THE BOARD'S DUTY TO KEEP ITS OPTIONS OPEN

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It is widely believed that large chapter 11 cases are now routinely handled via a quick 363 sale, followed by a not so quick liquidation of the residue of the debtor, along with a distribution of the sale proceeds. Indeed, commentators widely bemoan the fact that debtors arrive in chapter 11 with no choice but to do a quick sale because their lenders will not permit anything else.

In this paper, Professor Lubben argues that the root of the issue lies in corporate governance, and not bankruptcy. If leaving debtors in chapter 11 only with the option to engage in a quick sale process is decidedly a problem, then that problem has its roots in nonbankruptcy corporate law. He argues that ultimately this is a question of state law fiduciary duties; the foundation for this duty already exists in the Delaware Supreme Court's oft-maligned Omnicare, Inc. v. NCS Healthcare, Inc.

In short, state corporate law imposes a duty on the board to carefully consider any decision that will foreclose a future board's choices. In times of financial distress, this duty includes an obligation to carefully consider the effects of a particular decision on future restructuring options.

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I. INTRODUCTION

It is widely believed that large chapter 11 cases are now routinely handled by way of a quick 363 sale, followed by a not quite as quick liq-

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uidation of the residue of the debtor, along with a distribution of the sale proceeds.[1]

Commentators—especially academics—often suggest this turn of events is the result of debtor-in-possession ("DIP") lenders' ability to obtain superpriority status in a bankruptcy case, layering their debt on top of preexisting claims.[2]

But that is just not true. Priming fights are messy and time consuming, and thus routinely avoided.[3]

Instead, a DIP lender's power in chapter 11 comes from its power as a normal secured lender, even if that secured lending is ultimately "blessed" by the bankruptcy court.[4] The new DIP loan repays an old, prebankruptcy loan given by a nearly identical group of lenders.[5]

So the power in bankruptcy ultimately comes from the old secured loan, which enables the DIP lenders to make a new secured loan once the borrower is in bankruptcy.[6] That original secured loan is typically granted in the months before bankruptcy, as the firm begins to experience financial distress.[7]

In short, the roots of the issue lie in corporate governance, not bankruptcy.

That is, if the tendency for debtors to show up in chapter 11 with no option but to engage in a quick sale process is a problem, that problem has its roots in nonbankruptcy corporate law.[8] This explains why the issue seems so intractable to bankruptcy attorneys.

In this Article, I explain how the decision to lock a company into an all-encompassing secured loan, and thus a likely quick 363 sale, should be regulated. Namely, I argue that ultimately this is a question of state law fiduciary duties, and that the foundation for this duty already exists in

1. *E.g.,* Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759, 760 (2011); Sarah Pei Woo, *Regulatory Bankruptcy: How Bank Regulation Causes Fire Sales*, 99 GEO. L.J. 1615, 1625 (2011).

2. *See* Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557, 1604 (2013); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1238–41 (2006); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 924–27 (2003).

3. Mark Berman & Jo Ann J. Brighton, *Second-Lien Financings: Good, Bad and Ugly*, 25 AM. BANKR. INST. J. 1, 54 (June 2006); C. Edward Dobbs, *Business Bankruptcy Panel: The Brave New World of Finance*, 23 EMORY BANKR. DEV. J. 549, 573 (2007); Kenneth N. Klee & Richard Levin, *Rethinking Chapter 11*, 21 J. BANKR. L. & PRAC. 5 Art. 1 (2012).

4. 11 U.S.C. § 364 (2012).

5. Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235, 1251 (2013).

6. Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159, 160 (1997).

7. *See generally* Joshua D. Rauh & Amir Sufi, *Capital Structure and Debt Structure*, 23 REV. FIN. STUD. 4242 (2010) (demonstrating that traditional capital structure studies that ignore debt heterogeneity miss substantial capital structure variation).

8. *See* Michelle M. Harner & Jamie Marincic, *Behind Closed Doors: The Influence of Creditors in Business Reorganizations*, 34 SEATTLE U. L. REV. 1155, 1155 (2011).

the Delaware Supreme Court's oft maligned *Omnicare, Inc. v. NCS Healthcare, Inc.*[9]

In short, state corporate law imposes a duty on the board to carefully consider any decision that will foreclose a future board's choices. In times of financial distress, this duty includes an obligation to carefully consider the effects of a particular decision on future restructuring options.

