My Creditor's Keeper: Escalation of Commitment and Custodial Fiduciary Duties in the Vicinity of Insolvency

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Abstract

Fiduciary duties in the vicinity of insolvency form a notoriously murky area, where legal space warps. Courts openly acknowledge that it is exceptionally difficult to identify its boundaries, and the content of these duties is equally uncertain and inconsistent across jurisdictions. This paper expands the theoretical basis for a special legal regime in virtually or liminally insolvent firms. In addition to the conventional rationale of opportunistic risk shifting, law makers should be mindful of managers' tendency to unjustifiably continue failing projects, known as escalation of commitment. Second, this paper addresses the substantive content of a duty to protect creditors, either as a duty to consider creditors' interest or as the rule against wrongful (or insolvent, or reckless) trading. When these duties are enlivened, at the very edge of the zone of insolvency, the mission of directors should transform from entrepreneurial to custodial and should include a trustee-like duty of caution.

Keywords: corporate governance, fiduciary duties, stakeholders, creditors, vicinity of insolvency, zone of insolvency

JEL Classifications: K22

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I. INTRODUCTION

In several common law systems, creditors of corporate debtors enjoy legal protections beyond what their contracts with those companies afford them. These protections cover both large and small creditors, voluntary and involuntary ones alike. They derive from various duties, imposed on directors and other corporate fiduciaries by common law or by statute, that call for considering and sometimes promoting creditors' interests before the latter take over the company through formal bankruptcy proceedings - at the stage that is metaphorically described as the "vicinity" or "zone of insolvency".

The vicinity-of-insolvency duties form a notoriously murky area, where legal space warps. The contours of this area are fuzzy. Courts openly acknowledge that it is exceptionally difficult to identify clear guide posts for its threshold - as to when exactly these duties are enlivened. The content of these duties is equally uncertain and is not conceptually consistent across jurisdictions. At one end of the spectrum, Delaware law denies the legal existence of a zone of insolvency, thus relieving itself - and purportedly, also directors - of the need to consider creditors' interests outside of bankruptcy. At the other end, Canadian law locates shareholders' and creditors' interests at the same level, assigning no priority to any one of them *a priori*. In this view, creditors constitute one stakeholder constituency among several, including shareholders, employees, etc., whose interests directors should balance. Somewhere in a notional middle ground, the laws of several countries struggle to give concrete content to the duty to consider creditors' interest in the vicinity of insolvency. This is where we find the United Kingdom and Australia, for example.

The goal of this Article is two-fold. First, it expands the theoretical basis for a special legal regime in virtually insolvent or liminally insolvent firms. The standard account that is usually invoked to explain and justify special fiduciary duties to consider creditors' interest points to the danger of opportunistic high-risk behavior by managers on behalf of shareholders. I argue that this account may be sound but is nonetheless lacking. In addition to such opportunism, law makers should also be mindful of managers' tendency to unjustifiably continue failing projects, known as escalation of commitment. Unlike opportunistic risk-shifting, for which empirical evidence is surprisingly sparse, escalation of commitment is an irrational factor that has been widely documented and studied but has been largely neglected by legal scholars.

Second, this Article addresses the substantive content of the duty to protect creditors where such duties are recognized, either as a duty to consider creditors' interest or as the rule against wrongful (or insolvent, or reckless) trading. I argue that when these duties are enlivened, at the very edge of the zone of insolvency, the mission of directors should transform from entrepreneurial to custodial. That is, they should implement strategies that aim to preserve the firm - in working condition, to the extent possible, with a view to resuming regular business - but avoid seeking new projects with a view to maximizing profits. This could mean that the shield of the business judgment rule may not be available to the same extent as in regular circumstances. The Covid-19 pandemic that swept the globe in 2020 provides a fresh context for this approach and underscores the need to implement such a regime sensibly, with high deference to business decisions even if outside the scope of the business judgment rule.

The Article proceeds as follows. Part II addresses the role of creditors as corporate stakeholders and its legal implications for directors' duty to promote the company's interests. Next, it briefly reviews the problem of anti-creditor opportunism and presents the possibly bigger problem of escalation of commitment. Part III sets forth the custodial duties in the vicinity of insolvency. Part IV provides a comparative analysis of creditor-oriented duties in several common law jurisdiction and examines how they could implement a custodial approach. Part V concludes.

II. CREDITORS AS AN ENDANGERED SPECIES

The common wisdom in corporate finance and corporate law points to conflicts of interest between shareholders and creditors and notes that the latter are vulnerable to abuse by the former. These tensions are often described as an "agency problem" and the losses due to them are sometimes called "agency costs of debt". These are misnomers, however. Unlike managers, who are agents for the company and indirectly for shareholders, shareholders do not stand in the same position vis-àvis creditors.[1] There is no mission or project that creditors entrust to shareholders, and shareholder-appointed managers do not work for or on behalf of creditors. It is more accurate therefore to refer to opportunistic behavior by shareholders, through company managers, to the detriment of creditors, in the Williamsonian sense - namely, by exploiting transaction costs of contract formation, information asymmetry, vulnerability due to specific investment, etc.[2]

The economic literature has identified several mechanisms with which shareholders can opportunistically exploit creditors' vulnerability through risk shifting.[3] In the basic setting, shareholders appoint managers to operate the firm for profit and enjoy limited liability, such that creditors have recourse only to the company's assets, the company being a separate legal entity. This setting assumes that only property law and contract law apply (i.e., no fiduciary duties); the shareholder-manager agency problem is assumed away for convenience.[4] These mechanisms share a common feature, by which creditors are made to bear non-priced business risk after the credit terms - particularly, the interest rate - have been set. Assuming that higher business risk is accompanied by higher expected returns, shareholders enjoy the upside of increased risk without being fully exposed to its downside, which is borne by the creditors.

The literature identifies three major risk-shifting mechanisms: asset dilution, claim dilution, and asset substitution.[5] Asset dilution involves siphoning value away

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[1] *Nota bene:* with regard to creditors' interest and not, or not necessarily, to creditors directly. In line with standard legal convention, I take directors' duties to be owed to the corporation.

[2] *See* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 47-48 (1975); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 26-27 (1985); *see* also Armen A. Alchien & Susan Woodward, *The Firm is Dead; Long Live the Firm: A Review of Oliver E. Williamson's The Economic Institutions of Capitalism*, 26 J. ECON. LIT. 65 (1988).

[3] The following draws mainly on Smith and Warner's seminal article. Clifford W. Smith, Jr. & Jerold B. Warner, *Bankruptcy, Secured Debt, and Optimal Capital Structure: Comment*, 34 J. FIN. 247 (1979). *See* also the obligatory Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). For a summary *see* John Armour, Gerard Hertig & Hideki Kanda, *Transactions with C*reditors, in REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 109 (4th ed. 2017).

[4] In a more skeletal setting, an individual takes debt from creditors. The debtor-creditor opportunism analysis is similar but we are here interested in director duties.

[5] The terminology for these mechanisms varies in different accounts but their essence is similar. Some authors distinguish additional mechanisms - e.g., Smith and Warner, *supra* note 3 (discussing underinvestment).

from the company, either legitimately (e.g., through dividend payouts) or illegitimately (e.g., through self-dealing, also known as "tunneling").[6] When creditors seize the company upon default and insolvency, the remaining assets do not match the risk they bargained for. Claim dilution works similarly to diminish the scope of the collateral available to creditors upon default, but instead of depleting the company's assets it increases its liabilities by taking on more debt - again, beyond what the creditors have envisaged and priced. Finally, asset substitution stands for post hoc changes in the firm's line of business - specifically, by entering into higher-risk-higher-return projects. In the now-lower-likelihood event that those projects succeed, shareholders will garner the higher rewards, while creditors become more likely to end up with whatever scraps that remain in the company upon liquidation.

The effect of all of these mechanisms is the same - namely, exploitation and frustration. However, because risk shifting as described above is such a child's play, most creditors realize its prospects and take measures to hedge against it by adjusting credit terms. There is ample evidence that beyond setting interest rates in line with foreseeable risks, resourceful creditors design loan contracts (debentures) to accommodate particularly pertinent risks with appropriate covenants.[7] Moreover, participants in certain debt markets appear to identify and price such covenants and to penalize corporate debtors for breaching these obligations, thus providing incentives for optimal contracting and for compliance.[8] In fact, there is surprisingly little evidence that corporate debtors can *successfully* engage in opportunistic risk shifting to extract value from creditors. The available empirical evidence relates largely to publicly traded debt instruments. While there is evidence for increased risk taking,[9] evidence for risk *shifting* is sparse. Such risk shifting appears to take place only in

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[6] *See* Simon Johnson *et al.*, *Tunneling*, 90 AM. ECON. REV. PAPERS & PROC. 22 (2000); Vladimir Atanasov *et al.*, *Law and Tunneling*, 37 J. CORP. L. 1 (2011).

