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Creditors' Derivative Suits on Behalf of Solvent Corporations

Mismanagement—the breach of common law or statutory duties owed by directors to their corporations—seems to be an inescapable fact of corporate life. It plagues corporations whether they are public or closely held, financial or nonfinancial, successful or failing. Shareholders who suffer losses as a result of such conduct may bring a suit in derivative or implied derivative form, on behalf of the corporation, to recover damages from the directors. Thus the absence of profits, or the presence of losses, in a corporation does not limit the rights of its shareholders to sue on its behalf. See, e.g., In re Detroit Edison Co., 391 Mich. 182, 183, 214 N.W.2d 310 (1974). The corporation itself is the real party in interest, and the derivative suit is merely the vehicle by which the corporation may exercise its rights. See, e.g., Duxbury v. United Aircraft Corp., 325 F. Supp. 234, 235 (D. Conn. 1970).

1. The common law duties of care and loyalty to the corporation arise from statutes vesting the right to manage the corporation in its board of directors, see, e.g., Del. Code Ann. tit. 8, § 141(a) (Supp. 1978); Act of July 9, 1957 Ill. Laws, § 33, Ill. Ann. Stat. ch. 32, § 157.33 (Smith-Hurd Supp. 1978); cf. Cal. Corp. Code § 309(a) (West 1977) (defining directors' duty of care as "such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances").

2. See, e.g., Del. Code Ann. tit. 8, § 174 (1975) (directors liable to corporation, and to creditors in event of dissolution or insolvency, for unlawful dividend payments, stock purchases, or redemptions); N.Y. Bus. Corp. Law §§ 719(a), 720 (McKinney 1963 & Supp. 1978) (liability under certain circumstances for loans to directors, dividends, stock repurchases, and other distributions to shareholders, misappropriation of corporate assets, and negligent mismanagement).

3. See Selheimer v. Manganese Corp., 423 Pa. 563, 567, 582, 224 A.2d 634, 637, 645 (1966) (400,000 Class A shares, par $2.00, held by public, who elected three of seven directors; 200,000 Class B shares, par $0.20, held by defendant directors, who elected remaining four; liability based upon "gross mismanagement").


5. See Note, Public Creditors of Financial Institutions: The Case for a Derivative Right of Action, 86 Yale L.J. 1422, 1423-25 (1977) (77% of recent life insurance company insolvencies and 81-91% of recent bank failures due to self-dealing by insiders and management dishonesty).

6. In Bartle v. Markson, 299 F. Supp. 958, 963-64 (N.D.N.Y. 1969), aff'd, 423 F.2d 637 (2d Cir. 1970), the assets of Markson Bros., Inc. were stripped by another corporation, Son-Mark Industries, Inc., specially organized for that purpose. Markson Bros. eventually went bankrupt and its creditors brought suit successfully against directors who engineered the scheme. For many years prior to the initiation of the stripping plan, Markson Bros. had been one of the soundest companies in central New York state, with a Dun & Bradstreet credit rating of AAA-1. Id. at 961. For a discussion of the Markson litigation, see Knepper, Liability of Corporate Officers for Debts of Financially Troubled Corporations, 81 Com. L.J. 389, 392-93 (1976). Schemes like this one reappear from time to time in reported cases. See, e.g., Saracco Tank & Welding Co. v. Platz, 65 Cal. App. 2d 306, 150 P.2d 918 (1944); Darcy v. Brooklyn & N.Y. Ferry Co., 196 N.Y. 99, 89 N.E. 461 (1909).

7. Suits against the directors of an insolvent corporation often are brought by creditors and involve fraudulent conveyances, see Glenmore Distilleries Co. v. Seideman, 267 F. Supp. 915, 918 (E.D.N.Y. 1967) (salary payments while corporation insolvent), or violation of statutory liquidation procedures, see Kiernan v. Kahn Davis, Inc., 132 N.J. Eq. 245, 246-47, 28 A.2d 66, 67 (Ch. 1942) (salary and loan repayment after corporation had substantially ceased doing business and was insolvent). In each of these cases, the organizers evidently intended the corporation to be successful, and the unlawful conveyances were "but the reflex of an insolvent man," Clark, The Duties of the Corporate Debtor to Its Creditors, 90 Harv. L. Rev. 505, 542 n.98 (1977). Not infrequently, however, insolvency is
holders have responded to mismanagement\(^8\) by filing derivative suits seeking to enforce directors' duties in the name and for the benefit of the corporation.\(^9\) These suits have been acclaimed for their effectiveness in holding directors to the standards of conduct contemplated by the law.\(^10\)

Creditors have rarely participated in derivative litigation, since the law generally does not allow them to do so while the debtor corporation remains solvent.\(^11\) Until a few years ago this limitation upon creditors' rights was so well settled that it was seldom discussed in case law\(^12\) or commentary.\(^13\) Recent securities cases suggest, however, that


8. Throughout this Note, the term "mismanagement" is used to denote conduct by directors that is actionable in a shareholders' derivative action under current standards of liability.

9. More than 470 derivative suits were reported between 1956 and 1966, Dykstra, The Revival of the Derivative Suit, 116 U. Pa. L. Rev. 74, 74-75 & n.5 (1967); this represented an increase of about 160 over the number reported between 1946 and 1956, id. Replication of Dykstra's count for the period 1966-1976 indicates that more than 435 derivative suits were reported during those years. Memorandum on Derivative Litigation 1966-76 (Nov. 3, 1978) (on file with Yale Law Journal). These cases represent only a fraction of total litigation. Dykstra, supra, at 75.

10. More than 470 derivative suits were reported between 1956 and 1966, Dykstra, The Revival of the Derivative Suit, 116 U. Pa. L. Rev. 74, 74-75 & n.5 (1967); this represented an increase of about 160 over the number reported between 1946 and 1956, id. Replication of Dykstra's count for the period 1966-1976 indicates that more than 435 derivative suits were reported during those years. Memorandum on Derivative Litigation 1966-76 (Nov. 3, 1978) (on file with Yale Law Journal). These cases represent only a fraction of total litigation. Dykstra, supra, at 75.

11. See Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949) ("[The stockholders' derivative action] was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses."); cf. Rostow, To Whom and For What Ends is Corporate Management Responsible? in THE CORPORATION IN MODERN SOCIETY 48 (E. Mason ed. 1959) (stockholders' suit is "the most important procedure the law has yet developed to police the internal affairs of corporations," but there is hostility toward it "in higher business circles" and among courts and legislatures). Directors' growing demand for liability insurance, see Bishop, Understanding D & O Insurance Policies, HARV. BUS. REV., Mar.-Apr. 1978, at 20 (85-90% of listed corporations now carry such insurance, in amounts ranging from $5 million to $50 million), is testimony to their awareness of the risks to which mismanagement exposes them.

12. See, e.g., Kenrich Corp. v. Miller, 377 F.2d 312, 314 (3d Cir. 1967); Dorfman v. Chemical Bank, 56 F.R.D. 363, 364 (S.D.N.Y. 1972); Fagan v. LaGloria Oil & Gas Co., 494 S.W.2d 624, 628 (Tex. Civ. App. 1973) ("basic rule" that directors' breaches of duty do not create cause of action in creditor of corporation and "well recognized exception" applying when corporation is insolvent and has ceased doing business). There are exceptions to this general rule. Creditors' derivative actions have occasionally been maintained on behalf of solvent financial institutions. See Note, Understanding D & O Insurance Policies, HARV. BUS. REV., Mar.-Apr. 1978, at 20 (85-90% of listed corporations now carry such insurance, in amounts ranging from $5 million to $50 million), is testimony to their awareness of the risks to which mismanagement exposes them.