The duty thus imposes an obligation of thoughtfulness; it does not impose a particular outcome. In this respect, the duty is like the better-known duty of care, but perhaps with a bit more "bite," especially in Delaware. But before further developing the duty, I first review the debate over quick bankruptcy sales and the holding in *Omnicare.*

II. SECTION 363 SALES AND *OMNICARE*: A SWIFT OVERVIEW

There are two sections of the Bankruptcy Code (the "Code") applicable in chapter 11 that authorize the sale of the debtor's assets. Section 363(b) authorizes a trustee, and thus the chapter 11 DIP,[10] to sell its property outside the ordinary course of business.[11] And section 1123 permits a chapter 11 plan to include provisions for a sale too.[12]

The latter presupposes the drafting of a plan and disclosure statement, stakeholder voting, and a confirmation hearing.[13] Section 363 sales are much faster, and the Code provides no guidance on when either procedure should be used.[14]

Quick 363 sales of substantially all of the debtors assets became common in the second half of the 1990s,[15] but only came to widespread academic attention with the writings of Baird and Rasmussen in the early years of the present century. They argue that:

9. 818 A.2d 914 (Del. 2003). For critiques of the opinion, see, e.g., Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 831 (2006); Christopher M. Foulds, *For Whom Should the Corporation Be Sold? Diversified Investors and Efficient Breach in* Omnicare v. NCS, 38 J. CORP. L. 733, 733–35 (2013); Sean J. Griffith, *The Omnipresent Specter of* Omnicare, 38 J. CORP. L. 753, 754 (2013); Jonathan C. Lipson, *The Expressive Function of Directors' Duties to Creditors*, 12 STAN. J.L. BUS. & FIN. 224, 257–61 (2007); Stephen J. Lubben & Alana J. Darnell, *Delaware's Duty of Care*, 31 DEL. J. CORP. L. 589, 617–28 (2006).

10. 11 U.S.C. § 1107(a) (2012).

11. John J. Hurley, *Chapter 11 Alternative: Section 363 Sale of all of the Debtor's Assets Outside a Plan of Reorganization*, 58 AM. BANKR. L.J. 233, 240–41 (1984) (noting "it has become generally accepted that section 363(b) empowers a trustee or debtor in possession to sell all of the property of the debtor outside a plan of reorganization").

12. 11 U.S.C. §1123(b)(4) (2012).

13. *Cf.* Timothy D. Cedrone, *A Critical Analysis Of Sport Organization Bankruptcies in the United States and England: Does Bankruptcy Law Explain the Disparity in Number of Cases?,* 18 SETON HALL J. SPORTS & ENT. L. 297, 310–12 (2008) (explaining the chapter 11 plan process).

14. *See* J. Vincent Aug et al., *The Plan of Reorganization: A Thing of the Past?*, 13 J. BANKR. L. & PRAC., 4 Art. 1, 2 (2004) ("A Section 363 sale is generally the preferred method for selling assets because it is quicker and less expensive, and provides a quick fix to address continuing losses, rapidly depleting assets, and loss of cash flow.").

15. *E.g.*, Brazos Sportswear, Inc., No. 1:99-bk-00142 (Bankr. D. Del. Jan. 21, 1999). The author represented the debtor in this case. The sale motion can be found at docket number 195.

> Corporate reorganizations have all but disappeared. Giant corporations make headlines when they file for chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use chapter 11 merely to sell their assets and divide up the proceeds.[16]

Overstated, no doubt, but Baird and Rasmussen's forceful claims gave rise to a running debate between Lynn LoPucki and themselves,[17] with occasional contributions from others as well.[18] And soon the entire chapter 11 community was debating the merits of 363 sales.[19]

The rest of the world found out about 363 sales when they were used to save the automakers from liquidation.[20] The debate then became whether a government-controlled 363 sale was in some way different, and more objectionable, than a DIP lender-controlled 363 sale.[21]