[7] *See* Smith & Warner, *supra* note 3; *see* also George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073 (1995). For a recent study *see*, e.g., Barry E. Adler & Vedran Capkun, *Debt-Equity Conflict and the Incidence of Secured Credit*, 62 J. L. & ECON. 551 (2019).

[8] *See* John R. Graham *et al.*, *Corporate Misreporting and Bank Loan Contracting*, 89 J. FIN. ECON. 44 (2008).

[9] *See*, e.g., Giovanni Favaraa *et al.*¸*Debt Enforcement, Investment, and Risk-Taking across Countries*, 23 J. FIN. ECON. 22 (2017); Anna N. Danielova, Sudipto Sarkar, & Gwangheon Hong, *Empirical Evidence on Corporate Risk-Shifting*, 48 FIN. REV. 443 (2013).

limited circumstances.[10] In summary, while risk shifting may not be a myth, its actual severity is unclear at this stage.

The persuasive power of the risk shifting account is so compelling that lawyers have bought whole-heartedly into it. This is especially the case with regard to unbridled asset substitution by embarking on high-risk projects and claim dilution by taking on new debt, possibly because illicit asset dilution is covered by a battery of legal doctrines against self-dealing and fraudulent conveyances.[11] Paul Davies thus opined:

> [O]nce the shareholders' equity has been dissipated, or has been reduced to a very low level, and there is no prospect of its being rebuilt through the company's established business model, the incentive for company controllers (if acting in the shareholder interest) is to take on excessively risky projects, for their attention can focus exclusively on the potential upside of decisions.[12]

Authors writing from both common-law and civil-law perspectives share this view.[13] In *Moulin Global Eyecare Holdings Ltd. v. Mei* in the Hong Kong Court of

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[10] For financial economic studies finding no or very limited evidence for effective (i.e., abusive) risk shifting, *see* Kevin Aretz, Shantanu Banerjee, & Oksana Pryshchepa, *In the Path of the Storm: Does Distress Risk Cause Industrial Firms to Risk-Shift?*, 23 REV. FIN. 1115 (2019); Pablo Hernández-Lagos, Paul Povel, & Giorgo Sertsios, *An Experimental Analysis of Risk-Shifting Behavior,* 6 REV. CORP. FIN. STUD. 68 (2017); Erik Gilje, *Do Firms Engage in Risk-Shifting? Empirical Evidence*, 29 REV. FIN. STUD. 2925 (2016); Oksana Pryshchepa, Kevin Aretz, & Shantanu Banerjee, *Can Investors Restrict Managerial Behavior in Distressed Firms?*, 23 J. CORP. FIN. 222 (2013); Assaf Eisdorfer, *Empirical Evidence of Risk Shifting in Financially Distressed Firms*, 63 J. FIN. 609 (2008); B. Espen Eckbo & Karin S. Thorburn, *Control Benefits and CEO Discipline in Automatic Bankruptcy Auctions*, 69 J. FIN. ECON. 227 (2003); Gregor Andrade & Steven N. Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*, 53 J. FIN. 1443 (1998). For evidence in line with risk shifting, *see* Keming Li *et al*., *Risk-Shifting, Equity Risk, and the Distress Puzzle*, 44 J. CORP. FIN. 275 (2017). For surveys finding little support for the risk-shifting account, *see* John R. Graham & Campbell R. Harvey, *The Theory and Practice of Corporate Finance: Evidence From the Field*, 60 J. FIN. ECON. 187 (2001); Abe DeJong & Ronald VanDijk, *Determinants of Leverage and Agency Problems: A Regression Approach with Survey Data*, 13 EUR. J. FIN. 565 (2007). *See* also Itzhak Ben-David, Ajay A. Palvia, & Rene M. Stulz, How Important Is Moral Hazard For Distressed Banks? European Corporate Governance Institute – Finance Working Paper No. 681/2020 (2020) (finding that financially distressed banks reduce their leverage and decrease observable measures of riskiness, which is inconsistent with the view that moral hazard incentives would motivate them to take advantage of the bank safety net).

[11] *See*, e.g., Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505 (1977).

[12] Paul Davies, *Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency*, 7 EUR. BUS. ORG. REV. 301, 306 (2006).

[13] *See*, e.g., Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT'L REV. L. & ECON. 223, 228 (1991); Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575, 576-577 (1995); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 909 (1986); Andrew Keay, *Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors*, 66 MOD. L. REV. 665, 675 (2003); Kristin van Zwieten, *Director Liability in Insolvency and Its Vicinity*, 38 OXFORD J. LEGAL STUD. 382, 383 (2018);

Final Appeal, Gummow NPJ (formerly a Justice of the High Court of Australia) also adopted Davies's analysis.[14]

As empirical evidence on risk shifting is starting to accumulate, some legal authors also begin to pay attention to the empirical challenge and note that is does not support the risk shifting account as a major source of concern.[15] In tandem, there also seems to be a consensus that small and involuntary creditors - in particular, trade and tort creditors, respectively - cannot fully hedge against risk shifting and thus remain vulnerable to shareholder opportunism.[16] These modes of shareholder opportunism are less amenable to rigorous empirical testing by financial economists.

III. ESCALATION OF COMMITMENT

As noted in the preceding section, the legal discourse on creditors as corporate stakeholders focuses on risk shifting, such that legal policy is guided by basic economic theory, common sense, and mostly anecdotal evidence. This section aims to enrich the analytical framework by pointing to escalation of commitment as a potent factor in the dynamics of business. Escalation of commitment has been largely overlooked by legal scholars thus far, despite its pertinence to designing legal policy for the vicinity of insolvency.[17] It is submitted that escalation of commitment poses an equal, if not greater, challenge than risk shifting does to optimal regulation of companies in looming or virtual insolvency.

Horst Eidenmüller, *Trading in Times of Crisis: Formal Insolvency Proceedings, Workouts and the Incentives for Shareholders/Managers*, 7 EUR. BUS. ORG. REV. 239, 243 (2006); Gerald Spindler, *Trading in the Vicinity of Insolvency*, 7 EUR. BUS. ORG. L. REV. 339, 340 (2006); Aurelio Gurrea-Martínez, *The Avoidance of Pre-Bankruptcy Transactions: An Economic and Comparative Approach*, 93 CHI.-KENT L. REV. 711, 726 (2018).

[14] [2014] HKCFA 63 (H.K.), at para. 50.

[15] Some authors have pointed out the empirical question. *See*, e.g., Armour *et al*, *supra* note 3, at 111; Aurelio Gurrea-Martínez, *The Avoidance of Pre-Bankruptcy Transactions: An Economic and Comparative Approach*, 93 CHI.-KENT L. REV. 711, 726 (2018).

[16] For a few exceptions that have dealt with it in other contexts *see* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991).

[17] *See* Hanjo Hamann, *Unpacking the Board: A Comparative and Empirical Perspective on Groups in Corporate Decision-Making*, 11 BERKELEY BUS. L.J. 1, 45-46 (2014); Michael E. Murphy, *Assuring Responsible Risk Management in Banking: The Corporate Governance Dimension*, 36 DEL. J. CORP. L. 121, 155-156 (2011); Andrew J. Wistrich & Jeffrey J. Rachlinski, *How Lawyers' Intuitions Prolong Litigation*, 86 S. CAL. L. REV. 571, 619-620 (2013).

When a project that has consumed substantial resources fails to deliver or to progress as planned, its managers face a dilemma: should they invest additional resources in the hope that it reaches fruition or should they discontinue it and declare failure? Continuing a struggling project could reflect perseverance, resolution, and determination - sticking to one's guns; but it could also stem from managerial failure to face reality and act on current information - sticking one's head in the sand. Escalation of commitment refers to a broad phenomenon, in which decision makers adhere to a failing project despite strong indications that it should be aborted. Introduced in a seminal 1976 article by Barry Staw,[18] escalation of commitment has since been studied in hundreds of articles.[19] It is primarily an individual-level phenomenon linked to personal attributes such as biases in decision making. But escalation of commitment also varies with context, including organizational context and societal-level factors.

