannot save a financially troubled firm until it is too late for anyone (including a bankruptcy judge) to resuscitate the firm. Because the overconfidence bias causes people who are factually informed of the likelihood of harm to make incorrect decisions, even directors with full knowledge of the firm's finances may still be unrealistically optimistic about the firm's ability to recover.[22] Indeed, the behavioral tendencies to be overconfident and over committed to prior decisions cause directors to try to find ways to justify the reasonableness of their prior decisions rather than focusing on taking steps to remedy the firm's existing solvency problems.

III. EXISTING CONTROLS FAIL TO CONSTRAIN DIRECTORIAL DECISION MAKING

A. *Fiduciary Duties*

Directors have no explicit duty to consider whether it is in the firm's interests for directors to relinquish exclusive control over the firm by either seeking help from external insolvency or turnaround experts, or by placing it under the control and protection of federal bankruptcy laws. Because current corporate laws do impose broad fiduciary duties on directors, the desire to avoid the monetary liability, inconvenience, and potential embarrassment associated with litigation arguably gives directors an incentive to avoid DOA filings, thus protecting the firm's interests. As the next sections demonstrate, however, directors' unwillingness to harm (and potentially eliminate) shareholders' interests by placing the firm in bankruptcy is likely attributable to the vague nature of the directors' fiduciary duties to shareholders and other constituents of the firm both before and after a firm becomes insolvent. Thus, the behavioral tendency to avoid an early filing combined with vague legal rules naturally results in directors' reluctance to file early bankruptcy petitions.

1. *Solvent Businesses*

a. *To shareholders*. Boards of directors are given the authority to control and manage the firm's assets within the confines of the powers provided in the corporate charter.[23] These broad powers give

22. *See* Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1183 (1997) (explaining common behavioral biases).

23. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1974) ("The business and

directors the authority to file early bankruptcy petitions for businesses, but neither require timely filings nor sanction directors who cause DOA filings.[24] Most states' corporate laws impose two broad fiduciary duties on the directors of solvent firms—the duty to avoid self-dealing (i.e., the duty of loyalty) and the duty of care.[25] Directors arguably have moral obligations to the firm as well, though these moral duties are generally encompassed by the legal duties of loyalty and care.[26] The duty of loyalty requires directors to protect the firm's interests by refraining from engaging in acts that benefit themselves, but harm the firm.[27] Directors will be held liable for breaching the duty of loyalty either when they used their positions of trust and access to confidential information to participate in transactions in which they have an interest,[28] or because they placed their own interests before those of the firm.[29] A

affairs of every corporation . . . shall be managed by or under the direction of a board of directors."); REVISED MODEL BUS. CORP. ACT § 8.01(b) (1985) (stating that the business and affairs of the corporation shall be managed under the direction of the board of directors).

24. REVISED MODEL BUS. CORP. ACT § 8.01(b).

25. *See* R. Link Newcomb, Note, *The Limitation of Directors' Liability: A Proposal For Legislative Reform*, 66 TEX. L. REV. 411, 433 (1987) ("Courts impose liability on directors for failing to exercise care, which shifts the risk of loss from shareholders to directors for particular business decisions made by the board. Two rationales justify this shift. Placing the burden of risk upon decision makers both compensates shareholders for their losses and serves to deter directors from careless decision making."). *See generally* Zipora Cohen, *Directors' Negligence Liability to Creditors: A Comparative and Critical View*, 26 J. CORP. L. 351, 352 (2001) (discussing the rationale behind imposing liability on corporate directors); Thomas C. Lee, Comment, *Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Directors' Duty of Care*, 136 U. PA. L. REV. 239, 261-69 (1987) (comparing traditional tort concepts to the duty of care in the corporate context).

26. *See* Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 948 (1990). Those moral obligations would include the duties to: reasonably monitor or oversee the conduct of the firm's business and take steps to ensure that reasonably adequate information flows to the board; follow up on the information the board acquires; employ a reasonable decision-making process; make reasonable decisions. *Id.*

27. 1 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 122 (6th ed. 1998).

28. Whether a director is an interested party varies by state law but generally includes situations where the director is a party to a transaction involving the firm, has a financial or familial relationship with a party to such a transaction, or is subject to a controlling interest by a party to the transaction. *See* 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.23 (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE].

29. Ledbetter v. First State Bank & Trust Co., 85 F.3d 1537, 1540 (11th Cir. 1996); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). An interested

director who participates in a self-interested transaction involving the firm typically will be held liable for a breach of the duty of loyalty unless non-interested directors or shareholders approve the self-interested transaction after full disclosure, or the transaction is objectively or intrinsically fair to the corporation.[30]

In general, directors breach the duty of care when they fail to act diligently and prudently in managing the firm's affairs and their ill-advised decisions negligently cause harm to the firm.[31] In considering whether a director has breached the duty of care, courts evaluate the information available to the directors, the actual decision that ultimately caused harm, and the good faith or rationality of the process the directors employed before they made the harmful decision.[32] The duty of care thus monitors directors' oversight and decisional capacities by requiring them to be informed of all material information reasonably available to them and to make decisions with a reasonable amount of attention and skill.[33]

While the duty of care primarily focuses on decisions directors make that ultimately harm the firm or its shareholders, directors also have an affirmative duty to act in circumstances in which due attention would prevent a loss.[34] Allegations that directors have breached the duty of care because of their *failure* to act most often involve claims that a director failed to adequately supervise firm employees or to monitor top firm executives. Directors (especially

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officer or director has the duty to disclose all known material facts relating to the conflict of interest and the transaction that a reasonable person would consider important when voting on the transaction. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 28, § 1.14.

30. DEL. CODE ANN. tit. 8, § 144(a) (1974); Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993); Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1280 (Del. 1989); *Weinberger*, 457 A.2d at 710; 1 KNEPPER & BAILEY, *supra* note 27, at 122.

31. *See In re* Caremark Int'l Inc., 698 A.2d 959, 967 (Del. Ch. 1996); 1 KNEPPER & BAILEY, *supra* note 27, at 77-78.

32. Section 8.30 of the Revised Model Business Corporation Act provides the statutory approach to the duty of care that most states follow. Section 8.30 provides that directors must discharge their duties "(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation." REVISED MODEL BUS. CORP. ACT § 8.30 (1985); *see also* Meyers v. Moody, 693 F.2d 1196, 1209 (5th Cir. 1982); Steinberg v. Kendig (*In re* Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 652 (Bankr. N.D. Ill. 1998). *See generally* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 28, § 4.01(a) (discussing a director's duty of care).

33. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994); *Smith*, 488 A.2d at 872-73.

34. *In re Caremark Int'l Inc.*, 698 A.2d at 967.

outside directors) typically will have neither the time nor ability to closely monitor the firm's daily operations or firm managers' day-to-day decisions.[35] Given this, directors may have no actual knowledge of improper managerial acts, either because they have been misled by firm managers, or because they have simply failed to detect that managers have engaged in harmful conduct, such as causing the firm to violate applicable laws or regulations.[36]

Directors arguably breach the duty of care if they wait until a firm is DOA before placing it under the protection of bankruptcy laws or if they fail to supervise firm managers who engage in acts that cause the firm's insolvency. However, allegations that directors breached the duty of care are reviewed under the highly deferential business judgment rule.[37] The business judgment rule is designed to encourage directors to freely exercise their managerial discretion and to remove uncertainty from corporate transactions by avoiding an *ex post* appraisal of the managers' decisions.[38] Under the business judgment rule, director liability is predicated upon

35. Bainbridge, *supra* note 14, at 35; Melvin A. Eisenberg, *The Board of Directors and Internal Control*, 19 CARDOZO L. REV. 237, 237 (1997); Ira M. Millstein & Paul W. MacAvoy, Essay, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1283-86 (1998).

36. To avoid breaching the duty of care for failing to prevent illegal corporate activities, directors must generally monitor managers' acts, but need not possess detailed information about all aspects of the firm's operation, nor routinely interrogate all employees (unless there are grounds to suspect deception). Directors typically satisfy the duty to monitor by assuring that the firm has a good information and reporting system (i.e., by creating corporate compliance programs) or by specifically delegating oversight responsibilities to their audit or ethics committees or to third-parties acting on the firm's behalf (and subject to the directors' control). *In re Caremark Int'l Inc.*, 698 A.2d at 970 (finding that:

> a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards[)].

See also Eisenberg, *supra* note 35, at 252 (noting that "[t]he most significant instrument for executing" the directors' duty to monitor is internal and possibly external auditing).

37. *See* Ajay Sports, Inc. v. Casazza, 1 P.3d 267, 275 (Colo. Ct. App. 2000); *Smith*, 488 A.2d at 872-73.

38. *Ajay Sports, Inc.*, 1 P.3d at 275; *Cede & Co.*, 634 A.2d at 360 ("The rule operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation."); *Smith*, 488 A.2d at 872; Rabkin v. Philip A. Hunt Chem. Corp., No 7547, 1987 Del. Ch. LEXIS 522, at *9-10 (Del. Ch. Dec. 17, 1987).

concepts of gross negligence, not reasonableness.[39] Unless it can be shown that the directors acted with the primary goal of accomplishing an impermissible purpose, decisions made by disinterested directors who used a rational, deliberately considered process to be informed or who made a good faith effort to advance the firm's interests typically will be shielded from liability.[40] Thus, while shareholders theoretically can sue directors who made decisions that harmed the firm, or who failed to act to prevent harm (including hopeless insolvency) to the firm, the business judgment rule ensures that successful suits against directors will be rare.[41]

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39. Brehm v. Eisner, 746 A.2d 244, 262-63 (Del. 2000). Gross negligence typically is defined as "reckless indifference to or a deliberate disregard of the whole body of stockholders or actions that are without the bounds of reason." Potter v. Pohlad, 560 N.W.2d 389, 392 (Minn. Ct. App. 1997) (internal quotation marks omitted). If the business judgment rule is not applicable, directors are liable for simple negligence. 1 KNEPPER & BAILEY, *supra* note 27, at 84; *see also* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) (holding that directors "are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances").

40. *Smith*, 488 A.2d at 873; Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm*, 746 A.2d 244. Indeed, many scholars argue that this rule virtually eliminates liability for breaching the duty of care as long as directors show that their decision was made on an informed basis, in good faith and in the belief that the decision was in the firm's best interests even if the decision is later found to have been substantively wrong, unreasonable or irrational. *See, e.g.*, ROBERT C. CLARK, CORPORATE LAW § 3.4 (1986) (suggesting that "the mere mention of the business judgment rule brings smiles of relief to" directors' faces); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 299-300 (1999) ("[I]n practice the duty of care is all but eviscerated by a legal doctrine known as the 'business judgment rule.'"); Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1361-62 (1989) ("Courts accord near-complete deference to corporate decisions untainted by interest.").

41. Indeed, suits for all reasons by creditors or shareholders against directors for breaching their fiduciary duties appear to be quite rare. *See* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 709-10 (1993) [hereinafter LoPucki & Whitford, *Corporate Governance*]. Moreover, largely in response to *Smith v. Van Gorkom*, a Delaware decision that expanded director liability for breach of the duty of care, states quickly adopted "charter option" statutes that allowed corporations to include exculpatory clauses in their articles of incorporation that eliminate the personal liability of directors for monetary damages resulting from a breach of the duty of care owed to shareholders. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). Directors would remain liable for breaches of the duty of loyalty, bad faith, intentional misconduct, knowingly violating the law, improperly paying dividends, or engaging in transactions in which they receive an improper personal benefit. *See, e.g.*, *id.*

b. *To non-shareholders.* If a firm is solvent, directors generally will owe no fiduciary duties to employees or creditors[42] and instead must act in good faith consistent with the actual or implied contract.[43] It is unclear how to define directors' duties to involuntary creditors (the best example being tort creditors), since they did not choose to have a relationship with the firm and thus cannot rely on contractual rights. Directors are deemed not to have fiduciary duties to non-shareholders largely because of the prevailing view that corporations are managed by directors and officers for the sole purpose of maximizing shareholder interests.[44] This view recently

42. Nahman v. Jacks (*In re* Jacks), 243 B.R. 385, 390 (Bankr. C.D. Cal. 1999) (citing California law), *aff'd in part and rev'd in part,* 266 B.R. 728 (9th Cir. 2001); Steinberg v. Kendig (*In re* Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 652 (Bankr. N.D. Ill. 1998) (citing Delaware law); *In re* Revco D.S., Inc., 118 B.R. 468, 507-08 (Bankr. N.D. Ohio 1990) (noting Delaware courts' refusal to recognize any fiduciary duty to creditors of solvent firms); Browning Debenture Holders' Comm. v. DASA Corp., 454 F. Supp. 88, 104 (S.D.N.Y. 1978) (stating that neither firm nor directors owe fiduciary duties to creditors); Connolly v. Agostino's Ristorante, Inc., 775 So. 2d 387, 388 (Fla. Dist. Ct. App. 2000) (citing Florida law, "the general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent 'special circumstances' . . . "); Whitley v. Carolina Clinic, 118 N.C. App. 523, 526, 455 S.E.2d 896, 899 (1995) (citing North Carolina law, "[a]s a general rule, directors of a corporation do not owe a fiduciary duty to creditors of the corporation"). *But see* Brandt v. Hicks, Muse & Co. (*In re* Healthco Int'l, Inc.), 208 B.R. 288, 300-01 (Bankr. D. Mass. 1997) (concluding that the directors who approved a leveraged buy-out that ultimately caused the firm to file a Chapter 7 petition had a duty to creditors even though the decision to approve the LBO was made when the firm was solvent), *aff'd in part*, Comm'r of Revenue v. Brandt (*In re* Healthco Int'l, Inc.), 2001 U.S. Dist. LEXIS 15379 (D. Mass. July 8, 2001).

43. *See In re* Lifschultz Fast Freight, 132 F.3d 339, 346 (7th Cir. 1997); United States v. Jolly, 102 F.3d 46, 48 (2d Cir. 1996); Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1519 (S.D.N.Y. 1989); Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986); *see also* Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV L. REV. 505 (1977); Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982); Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968); Christopher L. Barnett, Note & Comment, Healthco *and the "Insolvency Exception": An Unnecessary Expansion of the Doctrine?*, 16 BANKR. DEV. J. 441, 441-43 (2000).

44. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 119-20 (1991); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1921 (1996) ("The efficiency goal of maximizing the company's value to investors remains, in our view, the principal function of corporate law."); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 521 (1990) (noting that "[i]n theory, the shareholders of public companies elect directors, who watch corporate officers, who manage/watch the company on the

has been challenged by scholars who argue that viewing public corporations as a bundle of privately-owned rights is unrealistic because corporations are a community of interests.[45] These "communitarian" scholars suggest that directors' fiduciary duties are to the firm itself (not exclusively to shareholders) and that directors have a duty to consider the needs and interests of non-shareholder interests (like employees, trade creditors, suppliers, and the local community) during the decision-making process.[46] Consistent with this view, some state constituency statutes now shield directors from liability to shareholders if they consider non-shareholder interests during the decision-making process.[47]

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shareholders' behalf"); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 917 (1988) (commenting that "the notion that in theory a corporation's 'own' interests could diverge from those of its shareholders is difficult to fathom"); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior*, *in* FOUNDATIONS OF CORPORATE LAW 8 (Roberta Romano ed., 1993).

45. *See, e.g.*, Blair & Stout, *supra* note 40, at 260-61; Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1023 (1996) (noting that communitarians disagree with the traditional view of corporate law's primary purpose: "to ensure that managers act as agents for the shareholder owners"); Nell Minow, *Shareholders, Stakeholders, and Boards of Directors*, 21 STETSON L. REV. 197, 218 (1991) (explaining stakeholder theory of corporate law which emphasizes duties to constituencies beyond shareholders); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 946-65 (1993) (advocating for a "neutral referee model" where directors would serve to balance the competing interests of employees and shareholders); *cf.* John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance As a Multi-Player Game*, 78 GEO. L.J. 1495 (1990); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 24 (1991) (emphasizing the need for "gap-filling responsibilities" to protect the interests of non-shareholders of a corporation); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 261-62 (1990) (discussing the emergence of public interests into the law governing corporate activity).