13. Occasional references in legal literature to creditors' derivative suits that have been allowed by courts almost always assume insolvency of the debtor corporation. See, e.g.,
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this disparity between shareholders' and creditors' rights has begun to narrow.\(^4\)

This Note argues that creditors of a solvent corporation should have a statutory right to bring suit in the name of the corporation against its directors for conduct breaching the trust of their office. After surveying creditors' limited rights against directors under current law, the Note presents the case for a new and expansive creditors' derivative suit. It concludes by suggesting a few limiting principles appropriate to the proposed right of action.

I. Traditional Creditors' Rights to Enforce Directors' Duties

A. The Creditors' Bill

Even without statutory authority, creditors in many jurisdictions can enforce a debtor corporation's cause of action against errant directors through a creditors' bill in equity.\(^5\) Traditionally, the bill required


14. In *Entel v. Guilden*, 223 F. Supp. 129 (S.D.N.Y. 1963), holders of warrants entitling them to purchase the common stock of an investment company brought suit against directors for receiving brokerage commissions on company contracts in violation of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -52 (1976). The relief sought by plaintiffs was recovery, for the benefit of the investment company, of the commissions illegally received. 223 F. Supp. at 130. The court denied a motion to dismiss for failure to establish a private right of action, reasoning that the duties created by the Investment Company Act were intended to benefit all classes of security-holders, including the plaintiff warrant holders, *Id.* at 132-33. The fact that the plaintiffs would not personally recover judgment did not concern the court: plaintiffs' status as intended beneficiaries of the statute was sufficient to ensure their right to enforce it.


prior exhaustion of legal remedies against the corporation: recovery of judgment, execution upon it, and usually, return of execution unsatisfied.\textsuperscript{16} This constituted a prima facie showing of corporate insolvency. The joinder of legal and equitable claims permitted by the Federal Rules of Civil Procedure\textsuperscript{17} and similar developments in state practice have eliminated the necessity of exhaustion in a prior lawsuit, but have not expanded creditors' substantive rights.\textsuperscript{18}

An exception to the insolvency requirement occurs when directors have acted with actual intent to defraud creditors.\textsuperscript{19} Creditors may then proceed against the directors of a solvent corporation to satisfy matured claims,\textsuperscript{20} and may move to avoid fraudulent conveyances even if their claims have not yet matured.\textsuperscript{21} Nevertheless, actual fraudulent intent is difficult to prove,\textsuperscript{22} and fraudulent-conveyance remedies do not extend to fiduciary breaches other than fraud.

\section*{B. Receivership and Bankruptcy}

Not all jurisdictions allow creditors' bills against directors.\textsuperscript{23} Creditors of an insolvent corporation may, however, petition the court for

\begin{itemize}
\item[16.] See D. Epstein, Debtor-Creditor Relations 152-53 (1973). When obtaining a prior judgment against the debtor corporation would be “impossible or useless,” courts have not required creditors to do so. Steele v. Isman, 164 A.D. 146, 149, 149 N.Y.S. 488, 491 (1914); see Lilienthal v. Bect, 108 A.D. 222, 223, 95 N.Y.S. 849, 850 (1903), rev'd on other grounds, 185 N.Y. 153, 77 N.E. 1002 (1909) (dissolution of corporation and appointment of receiver excuses creditors from requirement of exhaustion of remedies).
\item[17.] FED. R. Civ. P. 2, 18.
\item[19.] The presence of actual fraudulent intent establishes a fraudulent conveyance under §7 of the Uniform Fraudulent Conveyance Act (UFCA), which defines as fraudulent “[e]very conveyance made and every obligation incurred with actual intent, . . . to hinder, delay, or defraud either present or future creditors.” Insolvency of the debtor is not an element of a §7 fraudulent conveyance. Klein v. Rossi, 251 F. Supp. 1, 2 (E.D.N.Y. 1966). Actual intent to defraud may be contrasted with intent presumed in law, exemplified by §4 of the UFCA, which declares conveyances fraudulent if made without fair consideration by a debtor who is or will be thereby rendered insolvent. The primary difference between actual and presumed intent may lie in their respective burdens of proof. See note 22 infra.
\item[20.] The UFCA gives creditors whose claims have matured the right to disregard a fraudulent conveyance and attach or levy execution upon the property conveyed. \textit{Uniform Fraudulent Conveyance Act} §9(1)(b).
\item[21.] Id. §10(c).
\item[22.] See Sparkman & McLean Co. v. Derber, 4 Wash. App. 341, 349, 481 P.2d 585, 591 (1971) (plaintiff proceeding under §7 of UFCA must present “clear and satisfactory proof” of debtor's fraudulent intent, although he need show only “substantial evidence” of intent in order to proceed under §4).
\item[23.] See 3A W. Fletcher, supra note 15, §§1180-1181.
\end{itemize}
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the appointment of a receiver, who can himself enforce the corporation's cause of action.24

As an alternative to receivership, 25 three or more creditors holding claims totaling at least §5000 may institute bankruptcy or reorganization proceedings against the debtor corporation.26 Like a receiver, the trustee in such proceedings can enforce corporate causes of action against directors and recover judgment for the benefit of the debtor's estate.27 Should the trustee fail or refuse to prosecute the action, creditors may petition the court for permission to proceed with an action for and in the name of the trustee.28


25. When the debtor corporation is closely held, some courts recognize that receivership is an expensive and circuitous route for creditors to follow, and will in appropriate circumstances allow creditors to pierce le veil of the insolvent debtor corporation "as a matter of convenience." Burns v. Norwesco Marine, Inc., 13 Wash. App. 414, 419, 535 P.2d 860, 863 (1975); Harrison v. Puga, 4 Wash. App. 52, 63, 480 P.2d 247, 254-55 (1971). The important circumstance, according to the Harrison court, is whether there are "innocent third party rights involved." Id. at 63, 480 P.2d at 254. If there are, the supervision of a receiver is appropriate.

More generally, creditors can invoke the piercing doctrine as a convenient remedy to "random instances of self-dealing and mismanagement" that individually might not be provable as fraudulent conveyances, but collectively create an air of impropriety that courts cannot ignore. Clark, supra note 7, at 553; see id. at 540-45, 552-53. For an example of such a case, see Palmer v. Stokely, 255 F. Supp. 674, 680 (W.D. Okla. 1966) (cancellation of indebtedness owed to bankrupt corporation by corporation controlled by directors of bankrupt corporation). Piercing the corporate veil, like other equitable creditors' remedies, is available only when the debtor corporation is insolvent. See Emhart Corp. v. McLarty, 226 Ga. 621, 623, 175 S.E.2d 698, 700 (1970) (exhaustion of legal remedies required); Burns v. Norwesco Marine, Inc., 13 Wash. App. 414, 419, 535 P.2d 860, 863 (1975) (exhaustion not required, but debtor corporation manifestly insolvent).

26. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 303(b)(1), 92 Stat. 2589 (to be codified in 11 U.S.C. § 303(b)(1)) (effective Oct. 1, 1979) (hereinafter cited as 1978 Bankruptcy Act with citations to statutory sections only). The creditors' claims must be noncontingent, and if they are secured, the $5000 minimum must be net of security. Id. If there are fewer than 12 creditors (excluding employees, insiders, and transferees of voidable transfers), a single creditor with at least a $5000 claim may commence the proceeding. Id. § 303(b)(2). Generally, creditors prefer the bankruptcy option only in extreme cases, due to its high cost. See D. STANLEY & M. GIRTH, BANKRUPTCY 177 (1971) (costs of administration average 29.3% of total estate in straight-bankruptcy asset cases and 24.9% in Chapter XI reorganization cases).

27. See 1978 Bankruptcy Act, supra note 26, § 323 (trustee's capacity to sue as representative of debtor's estate); id. § 541(a)(1) (debtor's estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case"); S. REP. NO. 998, 95th Cong., 2d Sess. 82 (1978) (as used in § 541, "property" includes causes of action).

The court's appointment of a reorganization trustee is not automatic in every case, but is rather "for cause," which includes "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case." 1978 Bankruptcy Act, supra note 26, § 1104(a)(1).

C. State Corporation Codes

Statutes often specify acts giving rise to creditors’ suits against directors, and would seem to be an obvious vehicle for avoiding the common law prohibition of creditors’ suits on behalf of solvent corporations. But these statutes do not authorize such an expansion of creditors’ rights. Often, they explicitly limit rights of action to judgment creditors. When this limitation is missing, it has been judicially supplied.

II. The Creditors’ Derivative Action

A. The Principle of Proprietary Interest

The principle of “proprietary interest” has been offered by some courts to justify the limitation of creditors’ rights. The right to sue derivatively, they have held, is by its very nature an ownership right, like dividend participation and voting, vested in shareholders to the exclusion of all others. This principle, however, has been uniformly observed neither by courts nor by legislatures. Officers and directors who are not shareholders have a statutory right in at least one state to sue on behalf of their corporations, and creditors may sue derivatively.


30. See, e.g., Del. Code Ann. tit. 8, § 325(b) (1975); N.Y. Bus. Corp. Law § 720(b) (McKinney 1965).

31. See Waters v. Spalt, 22 Misc. 2d 937, 80 N.Y.S.2d 681 (Sup. Ct. 1948) (construing § 58 of New York’s Stock Corporation Law, which provided for liability of directors in certain cases “to such corporation and to the creditors thereof,” to create remedy for judgment creditors only).


33. See N.Y. Bus. Corp. Law §§ 719(a), 720 (McKinney 1963 & Supp. 1978). This right of action is not technically derivative, but rather original, since it is granted to directors and officers by statute. Conant v. Schnall, 35 A.D.2d 326, 328, 307 N.Y.S.2d 902, 904 (1970). Yet the director’s suit is functionally identical to the shareholder’s suit: “in both cases the action is prosecuted in the right and for the benefit of the corporation,” Tenney v. Rosenthal, 6 N.Y.2d 204, 210, 160 N.E.2d 463, 466, 189 N.Y.S.2d 158, 163 (1959), and recovery accrues solely to the corporation. Furthermore, the standard of liability in the director’s suit is identical to the standard in shareholder’s suits, since the statute creating the former “embrace[s] common-law and statutory causes of action imposing liability on directors . . . and covers every form of waste of assets and violation of duty whether as a
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...tively if the debtor corporation is insolvent.34

The possession of such rights by nonshareholders suggests that the law recognizes a broader scope of interests in the corporation than the principle of proprietary interest would admit. Nevertheless, this principle does express an idea that should not be disregarded altogether. The holders of proprietary interests in a solvent corporation, as the owners of its assets, are injured whenever mismanagement depreciates the value of those assets; conversely, they are the ultimate beneficiaries of any increase in the value of assets resulting from derivative litigation. Restricting the derivative right to holders of proprietary interests thus ensures that plaintiffs have a personal stake in the outcome of derivative litigation, and thereby encourages diligent prosecution of the corporation's cause of action.35

B. The Theory of Creditor Injury

It has often been assumed that the creditors of a solvent corporation are not injured at all by its mismanagement; nor, it would follow, are they benefited by derivative recovery.36 If it were true, this assumption would justify denying creditors the derivative right of action. Contemporary financial theory indicates, however, that the assumption is not correct. The attractiveness of a particular investment depends upon both its expected rate of return and its risk.37 With a fixed re-

34. See note 13 supra; Comment, California's New General Corporation Law: Directors' Liability to Corporations, 7 PAC. L.J. 613, 630-38 (1976) (discussing CAL. CORP. CODE § 316(c) (West 1977)). Moreover, the holders of convertible debentures and other "hybrid" securities seem to have emerging derivative rights against the directors of solvent corporations. See note 14 supra.

35. This rationale for the proprietary interest limitation of the derivative right of action is suggested in Comment, Stockholder's Derivative Actions by Holders of Convertible Debentures, 6 U. Mich. J.L. Rev. 760, 776 & n.81 (1975).

36. See, e.g., Appleton v. American Malting Co., 65 N.J. Eq. 375, 380, 54 A. 454, 456 (N.J. 1903) ("creditors can suffer no injury from [illegal payment of dividends] unless the capital is so impaired as to render the company insolvent"); Kempin, supra note 13, at 378 ("by the time the creditors have been injured the corporation must, by definition, be unable to pay its debts"); if corporation were solvent "creditors would be in no position to complain"); Comment, supra note 35, at 777-80.

37. This basic proposition is derived by economists from a number of assumptions concerning the behavior of investors toward risk. The derivation is set out in W. LEWELLEN, THE COST OF CAPITAL 8-18 (1969), and somewhat more formally in C. HALEY & L. SCHALL, THE THEORY OF FINANCIAL DECISIONS 93-105 (1973). An investor's "expected return" is the interest rate he expects to earn on his investment; his "risk" is measured...
Turn, investors prefer lower risk; with fixed risk, they prefer a higher rate of return. Risk and return are thought to be commensurable by investors in that they can be persuaded to hold riskier investments by higher rates of return.

Mismanagement depletes corporate assets, upon which creditors rely for repayment. As the creditors' "cushion" shrinks, their risk increases. Within reasonable limits, most creditors could be compensated for increased risk-bearing by an increase in the rate of return, but, unless they are able to renegotiate their contracts, this is not possible. The injury that creditors suffer thereby is thus comparable to a decline in the rate of return. But available remedies do not reflect this fact. A change in the rate of return confers upon creditors a right of action against directors. A change in risk-bearing does not do so; creditors are instead required to sit by until they suffer "real" injury.

by the variance, or dispersion, of the distribution of interest rates that he may possibly earn. The utility that a rational, risk-averse investor derives from an investment depends positively upon the former of these two factors and negatively upon the latter. Id. at 102-03.

38. Warrantholders, bondholders, and debentureholders are obviously "investors," yet so too are trade creditors; the only difference is that their investment is in kind rather than in currency. The existence of Dun & Bradstreet, with its 75,000 subscribers, see Letter from Guyon Knight III, Dun & Bradstreet Companies, Inc. (Sept. 18, 1978) (copy on file with Yale Law Journal), and myriad other credit-rating agencies is persuasive evidence that trade creditors, like other investors, take risk into account before committing their resources.


