By Gary M. Schildhorn and Brya M. Keilson

The Unresolved Dilemma of Creditors' vs. Stakeholders' Rights

Gary M. Schildhorn
Eckert Seamans
Cherin & Mellott LLC
Philadelphia

Brya M. Keilson
Gellert Scali Busenkell
& Brown LLC
Wilmington, Del.

Gary Schildhorn is a member of Eckert Seamans Cherin & Mellott LLC in Philadelphia. Brya Keilson is Of Counsel with Gellert Scali Busenkell & Brown LLC in Wilmington, Del.

A benefit corporation is a new form of corporate entity, and its directors are required to consider the impact of their decisions on stakeholders. Under the model benefit corporation law, stakeholders include shareholders, but also specifically include its employees and workforce, customers, community and social factors, the local and global environment, the short- and long-term interests of the benefit corporation and the ability of the corporation to accomplish its stated benefit purpose.[1] Creditors are excluded from the list of stakeholders. As explained by the drafters of the model legislation, this omission was intentional because existing state law is already available to creditors to protect their interests.

This article explores the complex dilemma faced by corporate directors of benefit corporations and bankruptcy courts should an insolvent benefit corporation seek approval to sell its assets under § 363 of the Bankruptcy Code in a situation where two bids are received. The first bid is higher in dollars, maximizing a return to creditors, but the second is more favorable in its treatment of stakeholders. The dilemma arises because in an insolvent company, directors comply with their fiduciary duty to the corporation when they maximize the return to creditors.[2] Further, in the context of a § 363 sale, courts generally determine that the highest and best bid is the one that yields the greatest return to creditors.[3] However, in a benefit corporation, the directors are legally mandated to consider the interests of stakeholders, which do not include creditors. Which sale transaction should be approved by the directors and the bankruptcy court: the highest bid that maximizes the return for creditors, or a lower bid that serves the interests of stakeholders?

Twelve states have passed legislation authorizing benefit corporations, and 14 states are considering legislation.[4] As of 2012, there are 333 mutual fund products in the U.S. that consider environmental, social or corporate governance criteria with assets of more than $640.5 billion.[5] Sixty million Americans say that they care whether companies are green, responsible and sustainable. More than 650 companies are benefit corporations, including Ben & Jerry's, Patagonia and King Arthur Flour.[6] These numbers evidence a growing movement from shareholder capitalism to stakeholder capitalism.

If a traditional corporation is solvent and, in particular, when a sale of the business is contemplated, the directors owe an exclusive duty to the company's shareholders to maximize their return.[7] The beneficiaries of directors' duties shift when the corporation is insolvent. In a recent decision of *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*,[8] the Delaware Supreme Court held:

> It is well settled that directors owe fiduciary duties to the corporation. When a corporation is *solvent*, those duties may be enforced by its shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.

The corporation's insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value."[9]

In *Official Committee of Unsecured Creditors ex rel. Estate of Lemington Home for the Aged v. Baldwin (In re Lemington Home for the Aged)*,[10] the Third Circuit Court of Appeals, in interpreting Pennsylvania law, stated that fiduciary duties of directors are owed not only to the corporation and its shareholders, but also the creditors of an insolvent entity.[11] The debtor in possession (DIP) bears the same fiduciary duty to creditors and shareholders as a chapter 11 trustee.

The paramount interests of creditors will generally determine the winning bid in a contested § 363 sale. When a debtor desires to sell an asset, its main responsibility—and the primary concern of the bankruptcy court—is the maximization of the value of the asset sold.[12] Because a trustee or DIP has the

1 Model Benefit Corporation Legislation, section 301.
2 *N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla*, 930 A.2d 92, 101-02 (Del. 2007).
3 *In re Taylor-Wharton Int'l LLC*, No. 09-14089, 2010 Bankr. LEXIS 3268, at *7-8 (Bankr. D. Del. June 8, 2010); *In re Integrated Res. Inc.*, 135 B.R. 746, 750 (Bankr. S.D.N.Y.), *aff'd*, 147 B.R. 650 (S.D.N.Y. 1992).
4 *See* B Corporation, www.bcorporation.net (last visited March 25, 2013).
5 SRI Basics, http://ussif.membershipsoftware.org/sribasics (last visited March 25, 2013).
6 *See* B Corporation, www.bcorporation.net (last visited March 25, 2013).
7 *See eBay Domestic Holdings Inc. v. Newmark*, 16 A.3d 1 (Del. Ch. 2010); *see also VFB LLC v. Campbell Soup Co.*, 482 F.3d 624, 634-35 (3d Cir. 2007).
8 930 A.2d 92 (Del. 2007).
9 *Id.* at 101-02 (footnotes omitted).
10 659 F.3d 282 (3d Cir. 2011).
11 *Id.* at 290 (citing *Citicorp Venture Capital Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982 (3d Cir. 1998)).
12 *In re Taylor-Wharton Int'l LLC*, 2010 Bankr. LEXIS 3268, at *7-8; *In re Integrated Res.*, 135 B.R. at 750.

duty to maximize the value obtained from an asset sale, when competing bids are readily comparable, the highest dollar bid will almost always be the winning one.[13] Where lower competing bids have been approved, other economic terms (such as certainty to close, due diligence outs or financial strength of the bidder) require acceptance of the lower bid if it is determined to be the highest and best result for creditors.[14]