46. *See, e.g.*, David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 225 (1991) (discussing constituency statutes and the new conception these laws create about a corporation's role in society); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 582-83 (1992) (questioning the traditional notion that "directors *ought* to be accountable exclusively to stockholders"); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1203-10 (1991) (advocating for protection of employees' interests in a corporation through a legal model of corporations where rights are defined "through a set of explicit and implicit contracts").

47. For a list of the statutes, see Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate*

Regardless of whether as a normative matter directors should act solely to maximize shareholders' interests, as a descriptive matter, maximizing shareholder wealth remains the primary goal of directors of American firms. In addition, there are a number of policy and pragmatic reasons to limit directors' direct liability to non-shareholders. First, exposing directors to increased legal exposure from a multiplicity of potentially unfounded claims will impede their ability to function as corporate directors and necessarily will increase administrative costs largely because directors may demand additional directors' and officers' ("D&O") liability insurance to cover these additional risks.[48] Moreover, treating non-shareholders as beneficiaries of the directors' fiduciary duties of loyalty and care potentially could overwhelm the courts and lead to inconsistent results since different constituents could file suits in different jurisdictions that have divergent standards for the directors' fiduciary duties. Finally, giving non-shareholders standing to sue the directors of solvent firms for the breach of a fiduciary duty exposes directors to the risk of double liability, since they presumably also can be sued by shareholders for breaching those same duties.

2. *Insolvent Businesses*

Though directors and managers are deemed to manage an insolvent firm's assets for the benefit of creditors and potentially shareholders or others with an interest in the firm,[49] they have no

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and Antitakeover Overreaching, 150 U. PA. L. REV. 1795, 1828 tbl.3 (2002). *See also* Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 45 (1991) (noting constituency statutes recognize protection for many groups including "managers, creditors, employees, customers, suppliers, and local communities").

48. *See* Melanie K. Palmore, Comment, *"Insured vs. Insured" Exclusions in Director and Officer Liability Insurance Policies: Is Coverage Available When Chapter 11 Trustees and Debtors-in-Possession Sue Former Directors and Officers?*, 9 BANKR. DEV. J. 101, 102 (1992) (noting increase in D&O liability insurance due to the rising standard of care imposed on directors).

49. *See, e.g.*, Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 355 (1985) (stating that the managers of the debtor-in-possession are fiduciaries); Pepper v. Litton, 308 U.S. 295, 307 (1939); Pay 'N Pak Stores v. Court Square Capital (*In re* PNP Holdings Corp.), 141 F.3d 1178 (9th Cir. 1998); Ford Motor Credit Co. v. Reynolds & Reynolds Co. (*In re* JKJ Chevrolet, Inc.), 26 F.3d 481, 485 (4th Cir. 1994); Unsecured Creditors Comm. of Debtor STN Enters., Inc. v. Noyes, 779 F.2d 901, 904 (2d Cir. 1985); Fed. Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982); Clarkson Co. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981); Steinberg v. Kendig, (*In re* Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 653-54 (Bankr. N.D. Ill. 1998); Berres v. Bruning (*In re* Bruning), 143 B.R. 253, 255-56 (Bankr. D. Colo. 1992) (finding that a trust arises in favor of creditors upon the firm's insolvency); Fox

fiduciary or statutory duty to protect the firm by filing a timely bankruptcy petition. Moreover, though directors remain fiduciaries of the firm once it becomes insolvent and they have additional duties to protect the interests of creditors upon the firm's insolvency,[50] there is no generally accepted definition for "insolvency."[51] Courts have defined insolvency either as a firm's inability to pay bills as they mature in the ordinary course of the business (equitable insolvency)[52] or when the fair market value of the firm's assets is less than its total liabilities (bankruptcy or balance sheet insolvency).[53] Other courts suggest that directors breach their fiduciary duties to creditors if decisions they make when the firm is solvent cause the firm to become insolvent.[54] Moreover, a prominent Delaware state court opinion suggests that directors' fiduciary duties to creditors start *before* actual insolvency when the firm is approaching insolvency, i.e., when it is in the "vicinity of

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v. MGM Grand Hotels, Inc., 187 Cal. Rptr. 141, 143 (Cal. Ct. App. 1982); St. James Capital Corp. v. Pallet Recycling Assocs. of N. Am., Inc., 589 N.W.2d 511, 514-15 (Minn. Ct. App. 1999); Ass'n of Haystack Prop. Owners, Inc. v. Sprague, 494 A.2d 122, 125 (Vt. 1985); JAMES D. COX ET AL., CORPORATIONS § 10.18 (1995) (discussing body of law that imposes on directors fiduciary duties to creditors when the firm is insolvent).

50. Directors of insolvent firms are deemed to have fiduciary duties to creditors because shareholders' residual interests in an insolvent firm are worthless and cannot be paid until creditors' claims are paid in full. *See* Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations,* 72 AM. BANKR. L.J. 103, 107-08 (1998); Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1512 (1993).

51. *See, e.g.*, Ramesh K.S. Rao et al., *Fiduciary Duty a la* Lyonnais: *An Economic Perspective on Corporate Governance in a Financially-Distressed Firm,* 22 J. CORP. L. 53, 61 (1996); Andrew D. Shaffer, *Corporate Fiduciary—Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About,* 8 AM. BANKR. INST. L. REV. 479, 513 (2000).

52. LaSalle Nat'l Bank v. Perelman, 82 F. Supp. 2d 279, 290 (D. Del. 2000).

53. Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 789 (Del. Ch. 1992). Statutes provide yet more definitions. The Bankruptcy Code defines an insolvent debtor as one whose debts exceed the fair market value of its property. 11 U.S.C. § 101(32) (1994). The Uniform Fraudulent Conveyance Act defines insolvency to occur when the debtor's present fair salable value of assets is less than the amount required to pay its probable liability on its existing debts as they mature. UNIF. FRAUDULENT CONVEYANCE ACT § 2(1) (1992). The Uniform Fraudulent Transfer Act defines insolvency to occur when the debtor's debts exceed the fair valuation of the debtor's assets and presumes a debtor is insolvent when it is generally not paying its debts as they become due. UNIF. FRAUDULENT TRANSFER ACT § 2(a)-(b) (1999). The lack of a generally accepted method to value the assets or liabilities adds even another layer of unpredictability. Rao et al., *supra* note 51, at 63 (noting lack of consensus on appropriate measure to value assets or liabilities).

54. *Sea Pines Co.*, 692 F.2d at 977; *Clarkson Co.*, 660 F.2d at 512.

insolvency."[55] Finally, courts recently have been willing to allow creditors to sue directors and officers based on a theory of "deepening insolvency." Under this theory, directors, officers, their accountants or lawyers who negligently or fraudulently extend an insolvent company's life by concealing or misrepresenting the company's true state of insolvency may be held liable to the firm's creditors.[56]

In addition to the uncertainty concerning the meaning of "insolvency," there is a breadth of views concerning the scope of directors' post-insolvency fiduciary duties.[57] Some courts and commentators narrowly characterize directors' duties as the traditional pre-insolvency duties (duty of care and duty of loyalty)

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55. Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp., No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991).

56. *See, e.g.*, Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001); Tabas v. Greenleaf Ventures, Inc. (*In re* Flagship Healthcare, Inc.), 269 B.R. 721 (Bankr. S.D. Fla. 2001); Steinberg v. Kendig (*In re* Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998). The deepening insolvency cause of action is similar to the liability imposed on directors of non-U.S. firms who cause a business to trade while insolvent. *See* Australian Companies Act, 1993, § 588G (Austl.); Insolvency Act, 1986, §§ 213-14, 247 (Eng.).

57. Courts are also split over whether the business judgment rule shields directors from liability for creditors' breach of fiduciary claims. *Compare* Comm. of the Creditors of Xonics Med. Sys., Inc. v. Haverty (*In re* Xonics, Inc.), 99 B.R. 870, 876 (Bankr. N.D. Ill. 1989) (applying the rule), *with* Mims v. Kennedy Capital Mgmt., Inc. (*In re* Performance Nutrition, Inc.), 239 B.R. 93, 111 (Bankr. N.D. Tex. 1999) (refusing to apply the rule), *and* Askanse v. Fatjo, No. H-91-3140, 1993 WL 208440 (S.D. Tex. Apr. 22, 1993) (same), *aff'd*, 130 F.3d 657 (5th Cir. 1997). If the duty applies, decisions the directors made during the firm's insolvency presumably will be deemed to have been taken in good faith as long as the directors were adequately informed and utilized a rational decision-making process.

For a general discussion of directors' duties, see Daniel B. Bogart, *Unexpected Gifts of Chapter 11: The Breach of a Director's Duty of Loyalty Following Plan Confirmation and the Postconfirmation Jurisdiction of Bankruptcy Courts*, 72 AM. BANKR. L.J. 303, 310-13 (1998) [hereinafter Bogart, *Unexpected Gifts*]; Daniel B. Bogart, *Liability of Directors of Chapter 11 Debtors in Possession: "Don't Look Back—Something May Be Gaining On You,"* 68 AM. BANKR. L.J. 155 (1994); Richard M. Cieri et al., *The Fiduciary Duties of Directors of Financially Troubled Companies*, 3 J. BANKR. L. & PRAC. 405 (1994); Carlos J. Cuevas, *The Myth of Fiduciary Duties in Corporate Reorganization Cases*, 73 NOTRE DAME L. REV. 385 (1998); Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467 (1993); Robert B. Millner, *What Does it Mean for Directors of Financially Troubled Corporations to Have Fiduciary Duties to Creditors?*, 9 J. BANKR. L. & PRAC. 201 (1999); Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647 (1996); Shaffer, *supra* note 51.

owed to shareholders,[58] others suggest that directors have only contractual duties (duty of good faith and fair dealing) to creditors,[59] while others suggest that directors are required only to act legally and not "divert, dissipate or unduly risk [the firm's] assets."[60] Where there are allegations of fraud, self-dealing or preferential treatment, a director's liability to creditors is less ambiguous.[61] In addition, directors who make either fraudulent[62] or preferential[63]

58. *See, e.g.*, Mosser v. Darrow, 341 U.S. 267, 274 (1951) (discussing prohibition against trustees allowing insiders to engage in self-interested trading); Ford Motor Credit Co. v. Weaver, 680 F.2d 451, 461 (6th Cir. 1982) (discussing fiduciary duties of due care). Most courts and commentators assume that directors' state law fiduciary duties continue during the bankruptcy case. *See* Comm. of Creditors Holding Unsecured Claims v. Citicorp Venture Capital, Ltd. (*In re* Papercraft Corp.), 187 B.R. 486, 498-500 (Bankr. W.D. Pa. 1995); *In re* Harp, 166 B.R. 740, 746 (Bankr. N.D. Ala. 1993). Because the federal Bankruptcy Code does not prescribe the duties, the duties could be based on state corporate law or federal common law. *See generally* Bogart, *Unexpected Gifts*, *supra* note 57, at 309-10 (discussing directors' fiduciary duties in Chapter 11 proceedings); C.R. Bowles, Jr. & Nancy B. Rapoport, *Has the DIP's Attorney Become the Ultimate Creditors' Layer in Bankruptcy Reorganization Cases?*, 5 AM. BANKR. INST. L. REV. 47, 53-54 (1997).

59. *See* Ann E. Conaway Stilson, *Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors*, 20 DEL. J. CORP. L. 1, 6, 92 (1995) (arguing that the duty to creditors should be rejected because creditors are adequately protected by contract and commercial law or by the common law of fraud).

60. *Steinberg*, 225 B.R. at 656; *see also* St. James Capital Corp. v. Pallet Recycling Assocs. of N. Am., Inc., 589 N.W.2d 511, 516 (Minn. Ct. App. 1999) (stating that directors do not have a duty to creditors to "minimize any loss that may occur as a result of the corporation's insolvency" because to impose such a duty would allow creditors "to interfere unduly and interject themselves in the day-to-day management of the corporation").

61. For example, a director/shareholder who pays himself a salary, but neglects to pay creditors' debts, breaches his fiduciary duty to creditors. Pepper v. Litton, 308 U.S. 295, 307-08 (1939). Similarly, directors who prolong a firm's corporate life by incurring debt based on misleading financial information and causing the firm to sink deeper into insolvency breach their fiduciary duties to creditors. *Steinberg*, 225 B.R. at 656. Moreover, directors consistently are deemed to have breached their duties to creditors if they withdraw substantially all assets from the firm without leaving sufficient resources to pay the firm's debts, dissipate assets, put firm assets at risk, or if they divert firm assets to themselves, other insiders, or preferred creditors. *See* Pierce v. United States, 255 U.S. 398, 402 (1921); *Steinberg*, 225 B.R. at 655.

62. 11 U.S.C. § 548 (1994). Transfers made within one year of the bankruptcy filing can be avoided under Section 548 of the Code. *Id.* Transfers that were made more than one year pre-petition can be avoided under state law fraudulent conveyance statutes using the trustee's avoiding powers provided in 11 U.S.C. § 544(b).

63. *Id.* § 547. Transfers to outside creditors may be avoided if they were made within ninety days of the filing, whereas transfers to insiders may be

payments to themselves before the bankruptcy filing can be forced to return those payments to the firm's bankruptcy estate[64] if the firm ultimately files a bankruptcy petition.[65]

In addition to the uncertainty concerning the meaning of "insolvency," and the scope of directors' post-insolvency fiduciary duties, it is unclear whether the directors' fiduciary duties (however defined) to creditors replaces or is coextensive with a duty to shareholders.[66] Requiring directors to consider the interests of both

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avoided for a longer period of time, up to a year before the filing. *Id.* § 547(b)(4).

64. The commencement of the case creates a bankruptcy estate that consists of the debtor's property wherever located. *Id.* § 541.

65. The debtor-in-possession ("DIP") or Trustee can recover property that the firm improperly transferred to others, including directors, managers, or preferred creditors. If the firm transferred property directly to directors or the directors benefited from transfers of firm property to third-parties, the directors can be forced to return either the property or the value of the transferred property to the bankruptcy estate because the trustee has the right to recover a preferential transfer from either the actual transferee or the person who benefited from the transfer. *Id.* § 550. However, even if the director voluntarily made the transfer to a third-party, the DIP or Trustee is limited to recovering the fraudulently or preferentially transferred funds from the transferee/third-party unless the director personally benefited from the transfer.

66. Some courts believe that upon insolvency, directors and officers no longer represent the stockholders. *See* Fed. Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982); Hovis v. Powers Constr. Co. (*In re* Hoffman Assocs., Inc.), 194 B.R. 943, 964 (Bankr. D.S.C. 1995). Others believe directors have duties to both creditors and shareholders upon insolvency. *See* Sanford Fork & Tool Co. v. Howe, Brown and Co., 157 U.S. 312, 316-19 (1895); Ed Peters Jewelry Co. v. C & J Jewelry Co., 124 F.3d 252, 276 (1st Cir. 1997) (claiming directors owe a duty of loyalty to both shareholders and creditors after the firm is insolvent); Butler v. Bantz (*In re* Howe Grain, Inc.), 209 B.R. 496, 499 (Bankr. D. Neb. 1997); Value Prop. Trust v. Zim Co. (*In re* Mortgage & Realty Trust), 195 B.R. 740, 750-51 (Bankr. C.D. Cal. 1996); Comm. of the Creditors of Xonics Med. Sys., Inc. v. Haverty (*In re* Xonics, Inc.), 99 B.R. 870, 872 (Bankr. N.D. Ill 1989).