40. See id. at 28-30 (use of "indifference curves" to represent different combinations of risk and return yielding equal investor satisfaction).

41. This is obviously true of such forms of mismanagement as excessive compensation of officers and directors, illegal distributions to shareholders, or sales of corporate property for inadequate consideration. It is equally true of mismanagement that diminishes the corporation's future earning potential—by usurping corporate opportunities, for example, or by causing the corporation to engage in illegal activities that damage its reputation in the community where it does business—since shareholders and creditors might reasonably rely upon the corporation's earning potential in making the decision to invest. The creditors' derivative right contemplated by this Note is intended to reach asset depletion in all these forms, and would thus be available to prosecute every type of mismanagement currently actionable in shareholders' suits. See note 8 supra.

42. Risk, the variance of expected returns, increases because the diminution of corporate assets caused by mismanagement makes it less likely that the corporation will meet periodic interest payments and repay principal at maturity. A given diminution may increase creditors' risk greatly or hardly at all, depending on the financial position of the corporation. However, investments with high initial risk due to the small size or low capitalization of the debtor corporation will become that much more risky following the depletion of assets.

43. The default in payment of principal occasioned by insolvency is, in effect, a negative interest payment giving creditors the right to pursue errant directors by legal process. See pp. 1301-04 supra.

44. A change in risk-bearing may be actionable under the terms of the credit contract. See pp. 1307-08 infra.

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It might be argued that creditors should anticipate the mismanagement of solvent debtors and protect themselves against it in their investment contracts. The restrictive covenants found in debenture indentures represent one form of contractual protection; yet each of these fails to protect all creditors as effectively as shareholders are protected by the derivative right of action.

First, smaller creditors may be hampered in their efforts to obtain effective protection by a lack of economic bargaining power. Second, there are many financing transactions for which complex and costly contractual arrangements are inappropriate. Finally, indentures and derivative suit against its directors for paying a dividend "improvidently and for the financial benefit of" Kerkorian, the controlling stockholder. Id. at 217. The debenture holders alleged, inter alia, that "the ability of MGM to pay interest and principal on the Debentures held by class members became questionable," id. at 221 n.6, and that consequently the market price of their securities (which were publicly traded) dropped, id. at 217. The court held that the plaintiffs, who brought the action under state law, were mere creditors and dismissed the derivative suit for want of standing. Id. at 219. An allied class action failed at the summary-judgment stage. Id. at 220-22.

46. The indenture is a lengthy, highly detailed contract between the debtor corporation and a trustee for the holders of bonds or debentures. Commonly used for issuance of debt securities to the general public, indentures are subject, with comparatively minor exceptions, to the requirements of the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1976), which defines eligibility requirements for trustees and imposes upon them certain duties and obligations. See W. CARY, CORPORATIONS 1262-64 (4th ed. 1969). The indenture contains elaborate covenants intended to save the debtor's assets from dissipation or encumbrance. Typical indenture covenants limit subsequent debt and pledge of assets, restrict dividends and other distributions to shareholders, regulate investments and lease transactions by the corporation, and provide for maintenance of minimum working capital and liabilities-to-assets margins. See AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURES 326-467 (1971); Garret, A Borrower's View of the Model Corporate Debenture Indenture Provisions, 21 Bus. Law. 675, 680-81 (1966).

47. By taking a security interest in real estate or other property that is unlikely to be diminished in value by the illicit activities of management, the creditor can insulate himself to some extent from the consequences of mismanagement. If on the other hand the creditor's collateral consists of inventory, accounts receivable, or other personalty subject to misappropriation or misuse, the existence of a security interest creates the possibility of injunctive protection against waste of the mortgaged property. See Devereux v. Berger, 223 Md. 264, 232 A.2d 469 (1969) (enforcing injunction in favor of secured creditor against debtor corporation and its president, which restrained impairment or diminution of corporate assets); G. OSBORNE, MORTGAGES § 134 (2d ed. 1970).

48. This alternative, which amounts to assuming the dual status of creditor and shareholder, might in many cases be cheaper than negotiating and preparing a complex credit instrument, and would assure the availability of injunctive relief, which may be unavailable to an unsecured creditor. See note 52 infra.

49. Moreover, acquiring a stock interest in a closely held debtor may be difficult or impossible for any creditor, large or small. See note 65 infra.

50. Although banks and other institutional lenders often incorporate restrictive covenants into their loan agreements and take security interests in the property of their corporate debtors, see B. MANNING, LEGAL CAPITAL 94-96 (1977), interbusiness financing seldom makes use of these arrangements, see FEDERAL RESERVE SYSTEM, FINANCING SMALL BUSINESS, 85th Cong., 2d Sess. 484-96 (Comm. Print 1958) (describing credit devices by
similar contracts may not have been written to cover all activities that
would be actionable in a shareholders' suit, nor may they provide
the lender with a flexible legal response to such activities. More gen-
erally, there are three paradigmatic situations in which creditors cannot
or do not obtain effective contractual protection against mismanage-
ment: (1) the refusal case, when the debtor corporation would not be
willing to grant such protection on terms acceptable to the creditor
even if negotiations were costless; (2) the transaction costs case, when
the grant of protection would occur but for the fact that the cost of
negotiation is prohibitive in view of the size of the creditor's invest-
ment; and (3) the oversight case, when the grant would occur, but the
creditor, unaware of the need for contractual protection, neglects to
negotiate for it.

These three cases outline the creditor injury tolerated by current
legal rules. Creditors are injured because they are precluded from ef-
ectic contractual protection by debtors' refusal to give it, by excessive
costs of negotiation, or by lack of foresight or sophistication. Smaller,
nonfinancial creditors seem especially prone to the last of these dis-
abilities, while the first, and to a lesser degree the second, are shared by
banks and other sophisticated lenders.

The gravity of creditor injury can also be influenced by the nature
which large businesses finance smaller ones). Such financing is a large and stable part of
the corporate financial framework. See R. Hungate, INTERBUSINESS FINANCING 11-14 (1962)
(Small Business Research Series No. 3) (for decade 1947-56, accounts payable by corpora-
tions averaged 136.6% of commercial bank business loans).

51. Mismanagement that would be actionable in a stockholders' derivative suit and
would, if carried far enough, breach a covenant in the credit contract, is not actionable
by creditors if stopped short of the point of breach. For instance, although conversion
of corporate property by directors might eventually breach a minimum working-capital
co ventant, illicit depletion of assets up to the point of breach cannot be prosecuted by
(Del. 1975) (plaintiffs alleging improper declaration of dividends by directors could not
claim any violation of their debenture indenture). Tighter specification of the covenants
cases this problem, but also increases both the complexity of the contract and the cost of
its negotiation and preparation. This in turn narrows the class of transactions for which
effective contractual protection is feasible.