People tend to remain married to their original choices and to commit resources to them even when it is no longer rational for them to do so. Behavioral scientists have identified several psychological factors that influence this tendency. The sunk cost fallacy is a prime factor. Although economic theory teaches that investment decisions should focus on future gains or losses, in actuality, people take non-recoupable past expenditure into account as a consideration for remaining invested or even continuing to invest rather than pulling the plug. Falling prey to the sunk cost fallacy has been related to personal motivation to avoid negative feelings associated with acknowledging failure and loss.[20] Camerer and Weber note that although escalation of commitment and the sunk cost fallacy are essentially the same

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[18] Barry M. Staw, *Knee-Deep in the Big Muddy: A Study of Escalating Commitment to a Chosen Course of Action*, 16 ORGANIZATIONAL BEHAVIOR & HUMAN PERFORMANCE 27 (1976) (hereinafter Staw 1976); *see* also Barry M. Staw, *The Escalation of Commitment to a Course of Action*. 6 ACAD. MGM'T REV. 577 (1981).

[19] *See* Dustin J. Sleesman *et al.*, *Cleaning up the Big Muddy: A Meta-Analytic Review of the Determinants of Escalation of Commitment*, 55 ACAD. MGM'T J. 541 (2012) (hereinafter Sleesman *et al*. 2012); Dustin J. Sleesman *et al.*, *Putting Escalation of Commitment in Context: A Multilevel Review and Analysis*, 12 ACAD. MGM'T ANNALS 178 (2018) (hereinafter Sleesman *et al*. 2018); *see* also Helga Drummond, *Escalation of Commitment: When to Stay the Course?*, 28 ACAD. MGMT. PERSPECTIVES 430 (2014).

[20] *See* Hal R. Arkes & Catherine Blumer, *The Psychology of Sunk Cost*, 35 ORG. BEHAV. & HUM. DECISION PROCESSES 124 (1985); Hal R. Arkes & Peter Ayton, *The Sunk Cost and Concorde Effects: Are Humans Less Rational Than Lower Animal*s, 125 PSYCH. BULL. 591 (1999); *see*, more recently, e.g. Gilead Feldman & Kin F.E. Wong, *When Action-Inaction Framing Leads to Higher Escalation of Commitment: A New Inaction-Effect Perspective on the Sunk-Cost Fallacy*, 29 PSYCHOL. SC. 537 (2018).

phenomenon, escalation is broader, since forms of commitment other than previous economic expenditures could drive it - e.g., a verbal commitment. They empirically find that irrational escalation is in fact broader than sunk-cost-related errors.[21] Self-justification is another factor that has been related to escalation of commitment. In this view, the need to protect one's self-identity could motivate escalation by those who made the original decision.[22] Self-presentation theory offers a related factor, in that decision makers adhere to prior decisions notwithstanding negative information in order to avoid the embarrassment of admitting a mistake.[23] More generally, people have been found to escalate in order to avoid the associated negative affect (bad feelings such as anger, regret, anxiety, etc.).[24] Last but not least, rational, agency-type self-interestedness could also motivate escalation.[25, 26]

Escalation of commitment is ubiquitous. In addition to experimental settings, it has been observed and studied in organizations large and small, in business corporations and in the public sector. Importantly for the present context, owner-managers, family firms, and venture capital firms exhibit escalation of commitment

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[21] *See* Colin F. Camerer & Roberto A. Weber, *The Econometrics and Behavioral Economics of Escalation of Commitment: A Re-Examination of Staw and Hoang's NBA data*. 39 J. ECON. BEHAVIOR & ORG. 59 (1999).

[22] *See* Staw, *supra* note 18; Joel Brockner *et al.*, *Escalation of Commitment to an Ineffective Course of Action: The Effect of Feedback Having Negative Implications for Self-Identity*, 31 ADMIN. SC. Q. 109 (1986); Joel Brockner, *The Escalation of Commitment to a Failing Course of Action: Toward Theoretical Progress*, 17 ACAD. MGMT. REV. 39 (1992). Sleesman *et al.* 2012, *supra* note 19, mention several other individual-level accounts, which have gained lesser attention in subsequent research, including

[23] *See* Joel Brockner *et al.*, *Face-saving and Entrapment*, 17 J. EXPERIMENTAL SOC. PSYCHOL. 68 (1981).

[24] *See* Kin Fai Ellick Wong, Michelle Yik, & Jessica Y. Y. Kwong, *Understanding the Emotional Aspects of Escalation of Commitment: The Role of Negative Affect*, 91 J. APP'D PSYCHOL. 282 (2006); Kin Fai Ellick Wong & Jessica Y.Y. Kwong, *The Role of Anticipated Regret in Escalation of Commitment*, 92 J. APP'D PSYCHOL. 545 (2007); Ming-Hong Tsai & Maia J. Young, *Anger, Fear, and Escalation of Commitment*, 24 COGNITION & EMOTION 962 (2010); Alexander T. Jackson *et al.*, *The Reciprocal Relationships between Escalation, Anger, and Confidence in Investment Decisions Over Time*, 9 FRONT PSYCHOL. 1136 (2018); Koen A. Dijkstra & Ying-yi Hong, *The Feeling of Throwing Good Money after Bad: The Role of Affective Reaction in the Sunk-Cost Fallacy*, 14 PLOS ONE e0209900 (2019); *see* also Henry Moon *et al.*, *The Tripartite Model of Neuroticism and the Suppression of Depression and Anxiety within an Escalation of Commitment Dilemma*, 71 J. PERSONALITY 347 (2003); on the role of affect in groups *see* Tori Y. Huang, Vangelis Souitaris, & Sigal G. Barsade, *Which Matters More? Group Fear versus Hope in Entrepreneurial Escalation of Commitment*, 40 STRATEGIC MGMT. J. 1852 (2019).

[25] *See* Peter Booth & Axel K.D. Schulz, *The Impact of an Ethical Environment on Managers' Project Evaluation Judgments Under Agency Problem Conditions*, 29 ACTG ORG. & SOC'Y 473 (2004).

[26] For additional individual-level accounts of escalation of commitment that have gained lesser attention in subsequent research, *see* Sleesman *et al.* 2012, *supra* note 19, at 543.

when the firm is on the verge of failure. Considerations of personal and family pride exacerbate the tendency to escalate in these settings,[27] and family owners in fact become more resolute in prolonging the life of their ailing firms.[28] Entrepreneurs in particular have been shown to be prone to escalate.[29]

Escalation of commitment is not only an irrational and emotional personal behavior. More often than not, it takes place in a broader social context of one's ingroup - in particular, the board of directors, the organization, and one's community and culture. A growing body of research documents escalation-related effects of these social contexts. Several studies have shown that for various reasons, boards of directors tend to get trapped in group dynamics that lead to escalation of commitment to failing projects.[30] Theory suggests that a higher proportion of qualified outside directors could help firms to de-escalate, especially in family firms, as they are less prone to commitment.[31] The evidence, however, indicates that outside directors may

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[27] *See* Dean Shepherd, Johan Wiklund, & Michael Haynie, *Moving Forward: Balancing the Financial and Emotional Costs of Business Failure*, 24 J. BUS. VENTURING 134 (2009); Jeremy A. Woods, Thomas Dalziel, & Sidney L. Barton, *Escalation of Commitment in Private Family Businesses: The Influence of Outside Board Members*, 3 J. FAMILY BUS. STRATEGY 18 (2012); Naveed Akhter *et al.*, *If we Can't Have it, then No One Should: Shutting Down Versus Selling in Family Business Portfolios*, 10 STRATEGIC ENTREPRENEURSHIP J. 371 (2016). On venture capital firms *see* David Devigne, Sophie Manigart, & Mike Wright, *Escalation of Commitment in Venture Capital Decision Making: Differentiating between Domestic and International Investors*, 31 J. BUS. VENTURING 253 (2016).

[28] *See* Francesco Chirico *et al.*, *To Merge, Sell or Liquidate? Socioemotional Wealth, Family Control, and the Choice of Business Exit*, J. MGMT. (forthcoming 2020).

[29] *See* Thomas B. Astebro, Scott Jeffrey & Gordon K. Adomdza, *Inventor Perseverance after Being Told to Quit: The Role of Cognitive Biases*, 20 J. BEHAV. DEC. MAKING 272 (2007); Robert A. Lowe & Arvids A. Ziedonis, *Overoptimism and the Performance of Entrepreneurial Firms*, 52 MGMT. SC. 173 (2006); Anne M. McCarthy, F. David Schoorman & Arnold C. Cooper, *Reinvestment Decisions by Entrepreneurs: Rational Decision-Making or Escalation of Commitment?*, 8 J BUS. VENTUR. 24 (1993).