Some courts and commentators view creditors as the true "owners" of a bankruptcy firm, see *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1360 (7th Cir. 1990), and some academic scholars have argued that Chapter 11 should be used only to protect creditors' interests because they replace shareholders as the residual stakeholders upon a firm's insolvency. *See, e.g.*, Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 362-63 (1997); Frost, *supra* note 50, at 114-15; *see also* Lin, *supra* note 50, at 1512 (commenting that the fiduciary duties owed to creditors when a corporation is insolvent can arguably be construed broadly to maximize the creditor's interest or narrowly to merely require the equal treatment of creditors); LoPucki & Whitford, *Corporate Governance*, *supra* note 41, at 709 (suggesting that managers should have fiduciary duties to both creditors and shareholders "until their claims or interests are extinguished"); David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11* shareholders and creditors potentially creates an irreconcilable conflict given the divergent interests shareholders and creditors have once the firm is either in the "vicinity of insolvency" or is insolvent. Because creditors are entitled to receive no more than the amount of debt owed them, they will want directors to avoid risky business decisions that *might* save the business, but if unsuccessful will likely dissipate the firm's remaining assets. They are not entitled to any "upside" in benefits the firm reaps from risky (but successful) actions and, thus, will prefer that directors avoid those risky activities even if high-risk activities may reap tremendous financial benefits for the firm.[67] In contrast, shareholders' interests in an insolvent firm are worthless because their interests will be paid only after all creditors have been paid.[68] Given this, shareholders have an incentive to encourage directors to engage in risky behavior to resuscitate the firm because they capture all the higher returns, but are protected on the downside because of their limited liability to the firm's creditors.[69]

To some extent, directors already are required to consider dual interests as they are prohibited from making distributions to stockholders if doing so would render the corporation insolvent or leave it with unreasonably small capital.[70] However, even if directors of insolvent or near-insolvent firms understand that they have a fiduciary duty to protect non-shareholder claims or interests, they also understand that even (perhaps especially) during a firm's insolvency, shareholders retain the right to compel annual meetings and vote to replace them as directors.[71] Though some scholars argue

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Reorganization Cases, 78 VA. L. REV. 461, 500 (1992) (noting that "as the fortunes of a bankrupt firm rise or fall during the course of a chapter 11 case, the firm's residual owner could change" and remarking that it is unclear "when or how the decisionmaking class should be chosen").

67. *See generally* EASTERBOOK & FISCHEL, *supra* note 44, at 69; Schwarcz, *supra* note 57, at 666-67 (discussing the differences between the rights and incentives of shareholders and creditors of a solvent corporation).

68. Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 106-07 (1984) (discussing conflicting interests of secured creditors, junior creditors, and shareholders).

69. *See* Frost, *supra* note 50, at 106.

70. *See* Brandt v. Hicks, Muse & Co. (*In re* Healthco, Int'l, Inc.), 208 B.R. 288, 301 (Bankr. D. Mass. 1997) (rejecting the argument that requiring directors to consider the interests of both groups creates irreconcilable conflict), *aff'd in part*, Comm'r of Revenue v. Brandt (*In re* Healthco Int'l, Inc.), 2001 U.S. Dist. LEXIS 15379 (D. Mass. July 8, 2001).

71. *See* DEL. CODE ANN. tit. 8, §§ 141(k), 216(3), 223 (2001); *see also* Saxon Indus., Inc. v. NKFW Partners, 488 A.2d 1298, 1300 (Del. 1984).

that these are phantom "rights" for shareholders of public corporations (because management often controls the outcome of shareholder votes),[72] directors nonetheless may feel conflicting loyalties upon the firm's insolvency and current law does not clearly explain how directors could simultaneously protect those potentially conflicting interests.[73]

3. *Conclusion*

Although directors have the authority to place a firm under the protection of federal bankruptcy laws, they have no explicit duty to either file a bankruptcy petition on behalf of an insolvent firm or refrain from filing one. Despite the ambiguity concerning the scope of directors' duties to creditors,[74] no court has ever suggested that directors breach those duties by failing to file an early bankruptcy petition or that directors should be held liable for placing a DOA firm in bankruptcy. If directors are unrealistically optimistic about their ability to save the financially troubled firm, or they want to avoid the harm to shareholder (or their own) equity interests in the firm, existing legal rules give directors no incentive to protect the firm's community of interest by filing a bankruptcy petition sooner rather than later. With no clear duty to protect the interests of the

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72. *See* Blair & Stout, *supra* note 40, at 310-11; David Millon, *New Game Plan or Business As Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001, 1018 (2000) ("[M]anagement determines the outcome of the annual election and typically gets its way on other shareholder votes too.").

73. In *Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343, 355 (1985), the Supreme Court noted that shareholder interests must be subordinated to creditor interests, but did not delineate the nature of the duties directors owed creditors. *See also In re* Cent. Ice Cream Co., 836 F.2d 1068, 1072-73 (7th Cir. 1987) (agreeing that the debtor's primary duty was to ensure sufficient assets to pay creditor claims, but also considered the shareholders' interests in being paid).

74. In addition to having potentially conflicting duties to creditors and shareholders, Trustees and DIPs potentially have intra-creditor conflicting duties during a bankruptcy case. Managers, who have an incentive to keep their jobs, will not want to dispose of a significant amount of the firm's assets even if the disposition might be in the best interest of the firm and its creditors. Thus, they are likely to give more favorable treatment to creditors who will not demand that they sell substantial portions of the firm or its assets. Similarly, managers have an incentive to favor creditors (like trade creditors or suppliers) who are likely to support keeping the firm intact (and retaining the current managers) even though the Trustee/DIP should treat all similarly-situated creditors alike. *See* Martin J. Bienenstock, *Conflicts Between Management and the Debtor In Possession's Fiduciary Duties*, 61 U. CIN. L. REV. 543, 544-46 (1992) (discussing incentives that affect managers' negotiations during Chapter 11 reorganizations).

firm (and its constituents) upon insolvency, directors understand that they face little risk of liability if they harm the firm by their decision to file (or not to file) a bankruptcy petition for the firm.[75]

Current fiduciary duties give directors no incentives to avoid DOA filings. Creating additional liability for directors who fail to file timely bankruptcy petitions would not be warranted, however, if non-legal controls give directors an incentive to avoid DOA filings. As the next section demonstrates, however, existing market controls fail to give directors an incentive to file timely bankruptcy petitions.

B. Market Restraints Fail to Curb Directors' Self-Interested Opportunistic Behavior

In theory, existing market restraints (such as product markets, capital markets, and the market for corporate control) will contain directorial opportunistic acts and induce directors to make decisions (including avoiding DOA filings) that are in the best interests of the business.[76] Rational manager/directors would not consistently and intentionally make harmful business decisions because, according to

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75. Notwithstanding the general understanding that directors have fiduciary duties to creditors during the firm's bankruptcy proceeding and that they must pay creditor claims before distributing property to owners, directors' fiduciary duties during bankruptcy cases are murky as well. *See, e.g.*, *Weintraub*, 471 U.S. at 355 (stating that the debtor-in-possession owes a fiduciary duty to stockholders, yet failing to explain how to reconcile this duty with the fiduciary duties owed creditors); Casco N. Bank v. DN Assocs. (*In re* DN Assocs.), 144 B.R. 195, 199 (Bankr. D. Me. 1992) (allowing counsel to be compensated from the bankruptcy estate despite the creditors' claim that counsel was working to advance interests adverse to the estate). Although the "absolute priority" rule requires that creditors be paid in full before equity, empirical research suggests that debtors can circumvent that requirement. *See* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 166-67 (1990). Moreover, despite the latest Supreme Court pronouncement on the absolute priority rule, it still remains possible that old equity can contribute new value to the reorganized firm and retain its equity position. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 454-58 (1999) (declining to decide whether the new value exception to the absolute priority rule exists, but holding that plans cannot grant equity interests for former owners if only old equity is allowed to propose a reorganization plan or compete for the equity).

Indeed, recovering fraudulent or preferential transfers is probably the greatest risk directors face in their firms' bankruptcies. *See generally* Clarkson Co. v. Shaheen, 660 F.2d 506, 512-13 (2d Cir. 1981); Rosebud Corp. v. Boggio, 561 P.2d 367, 372-73 (Colo. Ct. App. 1977) (director liable to creditor for not preventing officer-director from selling insolvent corporation and converting proceeds to himself to the detriment of corporate creditor).

76. *See* Cohen, *supra* note 25, at 352-53; LoPucki & Whitford, *Corporate Governance*, *supra* note 41, at 710-12; Rao et al., *supra* note 51, at 56.

the corporate control market theory, shareholders who are unhappy with those decisions will either sell their shares or call an annual meeting to replace them.[77] In addition, directors who make decisions that consistently harm their firms will so weaken the firm that it will become an easy take-over target (which also might lead to their removal as directors). Directors (especially inside directors) also have an incentive to act only in the firm's best interest because, according to the labor market theory, being associated with a board of an insolvent or bankrupt firm will cause reputational harm and affect their future employment prospects.[78] Likewise, because the salary of inside directors often is based on the firm's profitability, directors have an incentive to avoid making decisions that cause the firm to become insolvent.[79]

Directors also have an incentive to make decisions that are in the best interest of the firm because of certain social status influences. Specifically, directors of successful firms often are recognized and commended in the popular press, often on a published list of the "best" or "worst" boards.[80] Receiving positive recognition both enhances the director's self-esteem and also leads to potentially more lucrative social or professional opportunities. While directors of large businesses do not derive their principal income from director's fees, fees and benefits for serving on the boards of major companies can exceed one hundred thousand dollars annually.[81] The risk of losing this income arguably causes directors

77. In decisions involving breaches of the duty of care, courts imply that shareholders who object to a rational decision made by a director lack the right to sue the director for breach of the duty of care. Instead, their sole remedy is to elect other directors. *In re* Caremark, Int'l Inc., 698 A.2d 959, 968 (Del. Ch. 1996).

78. *See* Cohen, *supra* note 25, at 352.

79. *Id.*

80. Matthew Boyle, *The Dirty Half-Dozen: America's Worst Boards*, FORTUNE, May 14, 2001, at 249, 249; John A. Byrne, *The Best and the Worst Boards*, BUS. WK., Jan. 24, 2000, at 142, 142 (including a table of both the best and worst corporate boards); Louis Lavelle, *The Best & Worst Boards: How the Corporate Scandals Are Sparking a Revolution in Governance*, BUS. WK., Oct. 7, 2002, at 104, 104. Ironically, in 2000, the *Chief Executive* magazine ranked Enron's board among the top five boards. Editorial, *'Yes Men' Make up Boards that Miss Enron-type Failings*, USA TODAY, Feb. 21, 2002, at A16 [hereinafter *Yes Men*].

81. Enron directors were paid in excess of three to four hundred thousand dollars in cash and stock in 2001. Reed Abelson, *Enron's Collapse: The Directors; One Inquiry Suggests Board Played Important Role*, N.Y. TIMES, Jan. 19, 2002, at C1 [hereinafter Abelson, *Enron's Collapse*]; *Yes Men*, *supra* note 80, at A16. Other firms had similar (sometimes significantly higher) compensation plans for their directors. *See* Gary Strauss, *Corporate Perks Add Zing to Juicy Jobs on Boards: Free Products, Services Help Sweeten the Pot*, USA TODAY, Apr. 17, 2000, at B3 (reporting $645,700 annual fee to Microsoft directors, $386,320

to make decisions that will ensure that they remain on the current board and are asked to serve on future boards.[82] Thus, to the extent that directors value prestige and status, they will avoid making decisions that might embarrass them and harm their social esteem.

For several reasons, market controls generally will not curb directorial misconduct—especially when firms face financial crises. First, market controls are inadequate controls because not all markets are efficient and information is not always transparent.[83] Moreover, even if market controls discourage directors from making decisions that cause the firm's insolvency, the "final period" problem will make managers indifferent to market controls once the firm becomes insolvent. The final period problem arises when a person fears that she is about to lose her job and senses that she will be unable to secure equal or better employment.[84] Once the firm becomes insolvent, the final period bias will give directors (especially inside directors) an incentive to engage in high-risk activities to save the firm since they may know (or at least suspect) that their future financial opportunities are limited. That is, inside directors of insolvent firms will want to delay filing a bankruptcy petition for the firm since most will know (or at least suspect) they will be replaced if the firm files for bankruptcy.[85] Similarly, given the reputational harm that inside directors may suffer because of the public scrutiny of their conduct, they will seek to delay the filing if they believe they are unlikely to have future opportunities to serve as managers of large firms.[86]

Since many outside directors are shareholders, they also will have an incentive to delay a filing if they suspect that their equity interests will be eliminated by a bankruptcy filing. Indeed, as the

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to Dell directors, and $341,900 to Goldman Sachs directors).

82. Gary Strauss, *Do Conflicts Cloud the Objectivity of Corporate Boards?; Critics Say Side Deals Can Compromise Watchdog Duties*, USA TODAY, Mar. 5, 2002, at A1.

83. *See, e.g.*, Dierdre A. Burgman & Paul N. Cox, *Corporate Directors, Corporate Realities, and Deliberative Process: An Analysis of the* Trans Union *Case,* 11 J. CORP. L. 311, 354-58 (1996); Cohen, *supra* note 25, at 352; Michael C. Jensen, *Presidential Address: The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems,* 48 J. FIN. 831, 851-53 (1985).

84. Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 694 (1999).

85. *See infra* note 86.

86. For example, given the taint associated with them, one wonders what major corporation would be willing to hire Kenneth Lay (the now disgraced former Chief Executive Officer ("CEO") and Board Chair of Enron) or Andrew Fastow (Enron's former Chief Financial Officer ("CFO") who appeared to be the principal organizer and beneficiary of Enron's use of off-the-book accounting practices).

Enron case demonstrates, directors' economic incentives to protect their own pecuniary interests (by, for example, exercising stock options and selling stock) will discourage them from filing a bankruptcy petition for the firm at least until after they have protected those interests.[87] If the short-term monetary gains from delaying a filing are great, directors will conclude that those gains are worth any potential reputational harm.

Finally, some scholars suggest that increased director liability is unnecessary because directors typically make decisions that are in the firm's best interest because of corporate cultural norms of fairness and trust.[88] Directors who intentionally cause harm to businesses arguably will be "sanctioned" by feelings of guilt or shame, or will be shunned by their peers if they violate those cultural norms.[89] While that may be true in some instances, given the potential of enormous profits (like those in the Enron case),[90] it

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87. Enron's directors netted billions by strategically exercising stock options then selling shares. The Enron directors' selling activities appear to have been triggered by the directors' knowledge that Enron was insolvent (and would need to be placed in bankruptcy), that their investments would be worthless in the subsequent bankruptcy, and that they might be forced to resign in the bankruptcy. *See* Michael Duffy, *What Did They Know and . . . When Did They Know It?*, TIME, Jan. 28, 2002, at 16, 16. Specifically, from 1999 through mid-2001, insiders received $1.1 billion by selling approximately 17.3 million Enron shares. Leslie Wayne, *Before Debacle, Enron Insiders Cashed in $1.1 Billion in Shares,* N.Y. TIMES, Jan. 13, 2002, at B1. During this period, a director and former Enron executive received almost eighty million dollars for 1.4 million shares and another director sold one million shares for over seventy-five million dollars. *Id.* Though claiming the sales were unrelated to Enron's growing financial problems, Lay personally sold 1.8 million shares between 1999 and July 2001, and purportedly realized a gain of $123.4 million from exercising stock options in 2000. Peter Behr, *Enron CEO Says No to $60.6 Million,* WASH. POST, Nov. 14, 2001, at E1; Floyd Norris & David Barboza, *Enron's Many Strands: Ex-Chairman's Finances; Lay Sold Shares for $100 Million*, N.Y. TIMES, Feb 16, 2002, at A1; Wayne, *supra*, at B1. Similarly, in August 2001 Lay sold a total of $16.1 million in Enron stock and Jeffrey Skilling (whom Lay replaced as president and Chief Executive Officer) netted $15.5 million from sales of stock. Duffy, *supra*, at 16. J. Clifford Baxter (a former Enron executive and vice-chair of the board who quit in 2001) cashed in thirty-five million dollars in stock options. Paul Duggan & Peter Behr, *Ex-Enron Executive Found Dead in Car; Police Say Gun, Note Point to Suicide,* WASH. POST, Jan. 26, 2002, at A1. Baxter had expressed concerns about Enron's accounting practices and was considered a crucial witness by committees investigating Enron. *Id.* He committed suicide on January 25, 2002. *Id.*

88. Blair & Stout, *supra* note 40, at 316.

89. David A. Skeel, Jr., *Shaming in Corporate Law,* 149 U. PA. L. REV. 1811, 1821 (2001).

90. *See supra* note 81.

is questionable whether any norm will effectively prevent directors from taking (or refraining from taking) actions that harm the firm, if the financial benefit of betraying their firms substantially outweighs the costs associated with violating those norms.[91]

It is likely that most directors will remain wedded both to their confidence about their ability to save a financially troubled firm and to their belief that their prior decisions remain valid. Neither existing legal rules and duties, nor market norms give directors an incentive to seek outside help or information to challenge their belief that they have the ability to save the firm from insolvency. Given this, a legal rule is needed to protect firms from overly confident directors.