In one reported decision involving the sale of a nonprofit hospital, the district court, in overturning the decision of the bankruptcy court, ruled that both financial and nonfinancial considerations, such as furthering the hospital's health care mission, must be weighed in determining the highest and best offer.[15] In *In re United Healthcare Systems Inc.*,[16] the bankruptcy court refused to approve a private sale supported by the debtor because of the existence of a second purchaser willing to pay more. The district court, in reversing the bankruptcy court, determined that directors of a nonprofit corporation had a fiduciary obligation to further the hospital's health care mission and that the decision regarding the appropriate sale transaction should not be based solely on price.[17]

The holding in *United Healthcare* recognizes that state law regulating nonprofits creates for directors a duty of obedience to ensure that the charitable mission is carried out and the fact that the debtor is a charitable institution must be taken into consideration.[18] Debtors must comply with state law in operating or selling their assets.[19] *United Healthcare* stands for the proposition that in a nonprofit, where a debtor's board weighs both the financial and mission components of competing bids, the sale supported by the debtor should be approved. Only the board, and not a bankruptcy judge, could adequately weigh these factors. The *United Healthcare* case does not provide an answer if it appears that the debtor has disregarded or substantially impaired the interests of the creditors in favor of its mission.

What if the debtor is legally prohibited from considering the interests of creditors in a sale transaction as distinguished from the directors' duties in the nonprofit context? The directors of a benefit corporation are required to consider the interests of identified stakeholders, which do not include the interests of creditors. The argument can be made that by adopting legislation that excludes creditors from the list of stakeholders, directors must disregard creditor interests when considering a sale. The directors' clear duty as established by section 301 of the model benefit corporation law is to make decisions based on the best interests of stakeholders, which excludes creditors. Directors who approve a bid that provides the greatest return to creditors at the expense of stakeholders would breach their duty of loyalty to the corporation by failing to act in good faith. "Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith."[20]

A bankruptcy court would be equally challenged to resolve a dispute between creditors' rights and its mission. The corporation, a director and stockholders holding a minimum percentage of ownership interest or parties having standing under applicable law for derivative litigation have standing to bring an injunction action (the benefit corporation law does not authorize damage claims) compelling a benefit company to comply with its mission.[21] In deciding whether to grant an injunction, whose interests should the court consider: the rights of creditors under existing state law, or the rights of stakeholders under the model benefit corporation law?

Secured creditors could attempt to avoid having their collateral sold for less than fair value by credit-bidding, as authorized by § 363(k). However, § 363(k) authorizes the court "for cause" to deny a secured creditor the right to credit-bid. What constitutes "cause" that would allow a court to deny a secured creditor's right to credit-bid? Under 28 U.S.C. § 959(b), the DIP is required to manage and operate property according to the valid state law where the property is located. Has cause been established to deny a secured creditor's right to credit-bid where acceptance of that bid by the debtor would eliminate the interests of stakeholders and therefore violate state law? Would the fact that the creditor knew that it was lending to a benefit corporation where stakeholders' rights must be considered be cause to deny credit-bidding or at least require credit-bidders to include provisions to benefit stakeholder interests as part of the bid?

While disregarding the rights of creditors may be an unintended consequence of the legislation, it is extremely problematic. Benefit corporations must be able to provide creditors with reasonable expectations as to the value of their collateral in order to obtain financing and attract capital. Should a sale occur that dashes these expectations in favor of a corporation's mission, capital flight will follow. The laudable goal of creating stakeholder capitalism would be threatened. Even if directors of a benefit corporation are permitted to weigh the interests of creditors along with other stakeholders, how much weight should be given to those stakeholders' interests as compared to the interests of creditors of an insolvent benefit corporation?

At this time, these questions cannot be answered. The following suggestions are offered as possibly addressing some of these concerns in the context of a § 363 sale.

The drafting of carefully considered bidding procedures may provide a vehicle for minimizing issues at the sale hearing. A benefit corporation will have many stakeholders such as employees, the surrounding community and the environment. To avoid uncertainty as to what bid the debtor would recommend as highest and best, the debtor should provide guidance to potential bidders. The debtor should prioritize the importance that it attaches to the interests of competing stakeholders and provide a methodology that the debtor will utilize in comparing bids.

13 *In re Landscape Props. Inc.*, 100 B.R. 445, 447-48 (Bankr. E.D. Ark. 1988); *see also In re Castre Inc.*, 312 B.R. 426, 429 (Bankr. D. Colo. 2004); *In re F.A. Potts & Co.*, 86 B.R. 853, 862 (Bankr. E.D. Pa. 1988).

14 *In re Diplomat Constr. Inc.*, 481 B.R. 215 (Bankr. N.D. Ga. 2012); *In re Bakalis*, 220 BR 525, 533-34 (Bankr. E.D.N.Y.); *aff'd*, 93 B.R. 62 (E.D. Pa. 1988); *aff'd*, 891 F.2d 280 (3d Cir. 1985).

15 *In re United Healthcare Sys. Inc.*, No. 97-1159, 1997 U.S. Dist. LEXIS 5090 (D.N.J. March 26, 1997).

16 *Id.*

17 *Id.* at *15.

18 *See Id.*; *In re Brethren Care of South Bend Inc.*, 98 B.R. 927, 935 (Bankr. N.D. Ind. 1989).

19 28 U.S.C. § 959(b).

20 *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006); *see also Bridgeport Holdings Inc. Liquidating Trust v. Boyer (In re Bridgeport Holdings Inc.)*, 388 B.R. 548, 564 (Bankr. D. Del. 2008).

21 Model Benefit Corporation Legislation, section 305.

continued on page 86