Setting aside uninhibited fears of creeping socialism, largely limited to the specific context in which the auto cases occurred, the key debate with regard to quick 363 sales turns on the ways in which they differ from "normal" chapter 11 plans.[22] Namely, while a 363 sale is subject to court approval, specific classes of creditors lack any ability to vote against the sale as a class, and thus force the debtor to meet the cramdown requirements of section 1129(b).[23]

In some instances, a 363 sale allows for reorganizations that would not even comply with section 1129(a). For example, a sale that does not generate proceeds beyond the secured debt could never result in a confirmable plan because the debtor would be unable to pay administrative claims in full,[24] but it achieves nearly the same ends.[25] Indeed, it may be that a sale "free and clear" under section 363(f) provides a kind of discharge that even a plan could not, in that it allows the debtors to reor-

16. Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy,* 55 STAN. L. REV. 751, 751 (2002).

17. *See, e.g.,* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 688 (2003); Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 922 (2001) ("[T]he central focus of corporate reorganizations should . . . [be] how the firm's assets are used and who controls them."); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 14–15 (2007); Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's* The End of Bankruptcy, 56 STAN. L. REV. 645, 653–54 (2003).

18. Stephen J. Lubben, *The "New and Improved" Chapter 11*, 93 KY. L.J. 839, 856 (2005); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 859 (2004).

19. Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 892–95 (2014).

20. *See generally* Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L.J. 531 (2009) (discussing automotive bankruptcy cases and chapter 11).

21. *E.g.*, Ralph Brubaker & Charles Jordan Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of Chrysler and GM*, 2010 U. ILL. L. REV. 1375; Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727, 735 (2010).

22. Elizabeth B. Rose, *Chocolate, Flowers, and §363(b): The Opportunity for Sweetheart Deals Without Chapter 11 Protections*, 23 EMORY BANKR. DEV. J. 249, 259 (2006).

23. *See* A. Joseph Warburton, *Understanding the Bankruptcies of Chrysler and General Motors: A Primer*, 60 SYRACUSE L. REV. 531, 551 (2010).

24. 11 U.S.C. § 1129(a)(9)(A) (2012).

25. *See In re* Gulf Coast Oil Corp., 404 B.R. 407, 428 (Bankr. S.D. Tex. 2009).

ganize some assets while pitching other assets—especially those loaded with successor liability claims—into chapter 7.[26]

The merits of these arguments depend largely on the empirical assumptions and policy judgments made.[27] Namely, if the sale were not allowed, would a formal plan happen or would the case degrade into a chapter 7, or, heaven forbid, a state law foreclosure action? That is, what do 363 sales replace: chapter 11 cases or liquidations?

There is also a broader concern that quick 363 sales allow senior lenders—perhaps in cahoots with management—to abscond with value that would otherwise go to unsecured creditors or even shareholders. Presumably, this sort of conduct should be uniformly discouraged.

But in many cases, the reality is that the debtor has no choice but to commence a sale process because its DIP loan only provides funding for a relatively short period of time.[28] Lenders are able to impose such terms on debtors because the lender has a virtual stranglehold on the debtor's operations coming into bankruptcy by virtue of a lien on all of the debtor's assets and possession of all of the debtor's cash.[29]

A classic example can be seen in the case of Circuit City, the chain of electronics retailers. Circuit City filed for chapter 11 in November 2008, with a DIP loan that, at most, was going to last one year. But, by its terms, the lenders' commitment under the loan agreement dropped by almost $250 million after one month. And more importantly, within twelve weeks of the petition date, Circuit City was required to

> have prepared and distributed informational packages soliciting bids from potentially interested parties for the sale of their assets . . . [and] the Domestic Borrowers (i) shall have entered into a stalking horse bid (on an equity basis) on terms reasonably acceptable to the Administrative Agent with respect to the sale of their assets, which shall be conducted pursuant to bidding procedures and agency documents, each in form and substance reasonably acceptable to Administrative Agent and the Required Lenders, and (ii) filed a motion seeking the approval of a sales procedures order in connection with such stalking horse bid and bidding procedures, in form and substance reasonably acceptable to the Administrative Agent and the Required Lenders . . . [and]
>
> [ ] By no later than March 1, 2009, the Domestic Borrowers shall file a Plan of Reorganization and Disclosure Statement, which Plan of Reorganization provides for payment in full of the Pre-Petition

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26. Stephanie Ben-Ishai & Stephen J. Lubben, *Involuntary Creditors and Corporate Bankruptcy,* 45 U. BRIT. COLUM. L. REV. 253, 272 (2012).

