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

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

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

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

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

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

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

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

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

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

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

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

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

1. Traditional Corporate Articulations of Management Duties Owed to Creditors

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

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

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

[249] *Id.*

[250] *Id.*

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

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

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[251] *Id.*

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

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

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

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

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

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

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

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

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

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

[256] *Id.* at 875.

[257] *Id.*

[258] *Id.* at 878.

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

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

[261] *Id.* at 879.

[262] *Id.*

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

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

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

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

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

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

[265] *Id.* at 879.

[266] *Id.*

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

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

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

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

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

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

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

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

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

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

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

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

2. Directorial Duties to Creditors at Insolvency

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

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

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

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

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

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

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

[278]*Id.*

[279]*Id.*

[280]*Id.*

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

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

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

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

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

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

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[282] *Id.*

[283] *Id.*

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

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

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

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

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

[286]*Id.* at 789.

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

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

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

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

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

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

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

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

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

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

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

[294]*Id.* at 446.

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

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

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

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

3. Directorial Duties at Dissolution

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

a. *Creditor Rights Upon Corporate Dissolution*

1. Claims Against Dissolved Corporations — Survival and Limitations Statutes

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

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

[298]*Id.* at 1073.

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

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

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

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

[303]*See infra* note 316.

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

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

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

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

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

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

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

[307]*Id.*

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

[309]*See infra* note 316.

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

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

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

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

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

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

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

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

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

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

Id. (emphasis added).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2. Dissolution Statutes — Known Claims

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

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

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

[327]*See supra* note 315.

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

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

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

[331]*Id.*

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

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

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

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

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

3. Dissolution Statutes — Unknown Claims

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

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

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

Id. (emphasis added).

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

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

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

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

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

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

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

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

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

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

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

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

[343]*Id.*

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

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

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

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

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

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

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

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

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

(1) known claimants who did not receive written notice;

(2) claimants whose claims were forwarded to the corporation in a timely manner but which were not acted upon by the corporation; and

(3) claimants whose claims are contingent or are based upon events occurring after the effective date of the corporation's dissolution.

Id.

[350]*Id.* § 14.07(d)(1).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[364]*Id.* at 436.

[365]*Id.*

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

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

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

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

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

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

[369] *Id.*

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

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

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

Id. at 436 (emphasis added).

[372] *Id.* at 436.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[379]*Id.* at 307.

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

[381]*Id.* at 307.

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

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

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

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

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

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

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

[387]*Id.* at 613.

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

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

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

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

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

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

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

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

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

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

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

[395]*Id.* at 378.

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

[397]*Id.* at 379.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Id.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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Id.

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

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

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

[416]*See id.* § 18-1101(c)(2).

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

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

C. *Rejoinder to the Hypothetical: A Summation*

1. A General Summation

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

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

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

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

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

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

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

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

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

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

2. Application to the Hypothetical

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

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

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

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

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

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

IV. A THEORETICAL PERSPECTIVE ON DIRECTORIAL OBLIGATIONS TO CREDITORS

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

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

A. *Posing the Hypothetical*

1. The Hypothetical

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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[424] *Id.* § 17-1101(c).

[425] *Id.* § 17-1101(d)(2).

[426] *Id.* § 18-1102.

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

2. A General Commentary

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[435]*Id.* at 16.

[436]*Id.* at 13.

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

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

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

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

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

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

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

[441]*Id.* at 634.

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

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