If the covenants are drafted with sufficient care to "catch" a given act of misman-
gerage, the credit contract translates that act into an event of default, thereby allowing
the creditor or the trustee acting on behalf of debtholders to accelerate the maturity of
the debt. See AMERICAN BAR FOUNDATION, supra note 46, at 207, 217 (examples of such
default and acceleration clauses). It has been held that acceleration of indebtedness is an
adequate legal remedy against a solvent corporation, thus barring creditors from equitable
relief. See Kelly v. Central Hanover Bank & Trust Co., 11 F. Supp. 497, 510-12 (S.D.N.Y.
1935), rev'd on other grounds, 85 F.2d 61 (2d Cir. 1936). In contrast, shareholders frequently
seek and receive injunctive relief in derivative suits. See, e.g., Petty v. Penn-Tech Papers,
Inc., 347 A.2d 140 (Del. Ch. 1975) (temporary restraining order enjoining stock repurchases
for alleged purpose of maintaining management control); Rebell v. Muscat, 26 A.D.2d 685,
272 N.Y.S.2d 478 (1966) (preliminary injunction restraining increase or alteration of
corporate capitalization or debt structure).
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of the debtor corporation. If the corporation is closely held, creditors’ disabilities are magnified because the corporation’s shareholders and directors are likely to be the same people, and hence shareholders’ suits are improbable.

C. Policy Considerations

The creditors of a solvent corporation thus suffer injury from its mismanagement akin to that caused by the insolvency of the debtor corporation. Yet even if creditors cannot control mismanagement effectively by legal process or by contract, they can nevertheless anticipate it in the rates they charge. A creditor whose debtor is mismanaged is admittedly worse off than he would be if that mismanagement had not occurred. Investment, however, is probabilistic by nature; creditors must expect to lose interest or principal on a few loans, and can adjust their rates so loans that are fully paid make up the difference. Similarly, creditors must anticipate that events such as mismanagement will cause some investments to become less secure, even if payments are not missed. Characterizing a loss of either sort in any single credit transaction as legally cognizable injury disregards the essence of investment decisions.

53. If closely held corporations may be defined as those corporations with less than $5 million total assets, in 1973 there were 1,867,165 closely held and 37,505 public corporations that filed active corporation tax returns. INTERNAL REVENUE SERVICE, DEP’T OF TREASURY, 1973 CORPORATION INCOME TAX RETURNS 28. Creditors’ investments in closely held manufacturing corporations totaled $36.6 billion at the end of that year, as against investments of $319.3 billion in public manufacturing corporations. FEDERAL TRADE COMMISSION, QUARTERLY FINANCIAL REPORT FOR MANUFACTURING CORPORATIONS 50-51 (4th quarter 1973).

54. Such actions, however, do arise. The death or falling-out of business associates sometimes precipitates a shareholders’ suit in closely held corporations. See note 4 supra (citing cases).

55. This argument applies equally well to investments made by shareholders, indicating that a thorough justification for the existence of the shareholders’ derivative action would include an analysis of its systemic economic and social effects. The tendency of economic actors to allow for anticipated changes in market conditions is a familiar and important problem in economic-policy analysis. See, e.g., Lucas, Understanding Business Cycles, in STABILIZATION OF THE DOMESTIC AND INTERNATIONAL ECONOMY 7 (K. Brunner & A. Meltzer ed. 1977); Sargent & Wallace, Rational Expectations and the Theory of Economic Policy, 2 J. MONETARY ECON. 169 (1976). Furthermore, in some fields of law, expectations are taken into account to minimize the legal significance of economic impact. See, e.g., United States v. Willow River Power Co., 324 U.S. 499, 509-10 (1945) (power company took riparian interest subject to dominant public interest in navigation, therefore not entitled to compensation for federal government’s alteration of stream level); In re Valuation Proceedings, 445 F. Supp. 994, 1021-22 (Special Ct. 1977) (Friendly, J.) (“[W]hen an industry has long been the subject of direct and permanent regulation, governmental action is taken into account by those investing in it . . . [Provided that] government has not acted beyond its constitutional powers, a condemnee is not entitled to the recognition of values that have been impaired by . . . [such] government action.” (footnote omitted)).
The question of appropriate creditor rights, therefore, cannot be fully answered by the simple statement that every injury ought to have a remedy. Creation of a creditors' derivative action would occasion considerable changes in the corporate credit market, and the desirability of the action would depend in large part upon the value of these changes. This value, in turn, can be considered first from the point of view of the parties to the credit contract and then from a broader social perspective.

1. The Welfare of Contracting Parties

Creditors are clearly troubled by the prospect of intentional or negligent mismanagement depleting corporate assets during the term of their loans, particularly in small corporations in which there are few assets to deplete. Every "bad" loan weakens the lender's portfolio and ultimately lessens his chance of competitive success. It is small comfort that losses on a given loan may be recovered by charging higher interest rates, since competing creditors who are more successful in anticipating, detecting, and controlling mismanagement can charge lower rates. Against this backdrop of market competition, creditors concerned by mismanagement have negotiated contractual provisions with their debtors to deal with asset depletion, have attempted to bring derivative actions against directors, and in an unknown number of cases have refused to extend credit altogether.

A derivative action would attach a new legal right to creditors' investments that would allow creditors to control mismanagement more effectively. The existence of such a right would benefit creditors both directly and indirectly. Those with the resources and inclination to bring suit against directors would themselves attack mismanagement by legal process; less litigious creditors could shelter under the protec-

56. See Federal Reserve System, supra note 50, at 397; cf. id. at 414-15 (of 670 commercial-bank loan officers interviewed, 84% cited "questionable management ability" and 41% cited "poor moral risk" as "relatively important" factors leading to rejection of small business loan applications); Patterson, Credit Quality: Lessons of Recent Experience, J. Com. Bank Lending, Oct. 1976, at 17 (Chairman of Morgan Guaranty Trust asserts "character and experience of management" are of great importance in loan evaluation process; advises banks to "refuse to let profit considerations seduce us into doing business with people whose character we question").

57. See note 46 supra.

58. See notes 14 & 45 supra.

59. Cf. note 56 supra (importance of management ability and integrity in assessment of small business loan applications).

60. Although enforcement would not be without cost, the beneficial effect of the derivative action would not be wholly dissipated. Every creditor could be expected to enforce up to the point at which the marginal benefit to him equalled the marginal cost.
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tion provided by such suits.\textsuperscript{61}

The net effect of the creditors' action on the welfare of the contracting parties would depend on the impact of the action on both the creditor and the debtor. In two of the three paradigmatic cases of creditor injury,\textsuperscript{62} this welfare effect would be positive. When failure to reach a contractual agreement providing protection against mismanagement is attributable either to transactions cost or to creditor oversight, the existence of the derivative action would cause the creditor to be better off, and the debtor no worse off, for being able to enjoy the benefits that such an agreement would bring. In the remaining case, the fact that the debtor refuses to grant protection on terms acceptable to the creditor indicates that the creditor places less value on the right of action than the debtor places on freedom from it. Only in this case, then, would the existence of a derivative action cause a net welfare loss to the contracting parties.\textsuperscript{63}

The proportion of debtors that would refuse to give the protection that would be offered by a creditors' derivative action is probably not large. Refusal would occur mostly in closely held corporations, whose stock is not available on the market and whose affairs are not already scrutinized by public shareholders and their attorneys. Yet the standard of legal liability for directors of such corporations would be unaffected by the expansion of creditors' rights, since it would create no new substantive obligations. Directors would not be responsible for corporate losses beyond their control.\textsuperscript{64} Increased exposure to suit might

In this way he would maximize the benefit of the new action net of its cost. If the benefit to a given creditor were at all levels of enforcement less than its cost, he would not engage in this activity, yet still might benefit from the efforts of others, due to the "free rider" effect. See note 61 infra.