IV. PROPOSED LIABILITY FOR THE FAILURE TO TIMELY FILE

A. *Justifications for the Duty*

Imposing a penalty for failing to cede control of the firm to the bankruptcy court should discourage directors' overly optimistic decisions and, instead, encourage them to consider the realistic long-term viability of the firm. As noted in the next section, imposing a duty to file a timely bankruptcy petition would help discourage systematically overconfident directors by forcing them to admit at a much earlier point that they cannot save the firm, that the firm cannot avoid insolvency, and that the firm should be placed under the protection of the bankruptcy court.[92]

1. *A Clear Legal Rule Will Give Directors an Incentive to Seek Outside Advice*

As the Enron case illustrates, even financially sophisticated directors often fail to understand the strategic or financial risks facing their firms.[93] If directors believe that they made (or approved) the decisions that caused the firm's financial difficulties, they are unlikely to be willing to make a realistic appraisal of any

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91. *See* Blair & Stout, *supra* note 40, at 318-19 (questioning effectiveness of trust and integrity to prevent directors from behaving in opportunistic ways).

92. *See infra* Parts IV.A.1-3.

93. Enron's directors failed to prevent the accounting irregularities that ultimately led to the downfall of this firm notwithstanding the directors' impeccable credentials. Directors included Wendy Graham (former Chair of the Commodity Futures Trading Commission and wife of Sen. Phil Gramm); Lord John Wakekkham (a former leader of the Houses of Commons and Lords); William C. Powers, Jr. (the Dean of the Texas Law School); Raymond S. Trougbh (a financial consultant); Robert K. Jaedicke (the former Dean of Stanford's Business School); and, Paulo Ferraz Pereira (a former bank president). Abelson, *Enron's Collapse*, *supra* note 81, at C1.

action that questions the wisdom of their prior decisions. Similarly, if directors are overconfident about their abilities to save the firm and are generally incapable of admitting that their past decisions are no longer in the best interests of the firm, only an external influence will convince them that drastic measures (including, potentially a bankruptcy filing) are needed to save the firm. Moreover, if the board is both overconfident and fairly cohesive, they are likely to engage in "groupthink"—an adaptive response where people tend to close ranks and cling to a collegial status quo when confronted with challenges to the group's solidarity.[94]

Directors who suspect the firm is in the vicinity of insolvency, but are unsure whether the firm is actually insolvent, should seek the advice of external financial experts (like investment bankers or risk managers), or appoint a committee of the board that consists of completely independent directors who have financial management or accounting expertise.[95] Indeed, unless one of the directors has this specialized knowledge, a board would benefit from the services of an external expert who—in addition to forcing directors to reconsider their prior decisions—could provide a range of insolvency advice.[96] Directors who know they have a duty to file a timely bankruptcy petition will be more likely to seek and rely on the advice of financial or turnaround experts (or to insist that a director with this type of expertise be added to the board). Knowing *ex ante* the potential liability they face if they fail to carefully monitor manager's actions will cause directors to be more critical of their prior decisions and will make them more likely to protect the firm's community of interests, not just their interest in convincing themselves that they can save the firm or that their prior decisions continue to be sound. Directors already seek the advice of

94. Bainbridge, *supra* note 14, at 32.

95. *See* Helen S. Scott, *The SEC, the Audit Committee Rules, and the Marketplaces: Corporate Governance and the Future,* 79 WASH. U. L.Q. 549, 557-66 (2001) (discussing proposed SEC regulations that require directors to maintain an audit committee composed of independent directors who are financially literate and have at least one member with management or accounting expertise). While Enron's board created a committee to examine Enron's relationship with the Fastow partnerships, the committee had inherent conflicts of interests as all members of the committee (except one) were involved with creating the partnerships or had already reviewed the transactions. *See* Abelson, *Enron's Collapse*, *supra* note 81, at C1.

96. This advice could include methods for restructuring operations, creating a new capital structure, helping to stem the flow of losses, engaging competent management or retraining existing managers, and helping the directors develop a feasible and profitable business plan. *See, e.g.*, Hon. Conrad B. Duberstein, *Out-of-court Workouts*, 1 AM. BANKR. INST. L. REV. 347, 356 (1993).

investment bankers when considering whether a merger or takeover is "fair" financially and they rely on that fairness opinion to avoid liability if sued for a breach of fiduciary duty.[97] Similarly, it is not uncommon for companies who are seeking additional capital or are in merger discussions to obtain "solvency opinions."[98]

Imposing a duty to timely file should also encourage directors to more closely monitor managers, especially managers who encourage them to approve risky or questionable practices.[99] The duty would encourage the directors of firms who are facing a financial crisis to carefully scrutinize all financial information they receive from officers, especially if the officers appear reluctant to provide full information. Officers, like directors, likely will be concerned about their reputation and may be more reluctant to accurately portray the firm's finances if they fear that an accurate portrait may jeopardize their compensation or tenure with the firm. Imposing liability on directors who fail to protect the firm from a DOA bankruptcy filing should help bridge the inherent information disparity between the firm officers and the board by giving them an incentive to demand that the firm's managers give them detailed financial information to help them ascertain the true nature of the firm's financial condition.

Finally, as a practical matter, directors should routinely consult outside experts when managers ask them to approve irregular or suspicious financial reporting procedures like those used in Enron[100]—especially if they are financially unsophisticated and,

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97. *See* Helen M. Bowers, *Fairness Opinions and the Business Judgment Rule: An Empirical Investigation of Target Firms' Use of Fairness Opinions*, 96 N.W.U. L. REV. 567, 569-70 (2002); William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523, 525 (1992) ("It is more useful to think of fairness opinions as assuring the continued application of the business judgment rule during an era when it has been under severe attack.").

98. *See* Bayer Corp. v. Mascotech, Inc. (*In re* Autostyle Plastics, Inc.), 269 F.3d 726, 734 (6th Cir. 2001) (discussing "solvency opinion" that induced sale of half of the stock of a company); Brandt v. Hicks, Muse & Co. (*In re* Healthco Int'l, Inc.), 208 B.R. 288, 299 (Bankr. D. Mass. 1997) (discussing "solvency letter" prepared by appraisal firm during merger discussions), *aff'd in part*, Comm'r of Revenue v. Brandt (*In re* Healthco Int'l, Inc.), 2001 U.S. Dist. LEXIS 15379 (D. Mass. July 8, 2001).

99. Directors are highly deferential toward the firm's officers and tend not to carefully monitor the officers unless there is some type of crisis. *See, e.g.*, JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 41-49 (1989). Directors are especially unlikely to conclude that the officers have engaged in misconduct if the directors selected or decided to retain the officers, since that concession necessarily would place some of the blame on the directors. *See* Langevoort, *supra* note 7, at 811.

100. Of course, Enron's directors now contend that they approved of Enron's

thus, prone to engage in "herd behavior" by deferring to management decisions.[101] Though the board should not be discouraged from having a trusting relationship with the firm's officers,[102] directors must avoid the groupthink phenomenon, since it will encourage politeness and courtesy but discourage necessary oversight.[103]

2. *Creating an Explicit Duty to Timely File Will Clarify Directors' Fiduciary Obligations Once the Firm Is Insolvent*

Another benefit of imposing a duty to timely file is that it will help clarify directors' existing duties to firm constituents once the firm is insolvent. Imposing the duty to timely file is consistent with the communitarian view of the firm because it will clarify that directors must consider the interests of all firm constituents (creditors, shareholders, employees, etc.) upon the firm's insolvency.[104] While virtually all courts and academic commentators agree that Chapter 11 reorganizations are designed to benefit creditors,[105] many also believe that the debate about the efficiency or

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questionable accounting practices only because Enron's accounting firm, Arthur Andersen, failed to inform the board that the practices were improper. *See* Reed Abelson, *Enron's Many Strands: The Directors; Enron's Board Quickly Ratified Far-Reaching Management Moves,* N.Y. TIMES, Feb. 22, 2002, at C6 [hereinafter Abelson, *Enron's Board*]. It is quite likely that the directors will rely on this alleged misinformation to both defend against charges levied against them, and also to seek reimbursement from Andersen of any liability they incur.

101. Another behavioral trait—herd behavior—causes decisionmakers to ignore their information or judgment and instead imitate the actions of others. Bainbridge, *supra* note 14, at 28 (discussing herd behavior in making board decisions). Given this tendency, it is probably best for directors to routinely seek external assistance when they are asked to approve unusual financial transactions. Doing so will avoid a future claim that the directors (especially the members of the audit committee) lacked competence to adequately consider the transaction. *See* Scott, *supra* note 95, at 564-65 (discussing criticisms of SEC rules concerning the qualifications of audit committee members).

102. While it is unclear whether board friendships threaten board independence and pose harm to shareholder interests, it is clear that unduly adversarial relationships between boards and firm officers are counterproductive. *See* Langevoort, *supra* note 7, at 812-13.

103. Bainbridge, *supra* note 14, at 32.

104. *See* Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy,* 2001 U. ILL. L. REV. 503, 519-20 (2001) (arguing that bankruptcy rules should maximize collective welfare, not just the welfare of creditors because the debtor's financial distress affects creditors, shareholders, employees, and society overall).

105. *See* Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy,* 91 COLUM. L. REV. 717, 732-39 (1991) (analyzing the distinction between bankruptcy law and other creditor remedies under non-bankruptcy law

purposes of business bankruptcies also should consider the interests of employees, trade suppliers, and the community surrounding the debtor.[106] As the Enron and WorldCom bankruptcies demonstrate, corporate defaults have a dramatic impact on employees, the debtor's business associates, and the local community.[107] Thus, whether Chapter 11 normatively should protect the interests of anyone other than creditors, as a descriptive matter it is clear that business bankruptcies affect suppliers, taxing authorities, and others in the debtor's community. Having a clear duty avoids the uncertainties (and potential breach of duty litigation) resulting from the conflicting interests directors currently have because the duty will allow them to consider the firm's overall community of interests once the firm becomes insolvent.[108]

3. *The Duty to Timely File Will Lead to More Efficient Filings*

Finally, imposing a duty to timely place firms under the

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while accepting that the basic purpose of bankruptcy law is to re-allocate funds among creditors); Robert E. Scott, *Through Bankruptcy with the Creditors' Bargain Heuristic,* 53 U. CHI. L. REV. 690, 700-08 (1986) (book review) (comparing the risk-sharing aspects of bankruptcy law and its affects on creditors to that of a captain's decision while in command of a sinking ship).

106. Edward S. Adams, *Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results,* 73 B.U. L. REV. 581, 629-30 (1993) (discussing goals Congress intended to foster when it enacted Chapter 11, including protecting the investing public, protecting jobs, furthering overriding community goals and values); Symposium, *What Constitutes Success in Chapter 11?: A Roundtable Discussion,* 2 AM. BANKR. INST. L. REV. 229, 233-37 (1994) (recognizing community impact as a Chapter 11 concern, but re-asserting that paying creditors is the main goal); Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy,* 73 AM. BANKR. L.J. 499, 553 (1999) (noting Congress' keen awareness of how bankruptcy law may affect jobs and local communities).

107. Filings for public companies are at especially high levels. In addition to the Enron and WorldCom filings, other recent large corporate filings include Kmart, USAirways, United Airlines, and Global Crossing. In 2001, 257 publicly traded companies (with $256 billion in assets) filed for bankruptcy, a forty-six percent increase in filings, the highest recorded since 1980, and more than double the annual filings in the last recession (ninety-one in 1992, and 125 in 1991). Carter Pate, *The Phoenix Forecast: Bankruptcies and Restructurings 2002,* 2-3 (Mar. 2002), *at* http://www.abiworld.org/research/pwcreport.pdf. Recent empirical data suggest that potentially two million new employees annually may be employed by firms who file for bankruptcy. Warren & Westbrook, *supra* note 106, at 554.

108. As one commentator has stated in discussing constituency statutes, in many instances directors seem to be "blindly groping to balance the conflicting interests" of shareholders and creditors with little guidance to determine how to respond to the duties they may have to those constituent groups. *See* Mitchell, *supra* note 46, at 589.

protection of bankruptcy laws should result in earlier, more efficient Chapter 7 liquidations, Chapter 11 reorganizations, or Chapter 11 liquidations.[109] In general, Chapter 11 reorganizations are favored over liquidations because they give managers the possibility (even if remote) of restructuring the firm's finances or operations, thereby protecting employee jobs, paying creditors and producing a return for shareholders.[110] Whether because of local culture,[111] or a desire to take advantage of the delay allowed by a Chapter 11 filing, the vast majority of large firms (i.e. those with assets of $500,000) file first in Chapter 11 even if they have no realistic possibility of reorganizing.[112] Thus, Chapter 11 appears to have assumed the role of the chapter of choice for large businesses who intend to either reorganize *or* liquidate.[113] Even if firms that ultimately liquidate file

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109. H.R. REP. NO. 95-595, at 233-34 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6193 ("One of the problems that the Bankruptcy Commission recognized in current bankruptcy and reorganization practice is that debtors too often wait too long to seek bankruptcy relief."). The Code allows firms to liquidate in either Chapter 7 or 11. 11 U.S.C. § 1123(b)(4) (1994). As an initial matter, encouraging earlier filings was one of the goals of Chapter 11. *See* H.R. REP. NO. 95-595, at 220:

> The purpose of a business reorganization case, unlike a liquidation case, 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. 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.

110. *See* Adams, *supra* note 106, at 610 (theorizing that most debtors in possession will favor Chapter 11 reorganization over Chapter 7 liquidation because "Chapter 11 provide[s] a corporate debtor with considerable latitude regarding its creditors," and "offers managers an opportunity to retain their jobs and orchestrate the reorganization"); Warren & Westbrook, *supra* note 106, at 501 (proposing that since "liquidation bankruptcy terminates the business, few businesses will file for Chapter 7 unless they have no hope of survival").

111. *See* Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L.J. 501, 503 (1993) (suggesting "that local administrative practices and legal culture have more effect on choices in consumer bankruptcy than do features of the law").

112. Warren & Westbrook, *supra* note 106, at 523.

113. For example, Montgomery Ward's first Chapter 11 petition was filed in 1997. Ultimately, it filed a Chapter 11 liquidation in 2000. Leslie Kaufman & Claudia H. Deutsch, *Montgomery Ward to Close Its Doors*, N.Y. TIMES, Dec. 29, 2000, at C1. Similarly, Service Merchandise operated under Chapter 11 bankruptcy protection since 1999. By 2002, however, the company decided to cease all business operations. *Service Merchandise, A Retailer, To Close*, N.Y. TIMES, Jan. 5, 2002, at C4; *see also* Lynn M. Lopucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 601 (1993) [hereinafter Lopucki & Whitford, *Patterns*] (indicating that twelve percent of confirmed Chapter 11 plans are liquidations); Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. J. 319, 322

initially in Chapter 11, an earlier filing should better preserve the value of the firm and allow it either to be a more successful reorganization (which will benefit employees, trade creditors, suppliers, and the local community) or a more efficient liquidation that provides a higher return for creditors.