[30] *See*, e.g., Dale T. Miller & Cathy McFarland, *Pluralistic Ignorance: When Similarity is Interpreted as Dissimilarity*, 53 J. PERSONALITY & SOC. PSYCHOL. 298 (1987); James D. Westphal & Michael K. Bednar, *Pluralistic Ignorance in Corporate Boards and Firms' Strategic Persistence in Response to Low Firm Performance*, 50 ADMIN. SCI. Q. 262 (2005); Henry Moon et al., *Group Decision Process and Incrementalism in Organizational Decision Making*, 92 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 67 (2003); Sun Hyun Park, James D. Westphal, & Ithai Stern, *Set up for a Fall: The Insidious Effects of Flattery and Opinion Conformity toward Corporate Leaders*, 56 ADMIN. SCI. Q. 257 (2005); Leigh Plunkett Tost, Francesca Gino, & Richard P. Larrick, *When Power Makes Others Speechless: The Negative Impact of Leader Power on Team Performance*, 56 ACAD. MGMT. J. 1465 (2013).

[31] *See* Woods, Dalziel, & Barton, *supra* note 27; Ann K. Buchholtz, Michael Lubatkin & Hugh O'neill, *Seller Responsiveness to the Need to Divest*, 25 J. MGMT. 633 (1999).

not be effective in reducing escalation pressures.[32] Group decision-making and mere group diversity apparently are no guaranty for avoiding escalation traps.[33]

From a comparative perspective, escalation of commitment varies across cultures. Because it is anchored in individual behavioral tendencies and in societal situational conditions, one should expect that cultural stances should moderate the intensity of escalation. Cultural values provide implicit guidance about accepted and expected behavior that could enhance or inhibit individual tendencies. Cross-cultural analyses usually examine such variation along cultural dimensions - namely, fundamental themes about which cultures have different stances that can be measured and compared in dimensional models.[34] The dimensional theory most widely used in management studies was developed by Hofstede.[35]

Salter and his colleagues tested the effects of agency and self-justification theories on escalation of commitment in a sample of managers from nine countries (Canada, China, Hong Kong, India, Malaysia, Mexico, Pakistan, Singapore and the United States).[36] The results indicate that individualism intensifies the effect of agency on escalation behavior, such that escalation is more likely to occur in individualist countries. This, in turn, suggests a need for stronger risk management systems in locations and organizations that are characterized by individualism, which

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[32] *See* Westphal & Bednar, *supra* note 30; Park, Westphal, & Stern, *supra* note 30.

[33] *See* Sleesman *et al*. 2018, *supra* note 19, at 183.

[34] *See* Shalom H. Schwartz, *National Culture as Value Orientations: Consequences of Value Differences and Cultural Distance*, in 2 HANDBOOK OF THE ECONOMICS OF ART AND CULTURE 547 (Victor A. Ginsburgh & David Throsby eds. 2014). For a concise introduction to cross-cultural analysis of corporate governance, *see* Amir N. Licht, *Culture and Law in Corporate Governance*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 129 (Jeffery N. Gordon & Wolf-Georg Ringe eds, 2018) (hereinafter Licht 2018); *see* also Amir N. Licht, *The Mother of all Path Dependencies: Towards a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147 (2001).

[35] GEERT HOFSTEDE, CULTURE'S CONSEQUENCES: COMPARING VALUES, BEHAVIORS, INSTITUTIONS, AND ORGANIZATIONS ACROSS NATIONS (2D ED. 2001).

[36] *See* Stephen B. Salter, David J. Sharp, & Yasheng Chen, *The Moderating Effects of National Culture on Escalation of Commitment*, 29 ADVANCES IN ACTG 161 (2013). For related prior studies *see* Stephen B. Salter & David J. Sharp, *Project Escalation and Sunk Costs: A Test of the International Generalizability of Agency and Prospect Theories*, 28 J. ITN'T BUS. STUD. 101 (1997); Stephen B. Salter & David J. Sharp, *Agency Effects and Escalation of Commitment: Do Small National Culture Differences Matter?*, 36 INT'L J. ACTG. 33 (2001); Stephen B. Salter, Philip A. Lewis, & Luis Felipe Juárez Valdes, *Aqui No Se Habla Agencia. An Examination of the Impact of Adverse Selection and Framing in Decision-Making: a US/Mexico Comparison*, 15 J. INT'L FIN. MGMT. ACTG. 93 (2004); *see* also Paul D. Harrison *et al.*, *A Cross-Cultural Investigation of Managers' Project Evaluation Decisions*, 11 BEHAVIORAL RES. ACTG. 143 (1999).

tends to be higher in English-speaking countries, and especially so in the United States.[37]

In the present context, the extant evidence on individualism suggests that in the latter countries, there could be a more pressing need and justification for legal intervention to thwart escalation in financially distressed companies. In this view, for instance, high-individualism countries such as the United States would do better to reject Debtor-in-Possession ("DIP") arrangements rather than promote them. In contrast, lower-individualism countries could implement DIP arrangements with lesser fear that they would be exploited by incumbent managers to escalate - even if non-consciously - their firms into the ground. As a matter of practice, however, non-English-speaking Western European countries score lower on Hofstede's individualism than English-speaking ones, but the differences are modest in comparison to non-Western countries, which also suggests modesty in designing legal policy in light of this factor.

Salter and his coauthors also found that managers in long-term-oriented countries - typically, East Asian countries - are more likely to escalate projects with long-term consequences than those with only short-term effects. A study by other researchers argues that Chinese mangers have a greater preference to continue unprofitable projects than their US counterparts due to greater aversion to admitting failure in a collectivist culture and thereby losing face.[38] In addition, there are inconclusive findings on the effect of cultural uncertainty avoidance, which tends to be higher in English-speaking countries, on escalation of commitment, possibly due to the small sample (2-country) comparisons.[39] The latter findings thus confirm that escalation of commitment behavior responds to social normative cues, at least

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[37] I abstract here from the issues of using countries as proxies for cultures and of grouping countries into cultural regions. For discussions, *see* Licht 2018, *supra* note 34; Sjoerd Beugelsdijk, Tatiana Kostova, & Kendall Roth, *An Overview of Hofstede-Inspired Country-Level Culture Research in International Business since 2006*, 48 J. INT'L BUS. STUD. 30 (2017).

[38] *See* Chee W. Chow *et al.*, *Escalating Commitment to Unprofitable Projects: Replication and Cross-Cultural Extension*, 8 MGMT. ACTG. RES. 347 (1997).

[39] *Cf.* Mark Keil *et al.*, *Understanding Runaway Information Technology Projects: Results from an International Research Program Based on Escalation Theory*, 11 J. MGMT INFOR. SYS. 65 (1994); Mark Keil *et al.*, *A Cross-Cultural Study on Escalation of Commitment Behavior in Software Projects*, 24 MIS Q. 299 (2000); Charles R. Greer & Gregory K. Stephens, *Escalation of Commitment: A Comparison of Differences between Mexican and U.S. Decision-Makers*, 27 J. MGMT. 51 (2001).

informal ones, but it appears that they are too preliminary at this stage to offer a clear direction for legal policy formation.

Given that individuals and teams are prone to escalate, the practical challenge is to facilitate de-escalation - namely, shutting down the project or winding up the firm with a view to salvaging what could be saved. According to Chulkov and Barron,

> Research on the escalation of commitment provides strong support for the personal responsibility effect that contributes to escalation as long as the original decision makers are involved in the continuation of investment decisions. Studies on reversing escalation of commitment, or de-escalation, conclude that breaking the cycle of escalation decision errors is facilitated by a change in management.[40]

Change in management is thus the primary mode of breaking out of the escalation trap. Beyond changes in management, additional factors that could facilitate de-escalation include better information on costs and benefits of the project, regular evaluation and monitoring of projects, clear criteria for success and minimum target performance levels, and clear feedback about underperforming projects.[41] Such measures will have limited efficacy, however, as long as the information they generate is interpreted and acted on by decision-makers who have initiated the failing project and even by different persons who are nonetheless related to those decision-makers.[42] Change in management is therefore not only primary; it is essential.

IV. CUSTODIAL DUTIES IN THE VICINITY OF INSOLVENCY

This Part presents a framework for conceptualizing legal response to virtual or liminal insolvency, namely, when firm failure is a virtual reality or very nearly so absent some radical development. It is submitted that there could be reason in such situations to mandate a change of strategy from entrepreneurial to custodial. An entrepreneurial strategy is profit-oriented and principally shareholder-focused. In contrast, a custodial strategy could involve seeking return on investment but is premised on caution. It underscores preservation, protection of existing assets, and

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[40] Dmitriy V. Chulkov & John M. Barron, *Turnover in Top Management and De-Escalation of Commitment*, 51 APPLIED ECON. 2534, 2534-2535 (2019) (citing studies).

[41] Chulkov & Barron, *id.*, at 2535.