\textsuperscript{61} This could be called the "free rider" effect of the creditors' action: those creditors who cared to supervise and bring suit against debtors would decrease the risk of not only their own investments, but also the investments of other creditors who chose not to engage in such enforcement. Creditors' litigation could also help protect shareholders unlikely to sue due to lack of resources or sophistication.

\textsuperscript{62} See p. 1308 supra.

\textsuperscript{63} Debtors in the refusal case could be expected to respond to the existence of the creditors' action in several ways. Some closely held debtors might, for example, shift some or all of their debt financing to equity in order to avoid supervision by outside debt-holders. Others might simply shift to smaller creditors unlikely to enforce the derivative action against them. A few could be expected to leave the corporate sector, either by becoming unincorporated or by going out of business altogether. The remaining debtors would preserve their current legal status and financing arrangements and live with unwanted derivative action exposure. See note 83 infra (limitations on right of action could reduce welfare losses of some refusal-case debtors).

\textsuperscript{64} See Bishop, Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers, 77 YALE L.J. 1078, 1095-1101 (1968) (directors are seldom held liable in derivative litigation for mere negligence).
deter some entrepreneurs contemplating mismanagement, but strong social policies outweigh any welfare loss to such parties.

2. Social Welfare

The existence of a creditors' derivative action would invite closer supervision of debtors; before mismanagement can be prosecuted, it must be detected. One class of likely derivative-action plaintiffs would be those with a sizable financial stake in the debtor corporation, since for these creditors, some degree of supervision is routine business. Banks and other financial institutions supply a substantial amount of the financing for smaller corporations and have considerable investments in larger ones as well. They may also serve as trustees for 

65. Debtors' fear of harassing litigation, an understandable reason for refusal to give derivative-type protection to creditors, could be assuaged by restrictions on creditors' right of action. See note 83 infra.

Since a derivative right would be useless to creditors who did not have at least some access to the debtor's financial reports, some closely held debtors might refuse to give derivative rights in order to protect the privacy of those reports. One might question how many debtors would actually fall into this class, since larger lenders typically have access to debtors' balance sheets and profit and loss accounts, and credit bureaus and the financial press collect a considerable amount of financial data for the benefit of smaller creditors. See Bureau of Economic and Business Research, School of Business and Public Administration, Temple University, The Use of Financial Ratios and Other Financial Techniques and Services by Small Business ix, 1-4, 19 (1961) (interview survey of 299 "larger" small businesses in seven Pennsylvania cities; 82.5% who had recourse to bank financing had been required to submit balance sheet to bank; 61.6% profit and loss account as well; 69.3% had furnished financial statements to Dun & Bradstreet or other credit rating agency). One might also question the legitimacy of the privacy interest of corporations, which are "wholly artificial creation[s] whose internal relations . . . may be subject to most complete and penetrating regulation," Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 549 (1949). Nevertheless, there are limiting devices available to protect debtors' most pressing privacy concerns, and these could be employed to restrict creditors' right of action. See note 83 infra.

66. Adverse welfare effects on the parties could be virtually eliminated if creditors' derivative right were waivable by agreement. Then, whenever debtors valued freedom from creditor intervention more than creditors valued the right to intervene, they would insert a waiver clause into the credit contract reflecting this relative evaluation. But a waivable creditors' right would poorly serve important social goals of law enforcement and protection of minority shareholders, see pp. 1313-15 infra, since waiver would be likely to occur in cases in which directors strongly wished to preserve their freedom to mismanage with impunity.

67. Creditors with a large financial interest in the debtor tend also to be those with a longer-term interest. See Patterson, supra note 56, at 15-16. Compared to trade creditors whose claims may mature in 30 days, long-term lenders should be more concerned with mismanagement prior to the maturity of their claims.

68. In the first quarter of 1978, loans from banks accounted for 29.7% of the total liabilities (excluding stockholders' equity) of manufacturing, mining, and trade corporations with total assets under $5 million, and 11.8% of the total liabilities of such corporations with assets equal to or exceeding this amount. Federal Trade Commission, Quarterly Financial Report for Manufacturing, Mining and Trade Corporations 56-57 (1st quarter 1978).
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public debentureholders. In some trades a good deal of the capital of smaller companies is provided by larger, nonfinancial creditors who are often suppliers. The existence of a derivative right of action might encourage creditors like banks and large suppliers to monitor the finances and oversee the operations of their debtors more closely than before.

Though self-interest would motivate this additional supervision, its benefits might be felt by others, including debtors. Poor management is a problem in many companies, and in one form or another is responsible for a great number of business failures each year. Only a small portion of poor management is actionable "mismanagement," but careful oversight by commercially sophisticated creditors whose financial interest is coupled with working knowledge of the debtor's affairs could help to correct sloppy business practices, whether or not they could be the subject of litigation. The result might be fewer failures and less disruption in the business community.

Their sophistication aside, however, creditors are in many instances

69. See Trust Indenture Act of 1939, § 310(a), 15 U.S.C. § 77jij(a) (1976) (indenture trustee must be corporation with minimum combined capital and surplus of $150,000, authorized under laws of state of its incorporation to exercise corporate trust powers, and subject to supervision or examination by specified governmental authority).
70. R. Hungrate, supra note 50, at 105-41 (arrangements by which large supplier/distributors provide substantial, and indeed essential, finance to their smaller customers). For example, drug distributors often put in a base stock of inventory for new owner-operators, that ranges in value (in 1962) from $10,000 to $60,000. Id. at 121. Large feed mills finance equipment, perhaps worth $100,000, for their dealers and other small mills. Id. at 125. Such large trade creditors sometimes bring suit against directors of their debtors for mismanagement. See, e.g., Huron Milling Co. v. Hedges, 257 F.2d 258, 260 (2d Cir. 1958) (impairment of capital; long-term supplier held judgment for $15,353.88); Glenmore Distilleries Co. v. Seideman, 267 F. Supp. 915, 917 (E.D.N.Y. 1967) (fraudulent conveyance; supplier had judgment equal to $81,072.96 at time of suit).
71. Although such oversight could be formalized in, for example, periodic audits of the debtor's balance sheets, information gathered through more informal channels, such as contacts with other creditors or customers of the debtor, could well be more effective and less costly. See generally Left, Injury, Ignorance and Spite—The Dynamics of Coercive Collection, 80 Yale L.J. 1, 24-30 (1970) (describing credit-information network in business community).
73. See Dun & Bradstreet, The Business Failure Record 1975, at 12 (42.8% of business failures in 1975 were caused by management fraud (0.5%), neglect (1.1%), or incompetence (41.2%)).
74. See note 8 supra.
75. Oversight would also come from another, less obvious source. The existence of a right of action would encourage directors of closely held corporations (many subject for the first time to derivative liability) to purchase liability insurance. Insurers would have to satisfy themselves through independent investigation that the manner of operation of an applicant corporation rendered its directors insurable.
the only possible plaintiffs to vindicate the rights of closely held corporations and thus to hold directors to the standards of conduct embodied in corporate law. Offering a derivative right to creditors

76. Without a creditors' derivative right, causes of action of closely held corporations are often unenforceable by legal process. Legislatures considering the action may find instructive two lines of Supreme Court cases in which standards for judicial review have been relaxed to enforce rights that are otherwise unenforceable. In recent jus tertii cases, standing to assert the constitutional rights of third persons has depended upon the inability of such third persons to assert their own rights in timely and vigorous fashion. This requirement has been variously phrased, see, e.g., Singleton v. Wulff, 428 U.S. 106, 116 (1976) (plurality opinion of Blackmun, J.) ("some genuine obstacle" to third party's assertion of rights); id. at 126 (Powell, J., concurring in part and dissenting in part) (such assertion "in all practical terms impossible"); Griswold v. Connecticut, 381 U.S. 479, 481 (1965) (third-person rights "likely to be diluted or adversely affected" unless standing granted). Often, of course, the corporation meets even the strictest standard of incapacity set out in these cases, since a majority of its directors and shareholders are implicated in the mismanagement, and thus it is "in all practicable terms impossible" for the corporation to enforce its cause of action.