27. *See generally* Richard M. Hynes, *Reorganization as Redemption*, 6 VA. L. & BUS. REV. 183, 218 (2011) (arguing that, despite policy implications, judges should not consider bankruptcy stakeholder interests, nor should they "use the power of cramdown to coerce loans from senior classes").

28. Craig R. Bucki, *Cracking the Code: The Legal Authority Behind Extrastatutory Debtor-in-Possession Financing Mechanisms and Their Prospects for Survival*, 2005 COLUM. BUS. L REV. 357, 392.

29. Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 525–26 (2009).

> Liabilities and the Obligations upon the Consummation Date and which shall otherwise be reasonably acceptable to the Required Lenders.[30]

In short, within three months of filing, the debtor had to have a 363 sale underway, with a reorganization plan to pay out the sale proceeds filed a month after that. Circuit City really had no choice but to do a quick 363 sale—any other option would have had to have been completed within three months of the petition date, otherwise Circuit City would have triggered a default on its DIP loan.

In such a circumstance, the prebankruptcy lenders are the easy choice as DIP lenders, because any other approach will require either a messy priming fight or a DIP loan large enough to pay off the prebankruptcy loan, while still providing enough new funding to keep the debtor alive in chapter 11.[31] The already in place lenders will often have advantages that make such a loan, particularly when arranged with the speed needed to file a chapter 11 case, uncompetitive.[32]

Thus, if the harm that results from routine use of 363 sales is to be avoided, it must be prevented at a point well before the debtor's chapter 11 petition arrives at the bankruptcy court. This point is fully ventilated in Part IV below, but first a brief primer on *Omnicare*.

* * *

Never mentioned within the same breath as 363 sales—until now, at least—is the Delaware Supreme Court's decision in *Omnicare*.[33] But as I argue in the remainder of the Article, the case provides the basis for the kind of fiduciary duty that could regulate the overuse of 363 sales.

In *Omnicare*, NCS Healthcare, Inc., a company on the verge of bankruptcy, agreed to merge with Genesis Health Ventures, Inc.[34] Genesis had previously lost out on an acquisition because of Omnicare, Inc.,[35] so this deal was protected with a three-part defense that included a "force the vote" provision in the merger agreement,[36] no fiduciary out clause, and a voting agreement between two NCS shareholders—who were also officers—and Genesis that ensured that a majority of shareholders would vote in favor of the transaction.[37]

30. Senior Secured, Super-Priority, Debtor-In-Possession Credit Agreement at §5.18*, In re* Circuit City Stores, Inc., No. 08-35653 (Bankr. E.D. Va. 2008), *available at* http://bankrupt.com/misc/Executed_DIP_Agreement-Redlined.pdf.

31. Benjamin A. Berringer, *"It's All Just A Little Bit of History Repeating:" An Examination of the Chrysler and GM Bankruptcies and Their Implications for Future Chapter 11 Reorganizations*, 7 N.Y.U. J. L. & BUS. 361, 381 (2010).

32. Klee & Levin, *supra* note 3, at § 3.5.

33. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003).

34. *Id.* at 918.

35. Amy Y. Yeung & Charles B. Vincent, *Delaware's "No-Go" Treatment of No-Talk Provisions: Deal-Protection Devices After* Omnicare, 33 DEL. J. CORP. L. 311, 340 (2008).

36. *See* 74 Del. Laws. ch. 84 §§ 3, 11 (2003) (moving the statutory authorization for "force the vote" permission from DEL. CODE ANN. tit. 8, § 251(c), where it was at the time of the *Omnicare* opinion, to DEL. CODE ANN. tit. 8, § 146).

37. Peter V. Letsou & Steven M. Haas, *The Dilemma That Should Never Have Been: Minority Freeze Outs in Delaware,* 61 BUS. LAW. 25, 92 (2005).