While earlier filings ultimately should benefit the firm and its community of interests, a duty to timely file is neither risk-free nor cost-free. Bankruptcy proceedings—especially Chapter 11 reorganizations—are routinely criticized for being inefficient, for benefiting only bankruptcy professionals and for having excessive indirect and direct costs.[114] Imposing a duty to timely file arguably will cause directors to become overly risk averse and lead them to place solvent firms in bankruptcy. As an initial matter, it is worth noting that it is highly unlikely that a duty to timely file would cause a rational director of a completely solvent firm to place the firm in bankruptcy as business bankruptcy filings—especially for public companies—are rare.[115] Business filings remain an insignificant percentage of total filings notwithstanding the recent increase in corporate defaults.[116] Given the low filing rate, it

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(1991) (indicating that twenty to thirty percent of confirmed Chapter 11 plans are liquidation reorganizations).

114. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 20-27 (1986); Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173, 185 (1987); Rasmussen, *supra* note 113, at 323 (discussing the efficiency of bankruptcy law and noting the "robust" academic debate on whether efficiency, rather than redistribution of wealth, should be the main goal of bankruptcy); Scott, *supra* note 105, at 700-07 (concluding that bankruptcy is animated by a "conflict between the maximization of insolvent debtors' assets and distributional equality among claimants").

115. REPORT, *supra* note 1, at 303 (business bankruptcy filings represent only four percent of overall filings). Since 1983, the annual filing rates for public companies have ranged from 1.34% to 0.54%. Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* 54 VAND. L. REV. 231, 242 (2001). Though bankruptcy filings for public companies have been the subject of much academic commentary, small business filings (not those of publicly-held companies) dominate Chapter 11. *See* Warren & Westbrook, *supra* note 106, at 520, 550 (indicating that more than half of the business filers schedule less than $100,000 in assets and only fifteen percent have more than $500,000 in total assets as of filing and indicating that publicly traded cases were less than 0.006% of all business filings).

116. For example, despite the recent increase in business filings, business filings in both 2001 and 2002 were less than three percent of total bankruptcy filings. Admin. Office of the U.S. Courts, *Record Breaking Bankruptcy Filings Reported in Calendar Year 2001* (Feb. 19, 2002), *at* http://www.uscourts.gov/Press_Releases/cy01bk.pdf; Am. Bankr. Inst., *U.S. Bankruptcy Filing Statistics*, *at* http://www.abiworld.org/stats/currentstats.html (last visited Mar. 22, 2002); Am. Bankr. Inst., *U.S. Bankruptcy Filings 1980-2002 (Business, Non-Business,*

appears that even firms that face temporary financial setbacks can often be saved without the need to file for bankruptcy.[117]

Even a slight increase in bankruptcy filings likely would be unacceptable to critics who contend that business reorganizations under Chapter 11 are "unsuccessful,"[118] are substantially more expensive than market driven methods to resolve a firm's insolvency and fail to maximize the wealth or protect the owners' (i.e., the firm's creditors) state law entitlements to be paid pursuant to the

Total), at http://www.abiworld.org/stats/1980annual.html (last visited Feb. 28, 2003).

117. *See* Tabas v. Greenleaf Ventures, Inc. (*In re* Flagship Healthcare, Inc.), 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001) ("In the world of corporate workouts, turnaround managers and the possibility for a quick change in an economic tide, it is not uncommon for a corporation to revitalize itself and work out financial problems no matter how dire they appear.").

118. There is no clear definition of a "successful" Chapter 11 case. Some commentators define success as a confirmed reorganization plan, while others view the case as successful only if the firm either does not file a subsequent Chapter 11 petition or does not ultimately liquidate (either within or outside bankruptcy). *See* Lopucki & Whitford, *Patterns*, *supra* note 113, at 599-600 (chronicling lawyer and commentator definitions of "success"); *see also* Lynn M. Lopucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code? (First Installment)*, 57 AM. BANKR. L.J. 99, 100 (1983) (indicating success rate of twenty-six percent); Rasmussen, *supra* note 113, at 322 (indicating confirmation rate of seventeen to thirty percent); REPORT, *supra* note 1, at 308 (noting general lack of data, but citing statistics that suggest that Chapter 11 plans are confirmed in less than a third of all cases); *What Constitutes Success in Chapter 11? A Roundtable Discussion*, *supra* note 106, at 240-45 (discussing different views of what may constitute a Chapter 11 success). While smaller businesses confirm bankruptcy plans in less than thirty percent of all cases, the success rate for large, publicly-traded firms is estimated to be much higher. *See* Edward I. Altman, *Evaluating the Chapter 11 Bankruptcy-Reorganization Process*, 1993 COLUM. BUS. L. REV. 1, 5 (1993) (estimating that almost forty-eight percent of publicly-owned companies had a plan confirmed); LoPucki & Whitford, *Patterns*, *supra* note 113, at 600-01 (citing studies that show that the Chapter 11 plan confirmation rate is low because most Chapter 11 cases involve smaller companies); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437, 443 (1992) (suggesting that ninety percent of large, publicly-traded firms confirm a plan).

Recent empirical evidence suggests that Chapter 11 filings in Delaware are less "successful" than filings in other states as evidenced by the purportedly higher refiling rates for companies who filed there. *See* LoPucki & Kalin, *supra* note 115, at 254-60 (analyzing why Delaware refiling rates are higher than optimal). *But see* Robert Rasmussen & Randall S. Thomas, *Whither the Race? A Comment on the Effects of the Delawarization of Corporate Reorganizations*, 54 VAND. L. REV. 283, 285-86 (2001) (arguing against Lopucki and Kalin's assessment of Delaware's failure rate for Chapter 11 based on refilings because there may be "an optimal, non-zero amount of refilings").

terms of the firm's contracts with them.[119] Part of the controversy concerning the inefficiency of Chapter 11 reorganizations is the relatively high failure rate. Empirical data suggest, however, that many Chapter 11 reorganizations (and out-of-court workouts) are unsuccessful because firms enter bankruptcy reorganizations too highly leveraged and, in many instances, fail to sufficiently reduce debt in the reorganization.[120] While imposing the duty to file may cause some directors to prematurely file bankruptcy petitions for financially distressed (yet not insolvent) firms, firms that are not over-leveraged or otherwise hopelessly insolvent have a better chance of emerging from a Chapter 11 reorganization with fewer debts and paying a greater percentage of creditors claims in either a bankruptcy liquidation or reorganization.

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119. Some critics suggest that, rather than reorganizing firms under Chapter 11, a firm's assets should be auctioned as a going concern shortly after the bankruptcy filing. *See* Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633, 647 (1993) (arguing that an immediate auction should be as beneficial as a long search for different buyers of assets); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 128 (1986) (theorizing that reorganization will rarely be more optimal than liquidation); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization,* 83 COLUM. L. REV. 527, 531 (1983) (suggesting that market-based mechanisms are a possibility for cheaper and quicker reorganizations). Others argue that Chapter 11 should be replaced with a system that removes existing shareholders upon default and gives creditors the option to purchase shares of the reorganized debtor. *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 319 (1993) (offering proposed market remedies to bankruptcy that give creditors priority thereby eliminating prolonged negotiation and litigation expenses); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 785-86 (1988) (devising a model that divides interests between levels of creditors). Finally, some propose that debtors be allowed to waive their right to file for bankruptcy, or that Chapter 11 be abolished in favor of allowing creditors to exercise their state law collection remedies. *See* James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27, 69 (1991) (asserting that debtors may be just as efficient liquidators and distributors under non-bankruptcy creditor remedies in the absence of bankruptcy law); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 99 (1992) (proposing that allowing state law to handle resource allocation and the elimination of federal bankruptcy law would increase efficiency); Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J.L. & ECON. 595, 599 (1993) (arguing that parties should be able to waive bankruptcy process in favor of debt contracts).

120. *See* LoPucki & Kalin, *supra* note 115, at 262, 265 (theorizing that Delaware's bankruptcy courts' approach may not sufficiently induce firms to reduce their leverage ratios); Rasmussen & Thomas, *supra* note 118, at 300 (suggesting that insufficient debt reduction will fail to alleviate financial distress).

Moreover, it is simply unrealistic to assume that imposing a duty to timely file (even if the duty increases the overall number of filings) will dramatically increase insolvency costs. Though there are direct[121] and indirect costs[122] associated with bankruptcy proceedings, firms who experience financial distress will incur many of these costs even if they do not file for bankruptcy. Once a firm experiences financial distress, its creditors will increase their monitoring costs and the firm will incur costs to negotiate (or renegotiate) its debts with those creditors.[123] Likewise, financially distressed firms who may be forced to incur costs to participate in out-of-court restructurings, may need to eliminate or curtail business operations, and the firm may be harmed if their credit ratings are lowered once they default on debt repayment.[124] Indeed, even if Chapter 11 is unsuccessful (however defined), empirical data indicate that out-of-court restructurings may be even more expensive than a bankruptcy filing, may have even higher failure

121. Direct costs are the transaction costs of the bankruptcy case, primarily lawyer, accountant, and other professional fees. Adams, *supra* note 106, at 607. Direct costs appear to be considerably less than earlier suspected. *See* Stephen J. Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*, 74 AM. BANKR. L.J. 509, 515 (2000) (concluding that direct costs in large reorganizations are approximately two percent of firm assets); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 286 (1990) (placing costs at three percent of assets).

122. *See* Adams, *supra* note 106, at 608. Estimates of these direct and indirect costs vary widely. *See* Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067, 1077-78 (1984); James S. Ang et al., *The Administrative Costs of Corporate Bankruptcy: A Note*, 37 J. FIN. 219, 224-25 (1982); Sanjai Bhagat et al., *The Costs of Inefficient Bargaining and Financial Distress: Evidence from Corporate Lawsuits*, 35 J. FIN. ECON. 221, 242 (1994); David M. Cutler & Lawrence H. Summers, *The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation*, 19 RAND J. ECON. 157, 167-68 (1988) (theorizing that indirect costs were responsible for Texaco's decline in value); Stuart C. Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315, 335-38 (1990); Jerold B. Warner, *Bankruptcy Costs: Some Evidence*, 32 J. FIN. 337, 338 (1977); Weiss, *supra* note 121, at 289; Michelle J. White, *Bankruptcy Costs and the New Bankruptcy Code*, 38 J. FIN. 477, 483-84 (1983).

123. Block-Lieb, *supra* note 104, at 556-57 (arguing that eliminating the bankruptcy system will not eliminate all enforcement costs); Rasmussen & Thomas, *supra* note 118, at 294 (characterizing financial distress as "costly" and describing a financially distressed firm's indirect costs outside of bankruptcy).

124. In general, a credit rating reflects the rating company's opinion of a firm's capacity to pay its commitments on a timely basis. *See* Leo Brand, *Corporate Defaults: Will Things Get Worse Before They Get Better*, STANDARD & POOR'S CREDITWEEK, Jan. 31, 2001, at 16, 16.

rates, and, moreover, are often followed by a Chapter 7 filing.[125]

A duty to timely file should respond to one of the biggest criticisms of Chapter 11, i.e., the improper role managers play before and during the firm's bankruptcy. Some commentators argue that the debtor-in-possession model adopted by Chapter 11 is flawed because director-managers almost always retain control over the debtor and will strategically prolong the lives of hopelessly insolvent firms simply to extend their tenure as executives.[126] These critics maintain that Chapter 11 is viewed as a "way-station in a journey toward liquidation"[127] and that managers seek relief in a reorganization proceeding (or in serial proceedings)[128] simply to preserve their jobs.[129] To Chapter 11 critics, neither shareholders, creditors, nor employees benefit from Chapter 11 reorganizations;

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125. *See generally* Stuart C. Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 J. FIN. 161 (1997) (examining the transaction costs of out-of-court workouts); Gilson et al., *supra* note 122 (examining the success rates of out-of-court restructurings).

126. Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1044-45 (1992).

127. Baird & Jackson, *supra* note 68, at 126.

128. There have been a number of highly-publicized serial business bankruptcy filings. For example, TWA filed its first bankruptcy petition in 1992, its second in 1995, and its third in January 2001. Cynthia Wilson, *The History of TWA*, ST. LOUIS POST-DISPATCH, Dec. 2, 2001, at A10. The third filing was used to consummate a sale of the firm to American Airlines. *Id.* Similarly, Phar-Mor, Inc., filed for Chapter 11 protection in 1992 after allegations that its senior managers embezzled funds from the corporation then overstated earnings. Don Shilling, *Corporate Scandal, Rise of Larger Chains Doom Once-Promising Phar-Mor*, VINDICATOR (Youngstown, OH), Jul. 19, 2002. Though it emerged from Chapter 11 in 1995, it filed again in September 2001 and will be liquidated. *See Phar-Mor, Drugstore Chain, Files for Bankruptcy*, N.Y. TIMES, Sept. 25, 2001, at C2; Shilling, *supra* (discussing sale of company's assets); *see also* Altman, *supra* note 122, at 6 (commenting that a "non-trivial" number of emerged Chapter 11's refile); Edith Shwalb Hotchkiss, *Postbankruptcy Performance and Management Turnover*, 50 J. FIN. 3, 4, 7 (1995) ("Thirty-two percent of the sample firms are involved in a second bankruptcy or distressed restructuring."); LoPucki & Kalin, *supra* note 115, at 235 n.16 (2001) (commenting on the high rates of bankruptcy refilings); Lopucki & Whitford, *Patterns*, *supra* note 113, at 609 (characterizing refiling rates as "extraordinarily high"); James D. Key, Comment, *The Advent of the Serial Chapter 11 Filing and Its Implications*, 8 BANKR. DEV. J. 245, 255-58 (1991) (discussing serial Chapter 11 filings).

129. *See, e.g.*, Baird & Jackson, *supra* note 68, at 126 (contending that delay gives managers a strategic advantage over creditors). Likewise, critics contend that bankruptcy laws give managers the incentive to transfer wealth from creditors to equity holders and, by allowing the managers to remain in control of the debtor, allow them to overstate expected net cash flows, understate risks, and generally prevent creditors from being able to protect their interests during the bankruptcy proceeding. Bradley & Rosenzweig, *supra* note 126, at 1052-53.

only corporate managers, lawyers, and bankruptcy consultants benefit.[130]

While managers may have a career interest in preserving the firm,[131] empirical data indicate that, as a practical matter, Chapter 11 will not allow them to accomplish that.[132] Empirical data suggest that in most instances key managers or directors are either replaced or voluntarily leave within two years following the filing of a Chapter 11 petition and often have gloomy prospects for future employment in large firms in a managerial role.[133] Though the recent practice adopted by some bankruptcy courts of allowing the debtor to pay key employees pre-petition or post-petition "retention" incentives or bonuses suggest that these managers are valuable to the firm at least in the initial stages,[134] directors and managers most

130. Bradley & Rosenzweig, *supra* note 126, at 1073.

131. LoPucki & Whitford, *Corporate Governance*, *supra* note 41, at 685 (recognizing that Chapter 11 reorganization may be the "only means of salvaging" the careers and reputations of managers).

132. *Id.* at 723-24 (finding that there was a change in CEOs of large, corporate debtors in ninety-one percent of the cases studied); LoPucki & Whitford, *Patterns*, *supra* note 113, at 610 (discussing rapid turnover of corporate managers in Chapter 11 reorganizations of publicly held companies); Stuart C. Gilson, *Bankruptcy, Boards, Banks and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, 27 J. FIN. ECON. 355 (1990) [hereinafter Gilson, *Blockholders*]; Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241 (1989) [hereinafter Gilson, *Management Turnover*]; Warren, *supra* note 118, at 449 (finding that seventy-one percent of managers of firms filing for bankruptcy lost their jobs).

133. LoPucki & Whitford, *Corporate Governance*, *supra* note 41, at 723-24; LoPucki & Whitford, *Patterns*, *supra* note 113, at 610; Gilson, *Blockholders*, *supra* note 132; Gilson, *Management Turnover*, *supra* note 132; Warren, *supra* note 118, at 449.