[42] *See* Brian G. Gunia, Niro Sivanathan & Adam D. Galinsky, *Vicarious Entrapment: Your Sunk Costs, My Escalation of Commitment*, 45 J. EXPERIMENTAL SOC. PSYCHOL. 1238 (2009); *see* also Jeremy A. Woods, Thomas Dalziel, & Sidney L. Barton, *Escalation of Commitment in Private Family Businesses: The Influence of Outside Board Members*, 3 J. FAMILY BUS. STRATEGY 18 (2012).

loss-minimization, and is often creditor-focused. The following section reviews the custodial duties of trustees and especially their distinctive duty of caution. Next, I discuss the implementation of such custodial duties by adopting custodial strategies in business firms.

The analysis in this Part is conceptual and positive, and in the following Part - comparative. I do not make a strong normative claim about the desirability of imposing a duty to implement such strategies. Legal systems differ on the mode of regulating the zone of insolvency such that imposing such a duty might not be compatible with their general approach. There are sound justifications for doing so, however, in systems that do recognize the zone of insolvency as a legally relevant circumstance.

A. Custodial Duties of Trustees

While owing a similar duty of undivided loyalty to their beneficiaries, trustees and corporate directors differ fundamentally in the nature of their core assignment. Conventional trust funds should provide for the needs of the beneficiaries, whereas business corporations invest in risky projects with inherently uncertain returns. In *Cinerama, Inc. v. Technicolor, Inc.*, Chancellor Allen thus contrasted the responsibilities of trustees and directors:

> [T]rust law differs from corporate law. In general, the duties of a trustee to trust beneficiaries (those of loyalty, good faith, and due care), while broadly similar to those of a corporate director to his corporation, are different in significant respects. Corporate directors … will often be required to take risks with the assets they manage. Indeed, an unwillingness to take risks prudently is inconsistent with the role of a diligent director. The trustees role is, classically, quite different. The role of the trustee is prudently to manage assets placed in trust, within the parameters set down in the trust instrument. *The classic trusteeship is not essentially a risk taking enterprise, but a caretaking one*.[43]

The content of the trustee's duty as a caretaker has evolved over generations and took its modern shape around the turn of the millennium. Historically, during its early stages of development in England between the late thirteenth century and early sixteenth century, the trust transformed from a purely passive custodial device into a more discretionary instrument that authorized and required trustees to manage the

[43] 663 A.2d 1134, 1148 (1994) (emphasis added).

trust fund.[44] Getzler notes that while "active trust management became a structural element of the modern trust by the start of the seventeenth century, … such active duties were not fundamental to the basic function of the trust, which remained a custodial device segregating the entrusted assets from creditors of the legal owners."[45] Those assets comprised mostly real property, which required a limited amount of oversight and active management, and trustees were typically friends and members of the family who operated without remuneration for their services.[46] Socio-economic developments during the nineteenth century have changed much of that, however. In the latter part of that century, many trust funds included financial assets that required management and trust services by non-professional solicitors began to emerge. The new circumstances engendered concomitant legal developments.

Two seminal U.K. cases have formed the framework for trustees' duties of investment. In *Speight v. Gaunt* (1883), the House of Lords held that "as a general rule a trustee sufficiently discharges his duty if he takes in managing trust affairs all those precautions which an ordinary prudent man of business would take in managing similar affairs of his own."[47] Shortly thereafter, in *Learoyd v. Whiteley* (1887), the House of Lords elaborated:

> [A trustee] is not allowed the same discretion in investing the moneys of the trust as if he were a person sui juris dealing with his own estate. Business men of ordinary prudence may, and frequently do, select investments which are more or less of a speculative character; but it is the duty of a trustee to confine himself to the class of investments which are permitted by the trust, and likewise *to avoid all investments of that class which are attended with hazard*.[48]

Speight and *Whiteley* together stand for two related propositions that retain their viability despite substantial developments since they were rendered. The first proposition may be called the "prudent person rule"; the second - the "no hazard rule". The prudent person rule sets the benchmark for assessing the qualifications

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[44] *See* Joshua Getzler, *Duty of Care*, in BREACH OF TRUST 41, 43 (Peter Birks & Arianna Pretto eds., 2002).

[45] *Id.*, at 44.

[46] *See id.*, at 67 *et seq.*; *see*, generally, CHANTAL STEBBINGS, THE PRIVATE TRUSTEE IN VICTORIAN ENGLAND (2002).

[47] Speight v. Gaunt (1883) LR 9 App Cas 1, 19, [1883] UKHL 1 (Lord Blackburn), affirming Speight v. Gaunt (1883) LR 22 Ch D 727, 739-740, [1883] EWCA Civ 1 (Jessel MR) ("on general principles a trustee ought to conduct the business of the trust in the same manner that an ordinary prudent man of business would conduct his own").

[48] Learoyd v. Whiteley (1887) 12 App Cas 727, 733, [1887] UKHL 1 (Lord Watson) (emphasis added).

required from a reasonable trustee to handle a sizeable trust fund. This rule comprises two (again, related) sub-rules - one addressing her financial proficiency and another one addressing the knowhow she is expected to utilize in managing the trust. Much has changed with regard to both issues between the late nineteenth century and today. The paradigmatic person has changed from the "prudent man (of business)", who could be a volunteer family or friend or a remunerated but financially amateur professional, into the "prudent investor", who is versed in and can utilize current knowledge in financial economics. Their respective knowhow has changed as well - from lay intuitions and familiarity with inflexible rules of appointment about permissible investments into Modern Portfolio Theory, which calls for using diversification for tailoring different risk/return profiles to the needs of the beneficiaries without *a priori* ruling out certain assets as too risky. This massive transformation has now been partially codified;[49] it is extensively covered in the literature;[50] and will not occupy us much further.

The second, "no hazard rule", has received relatively lesser attention than the prudent man/investor rule has but it is the one of most interest here. *Whiteley* and the "no hazard rule" it expresses continue to inform contemporary trust law. U.K. courts continue to cite *Whitely* as authority, either directly or indirectly, through other seminal cases that rely on it.[51] So do courts in Australia.[52] Reflecting a similar approach, U.S. trust law imposes a duty to exercise *caution* as part of a larger set of the trustee's custodial obligations "to safeguard, preserve, or protect the trust assets

[49] *See*, e.g., section 1 of the Trustee Act 2000 (U.K.); section 36 of the Pensions Act 1995 (U.K.); RESTATEMENT (THIRD) OF TRUSTS § 90 (2007) (U.S.).

[50] *See*, e.g., J.E. PENNER & JEREMIAH LAU, THE LAW OF TRUSTS §§10.12-10.16 (11th Ed., 2019); GRAHAM VIRGO, THE PRINCIPLES OF EQUITY & TRUSTS 373 *et seq*. (3d Ed., 2018); Robert H. Sitkoff, *Fiduciary Principles in Trust Law*, in THE OXFORD HANDBOOK OF FIDUCIARY LAW (Evan J. Criddle, Paul B. Miller & Robert H. Sitkoff eds. 2019). The challenge facing contemporary trustees in light of Modern Portfolio Theory is wittily captured in Tony Molloy, *I am a trustee. I can't make head or tail of* $P_0 = S_0N(d_1) - X_e^{-rt}N(d_2)$ *where* $d_1=[Ln(S_0/X) + (r+\sigma^2/2)t]/\sigma\sqrt{t}$ *and* $d_2=d_1-\sigma\sqrt{t}$*. Am I at risk?*, 15 TRUSTS & TRUSTEES 524 (2009).

[51] *See* Daniel v. Tee [2016] EWHC 1538 (Ch), [38]-[40] (citing Nestle v National Westminster Bank plc [1993] 1 WLR 1260, 1268); The Charity Commission for England and Wales v. Mountstar (PTC) Ltd [2016] EWHC 876 (Ch), [53]; Independent Trustee Service Ltd v. GP Noble Trustees Ltd [2010] EWHC 1653 (Ch), [54] (citing Cowan v Scargill [1984] 2 All ER 750, 762).