After the merger was announced, Omnicare, as Genesis had feared, made a superior offer, and the NCS board changed its recommendation and urged that NCS shareholders vote against the Genesis merger.[38] This did not really matter, because the various lockup devices put the original deal on autopilot once it was approved by the NCS board. The board had no ability to stop the shareholder vote, despite recanting its earlier approval, and the voting agreement meant the deal was sure to be approved.

Before the *Omnicare* opinion, many practitioners believed that in a stock-for-stock merger, not subject to *Revlon*,[39] a target board could agree to a fully locked-up deal if the board met its duty of care. But after *Omnicare* something more is required: a fiduciary out, or some other way to ensure that a deal that the board no longer fancies could be stopped.[40]

Omnicare is a puzzling decision, probably the most criticized Delaware Supreme Court decision in recent memory.[41] The precise basis for the holding was left quite vague. It appears that the decision is an application of *Unocal*, but that case's test—designed to see if a board's takeover defense is reasonable in relation to the threat posed by a hostile bidder[42]—does not easily lend itself to the result in *Omnicare*.[43]

The NCS board was not worried about a hostile bid or entrenching itself; instead, it was giving deal protections to the buyer who itself was worried about a hostile bid.[44] In that context, the decision to lock up the deal, while foolish in hindsight, looks more like a decision about deal consideration, and the application of *Unocal* is just odd.[45]

Some might rightly wonder if the Court's majority did not simply save the board from a faulty decision. Arguably such a defect is better remedied by awarding damages against the board, rather than by upending an agreed upon deal.

But what if *Omnicare* is better understood as a special duty for the current board to avoid restricting a future board? The next Part develops this argument.

III. UNDERSTANDING *OMNICARE*

In its opinion, the *Omnicare* majority explains that "the NCS board had no authority to execute a merger agreement that subsequently pre-

38. *Omnicare*, 818 A.2d at 918.

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

40. *Omnicare*, 818 A.2d at 936.

41. J. Travis Laster, *Omnicare's Silver Lining*, 38 J. CORP. L. 795, 795 (2013) ("Fashion dictates that *Omnicare* be criticized.").

42. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

43. *Id.* at 954-55; *see* Stephen M. Bainbridge, *The Geography of Revlon-Land*, 81 FORDHAM L. REV. 3277, 3295 (2013).

44. *Cf.* Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 536 (2002).

45. Lubben & Darnell, *supra* note 9, at 619 (arguing that the *Unocal* enhanced scrutiny makes no sense when there is no threat of director entrenchment).

vented it from effectively discharging its ongoing fiduciary responsibilities."[46] In this Part, I argue that this duty applies to the execution of all agreements, such as senior loan agreements, that might prevent the board from exercising its fiduciary duties in the future.

It would be easy to relegate *Omnicare* to the field of deals and deal protection devices. Indeed, most have assumed just that.[47]

It would seem especially difficult to extend the case to the context of financial distress because the court expressly held that the NCS board should have considered the interests of its shareholders, notwithstanding that firm's obvious financial distress.[48] That is, because the court seemingly allowed the board to prioritize shareholder interests over creditor interests, maybe *Omnicare* actually undermines the notion of special duties in times of financial distress.

But the latter argument confuses the specific facts of *Omnicare* with the broader point that the Supreme Court was making about the board's role in a Delaware corporation. Delaware law uniformly requires joint board and shareholder action with regard to any major transaction,[49] buttressed by a strong board fiduciary duty when the shareholder prong of the duality is not apt to work.[50]

For example, when there is a controlling shareholder on both sides of a transaction, the shareholder vote becomes ineffectual, and the board must take on a duty of extra diligence.[51] In *Omnicare*, the vote was ineffectual but the board tied its hands nonetheless. This is the problem the *Omnicare* court set out to address.[52]

None of this turns on who the beneficiary of more board diligence might be—the duty is owed to the corporate entity, rather than any specific stakeholder group.[53]

While the Delaware legislature did expressly allow "force the vote" provisions, the state supreme court's approach in *Omnicare* seems to say

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46. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 938 (Del. 2003).

47. *E.g.,* E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments,* 153 U. PA. L. REV. 1399, 1460 (2005).