134. Richard A. Oppel, Jr. & Kurt Eichenwald, *Enron Paid $55 Million For Bonuses*, N.Y. TIMES, Dec. 6, 2001, at C1. The practice of paying huge sums to key employees of debtor firms is not uncommon. Large business debtors argue that they must give retention, or "pay to stay" bonuses to mission-critical employees to prevent them from abandoning the firm during the thankless phase of rebuilding or dismantling an ailing enterprise. *See Bethlehem Asks to Give $9 Million in Bonuses; Bankruptcy Judge Gets Plan*, PLAIN DEALER (Cleveland), Dec. 29, 2001, at C1 (discussing retention bonuses for Bethlehem Steel Corp. and LTV Corp. executives); Nancy Rivera Brooks, *Enron Execs Were Paid to Remain*, L.A. TIMES, Dec. 7, 2001, at B3 (contrasting average $110,000 retention bonus to average $4500 severance pay to lower level workers and discussing retention bonuses for PG&E Corp.'s key managers); Ann Davis, *Want Some Extra Cash? File for Chapter 11*, WALL ST. J., Oct. 31, 2001, at C1; *Enron Asks Court for Another Round of Retention Bonuses*, WALL ST. J., Apr. 1, 2002, at C6 (reporting that Enron petitioned the court to approve a third round of bonuses worth $130 million to key employees); Jeff St. Onge, *Bankruptcy Judge OKs WorldCom Bonuses; $25M Intended to Help Retain Key Staff*, THE RECORD (Bergen County, N.J.), Oct. 30, 2002, at B1 (reporting that a

likely understand that they will be replaced if their firms are placed in bankruptcy. Given this, they have every incentive to delay the filing to preserve their jobs.

Creditors' interests during the bankruptcy case already have some protection from managers' opportunistic behavior because the bankruptcy court oversees many of the decisions managers make during the firm's bankruptcy proceeding and creditors have the right to curtail some of management's decision-making authority[135] or to replace managers or require that they be supervised.[136] Even

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bankruptcy judge approved twenty-five million dollars in retention bonuses for WorldCom key executives over the objections of creditors); Nelson D. Schwartz et al., *Greed-Mart; Attention Kmart Investors. The Company May Be Bankrupt, But Its Top Brass Have Been Raking It In*, FORTUNE, Oct. 14, 2002, at 139, 139 (reporting Kmart's use of over two million dollars in "inducement payments" and incentives to top executives); *Speedo Maker Asks Bankruptcy Judge to Approve Bonuses,* N.Y. TIMES, Sept. 7, 2001, at C6 (discussing retention bonuses for key employees of Warnaco Group (the maker of Calvin Klein jeans and Speedo swimwear)); Chris Woodyard & Martin Kasindorf, *Enron Execs Pocket Big Bonuses*, USA TODAY, Feb. 1, 2002, at B1.

Legislation recently was proposed to recover excessive funds paid to officers and directors both before and after a bankruptcy filing. *See* Employee Abuse Prevention Act of 2002, H.R. 5221, 107th Cong. (2002).

135. For example, creditors who are unhappy with management's governance decisions can move to dismiss the case or convert it to a Chapter 7 liquidation. 11 U.S.C. § 1112(b) (1994). In addition, debtors are required to negotiate with the creditors' committee to get the plan confirmed and creditors can move to terminate the debtor's exclusive right to propose a plan. *Id.* § 1102(a)(1) (requiring of creditor committee); *id.* § 1121(c) (granting creditors' committee the right to terminate exclusivity). Though 11 U.S.C. § 1102(a)(1) requires that a creditors' committee be appointed, in practice they generally are not appointed in small business filings. *See, e.g.*, Frost, *supra* note 50, at 104, 113 (1998). Moreover, courts can use informal procedures like increased monitoring, mediating, status conferences, expedited procedures and the threat of reduced counsel fees to curtail managers' authority. *See* Hon. A. Thomas Small, *Small Business Bankruptcy Cases*, 1 AM. BANKR. INST. L. REV. 305, 307 (1993) (discussing fast track procedures used in the Eastern District of North Carolina). These creditors' rights tend to have little value in smaller Chapter 11 cases where unsecured creditors tend not to participate because of the small stakes involved.

136. In most Chapter 11 cases, a Trustee is not appointed and the debtor continues to operate the firm as a debtor-in-possession ("DIP"). The DIP has the same rights, powers, and duties given to a Trustee. 11 U.S.C. § 1107(a). It is quite likely that the DIP in a Chapter 11 reorganization will be reluctant to pursue claims against the directors, since the managers of a Chapter 11 debtor almost always are the same managers who operated the firm pre-petition. In cases where the DIP unjustifiably refuses to bring an avoidance action, the unsecured creditors' committee can seek leave from the court to pursue the claims on behalf of the DIP. *See* La. World Exposition v. Fed. Deposit Ins. Co., 858 F.2d 233, 248 (5th Cir. 1988); *see also In re* Perkins, 902 F.2d 1254, 1258

imposing a duty to timely file will not prevent managers from continuing to retain some benefits from Chapter 11 filings. Likewise, imposing the duty to timely file may not prevent director-managers from using Chapter 11 to delay their inevitable termination. However, requiring directors to file earlier ultimately should cause creditors to receive a higher percentage of recovery on their claims, should lead to more successful reorganizations, and might even allow shareholders to retain some of their interests in the reorganized business.[137] Managers will have less of an opportunity to waste corporate assets pre-filing if directors ensure that firms file for bankruptcy at an earlier date. Finally, it is worth noting that even if (1) the duty to timely file increases the number of corporate bankruptcy filings and (2) Chapter 11 is not perfect, as a practical reality, it has proven to be better than the existing alternatives.[138]

Before discussing proposed elements for the duty to timely file, the next section briefly addresses the likely criticisms of any proposal to increase directors' liability.

B. *Potential Unintended Consequences of a Duty to Timely File*

1. *Imposing Liability May Have a Chilling Effect on Directors*

The most compelling reason not to impose a duty to timely file is the risk that the duty will cause directors to either refuse board service or make them overly cautious.[139] Risk-averse actors would

(7th Cir. 1990). Moreover, in particularly egregious cases, creditors who are unhappy with management's governance decisions can move to have a Chapter 11 trustee appointed to replace managers or to have an examiner oversee aspects of the case. 11 U.S.C. § 1104(a). Again, it is likely that these rights will be exercised only in larger business filings.

137. Indeed, if the bankruptcy reorganization is a "success" and creditors are generally happy with the performance of the firm's management team during bankruptcy, current managers are more likely to be allowed to remain with the firm.

138. *See generally* Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79, 107-09 (1992); Warren, *supra* note 118, at 477-78. Indeed, one *critic* of Chapter 11 has concluded that Chapter 11 must in fact be efficient, or else it would not have survived. *See* Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 413 (1990).

139. During the height of the D&O insurance crisis in the mid-1980s, several news reports indicated that directors resigned due to lack of insurance. *See* 2 DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE FIDUCIARY DUTIES OF CORPORATE DIRECTORS 2174 nn.1837-39 (1998). Unfortunately, limited empirical data substantiates this. *See generally* Cohen, *supra* note 25, at 352-53 (citing paper that suggests that directors in Australia make decisions in the

rationally take excessive precautions and avoid risky decisions. Similarly, though directors tend to be well-educated, if they are not lawyers, they may overestimate the likelihood of their liability exposure and may make conservative decisions to ensure they comply with the legal rules.[140] Directors, who tend to hold prominent positions with other companies, often respond to legal interventions to avoid being subjected to prolonged litigation.[141] Thus, even if a director suspects that she would not be held liable for violating a duty, she will act with caution to avoid the delays associated with litigation and the exposure of potentially embarrassing facts. Similar arguments concerning the potential of skewing director decision-making were raised when it appeared that states were poised to increase potential director liability for breach of care lawsuits[142] and when the Securities and Exchange Commission proposed additional disclosure requirements for audit committees.[143]

To be sure, firms need managers and directors who are willing to take reasonable risks because risks are an essential condition for promoting and advancing corporate profits. Moreover, a proposal that imposed liability on *all* directors of *all* firms that file for bankruptcy or that exposed directors (especially outside directors) to unlimited or massive liability would most certainly cause some qualified individuals to refuse to serve as directors of corporate boards.[144] If, however, directors could predict *ex ante* the likely

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shadow of their potential personal liability); Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 459-60 (1993) (arguing for courts to apply a lower standard of review in liability cases to avoid over-deterring directors); Rao et al., *supra* note 51, at 57-60 (suggesting that directors who believe "they will not be liable for good faith mistakes in judgment will be significantly less risk-averse than those who fear they may be held accountable for taking a risk that turns out badly," and citing survey that indicated that directors considered the potential for liability when deciding whether to serve as directors); Shaffer, *supra* note 51, at 555; Tamar Lewin, *Director Insurance Drying Up*, N.Y. TIMES, Mar. 7, 1986, at D1 (citing a survey by a management research firm that indicated an overwhelming number of chief executives stated they would decrease the number of directorships they accepted because of the fear of increased liability).

140. *See* Cohen, *supra* note 25, at 353; Rao et al., *supra* note 51, at 58-59.

141. *See* Langevoort, *supra* note 7, at 823.

142. *See, e.g.*, Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163, 173-77 (1997).

143. Gregory S. Rowland, *Earnings Management, the SEC, and Corporate Governance: Director Liability Arising from the Audit Committee Report*, 102 COLUM. L. REV. 168, 202 n.144 (2002).

144. Corporations and their directors reacted so swiftly (and negatively) to

amount of liability they face if they fail to protect the firm by timely filing a bankruptcy petition, and if the duty included a modest safe harbor provision to give the directors an additional period of time to comply with the duty, no rational director should either refuse to serve or provide overly cautious service.

2. A Duty to Timely File Will Increase Director and Officer Liability Insurance Costs

Exposing directors to greater liability may also have the unintended result of increasing the firm's director and officer liability insurance costs. D&O policies serve two primary functions. First, directors are entitled to seek direct payment under the policy ("liability coverage") if the firm does not (or cannot) fully reimburse or indemnify them for litigation expenses relating to their duties as directors of the firm.[145] D&O coverage also insures the firm for any expenses it incurs if it has to indemnify directors for wrongful acts, errors, omissions, or breaches of duty.[146] D&O policies can also insure firms against claims against the firm that are not otherwise covered ("entity coverage").[147]

D&O insurance policies are costly, increased in the mid-1980s due to an overall increase in the number of bankruptcies, mergers, acquisitions, hostile takeovers, and public offerings, and appear to have skyrocketed as a result of the recent accounting scandals.[148] Though costly, firms treat D&O coverage as a cost of doing business because they know they will lose qualified directors if they fail to

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Smith because it imposed potentially unlimited liability. The actual personal liability of the directors in that case purportedly was $23.5 million. ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 727 (4th ed. 1990).

145. Palmore, *supra* note 48, at 105-06. Firms may be prevented under applicable state law from indemnifying directors who breach the duty of good faith or loyalty. *Id.* at 106-07. If the firm is statutorily prevented from indemnifying the director, the director would then seek reimbursement directly from the insurer. *Id.* at 108-09.

146. *See* George Ong, *Directors and Officers Insurance Proceeds in Bankruptcy: The Impact on an Estate and its Claimants*, 13 BANKR. DEV. J. 235, 239 (1996).

147. Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376, 396 (D. Del. 2002). The policy in this case was limited to claims filed against the firm for violations of federal securities laws.

148. *See* Ong, *supra* note 148, at 235 n.3; Palmore, *supra* note 48, at 104 n.18; Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1, 13-14 (1989); Christopher Oster, *Directors' Insurance Fees Get Fatter: Paying More for Less Coverage Occurs as Fewer Insurers Retain Appetite for Liability Business*, WALL ST. J., Jul. 12, 2002, at C1.

provide this coverage.[149] It is especially likely that outside directors would resign if D&O insurance is not provided, since they are not employed by the debtor firm and thus have less of an incentive to give beneficial advice or assistance to the firm.[150] While D&O premiums likely would increase if there is a duty to timely file, the risk to insurers and costs to firms should be modest as long as the duty is carefully defined and limited. That is, the risk to directors (and, thus insurers) imposed by breaching the duty to timely file should not significantly increase the firm's insurance costs as long as directors (and, thus insurers) can reasonably anticipate both when directors are likely to be fined and the amount of that fine.

In theory, the availability of insurance will remove any incentive for directors to file earlier petitions. That is, if directors understand that they face no true liability, they may be unwilling to change their views. This is unlikely to occur for several reasons. First, while it is reasonable to assume that directors who intend to harm the firm will refuse to change their behavior even in the face of an increased risk of liability, this assumption is not a reasonable one for directors who fail to file timely petitions based on an unrealistic (but good faith) belief in their ability to save a firm. Moreover, directors are likely to attempt to comply with changes in the law to avoid the risk of litigation—even if they think that their decisions are justified under existing law.[151] Thus, a director who is attempting to act in the firm's best interest will seek the opinion of external, independent experts if he knows that he faces enhanced liability for failing to ensure the continued financial feasibility of a firm. If the expert opines that the firm cannot be saved absent drastic measures (including, perhaps, a bankruptcy filing), no reasonable director will continue to adhere to his belief that he (and the board) can save the firm. Finally, academic literature suggests that changes in the law often lead to changes in norms.[152] Given this, increasing directors' legal liability is likely to influence their behavioral rules and standards (including whether to increase their

149. It appears that several corporations lost directors in the mid-1980s when their D&O insurance lapsed. *See* Rao et al., *supra* note 51, at 58-59; Laurie Baum, *The Job Nobody Wants*, BUS. WK., Sept. 8, 1986, at 56, 56-57; Lewin, *supra* note 139, at D1.

150. *See* Bienenstock, *supra* note 74, at 545 (suggesting that independent directors are likely to resign if they are major shareholders and assume their equity positions will be eliminated during the bankruptcy or if D&O insurance lapses).

151. *See* Langevoort, *supra* note 7, at 823.

152. *See generally* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1641-53 (2001).

reliance on outside insolvency opinions) because changing the law governing directors' duties to a firm will affect the norm-based corporate culture.[153]

The next section of this Article presents a model for a duty to timely file and explains why a carefully crafted duty like the one represented in this model will not harm the firm and will, instead, give directors an incentive to act in the firm's best interest.

C. *Elements of the Duty*

1. *Establishing Liability*

To overcome behavioral tendencies that might cause directors to delay placing the firm under the protection of federal bankruptcy laws, the duty to timely file should require directors to file a bankruptcy petition within thirty days after the time they knew or reasonably should have known that the firm was insolvent. Providing a thirty day safe harbor gives the directors time while the firm is in (or approaching) the "vicinity of insolvency" and during a short time period following insolvency to determine whether they need to place the firm in bankruptcy (and avoid liability) or quickly initiate a plan to turnaround the firm's financial crisis (thus, avoiding the need to file for bankruptcy).[154] Liability should not be based on the date of the actual knowledge of insolvency for two main reasons. First, basing liability on actual knowledge will allow directors to avoid learning that a firm is approaching insolvency. Moreover, if most directors fail to file timely petitions because of the behavioral tendency to be overoptimistic, liability based on actual knowledge will not force directors to seek outside advice to determine whether the firm can be saved outside of bankruptcy.

Insolvency should have a fairly precise definition so directors will know *ex ante* when they potentially face liability. Thus, insolvency should be defined as the time when directors knew or should have known that the firm would be unable to pay its

153. *Id.*

154. In addition, creating a safe harbor should decrease the number of preferential transfers made before and during the ninety day window. Currently, directors have an incentive to delay a bankruptcy filing if they know that they made preferential or fraudulent transfers to themselves or favored creditors. While the Trustee or DIP can recover some preferential transfers, the recovery period is limited to either ninety days before the filing (for transfers to non-insider creditors), or one year (for insider creditors). 11 U.S.C. § 547 (1994). Directors who suspect their firms are in the vicinity of insolvency have an incentive to delay filing the petition to make sure the ninety day preference window "closes," thus preventing the Trustee/DIP from recovering the transfer from a favored creditor.

probable liabilities on its existing debts when they mature, or directors knew (or should have known) that the firm's liabilities exceed the fair market value of the firm's current tangible assets.[155]

To avoid such characterizations of insolvency, when evaluating whether directors have failed to file timely, intangible property should not be included as an asset and courts should be allowed to consider evidence other than that listed on the debtor's schedules. These objective insolvency tests (unlike the indeterminate "vicinity of insolvency" test) give greater predictability to directors because they give directors a readily ascertainable point to determine when their fiduciary duties shift from one firm constituent (i.e., shareholders) to the firm's community of interests.