The Court has reiterated its concern for enforcing otherwise unenforceable legal rights in its mootness cases. Review has sometimes been granted when it might otherwise be denied, if the asserted injury is "capable of repetition, yet evading review." Southern Pac. Terminal Co. v. ICC, 219 U.S. 498, 515 (1911), quoted in Sosna v. Iowa, 419 U.S. 393, 399-400 (1975); see Moore v. Ogilvie, 394 U.S. 814, 816 (1969). Again, the analogy is useful: director misconduct in many closely held corporations "evas[es] review" unless it leads to insolvency within the statutory limitations period. Nor can this analogy be dismissed by the simple observation that these cases involve the constitutional rights of natural persons, whereas derivative litigation deals with the rights of corporations. Enforcement of the corporation's rights through derivative litigation is perhaps the most effective way to enforce corporate law, a policy of clear social importance.

77. The enforcement of corporate law has independent significance if directors' duties ought to be enforced even when their breach does not injure the corporation and its creditors. Corporate law may seek to maintain public confidence in the integrity of management, compare Magida v. Continental Can Co., 231 F.2d 843, 846 (2d Cir.), cert. denied, 331 U.S. 972 (1958) (interpreting § 16(b) of Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1970)) ("policy of the statute is to protect minority stockholders and the public against manipulated market fluctuations") with Champion Home Builders Co. v. Jeffress, 490 F.2d 611, 619 (6th Cir.), cert. denied, 416 U.S. 986 (1974) (absence of corporate damage irrelevant in assessing § 16(b) liability), or it may seek to enforce concepts of morality regarding "fair play" by directors, cf. Deutsch, Correspondence, 88 YALE L.J. 235 (1978) (bona fides of management can only be enforced by corporate law flexible enough to adjust to entrepreneurs' attempts to circumvent fixed legal rules). In simplest terms, corporate law may enforce the notion that corporate directors should under no circumstances profit from knowing breaches of trust. See Meinhard v. Salmon, 249 N.Y. 458, 464-65, 164 N.E. 545, 546-47 (1928) (Cardozo, J.) (standard of fiduciary duty is "[n]ot honesty alone, but the punctilio of an honor the most sensitive"); liability imposed even though there was no proof of injury resulting from breach of trust).

Concern for law enforcement both to redress injury and to maintain fiduciary standards has played an important role in the development of the shareholders' derivative action. See Ashwander v. TVA, 297 U.S. 288, 321-22 (1936) (granting standing to preferred shareholders to bring derivative action) ("[T]he owners of preferred stock may be the only persons having a proprietary interest in the corporation who are in a position to protect its interests against what is asserted to be an illegal disposition of its property. A court of equity should not shut its doors against them.") (footnote omitted)); Diamond v. Oreamuno, 24 N.Y.2d 494, 503, 228 N.E.2d 910, 915, 301 N.Y.S.2d 78, 85 (1969) (allowing derivative action regardless of lack of allegation of injury to corporation) ("There is
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would allow private enforcement actions to reach a large class of corporations from which they are foreclosed today, thereby encouraging more honest behavior on the part of corporate management.

III. Limitations on the Creditors' Right of Action

Expansion of creditors' rights would entail the possibility of abuse by creditors' attorneys, who could bring groundless actions to earn contingent fees from settlement, and by creditors themselves, who might use the threat of litigation as a lever to accelerate the maturity of their claims. Conflicts of interest among plaintiffs could pose an additional problem, since competitors who were nominal creditors of the corporation could bring derivative suits intended primarily to harass management. These problems are real, but also familiar. The specter of meritless litigation has haunted shareholders' derivative actions since their inception, and various limiting devices have evolved in response. Most of these devices could be employed in analogous forms in creditors' suits.

ample room ... here ... for a 'private Attorney General' to ... enforce proper behavior on the part of corporate officials through the medium of the derivative action ... Only by sanctioning such a cause of action will there be any effective method to prevent the ... abuse of corporate office complained of." (citations omitted)).

78. See notes 53 & 54 supra (closely held corporations).

79. The encouragement of managerial honesty has in fact played a considerable role in the development of derivative remedies. For example, the California legislature recently suspended the contemporaneous-ownership requirement in shareholders' suits, see note 82 infra, when the plaintiff can make a preliminary showing that, inter alia, "no other similar action has been or is likely to be instituted," CAL. CORP. CODE § 800(b)(1)(i)(ii) (West 1977), and "unless the action can be maintained the defendant may retain a gain derived from defendant's willful breach of a fiduciary duty," id. § 800(b)(1)(i)(iv).

80. A creditor might wish to accelerate his loan even in the absence of mismanagement if, for example, interest rates had increased since the date of the loan. Requiring courts to supervise settlements of creditors' actions could largely eliminate arm-twisting of this sort, since the institution of legal process would itself prevent creditors from obtaining a self-serving compromise of their claim against directors. See p. 1317 infra.

81. In 1944 a special committee of the New York Chamber of Commerce reported that the filing of meritless derivative suits by shareholders in that state had become a "marked epidemic proportions." Comment, supra note 34, at 634-35. The New York security-for-expenses statute was adopted in response to that report. See W. Cary, supra note 46, at 931-32. For a virulent critique of both the report and the statute, see Horstein, The Death Knell of Stockholders' Derivative Suits in New York, 32 CALIF. L. REV. 123 (1944).

82. These devices include requirements that plaintiffs: (1) hold a minimum number of shares at the time of the alleged misconduct (the contemporaneous-ownership rule); (2) make prior demand for action upon directors and perhaps shareholders; (3) furnish security-for-expenses bonding; (4) adequately represent the interests of the class of shareholders; and (5) submit to court scrutiny of settlements. Different rules have evolved in different jurisdictions, and any given jurisdiction may not have adopted all of these limitations. See generally Note, Derivative Suits—Mechanics, Motives and Suggested Improvements, 36 B.U. L. REV. 78, 78-91 (1956).

83. The purpose of these limiting devices would be to strike a reasonable balance between debtors' welfare on the one hand and the social value of law enforcement on the
As a first step, creditor-plaintiffs should be required to show that they held an obligation of the debtor corporation when the alleged mismanagement occurred, and that they continue to hold the obligation at the time of suit. Failure to adopt these rules would enlarge the class of potential derivative-action plaintiffs to include those who acquired a claim against the corporation with the intention of bringing suit, and those whose only remaining interest would be the prosecution of an action against directors. Litigation by such plaintiffs could be greatly abused, since their sole interest might be settlement for personal, not corporate, benefit. Debtors' legitimate interest in protection from such "strike suits" seems to outweigh any law-enforcement value they might have.