48. *Omnicare*, 818 A.2d at 918. *Cf.* Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1343 n.69 (2007).

49. *E.g.,* DEL. CODE ANN. tit. 8, § 252(c) (West 2014) (merger); *id.* § 271(a) (sale of assets); *id.* § 275(b) (dissolution); *id.* § 242(b)(1) (amendment to certificate of incorporation). *See* Christopher M. Bruner, *Power and Purpose in the "Anglo-American" Corporation*, 50 VA. J. INT'L L. 579, 594 (2010).

50. Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994).

51. *See* Lyman Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 DEL. J. CORP. L. 405, 422 (2013).

52. *Omnicare*, 818 A.2d at 937 ("The NCS board could not abdicate its fiduciary duties to the minority by leaving it to the stockholders alone to approve or disapprove the merger . . . .").

53. Francis G.X. Pileggi & Jeffrey M. Schlerf, *Duties of Directors and Managers of Distressed Companies: A Review of Cases from Delaware's Supreme Court, Court of Chancery and Bankruptcy Court*, 28 DEL. LAW. 17, 19 (2010).

that such provisions are only really useful when they do no harm to the broader structure of the corporate law.[54]

The question of *Omnicare's* scope and its application beyond takeovers is more difficult because the opinion does invoke *Unocal*, the classic takeover defense case from the 1980s. On the other hand, many have doubted the application of *Unocal* to the case, because

> *Unocal* involved a specific context—hostile takeovers—and a specific risk— entrenchment. While the specter of self-interest may be omnipresent, the risk of entrenchment is not. There is much less entrenchment risk in friendly mergers. In such cases, there should at least be some basis for suspecting self-interest on the part of the target board before applying enhanced scrutiny. In *Omnicare*, there is simply no reason to believe that the board behaved in any way other than perfectly selflessly. The "omnipresent specter" thus seems to have been conspicuously absent, along with any basis for applying *Unocal* scrutiny.[55]

What, then, is *Omnicare* about? In short, I read the case as being about preserving the dual roles of board and shareholder, and, in particular, leaving open the possibility that future boards might have to exercise their role in the overall governance system.[56]

Omnicare then stands for the idea that the board of a Delaware corporation may not act in a way that delegates the board's duties to others or restricts the board's obligation to respond to future events.[57] As the *Omnicare* court explains, boards must act reasonably in response to any threat to corporate policy and effectiveness.[58] This is true whether the threat is posed by deal protection devices that stand in the way of a better deal, or by unfair or otherwise inequitable tactics that may generally stand in the way of effecting long or short term corporate policies.

But Delaware does not tend to examine decisions for their substantive correctness.[59] Thus, it is important to emphasize that the *Omnicare* duty as I understand it involves a procedural requirement that boards only bind their future counterparts after deep, thoughtful consideration. That is, only after weighing the consequences of a decision can a current board preclude action by a future board.

54. Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1595 (2005).

55. Sean J. Griffith, *The Costs and Benefits of Precommitment: An Appraisal of Omnicare v. NCS Healthcare*, 29 J. CORP. L. 569, 591 (2004) (footnotes omitted).

56. Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity*, 58 EMORY L.J. 713, 730 (2009).

57. *Omnicare*, 818 A.2d at 938 ("The stockholders of a Delaware corporation are entitled to rely upon the board to discharge its fiduciary duties at all times. The fiduciary duties of a director are unremitting and must be effectively discharged in the specific context of the actions that are required with regard to the corporation or its stockholders as circumstances change.").

58. *Id.* at 932.

59. Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1094 (2004).

How that might work in the specific context of financial distress and chapter 11 is the subject of the next Part.

IV. FINANCIAL DISTRESS AND BOARD DUTIES

The approval of a significant new credit line, especially one that will be secured by all of the borrower's assets, is undoubtedly a board-level decision. The question is what should go into the board's decision making process.