[52] *See Elder's Trustee & Executor Co Ltd v. Higgins* [1963] HCA 48, [29].

and the safety of the principal."[53] The Restatement on Trusts distinguishes this duty from the duty to have skill and exercise care:

> In addition to the duty to use care and skill, the trustee must exercise the caution of a prudent investor managing similar funds, in similar circumstances, for similar purposes. … [T]his requirement of caution requires the trustee to invest with a view both to safety of the capital and to securing a reasonable return.[54]

This duty of caution, "to avoid all investments … which are attended with hazard" as *Whiteley* put it, is unique to trustees, distinguishing them from corporate directors. This obligation defines trustees as caretakers, whereas directors are business managers. While both actors control other people's assets with a view to generating income, there is a fundamental difference between their core missions. In managing the trust fund, trustees must exercise substantive care; they must take reasonable precautions to avoid loss, especially capital loss, although they need not and cannot insure against such loss. Diversification is the primary tool with which trustees are expected to achieve this goal. In contrast, genuine business managers engage in entrepreneurship. They seek to capitalize on uncertainty inherent in unique ideas, combinations, and opportunities.[55] Conservatism or caution, including by way of risk-reducing diversification, are anathema to entrepreneurship and therefore to business management.[56] Shareholders should expect (and cannot complain, legally) that directors invest all of the company's resources in a single idiosyncratic venture with highly uncertain returns. In line with this basic difference in their core missions, judicial review of trustee care and of directors' care also differs. While managerial discretion of trustees is subject to substantive judicial review akin to implementing the

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[53] 76 Am. Jur. 2d Trusts § 404 (2005) (footnotes omitted).

[54] Restatement (Third) of Trusts § 90 cmt e (2007); *see* also *id*., § 77(1) (a trustee must exercise "reasonable care, skill, and caution."). Note that "the duty of caution does not call for avoidance of risk by trustees but for their prudent management of risk. … although an inferred, general duty to invest conservatively is a traditional and accepted feature of trust law, that duty is necessarily imprecise in its requirements and is applied with considerable flexibility." *Id.*, § 90 cmt e(1).

[55] For canonical expositions of these ideas *see* JOSEPH A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT (Redvers Opie trans., Transaction Publishers 1983) (1912); ISRAEL M. KIRZNER, COMPETITION AND ENTREPRENEURSHIP (1973); ISRAEL M. KIRZNER, DISCOVERY AND THE CAPITALIST PROCESS (1982); *see* also Israel M. Kirzner, *Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach,* 35 J. ECON. LIT. 60 (1997). "Uncertainty" is used here in its pure Knightian meaning. *See* FRANK H. KNIGHT, RISK, UNCERTAINTY, AND PROFIT (1921). I develop these points in more detail in Amir N. Licht, *The Name of the Rose: Precautions and Business Judgment of Company Officers*, 19 ISRAEL J. L. & BUS. 536 (2015) (in Hebrew).

[56] This does not relieve corporate directors from the responsibility to manage risks that are foreseeable and avoidable as part of their duty of oversight, which is analogous to trustees' duty to protect the fund from external threats. *See* In re Caremark Int'l. Inc. Deriv. Litig. 698 A. 2d 959 (Del Ch. 1996).

duty of care of other professionals, the exercise of discretion in business should be reviewed with respect to its process under the business judgment rule, leaving the substantive decision essentially immune.[57]

B. Caution and De-escalation in the Vicinity

The review of escalation of commitment provided in the preceding Part reveals a powerful, tenacious factor that bears directly on the vicinity of insolvency conundrum. The currently dominant account, of risk shifting, is premised on rational responses to economic incentives. One must never underestimate the potency of economic incentives for opportunistic behavior, and the present paper does not purport to do so. Opportunistic risk shifting thus remains a relevant consideration for legal policy design, but as noted, the evidence suggests that its severity should not overstated. It is an elegant theory with thus far little evidence to support it. Crucially, risk shifting differs from escalation of commitment in that the former is more susceptible to market discipline and to self-regulation by contract, even if not perfectly so, as the available empirical evidence indeed suggests. The need for legal intervention is therefore more limited, primarily to situations in which creditors cannot reasonably fend for themselves (e.g., tort creditors).

Escalation of commitment, in contrast, being largely detached from rational calculations, presents a more compelling justification for legal regulation and a more interventionist one at that. In this view, managers - especially owner-managers - of virtually insolvent firms may not enjoy the usual level of deference that the law affords to their business judgment in regular times, as their discretion at that point is prone to be clouded by a misplaced motivation to stay the course, weather the storm, and similarly-spirited no-quitting notions. Optimal law for situations of liminal insolvency consequently may need to mandate a change of course, order entering into a safe harbor, require a change of the people at the helm, or, eventually, call for docking the enterprise. If water is flooding the ship, threatening to sink it, its captains should focus on stabilizing it, or finding a shelter, or handing over the helm to

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[57] *See* Robert Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 655-57 (2004); Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("'substantive due care'... [is] a concept [that] is foreign to the business judgment rule. … Due care in the decisionmaking context is *process* due care only.") (emphasis in the original). The doctrine of waste, which used to be treated as a substantive exception to the business judgment rule is now more accurately conceptualized a doctrine of fiduciary loyalty. *See* SEPTA v. AbbVie, Inc., 2015 Del. Ch. LEXIS 110, *47 (Del. Ch., 2015), aff'd, 132 A.3d 1 (Del. 2016).

somebody else, rather than on breaking speed records even if that was the original purpose of the voyage. Current knowledge about escalation of commitment supports concerns that these captains likely will fail to do so on their own volition such that there could be a need to force them to do that.

Adopting a duty of caution by analogy from trust law can provide a framework for regulating the conduct of corporate fiduciaries in liminal insolvency situations in legal systems that wish to impose special rules for such circumstances. When this duty is triggered, directors should change their management strategy from entrepreneurial to custodial and operate as caretakers for the firm. This change of strategy would discharge the duty to consider creditors' interests that some legal systems impose. Creditors' only legitimate interest is in having their debts serviced, and in the vicinity of insolvency - in preserving the value of the debt. Sometimes this could mean ceasing trading immediately; in other cases, this could mean continuing trading while incurring new debts. New and even higher indebtedness in and as of itself is not necessarily in conflict with creditors' interest. The crucial issue is whether the strategy that guides the firm addresses their interest. A custodial duty of caution does exactly that, as it focuses on preserving a source of income stream over a long period while seeking to maximize its value subject to this overriding constraint.

Importantly, a duty of caution in the vicinity of insolvency is not inimical to shareholders' interest either, at least insofar as shareholders care about the viability of the firm and are not agnostic to its collapse (e.g., if they are highly diversified). For many entrepreneurs and certainly for many owner-managers of small companies, such an attitude seems at least as plausible as the wild "bet the farm" scenario that informs the common economic account (and is not baseless itself). When escalation of commitment is factored into the analysis, a duty of caution makes even greater sense, as it forces managers to pull the plug on the entrepreneurial project they have been committed to but is now failing. Without a clear change in the content meaning of directors' responsibility for corporate strategy, there is only little hope that calls for a "rescue culture" would engender actual rescues of distressed firms.

Accepting in principle that there is room for a duty of caution in the vicinity of insolvency, several secondary issues then arise. First, should the custodial caretaking strategy replace the entrepreneurial strategy of business of regular times or should it guide directors in tandem with the latter? This question is equivalent to asking whether directors should focus only on creditors' or on shareholders' interests or should they balance the interests of these two constituencies somehow. Framing the question as one of business strategy and a concomitant legal obligation points, I believe, to the dichotomous approach as the preferred one. Creditors' interest must replace shareholders' interest as the focal object of corporate strategy. One could adopt a high- or low-risk entrepreneurial strategy or, similarly, a high- or low-risk caretaking strategy, but it is difficult to implement both of them at the same time as they seek to achieve incompatible goals. Moreover, since judicial review of such strategies differs in fundamental respects, as noted above, it is hard to see how a "mixed strategy" could be subject to a unitary judicial review. If I am wrong, however, such that the two approaches could be implemented in a mixed mode, there could also be room for balancing the interests of shareholders and creditors in the vicinity of insolvency. We return to this point in the comparative analysis below.

Second, at what stage should this duty arise? That is, what degree of financial distress short of certain insolvency should enliven the duty? Relatedly, what should be the criteria for assessing such distress (e.g., balance sheet and/or liquidity solvency), and at what level of confidence about such distress should directors decide to shift gears and move into protective mode to comply with the duty of caution? In principle, every business faces some probability of failure and will occasionally tread into the periphery of the zone of insolvency in that insolvency would be a non-negligible contingency that could nonetheless be avoided with appropriate strategic measures. In certain industries, moreover, the probability of failure is so substantial that insolvency is more likely than not from the outset. Overall, only about half of new small businesses make it beyond the five-year mark.[58] In hi-tech and bio-tech start up projects that are financed by venture capital, the company is insolvent by design until a very late stage, in which it either succeeds or, more often then not, is wound up and liquidated.[59] Surely that does not mean that entrepreneurs should avoid starting new businesses in those industries in general or shut down the business when

[58] High likelihoods of failure of new startup businesses characterize both high-tech and low-tech ventures. On the bright side, it is a myth that most restaurants fail in their first year. *See* Tian Luo & Philip B Stark, *Nine out of 10 Restaurants Fail? Check, Please*, 12(2) SIGNIFICANCE (2015), DOI: 10.1111/j.1740-9713.2015.00813.x; Kristin Pryor, Here Are the Startup Failure Rates by Industry, Tech.co, January 12, 2016, https://tech.co/news/startup-failure-rates-industry-2016-01

[59] Venture capital firms are not immune to escalation of commitment. *See supra* note 27.

it reaches its half-life while still buoyant. Bearing in mind that shifting to custodial creditor-oriented strategy is a major decision that cannot be taken lightly nor easily reversed, and that coping with financial distress does not in and as of itself justify abandoning the entrepreneurial strategy, it seems that a duty of caution should be triggered only in liminal insolvency (or any synonym with an equivalent effect) - namely, at the very edge of the zone of insolvency close to insolvency, not in the penumbra of the zone. But, again, this is a point on which legal minds can differ and has been subject to extensive judicial analysis without a clear conclusion thus far, as the comparative analysis below indicates.