Experience with shareholders' suits suggests, however, that these rules alone would not control abuse of the creditors' action. Creditors

other. Debtors' welfare would be of concern only in the refusal case, since only in that case would the existence of the derivative action have an adverse effect. See p. 1311 supra. The limiting devices would attempt to distinguish among debtors on the basis of their reason for refusal: (1) the need to avoid creditor supervision in order to accomplish contemplated mismanagement; (2) the desire for privacy for legitimate business reasons; or (3) the fear of strike suits and meddlesome litigation. See pp. 1311-12 & note 65 supra. If refusals were always motivated by a single one of these reasons, an ideal limiting device would foreclose all actions against debtors whose refusal was motivated by reasons (2) or (3), and foreclose none against debtors motivated by reason (1). Such a device would eliminate all adverse effects on debtor welfare except those arising from an efficient law-enforcement policy. In practice, however, this degree of discrimination would probably be unattainable, since practicable limiting devices could not distinguish among debtors on the basis of their undisclosed motivation, especially if some debtors had mixed motives for refusing to grant contractual protection. The limiting rules presented here try to approximate ideal discrimination by falling most heavily upon plaintiffs who would seem unlikely to bring meritorious claims with an intention to press them forcefully to a conclusion.

84. In the context of the shareholders' suit, this is the contemporaneous-ownership rule. See note 82 supra. A creditor who could not satisfy the rule would have suffered no injury from mismanagement, in either sense in which the term "injury" is used in this Note. He would not have been injured according to standard financial analysis, because the risk of his investment would not have changed since he made it. See pp. 1305-06 supra. Nor would he have been injured in an expectational sense: even if he did not know of the mismanagement at the time he acquired his claim, he could have been expected to realize that the risk of corporate investments is sometimes greater than it appears to be due to undetected mismanagement in the past. See p. 1309 supra.

85. This is a common if not universal requirement in shareholders' actions. See, e.g., N.Y. Bus. Corp. Law § 626(b) (McKinney 1963); 3B Moore's Federal Practice § 23.1.17 (2d ed. 1978) (discussing Fed. R. Civ. P. 23.1). In conjunction with the contemporaneous-debt requirement, see note 84 supra, it would tend to foreclose suits by "roll-over creditors," i.e., creditors who provide more or less permanent lines of credit to the corporation through a series of short-maturity loans. Empirically, however, this class of creditors may not be significant, since industry studies indicate that longer-term financing, even that supplied by trade creditors, tends to utilize credit devices of some permanence. See R. HUNGATE, supra note 50, at 105-41. Should this treatment of roll-over creditors appear too harsh, however, an alternative would be to suspend the contemporaneous-debt requirement, provided the plaintiff had no knowledge of the alleged mismanagement prior to acquiring his claim.
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satisfying both rules could still be expected to bring suits of questionable merit motivated by the prospect of lucrative settlements. In the context of the shareholders' action, security-for-expenses bonding is the traditional legislative response. A more extreme alternative would be outright limitation of the right of action to creditors with a substantial financial stake in the corporation. The required investment could be specified either as a proportion of total corporate assets or as a fixed dollar sum, say $10,000. Bonding seems preferable since directors would otherwise have the option of avoiding creditor supervision altogether by not soliciting credit from any single source in excess of the statutory exemption. Whether the right of action is limited absolutely or conditioned upon bonding, court supervision of settlements could help eliminate private deals between creditor-plaintiffs and directors which compromise the rights of the corporation, its shareholders, or other creditors.

Predatory litigation by competitors who acquired a claim against the corporation in order to bring suit would present a separate problem. Predation could be largely controlled by a requirement that the plaintiff fairly and adequately represent the interests of the class of creditors. This requirement would bar a creditor from prosecuting an action if it appeared to the court that his interests in so doing would be inimical of those of the corporation and its other creditors.

Creditors, like shareholders, should be required to make demand upon the board of directors to bring suit before proceeding with a suit of their own. Aside from the fact that compliance with such a

86. See, e.g., CAL. CORP. CODE §§ 800(d), (e) (West 1977); N.Y. BUS. CORP. LAW § 627 (McKinney Supp. 1978).
87. For example, no creditor could bring suit unless his claim at the time suit was brought equalled at least five percent of total corporate assets.
88. Outright limitation of the right of action would, however, furnish quite effective protection for debtors' privacy interest, see note 65 supra, since it would absolutely bar creditors from bringing derivative actions and hence from inspecting corporate documents. It might, moreover, be attractive politically, since a moderate fixed-dollar specification would have the effect of excluding very small debtors altogether.
89. Directors could thus attain, in effect, a waiver of the creditors' derivative right, an undesirable result on public policy grounds. See note 66 supra.
90. This requirement already exists for shareholders' suits brought in federal court. FED. R. CIV. P. 23.1. Its dual purposes there are to lessen the chance of meritless litigation and to "prevent the unrighteous compromise of a just shareholder's action." 3B MOORE'S FEDERAL PRACTICE, supra note 85, ¶ 23.1.24[1], at 129. It would have the same effect in creditors' suits.
93. Cf. CAL. CORP. CODE § 800(b)(2) (West 1977) (shareholders' suits); N.Y. BUS. CORP. LAW § 620(c) (McKinney 1963) (same).
demand would make a creditors' action unnecessary, the cumulative effect of creditors' demands might be beneficial to the efficient management of the corporation. The demand requirement should be waived, however, if a majority of directors participated in the alleged mismanagement, because demand would then be fruitless.

Demand upon shareholders should not be required, nor ratification by them allowed. The statute creating the derivative right of action would recognize creditors' interest in the financial integrity of solvent corporations. Ratification could deprive creditors of the ability to protect that interest; it could, moreover, foreclose creditors' suits in precisely those situations in which they would be most useful. Shareholders, or directors in control of the proxy machinery, should not be allowed to frustrate in this manner creditors' attempts to enforce their new legal rights.

Conclusion

The corporation at its best is an exceedingly effective device for raising capital at limited risk. At its worst it may be employed by an entrepreneur to shield himself from the claims of creditors while he expropriates corporate property for his personal benefit. The insolvency remedies have evolved to deter this sort of conduct and to compensate creditors injured by it. But these remedies reach only a portion of the conduct injuring creditors, that occurring at or near the point of insolvency. A derivative right of action could close this important gap in creditors' remedies and serve society's interest in promoting honest conduct on the part of corporate management.

94. Cf. Note, Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit, 73 HARY. L. REV. 746, 748 (1960) (recognizing such effect in shareholders' suits).
96. It is widely recognized that a majority of shareholders cannot vote to ratify management conduct constituting "fraud" upon a dissenting minority. See 1 G. HORNSTEIN, CORPORATION LAW & PRACTICE § 358 (1959 & Supp. 1968). Courts have never had occasion to decide whether ratification by 100% of shareholders could bar a derivative action by creditors against directors. A decision that it could not seems to follow from the nature and purposes of the creditors' right of action. This conclusion should apply to all forms of mismanagement actionable in the creditors' suit, whether or not they could be denominated "fraud."
97. See THE ECONOMIST, Dec. 18, 1926, at 1058 (inventor of principle of limited liability deserves place of "honour with . . . pioneers of the Industrial Revolution. The genius of these men produced the means by which man's command of natural resources was multiplied . . .; limited liability . . . [produced] means by which the huge aggregations of capital required to give practical effect to their discoveries were collected, organised, and efficiently administered").