Though some commentators have suggested that there is no objective criteria to determine insolvency[156] and it may not be possible to determine insolvency with mathematical precision in all cases, it is simply unrealistic to assume that the firm's managers consistently will be able to successfully mislead directors who are attempting to be informed about the firm's finances. That is, just as the Enron board sought advice when asked to consider the proposal to use partnerships to hide Enron debt,[157] it is likely that directors

155. Debtors may not accurately state assets and debts on their bankruptcy schedules (as evidenced by the Enron schedules that indicate that company was balance sheet solvent). *See* Internet Bankruptcy Library (July 22, 2002), *at* http://www.bankrupt.com/enron.txt. Likewise, WorldCom's bankruptcy schedules listed $103 billion in assets and forty-three billion dollars in debt, though more than fifty billion dollars of the assets were intangible. *See* Internet Bankruptcy Library (July 22, 2002), *at* http://www.bankrupt.com/WorldCom.txt. Indeed, the Business Bankruptcy Project, a recent large-scale study of all types of business bankruptcies, indicates that twenty-five percent of business debtors claim to be balance sheet solvent and, among businesses in Chapter 11 and 13, the proportion rises to more than one in three. Warren & Westbrook, *supra* note 106, at 536-37. Fifty-five percent of the Chapter 11 cases with assets over $500,000 claimed to be solvent, versus twenty-one percent of those with assets of less than $500,000. *Id.* at 540. The data does not indicate whether businesses inflated the value of their assets to reassure creditors (and thus were actually balance sheet insolvent) or whether the businesses were equitably insolvent even if not balance sheet insolvent. *Id.* at 539.

156. *See, e.g.*, Stephen R. McDonnell, Greyer v. Ingersoll Publications Co.: *Insolvency Shifts Directors' Burden From Shareholders to Creditors*, 19 DEL. J. CORP. L. 177, 206 (1994); Barbara Franklin, *Directors' Duties: Insolvency Shifts Burden From Shareholder to Creditor*, N.Y. L.J., Aug. 6, 1992, at 5, 5 (suggesting that determining when a firm is insolvent is a tough task that requires expensive expert opinions).

157. Enron's board appeared to have received detailed briefings about the purpose and structure of the Fastow partnerships and the Securities and Exchange Commission's concerns about the quality of Enron's financial

will be told (or will discover) that the firm has (or soon will have) financial obligations that could render it insolvent.[158] If the board knows that the firm is experiencing financial difficulties and is asked to permit the firm to engage in a questionable (though arguably legal) financial transaction to preserve the appearance of the firm's solvency,[159] the board should at least know that the firm is in the *vicinity* of insolvency. If the board chooses to approve of a questionable financial practice, it would do so knowing that it faces liability if the firm is currently insolvent and the maneuver fails to prevent the firm from filing for bankruptcy.[160] Finally, it is unrealistic to suggest that directors are incapable of determining

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statements at least two years before the bankruptcy filing. *See* Abelson, *Enron's Board*, *supra* note 100, at C6. In addition, Enron's law firm, Vinson & Elkins, stated that Enron's accounting practices (though—they opined—not illegal) could embarrass the company and cause litigation. Peter Behr & April Witt, *Concerns Grow Amid Conflicts; Officials Seek to Limit Probe, Fallout of Deals*, WASH. POST, July 30, 2002, at A1. The law firm's advice raises questions of conflicts of interest, too. Because the firm had advised Enron about the use of the partnerships in the late 1990s, it arguably should not have given Enron advice about the continued legality of those partnerships. *Id.*

158. As a practical matter, firms either intentionally or unintentionally signal when they are in financial distress. Typical signals that a firm is experiencing financial distress are the refusal of creditors to extend credit on favorable (or any) terms; the departure of key employees; an erosion of the firm's goods/services; a decrease in inventory or a delay in the firm's ability to place orders; a delay in the release of financial statements; or, at the latter stages, a rating agency downgrade or the issuance of an auditor's going concern or qualified opinion letter. When directors see those "red flags," they should be on notice that the firm is either in the vicinity of insolvency or is insolvent.

159. This is exactly what Enron did when it asked its directors to approve the Fastow partnerships. Despite what appeared to be a direct conflict of interest, the board waived Enron's conflict-of-interest rules in June and October of 1999 to permit Fastow to oversee the partnerships while remaining Enron's CFO. Abelson, *Enron's Collapse*, *supra* note 81, at C1; *see* Kathleen Day & Peter Behr, *Enron Directors Backed Moving Debt Off Books,* WASH. POST, Jan. 31, 2002, at A1. This waiver ultimately permitted Fastow to earn approximately thirty million dollars running the partnerships and hold a controlling interest in most of them. Day & Behr, *supra*, at A1. Of course, individual Enron directors had their own conflicts, as many of them earned huge consulting fees from Enron, worked for non-profits that were funded by Enron, were members of the boards of firms who were major Enron shareholders, or worked for companies that had significant business transactions with Enron. *See, e.g.*, Christopher H. Schmitt, *One Cozy Bunch: As Enron Fell, Even Its Outside Board Members Had Become Insiders*, U.S. NEWS & WORLD REP., Feb. 11, 2002, at 28, 28; *Yes Men*, *supra* note 80, at A16 (reporting that one director earned almost $500,000 in consulting fees).

160. To encourage directors to carefully monitor the firm's solvency, they should not be entitled to rely on the business judgment rule and instead should be subject to liability for simple negligence.

whether a firm is insolvent, since they already have a duty to cease distributions to stockholders if doing so would render the firm insolvent or leave it with insufficient working capital.[161]

This duty arguably forces directors to consider a bankruptcy filing even before the firm is in the "vicinity of insolvency." If directors are required to file a petition within thirty days of insolvency, they necessarily will need to seek outside insolvency advice (or themselves conduct an additional internal insolvency analysis) at a much earlier period. Though directors would have a relatively short time period in which to decide whether to place the firm under bankruptcy protection, bankruptcy laws already deem the firm's insiders to have knowledge of the firm's potential insolvency up to a year before the filing.[162] Moreover, because it is likely that a firm that is approaching insolvency will be in default on its credit obligations and will otherwise signal that it is facing a financial crisis, the thirty days is not unreasonable. Thus, unless the firm suffered an unexpected financial setback, directors will have known for considerably more than thirty days that a firm is having a financial crisis and that drastic steps might need to be taken to save the firm. Finally, there are benefits to having directors file after the firm has encountered a financial crisis—but before the firm is actually insolvent—since earlier filings increase the possibility that shareholders' interest in the firm will be at least partially preserved.[163]

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161. REVISED MODEL BUS. CORP. ACT § 8.33 (1985).

162. 11 U.S.C. § 547(b)(4)(B) (1994) allows the bankruptcy trustee to avoid preferential payments made up to one year before the filing of the bankruptcy petition if the transfer is to an insider. In contrast, transfers to non-insiders can be avoided only if they are made within ninety days of the bankruptcy filing. *Id.* § 547(b)(4)(A).

The directors of Enron knew that using the Fastow partnerships to hide Enron's debts allowed Enron to significantly overstate earnings for several years. They also knew several months before the filing that allowing Enron's CFO to oversee the partnerships was at best questionable, as they ultimately suspended Enron's conflict of interest rules to allow him to remain in this dual capacity. Moreover, the Enron directors—especially the insiders—engaged in numerous acts (selling stock, exercising stock options, paying themselves retention bonuses) well before the filing that personally benefited themselves, but harmed employees and general creditors. *See* Oppel & Eichenwald, *supra* note 134, at C1 (reporting that days before bankruptcy filing, Enron paid 500 key employees $55 million in "retention incentives").

163. *See* Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations,* 87 VA. L. REV. 921, 952-54 (2001) (questioning the appropriate time for wiping out the equity interest of shareholders).

2. *Establishing the Amount of Liability*

The fine imposed for breaching the duty to timely file should be an amount equal to three times the highest directors' fee paid, or the value of the property given in lieu of a fee, in the three years before the filing.[164] Tying the sanction to the directors' fee in effect requires directors to reimburse the firm for their failure to act in the best interest of the firm by filing a timely bankruptcy petition. The fine should be based on a three-year period to prevent directors from strategically causing themselves to receive relatively small compensation in the filing year.[165] Trebling is needed to ensure that the sanction is high enough to cause directors to overcome their natural tendencies to avoid admitting that the firm cannot be salvaged. Trebling also serves as a liability cap which allows directors (and potentially the firm's insurer) to calculate *ex ante* the extent of potential liability if they choose not to place an insolvent firm under the protection of federal bankruptcy laws.

Though directors of larger firms often receive sizeable director's fees,[166] most outside directors tend to be highly compensated officers of other corporations and thus serve on boards for non-financial reasons, including prestige and the contacts they make with other outside directors.[167] Proposing a significantly higher fee or one that does not relate to money or property the directors received from the firm would be unwise because that likely would overdeter and

164. This Article does not specifically consider the amount of damages that should be assessed against directors of firms that do not pay fees. These directors also should face a sanction to avoid having firms pay their directors in forms other than cash to avoid liability for breaching the duty to timely file. If firms choose to pay their directors in stock or stock options, the fine should be three times the value of the stock when the directors either sell it or when they have the first opportunity to sell it. If directors receive no form of compensation for serving as directors, the fine could be based on other objective criteria such as, for example, some percentage of the difference between the unexplained and unaccounted for discrepancies between the assets listed in the bankruptcy schedules and those listed on the firm's most recent financial statement prepared for an outside lender.

165. In addition, directors should be subject to the fine even if they waive their right to receive a director's fee.

166. Enron directors were paid in excess of $300,000-$400,000 in cash and stock in 2001. *Yes Men*, *supra* note 80, at A16; *see* Abelson, *Enron's Collapse*, *supra* note 81, at C1. Other firms had similar (sometimes significantly higher) compensation plans for their directors. *See* Gary Strauss, *Corporate Perks Add Zing to Juicy Jobs on Boards Free Products, Services Help Sweeten the Pot,* USA TODAY, Apr. 17, 2000, at B3 (reporting $645,700 annual fee to Microsoft directors, $386,320 to Dell directors, and $341,900 to Goldman Sachs directors).

167. *See* Eisenberg, *supra* note 25, at 970-71 (discussing the nonfinancial benefits outside directors receive in addition to the directors' fee).

discourage too many qualified and competent directors from serving on corporate boards. Because so few firms actually file bankruptcy petitions, and the proposed duty to timely file gives directors a thirty-day safe harbor, this sanction should not cause rational directors to refuse to serve or make overly cautious decisions.

Since this proposal would be imposed only if the firm is placed under the protection of federal bankruptcy laws, directors of firms that are liquidated outside of bankruptcy (for example, in a state receivership) would not face treble damages. Adopting such a model arguably could lead to unwanted forum shopping. In general, directors' obligations to firms should not turn on whether the insolvent firm files a bankruptcy petition or dissolves under state law.[168] While it is possible that the prospect of a fine in bankruptcy might cause some directors to allow their firms to be liquidated outside of bankruptcy, this result is unlikely for several reasons. While directors generally control whether the firm files for bankruptcy, and most Chapter 11 filings are voluntary petitions, as one noted academic commentator has observed: bankruptcy filings are rarely truly voluntary.[169] Instead, firms most often are placed in bankruptcy typically after an institutional lender with a security interest in all the firm's assets threatens to exercise its state law remedies to seize them, the IRS threatens to levy on a firm's assets, or an unsecured creditor attempts to obtain a security interest in the debtor's assets.[170] Moreover, creditors always have the right to file an involuntary bankruptcy petition if the firm appears insolvent and is not paying its debts when due.[171] Finally, while directors have somewhat ambiguous fiduciary duties to creditors when the firm becomes insolvent, directors who intentionally let a firm deteriorate—rather than declare bankruptcy for the firm—to avoid being fined for failing to file timely most likely would be deemed to have violated both the duty of care and duty of loyalty they owe shareholders and the fiduciary duties (however defined) they owe creditors.[172]

168. *See* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 822 (1987) (arguing that the resolution of debts should not change based on whether a bankruptcy court or non-bankruptcy form resolves the dispute).

169. *See* Douglas G. Baird, *The Reorganization of Closely Held Firms and the "Opt Out" Problem*, 72 WASH. U. L.Q. 913, 926-27 (1994).

170. *Id.*; *see also* William C. Whitford, *What's Right about Chapter 11*, 72 WASH. U. L.Q. 1379, 1388-89 (1994) (discussing reason that Baldwin-United filed a liquidating Chapter 11).

171. *See* 11 U.S.C. § 303 (1994).

172. *See* St. James Capital Corp. v. Pallet Recycling Assocs. of N. Am., Inc., 589 N.W.2d 511, 516 (Minn. Ct. App. 1999) (noting that while directors of

3. *Collecting the Fine*

Only the debtor-in-possession ("DIP") or Trustee (or a creditors' committee acting on their behalf) should be allowed to sue the directors and any fine assessed should be payable to the Estate, not individual creditors.[173] Giving only one entity standing to sue and making the fine payable only to the debtor should eliminate the most common concerns raised when proposals are made to increase director liability. That is, allowing the DIP or Trustee to sue directors would not expose directors to a large number of unfounded claims filed by multiple creditors' counsel, who arguably would have an incentive to file potentially groundless claims on behalf of their individual claims.[174] Likewise, since the claim can be filed only in the firm's bankruptcy case, allowing the DIP or Trustee to assert this claim will not overwhelm the courts, there will not be a dramatic increase in administrative costs (because there will be only one claim), nor will there be a risk of inconsistent results.[175] Since only the firm's bankruptcy estate would be entitled to receive the fine for the failure to file timely, directors need not fear being sued later by shareholders or creditors in a derivative capacity. Plus, directors who remain on the board of the debtor firm would be required to defend only one claim, which should not prevent them from functioning as corporate directors.

Trustees should not, however, be limited to collecting the fine just from the directors (who might either be unwilling or unable to pay it). If the firm purchases third-party insurance, the Trustee should also be allowed to seek payment of the directors' fines from the insurer.[176] Just as Trustees would look to the D&O policy for

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insolvent firms have limited duties to creditors, they cannot simply walk away and allow the corporate assets to waste to the creditors' detriment).

173. Trustees already have standing to file breach of fiduciary duty claims against the current or former directors of debtor companies. *See, e.g.*, Brandt v. Hicks, Muse & Co. (*In re* Healthco Int'l, Inc.), 208 B.R. 288, 300 (Bankr. D. Mass 1997) (holding that a bankruptcy Trustee has standing to sue directors, lawyers, and accountants for breach of their fiduciary duties of loyalty and care), *aff'd in part*, Comm'r of Revenue v. Brandt (*In re* Healthco Int'l, Inc.), 2001 U.S. Dist. LEXIS 15379 (D. Mass. July 8, 2001).

174. *See Creditors' Derivative Suits on Behalf of Solvent Corporations*, 88 YALE L.J. 1299, 1315-17 (1979) (suggesting that expanding creditors' rights to sue the directors of solvent corporations creates the possibility of an increase in groundless claims filed by attorneys who seek contingent fees from settlement and the risk of predatory litigation by competitors who obtain a claim against the corporation merely to file suit).

175. *See* McDonnell, *supra* note 156, at 208 (suggesting, with no evidentiary support, "that multiple creditors will assert competing claims against the directors alleging a breach of fiduciary duties"); Franklin, *supra* note 156, at 6.