In normal times, there is little doubt that the ultimate outcome of the board's decision in this situation would be reviewed with the benefit of the business judgment rule.[60] Normally, a decision made by an insolvent corporation is also subject to the business judgment rule, even when the board makes a decision that ultimately turns out poorly.[61]

The central difference is the specific issue of granting a business-wide security interest, given the background condition of financial distress. Most importantly, the decision to grant the security interest limits the options of future boards in ways that are likely to have immediate significance.[62] The last factor is key, inasmuch as board-level decisions are always apt to involve a choice of paths. The simple fact of making a decision is not enough to make the decision special for corporate law purposes.

But making such a decision in a time of financial distress is tantamount to deciding that the senior lenders, and not the board, will have the power over the debtor's reorganization decisions.[63] And "[c]ontrol decisions . . . are central to bankruptcy policy."[64]

The unique and arguably valuable aspect of U.S. reorganization law often turns on the central role given to management, albeit in a system of countervailing checks and balances.[65] In particular, chapter 11 leaves the bulk of the reorganization to business decision makers, and rejects the model, so common in many other jurisdictions, that vests control in a bankruptcy professional.[66]

60. *Cf.* Gabelli & Co., Inc. Profit Sharing Plan v. Liggett Grp., Inc., 444 A.2d 261, 264 (Del. Ch. 1982).

61. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 205 (Del. Ch. 2006), *aff'd*, 931 A.2d 438 (Del. 2007).

62. *See* Wayne O. Hanewicz, *Director Primacy, Omnicare, and the Function of Corporate Law*, 71 TENN. L. REV. 511, 538 (2004).

63. Jay Lawrence Westbrook, *Bankruptcy Control of the Recovery Process*, 12 AM. BANKR. INST. L. REV. 245, 251 (2004); *see also* Robert K. Rasmussen, *Where Are All the Transnational Bankruptcies? The Puzzling Case for Universalism*, 32 BROOK. J. INT'L L. 983, 985 (2007).

64. Westbrook, *supra* note 18, at 856.

65. Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 420 (2007); *see also* Oscar Couwenberg & Stephen J. Lubben, *The Costs of Chapter 11 in Context: American and Dutch Business Bankruptcy,* 85 AM. BANKR. L.J. 63, 68 (2011); John T. Roache, *The Fiduciary Obligations of A Debtor in Possession,* 1993 U. ILL. L. REV. 133, 142.

66. John Wm. Butler, Jr. et al., *Preserving State Corporate Governance Law in Chapter 11: Maximizing Value Through Traditional Fiduciaries*, 18 AM. BANKR. INST. L. REV. 337, 337 (2010).

While management is not without its chauvinisms, giving management control offers a unique combination of institutional knowledge with a *relatively* neutral player.[67] The model does place extra stress on the quality of management.[68] And it also means that control needs to stay with management: it cannot be outsourced to another player in the chapter 11 process without undermining the basic working of the model.[69]

Thus, the *Omnicare* duty can be used to support the model of control on which chapter 11 is predicated. Though the *Omnicare* duty offers support, it is not an absolute fix.

There are some instances where handing control to a senior lender is the only, and likely better, choice, as compared with a chapter 7 case.[70] Still, it also seems likely that the number of cases in which control is given to a senior lender is higher than it should be.

Approaching the issue as one of corporate governance instead of bankruptcy is beneficial because corporate governance aligns the incentives of managers at a point where it can produce real change. The fiduciary duty will serve to highlight the issue and force a more thoughtful analysis of the choice to enter into a senior credit facility in circumstances where doing so will limit the choices if and when a chapter 11 case must be filed.

Initially, it may seem strange to solve a problem of federal bankruptcy law using state corporate law. Yet, it has long been recognized that the collective process of bankruptcy is not likely to work if strictly confined to a specific temporal period. Thus, the bifurcation between prebankruptcy and postbankruptcy has always been subject to adjustment under the general heading of avoidance laws.[71]

In short, the use of the *Omnicare* duty would most likely result in a state law fiduciary duty claim that would probably be enforced in federal bankruptcy court.[72] The board would have the duty in the prebankruptcy period, but enforcement of breaches of the duty would most often take place as part of the firm's chapter 11 case. This will allow the bankruptcy courts some ability to shape the duty and better tailor the rule to the specific context of restructuring.