A third issue concerns the persons who should implement the custodial strategy under the duty of caution. Here, a broad menu of approaches is available. At one end, the law could entrust the caretaking responsibility with the directors who have been running the firm until that point, in line with the U.S. DIP mechanism, which leaves the directors of a bankrupt firm in place. A large literature discusses the DIP mechanism as a means to facilitate restructuring of struggling companies but the empirical evidence about its effectiveness is equivocal.[60] From an escalation-of-commitment perspective, however, there is reason to doubt that DIP could be effective notwithstanding other considerations such as the desire to avoid over-deterrence of managers.[61] Legal policy that takes escalation of commitment into account would rather strive to replace the existing managers with ones who are not committed to the failing project or could at least reinvigorate the incumbent management team. Appointing an external advisor to the top management team on behalf of creditors - especially one whose advice is like a command like a Chief Restructuring Officer ("CRO") - could provide a compromise solution.[62]

Legal policy for the zone of insolvency is less clear, however. On the one hand, the firm is not yet bankrupt and there is still a chance that it could trade its way

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[60] This literature is beside the present scope. For empirical studies *see*, e.g., . Barry E. Adler, Vedran Capkun & Lawrence A. Weiss, *Value Destruction in the New Era of Chapter 11*, 29 J. L. ECON. & ORG. 461 (2013); Avner Kalay, Rajeev Singhal & Elizabeth Tashjian, *Is Chapter 11 Costly ?*, 84 J. FIN. ECON. 772 (2007); Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization*, 61 J. FIN. 1253 (2006).

[61] *See* Adler *et al.*, *id*. (arguing that managers' influence over the decision to file a bankruptcy petition results in a delay in filing and a reduction of asset value).

[62] *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006).

out of financial distress. On the other hand, that chance would be maximized if it were exploited by directors who are not overly committed to prior choices. Crucially, as long as creditors do not take over the company through formal insolvency proceedings, the directors remain shareholder-appointed and thus harbor allegiance to them regardless of formal legal obligations. In smaller firms, shareholders and directors often overlap, making it even more challenging to require them to shift (or split) their focus to creditors' interest. As noted above, forced changes in the composition of management teams, particularly by adding independent professionals, could facilitate de-escalation.[63] A potentially promising approach for implementing a custodial duty of caution with extant directors thus could compel them to consult with an external expert, especially with regard to restructuring, akin to a CRO. Such an expert could more effectively cause the directors to acknowledge reality and de-escalate by shifting to a caretaking strategy with the hope to resume entrepreneurial business in the future.

V. CARING FOR CREDITORS ACROSS COUNTRIES

Legal systems around the world exhibit significant variation with regard to directors' duties to protect creditors' interests, especially when the company is nearing insolvency and in particular, when the company appears to be doomed for insolvency. Legal approaches run the gamut from denying all protection beyond those provided by contract to fully equalizing the status of creditors to that of shareholders and other stakeholders. The protections that laws afford to creditors in such circumstances through fiduciary duties - when laws afford it, while putting aside other bankruptcy doctrines[64] - also vary, from a strict injunction to file for bankruptcy, to a requirement to endeavor to minimize creditors' losses, to a vague duty to consider

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[63] *See supra* text to note 30 *et seq*.

[64] Putting aside other bankruptcy doctrines is not a straightforward move. Bankruptcy laws are part and parcel of every corporate governance system such that there cannot be a clear-cut distinction between them and fiduciary duties, for instance. On such "insolvencification" of corporate governance in the European Union *see*, Martin Gelter, Centros *and Defensive Regulatory Competition: Some Thoughts and a Glimpse at the Data*, 20 EUR. BUS. L. REV. 467 (2019); Marek Szydło, *Directors' Duties and Liability in Insolvency and the Freedom of Establishment of Companies after* Kornhaas, 54 COMMON MARKET L. REV. 1853 (2017); Wolf-Georg Ringe, Kornhaas *and the Challenge of Applying* Keck *in Establishment*, 42 EUR. L. REV. 270 (2017); Luca Enriques & Martin Gelter, *How the Old World Encountered the New One: Regulatory Competition and Cooperation in European Corporate and Bankruptcy Law*, 81 TUL. L. REV. 577 (2007).

creditors' interest. This Part reviews a sample of such approaches from common law jurisdictions and examines the extent to which they could harness a custodial duty of caution to address the escalation of commitment problem. First, the two extreme positions in the United States and Canada are noted. Next, I proceed to more nuanced versions found in the United Kingdom, Australia, and New Zealand.

A. The United States

U.S. law - at least Delaware law - endorses the strongest version of shareholder primacy.[65] Under current doctrine, only the interest of shareholders as a constituent group can be the objective of Delaware corporations. According to the seminal decision in *Guth v. Loft*, "[c]orporate officers and directors … stand in a fiduciary relation to the corporation and its stockholders."[66] Repeated in numerous occasions since it was formulated, this doctrine has been solidified in *eBay Domestic Holdings, Inc. v. Newmark*, where the Delaware Chancery Court stated that "[d]irectors of a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization—at least not consistently with the directors' fiduciary duties under Delaware law."[67] Writing extra-judicially, former Delaware Chief Justice Strine thus argued that "[d]espite attempts to muddy the doctrinal waters, a clear-eyed look at the law of corporations in Delaware reveals that, within the limits of their discretion, directors must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare."[68]

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[65] I refer here to Delaware's general corporate law. The legal landscape in the United States is broader and more varied, but not in a way that affects the present analysis. Delaware and several other states have special statutes on "benefit corporations", and 35 U.S. states (but not Delaware) have adopted "corporate constituency statutes" or "stakeholder laws". *See*, generally, Brett H. McDonnell, *Corporate Constituency Statutes and Employee Governance*, 30 WM. MITCHELL L. REV. 1227 (2004); Brett McDonnell, *Benefit Corporations and Strategic Action Fields or (The Existential Failing of Delaware)*, 39 SEATTLE U. L. REV. 263 (2016); David G. Yosifon, *Opting out of Shareholder Primacy: Is the Public Benefit Corporation Trivial*, 41 DEL. J. CORP. L. 461 (2017).

[66] Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939). *See* also Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) ("The directors of Delaware corporations stand in a fiduciary relationship not only to the stockholders but also to the corporations upon whose boards they serve.") (citing *Guth*).

[67] eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 35 (Del. Ch. 2010).

[68] Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 768 (2015). Strine was careful to distinguish his understanding of positive doctrine from his views on desirable law. *See* Leo E. Strine, Jr., *Toward Fair and Sustainable Capitalism* (U. of Penn. Inst. for L. & Econ. Research Working Paper No. 19-39, 2019).

Guth is uniquely shareholder-focused in two respects. First, it refers to shareholders as direct beneficiaries of directors' fiduciary duties, in parallel with the corporation, and thus seemingly by-passes the latter's separate legal personality. Second, *Guth* considers the interests of the corporation and of stockholders as perfectly overlapping. The upshot is that the interests of all other stakeholder groups are necessarily excluded inasmuch as they are not aligned with shareholders' interests or else the directors risk falling into a disabling situation akin to dual fiduciary even if not formally so.