176. If there is an "insured vs. insured" exclusion in the liability policy, the

payment, however, directors might also seek to pay the fine from the insurance proceeds. Whether they should be allowed to do so would depend on whether paying their claims would harm the debtor firm. If the proceeds are not property of the debtor firm's estate, the insurer could pay the claims and the debtor would not be harmed.[177]

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insurer might argue that neither the DIP nor the Trustee can sue directors, since both parties arguably would be insureds under the policy. Insurers exclude insured versus insured claims from coverage based principally on the desire to avoid collusive claims by the firm against its directors and to prevent the firm from treating the liability policy as an errors or omissions policy. *See* Gray v. Executive Risk Indem., Inc. (*In re* Molten Metal Tech., Inc.), 271 B.R. 711, 728 (Bankr. D. Mass 2002). Because both the Trustee and DIP are separate legal entities from the pre-petition firm, and because in many cases the Trustee acts as an adversary party to the debtor's officers and directors, it is questionable whether such an exclusion would apply. *See id.* at 728-29 (concluding that an insurance company could not decline coverage based on the insured vs. insured exclusion against the Chapter 11 Trustee both because of the literal language of the policy and also because the Trustee is not the legal equivalent of the debtor); Rieser v. Baudendistel (*In re* Buckeye Countrymark, Inc.), 251 B.R. 835, 840 (Bankr. S.D. Ohio 2000) (finding that the bankruptcy trustee is a "separate legal entity that neither represents the Debtor nor owes the Debtor a fiduciary obligation").

177. Most courts generally conclude that the D&O policy itself is property of a debtor's estate. *See* Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 757-59 (5th Cir. 1995); Minoco Group of Cos. v. First State Underwriters Agency of New England Reinsurance Corp. (*In re* Minoco Group of Cos.), 799 F.2d 517, 518 (9th Cir. 1986). While some courts have concluded that proceeds are property of the estate, others have concluded that proceeds are excluded from the estate. For cases holding that proceeds are property of the estate, see *Ochs v. Lipson (In re First Cent. Fin. Corp.)*, 238 B.R. 9, 17 (Bankr. E.D.N.Y. 1999) ("It may well be that proceeds of certain D & O insurance policies, which provide direct entity coverage to a corporate debtor, can be considered property of the estate." (quoting Homsy v. Floyd (*In re* Vitek, Inc.), 51 F.3d 530, 535 (5th Cir. 1995))); *Int'l Heritage, Inc. v. Gilbert (In re Int'l Heritage, Inc.)*, 239 B.R. 306, 311 (Bankr. E.D.N.C. 1999); *In re Sacred Heart Hosp.*, 182 B.R. 413, 421 (Bankr. E.D. Pa. 1995); *Circle K Corp. v. Marks (In re Circle K Corp.)*, 121 B.R. 257, 260 (Bankr. D. Ariz. 1990); and, *Johns-Manville Corp. v. Asbestos Litig. Group (In re Johns-Manville Corp.)*, 26 B.R. 420, 434 (Bankr. S.D.N.Y. 1983). Those concluding that proceeds are not property of the estate include *La. World Exposition, Inc. v. Fed. Ins. Co. (In re La. World Exposition, Inc.)*, 832 F.2d 1391, 1401 (5th Cir. 1987); *Pintlar Corp. v. Fid. and Cas. Co. (In re Pintlar Corp.)*, 175 B.R. 379, 385 (Bankr. D. Idaho 1994), *rev'd by* 124 F.3d 1310 (9th Cir. 1997); *Nat'l Union Fire Ins. Co. v. Official Unsecured Creditors' Comm. of Technical Equities Corp. (In re Technical Equities Corp.)*, 163 B.R. 350, 354, 358 (Bankr. N.D. Cal. 1993); *In re Daisy Sys. Sec. Litig.*, 132 B.R. 752, 755 (N.D. Cal. 1991); and, *Helfand v. Nat'l Union Fire Ins. Co.*, 13 Cal. Rptr. 2d 295, 310 (Cal. Ct. App. 1992). For a broader discussion about whether D&O liability insurance is property of the debtor's bankruptcy estate, see Nan Roberts Eitel, *Now You Have It, Now You Don't: Directors' and Officers' Insurance After a Corporate Bankruptcy*, 46 LOY. L. REV. 585 (2000).

If the proceeds are property of the estate and directors are *not* allowed to seek payment from those proceeds, they arguably could file an indemnification claim against the firm seeking to be reimbursed for the fine.[178]

Even if such a claim is filed, the firm ultimately should not be harmed as the claim would be a pre-petition unsecured claim in the firm's bankruptcy[179] which would be paid along with all other general unsecured claims.[180] In addition, to protect general unsecured claims from having to share *pro rata* with the directors, courts could rely on principles of equitable subordination[181] to further ensure that they are not harmed by payment of the

178. Because the aggregate total amount of coverage under a D&O policy often includes the limits payable both to the firm (as indemnification or entity coverage) and its directors (for liability), payments made to directors may reduce the firm's potential coverage. *Ochs*, 238 B.R. at 13. That is, because payments typically are made on a first-come, first-served basis, if the directors' liability claims equal the amount of the cap, the insurance company would not be required to pay any of the firm's indemnification or entity coverage claims. *See id.*

179. The claim would be a pre-petition claim because the directors' breach and the firm's obligation to insure the directors occurred pre-petition. *See* Christian Life Ctr. Litig. Def. Comm. v. Silva (*In re* Christian Life Ctr.), 821 F.2d 1370, 1374 (9th Cir. 1987); *In re* Baldwin-United Corp., 43 B.R. 443, 454 (S.D. Ohio 1984).

180. *In re* Amfesco Indus., Inc., 81 B.R. 777, 786 (Bankr. E.D.N.Y. 1988). The indemnification claim could be paid before all other unsecured claims only if it is viewed as an administrative expense in the firm's bankruptcy. Administrative expenses are those claims that are "actual, necessary costs and expenses of preserving the estate." 11 U.S.C. § 503(b)(1)(A) (1994). Though at least one court has suggested that a bankruptcy court has the discretion to give administrative priority to directors' litigation expense claims arising from a pre-petition claim, in general, directors' indemnification claims should receive this priority treatment only if the court concludes that retaining the directors is essential for the preservation of the bankruptcy estate. *See In re Baldwin-United Corp.*, 43 B.R. at 462 ("[O]nly if the estate has or will benefit from the individual's services should administrative priority lie.").

181. There may be some instances where creditors would be harmed if the directors' fine were paid *pro rata* with their general unsecured claims and, in that case, the court should consider subordinating the directors' claims. Courts can equitably subordinate claims pursuant to section 510(c) of the Bankruptcy Code for reasons of equity and fairness if a creditor has engaged in some type of misconduct associated with the claim it is asserting in the bankruptcy case. *See* 11 U.S.C. § 510(c). The doctrine of equitable subordination was established in *Pepper v. Litton*, 308 U.S. 295, 311 (1939), and further developed in the courts as a policy against fraud and the breach of fiduciary duties. Though equitably subordinating claims causes the subordinated claim to be paid after other claims (not to disallow it), most debtors lack sufficient assets to pay all general unsecured claims in full. Thus, subordinating the directors' indemnification claims will in most cases mean that the claims will not be paid.

directors' fine.[182] Courts often cite a breach of a fiduciary duty as conduct that justifies equitably subordinating a claim[183] and will find inequitable conduct when a fiduciary misuses his position to the disadvantage of other creditors or when a third party uses his position to the disadvantage of other creditors.[184] Given this, subordinating the indemnification claims of directors who fail to file a timely bankruptcy petition should be warranted in almost all cases.[185]

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182. Even if a creditor's misconduct is not illegal or does not give rise to legal liability, courts can subordinate a claim if there is proof that the claimant engaged in some type of inequitable conduct that resulted in injury to the creditors or conferred an unfair advantage to the claimant, or if allowing the creditor to claim a *pro rata* share in the bankruptcy estate would unfairly harm other creditors. Stoubmos v. Kilimnik, 988 F.2d 949, 958 (9th Cir. 1993); Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692, 700 (5th Cir. 1977); Allied E. States Maint. Corp. v. Miller (*In re* Lemco Gypsum, Inc.), 108 B.R. 831, 834 (Bankr. S.D. Ga. 1988).

183. Estes v. N & D Props., Inc. (*In re* N & D Props., Inc.), 799 F.2d 726, 732 (11th Cir. 1986) ("Appellee's behavior while in control indicates that she was acting solely for her own benefit, to minimize her risk of loss without any consideration for other creditors. Such pursuit of personal gain at the expense of other creditors has been recognized as a breach of fiduciary duty justifying equitable subordination." (citing Bergquist v. First Nat'l Bank of St. Paul (*In re* Am. Lumber Co.), 7 B.R. 519, 528-29 (Bankr. D. Minn. 1979))); Cosoff v. Rodman (*In re* W.T. Grant Co.), 699 F.2d 599, 610-11 (2d Cir. 1983); Liberty Mut. Ins. Co. v. Leroy Holding Co. (*In re* Fort Ann Express, Inc.), 226 B.R. 746, 755 (N.D.N.Y. 1998); Freytag v. Am. Fed. Bank, F.S.B. (*In re* Freytag), 155 B.R. 150, 157 (Bankr. N.D. Tex. 1993) (citing Fabricators, Inc. v. Technical Fabricators, Inc. (*In re* Fabricators, Inc.), 926 F.2d 1458, 1467 (5th Cir. 1991)); *In re* Delta Smelting & Ref. Alaska, Inc., 53 B.R. 877, 885 (Bankr. D. Alaska 1985) (noting "before a bankruptcy court may disallow or subordinate a claim, some basis must exist of the sort traditionally cognizable by equity as justifying its intervention, such as fraud, breach of fiduciary duties, mismanagement, [or] overreaching" (quoting Stebbins v. Crocker Citizens Nat'l Bank (*In re* Ahlswede), 516 F.2d 784, 788 (9th Cir. 1975))).

184. Capitol Bank & Trust Co. v. 604 Columbus Ave. Realty Trust (*In re* 604 Columbus Ave. Realty Trust), 968 F.2d 1332, 1353, 1359-60 (1st Cir. 1992) ("The doctrine [of equitable subordination] permits a bankruptcy court to rearrange the priorities of creditors' interests, and to place all or part of the wrongdoer's claim in an inferior status."); *Allied E. States Maint. Corp.*, 108 B.R. at 836 n.3 (finding that absent equitable subordination, "[t]he cumulative effect of the [directors'] conduct would be to elevate them to a secured status by which they would be made whole to the extent of the value of the assets of the estate, while at the same time depriving unsecured creditors of their *pro rata* share").

185. Because all directors have a duty to creditors once the firm becomes insolvent, failing to protect those interests by filing a timely bankruptcy petition arguably would warrant subordinating *all* directors' claims, not just those of the inside directors. However, a claim of a truly independent outside

4. *Defenses to Breach of Duty*

Truly independent directors who rely in good faith on the advice rendered by independent financial advisors (who themselves must lack a conflict of interest with the firm)[186] should have at least a qualified defense to a claim that they breached the duty to timely file.[187] Though directors should not be required to seek outside advice to avoid breaching the duty to timely file, directors likely will conclude that it is in their best interests to seek—then follow—advice provided by truly independent financial experts who have no actual or perceived conflict of interest. Directors who learn from either internal or external financial experts that the firm is approaching insolvency or is already insolvent can use the expert's advice, protect the firm, and place the firm under the protection of the bankruptcy court. Conversely, directors who seek external advice and either disagree with the advice or conclude that they can resuscitate the firm outside of bankruptcy can rationally choose not to place the firm in a bankruptcy proceeding (with full knowledge of their potential liability if the firm subsequently files).

If the expert opines that the firm is *not* insolvent but that opinion is an erroneous one, directors should have the right to sue the expert to recover any damages they must pay for breaching the

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director should not be subordinated if the director can establish by board minutes that he voted in favor of a timely bankruptcy filing but was outvoted. In that case, the outvoted director should be allowed to assert his unsecured claim with all other unsecured claims. At least with respect to the Enron directors, it is unclear how many of the purportedly outside directors were truly independent, given their consulting and other pecuniary relationships with Enron. *See* Abelson, *Enron's Collapse*, *supra* note 81, at C1.

186. *See In re* Tri-Star Pictures, Inc., Litig., 634 A.2d 319, 323 (Del. 1993) (noting the "questionable reliability" of a financial advisor's opinion where the financial advisor, at the time it gave a fairness opinion to the firm regarding a business combination, was party to an agreement with that firm which provided for the advisor to continue to provide investment banking services to the firm and the combined entity).

187. Because directors have a duty to become reasonably confident about the veracity of opinions, reports, or other forms of outside advice before making decisions in reliance on that advice and must actively oversee the expert's work, they should have only a qualified defense to a breach of duty claim. Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1283-84 (Del. 1989); REVISED MODEL BUS. CORP. ACT § 8.30(e) (1985). Given the superior knowledge the firm's inside directors possess, they generally should not be allowed to assert a qualified defense, especially if they failed to disclose information to the other members of the board or the boards' external experts and if the withheld information would have alerted either the board or the external experts of the firm's insolvency. *Cf.* Graham v. Taylor Capital Group, Inc. (*In re* Reliance Sec. Litig.), 135 F. Supp. 2d 480, 502-03 (D. Del. 2001) (discussing liability of outside directors under Section 10(b) of the Exchange Act).

duty to timely file unless the directors waived this right in the expert's engagement agreement.[188] Moreover, directors also should be allowed to rely on the expert financial advice as a defense if the DIP or Trustee seeks to subordinate their indemnification claims.[189]

V. CONCLUSION

Current legal rules fail to respond to behavioral tendencies that cause directors to refuse to relinquish exclusive control of the firm by placing it under the protection of the bankruptcy court. Chapter 11 reorganizations are designed to either preserve the ongoing-concern value of firms or efficiently liquidate them. Encouraging earlier filings should increase the likelihood that the firm can successfully reorganize, should decrease the likelihood that the firm will need to file serial bankruptcy petitions, and should yield greater benefits for the firm's community of interests (including creditors,

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188. DEL. CODE ANN. tit. 8, § 141(e) (2001). This would be consistent with state statutes that provide a safe harbor for directors who rely on outside advice but are later accused of breaching their fiduciary duties to shareholders. For example, directors of Delaware corporations shall, in the performance of their duties, be:

> [F]ully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

Id. If the financial advisor's engagement letter exculpates the advisor from, or indemnifies the advisor against, liability, the directors would not be allowed to sue. The only exception would be in cases of gross negligence or willful misconduct. *See* Daniel C. Cohn, *Advising the Board of Directors of a Financially-Distressed Company* (June 18-19, 2001), *at* http://www.abiworld.org/abidata/online/conference/01banker/Cohn.html; *see also* Marsha L. Goldstein, *Retention of Professionals in Bankruptcy Cases: Ethical Issues and Special Considerations, in* CHAPTER 11 BUSINESS REORGANIZATIONS (2002), *available at* WL SG108 ALI-ABA 245, at *262; Sidney J. Nurkin et al., *Fiduciary Duties of Boards of Directors of Financially Troubled Corporations, in* REPRESENTING TECHNOLOGY COMPANIES IN THE NEW BUSINESS ENVIRONMENT (Dec. 2001), *available at* WL 683 PLI/Pat 213, at *237-38 (noting exception to exculpation clauses when director authorizes an unlawful distribution); David F. Smith, *Investment Banking Perspective, in* STRUCTURING MERGERS & ACQUISITIONS 2001 (PLI Corp. Law & Practice Course, Handbook Series No. B0-00ZD), *available at* WL 1224 PLI/Corp 7, at *23.

189. That is, if external experts erroneously conclude that the firm is solvent and directors ultimately are sued for the failure to timely file, any reimbursement claim should be paid *pro rata* with other unsecured claims rather than being subordinated under section 510 of the Bankruptcy Code. *See* 11 U.S.C. § 510 (1994).

shareholders, employees, suppliers, and the local community) whether the firm is liquidated or reorganized in the bankruptcy proceeding. Specifying that directors have a fiduciary duty to the firm to file timely a bankruptcy petition will help combat the behavioral biases that prevent directors from filing early bankruptcy petitions and will also help clarify the current uncertainty directors face when considering the scope of their fiduciary duties post-insolvency.