Inevitably, the development and application of *Omnicare* to the context of credit agreements will undoubtedly trigger concerns about lia-

67. Michelle M. Harner, *The Search for an Unbiased Fiduciary in Corporate Reorganizations*, 86 NOTRE DAME L. REV. 469, 486 (2011).

68. *See* Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1492 (1993).

69. A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875, 892 (2009).

70. *See* James J. White, *Death and Resurrection of Secured Credit*, 12 AM. BANKR. INST. L. REV. 139, 148 (2004).

71. *E.g.*, ORLANDO BUMP, FRAUDULENT CONVEYANCES: A TREATISE UPON CONVEYANCES MADE BY DEBTORS TO DEFRAUD CREDITORS 504 (James McIlvaine Gray ed., 4th ed. 1896).

72. Kelli A. Alces, *Enforcing Corporate Fiduciary Duties in Bankruptcy*, 56 U. KAN. L. REV. 83, 89 (2007).

bility and the potential for excessive risk aversion by the board in times of financial distress.[73] Some degree of risk aversion is by design. It is widely accepted that fiduciary duties exist to align the board's incentives with the firm's.[74] Because *Omnicare*, like its predecessor *Unocal*, is a kind of prologue obligation,[75] if the board's approval of the senior credit facility were found reasonable, the board would then continue to benefit from the tremendous deference the Delaware courts give boards in all situations as a result of a generous business judgment rule and section 102(b)(7)'s protection against routine liability for duty of care claims.[76]

A kind of gatekeeper function might also develop since professionals can be liable for aiding and abetting fiduciary duties, and they do not benefit from section 102(b)(7) provision protections.[77]

A certain number of firms that currently enter into senior credit facility prebankruptcy will now wait and seek approval of those facilities as DIP loans. This will allow the DIP loan to be vetted by creditors and the courts in a way not possible under state corporate law.[78]

The more difficult problem is if enforcement of the *Omnicare* duty will result in bankruptcy cases that need not have happened, costing the firm more than resolution of its distress outside of court. Arguably this is not so much a consequence of the *Omnicare* duty itself, but rather the potential overenforcement of the *Omnicare* duty. Such problems are best addressed by the judiciary directly.[79]

Some might argue that the duty is useless in this context, because the corporation inevitably has an obligation to indemnify the board.[80] But remember that the claim for indemnification arguably arises prepetition, and thus will be paid along with other unsecured claims at cents on the dollar. Plus, there is always the chance that the claim could be equitably subordinated too.[81]

73. *See* Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71, 144 (1989).

74. *See, e.g.*, Jill E. Fisch, *Taking Boards Seriously,* 19 CARDOZO L. REV. 265, 269 (1997); Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J.L. REFORM 55, 80 (2011).

75. *In re* Trados Inc. S'holder Litig., No. CV 1512-VCL, 2013 WL 4511262, at *20 (Del. Ch. Aug. 16, 2013).

76. *See* Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 837 (2007).

77. *In re* Rural Metro Corp., 88 A.3d 54, 86 (Del. Ch. 2014).

78. Of course, even vetting the agreements under the Code is far from perfect. David A. Skeel, Jr.*, The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905, 1929 (2004).

79. Michelle M. Harner, *Corporate Control and the Need for Meaningful Board Accountability*, 94 MINN. L. REV. 541, 567 (2010).

80. DEL. CODE ANN. tit. 8, § 145 (West 2014).

81. 11 U.S.C. § 510(c) (2012).

V. CONCLUSION

This short Article has suggested the outlines of how the overuse of senior credit facilities on the eve of bankruptcy—and the threat that those facilities pose to the normal location of control in chapter 11 proceedings— might be addressed under extant Delaware corporate law.

Normally one might expect that such speculative readings of the caselaw will remain mostly of academic interest. But given the increasing use of litigation trusts to find some source of recovery for unsecured creditors, who otherwise are left entirely unpaid in many modern chapter 11 cases— yet another effect of the overuse of secured credit— the cause of action suggested herein just might find its way into actual litigation in the near future.[82]

82. Andrew J. Morris, *Clarifying the Authority of Litigation Trusts: Why Post-Confirmation Trustees Cannot Assert Creditors' Claims Against Third Parties*, 20 AM. BANKR. INST. L. REV. 589, 595 (2012).