This logic guides the Delaware Supreme Court's landmark decision in *Gheewalla*.[69] As Vice Chancellor Laster noted in *Quadrant I*, prior to *Gheewalla*, Delaware law held that "upon insolvency, the beneficiaries of the directors' fiduciary duties shifted from the corporation's stockholders to its creditors, and that after insolvency directors had a fiduciary obligation to preserve value for the benefit of creditors" - a "trust fund doctrine [that] would resemble English law."[70] This doctrine "included an obligation to manage the corporation conservatively."[71] Then there followed a period of legal ambiguity due to Chancellor Allen's famous *dictum* in *Credit Lyonnais*,[72] which suggested a multiple-stakeholder enterprise approach to directors' duties in the vicinity of insolvency, engendered much discussion, but was eventually rejected in *Gheewalla*:

> When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.[73]

Gheewalla is particularly noteworthy because the Court goes to great lengths "to provide the directors with clear signal beacons and brightly lined channel markers as they navigate with due care, good faith, and loyalty on behalf of a Delaware corporation and its shareholders."[74] So much so, that by drawing a sharp distinction

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[69] N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

[70] Quadrant Structured Prods. Co. v. Vertin, 102 A.3d 155, 172-173 (Del. Ch., 2014) (*Quadrant I*).

[71] Quadrant Structured Prods. Co. v. Vertin, 115 A.3d 535, 545 (*Quadrant II*) (Laster VC).

[72] Credit Lyonnais Bank Nederland, N.V. v. Pathé Commc'ns Corp., 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

[73] *Gheewalla*, *supra* note 69, at 101.

[74] *Gheewalla, id.*, citing *Malone*, *supra* note 66, at 10 (Del. 1998).

between solvency and insolvency, it effectively denies as a matter of law the existence of a murky zone of insolvency, although in reality, vagueness and uncertainty characterize this setting.[75] Directors of Delaware corporations consequently do not owe an obligation to implement a custodial ("conservative") strategy with a view to protecting creditors' interests, although they may do so with a view to promoting shareholders' interest under the umbrella of the business judgment rule. A license to manage cautiously in the vicinity of insolvency, as opposed to a duty to do so, obviously is a much weaker protection against escalation of commitment.

B. Canada

While Delaware law renounces any recognition of nuance and ambiguity with regard to pre-insolvency creditor-oriented fiduciary duties, Canadian law wholeheartedly embraces ambiguity and uncertainty as it endorses the opposite approach. In essence, both Delaware and Canada ignore the vicinity of insolvency as a matter of practice, but while Delaware eliminates it as a matter of law, Canada comes close to locating every business decision in some proximity to insolvency, with concomitant implications for directors' fiduciary duties. The Canada Business Corporations Act ("CBCA") renders the corporation the nominal beneficiary of directors and officers' fiduciary duties.[76] In tandem, the CBCA's provision on oppression enumerates creditors among those entitled to a remedy against oppression.[77] This has led the Supreme Court of Canada to adopt an open-ended stakeholderist doctrine. In considering a petition by institutional bondholders in *BCE*, the Court held:

> [T]he duty of the directors to act in the best interests of the corporation comprehends a duty to treat individual stakeholders affected by corporate actions equitably and fairly. There are no absolute rules. In each case, the question is whether, in all the circumstances, the directors acted in the best interests of the corporation, having regard to all relevant considerations, including, but not confined

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[75] See *Quadrant I*, supra note 70, at 173n4 ("In Gheewalla, the Delaware Supreme Court discarded the zone"); *Quadrant II*, supra note 71, at 546 ("There is no legally recognized 'zone of insolvency' with implications for fiduciary duty claims."); Kirschner v. FitzSimons (In re Tribune Co. Fraudulent Conveyance Litig.), 2018 U.S. Dist. LEXIS 204632 (S.D.N.Y. Nov. 30, 2018) (referring to "Gheewalla's rejection of the 'zone of insolvency' theory").

[76] Canada Business Corporations Act, R.S.C. 1985, c C-44, § 122.

[77] CBCA, § 241(2). *Compare* the parallel provision on unfair prejudice in § 994 of the Companies Act 2006 (U.K.), which does not enumerate creditors. A provision inspired by Canada's oppression section exists in Antigua. Antiguan International Business Corporation, § 204. *See* Re Stanford International Bank Ltd (Antigua and Barbuda) [2019] UKPC 45, para. 26-27.

to, the need to treat affected stakeholders in a fair manner, commensurate with the corporation's duties as a responsible corporate citizen.

Directors may find themselves in a situation where it is impossible to please all stakeholders… There is no principle that one set of interests - for example the interests of shareholders - should prevail over another set of interests.[78]

The *BCE* Court thus put on the table what many have swept under the carpet. By using fairness rather than loyalty as the framework of analysis, *BCE* allows for conflicting interests to be balanced against one another. However, as the Court candidly acknowledges, this ruling gives directors no guidance as to how they should resolve this dilemma and in fact notes that "the court looks beyond legality to what is fair, given all of the interests at play."[79] A 2019 amendment to the CBCA (re-)locates the issue within fiduciary duties, as it authorizes directors and officers to consider the interests of shareholders, employees, retirees and pensioners, creditors, consumers, and governments; the environment; and the long-term interests of the corporation.[80] Consistent with *BCE*, this new provision does not prioritize any of these interests. It is thus silent about the strategy or mix of strategies that directors should implement, and is agnostic to the vicinity of insolvency.

C. The United Kingdom, Australia, and New Zealand

The United Kingdom, Australia, and New Zealand present a complex, intermediate approach to creditor-oriented fiduciary duties, hereinafter referred to as the Anglo approach. Certain elements of this approach have evolved by way of cross-fertilization through judicial exchange of ideas among these jurisdictions such that despite substantial differences, it warrants analysis as a largely single approach.[81] The Anglo approach has two prongs: first, a common law rule on directors' duty to consider the interest of creditors that is viewed as applying to the vicinity of insolvency; second, a statutory provision that in different formulations and titles imposes personal liability on directors for failing to take action to protect creditors,

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[78] BCE Inc. v. 1976 Debentureholders, 2008 SCC 69, para. 82-84 (Can.).

[79] *BCE*, *id.*, at para. 71.

[80] The new section 122(1.1) resembles Peoples Department Stores Inc. (Trustee of) v. Wise, 2004 SCC 68, para. 42 (Can.) ("[I]n determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, inter alia, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.").

[81] Certain elements of the Anglo approach can also be found in Singapore, Hong Kong, and Israel but will not be discussed here.

when the company is virtually insolvent. But before we look at these rules, a note on the benchmark approach to the objective of the company in these jurisdictions.

Company law in these jurisdictions is more loyal to the classical formula of fiduciary loyalty by making the company alone the beneficiary of directors' fiduciary duties. Moreover, it has traditionally taken a comprehensive approach to the best interests of the company by referring to "the company as a whole".[82] While recognizing shareholders the ultimate arbiters of corporate affairs, this formulation can accommodate different stances on who counts for the company's best interests. The U.K. Companies Act 2006 preserves this approach.[83] Section 172 of the Act is explicit in designating shareholders as the ultimate beneficiaries of the company's business. In tandem, this section requires directors to consider other stakeholders, yet stakeholders' interests are subordinated to the interests of shareholders.[84] Corporation statutes in Australia and New Zealand do not have parallel provisions beyond the general fiduciary duty to manage the company in good faith, such that this point is governed by traditional common law.[85]

Against this backdrop, courts in these jurisdictions have developed a doctrine that requires directors to consider the interests of creditors, especially in the vicinity of insolvency. In the standard historiography of the doctrine,[86] its early pronouncements were made in Australia and New Zealand.[87] In *Nicholson v. Permakraft*, Cooke J said:

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[82] *See* Greenhalgh v. Arderne Cinemas [1951] Ch. 286, 291 (C.A.) ("*Greenhalgh*"); Allen v. Gold Reefs of West Africa Ltd [1900] 1 Ch 656, 671.

[83] Companies Act 2006, s. 170(1) (U.K.).

[84] For discussions, *see*, e.g., Andrew Keay, *Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's Enlightened Shareholder Value Approach*, 27 SYDNEY L.R 577 (2007); Georgina Tsagas, *Section 172 of the Companies Act 2006: Desperate Times Call for Soft Law Measures*, in SHAPING THE CORPORATE LANDSCAPE: TOWARDS CORPORATE REFORM AND ENTERPRISE DIVERSITY (Nina Boeger & Charlotte Villiers, eds) 131 (2018).

[85] For Australia *see* Corporations Act 2001 (Austl.), s 181; Ngurli Ltd v. McCann (1953) 90 CLR 425 (Austl.), at para. 24 (citing *Greenhalgh*); *see*, generally, Rosemary Teele Langford, *Best Interests: Multifaceted but not Unbounded*, 75 CAMB. L.J. 505 (2016). For New Zealand, *see* Companies Act 1983 (N.Z.), s 131; *see*, generally, JOHN FARRAR & SUSAN WATSON, COMPANY AND SECURITIES LAW IN NEW ZEALAND (2nd ed. 2013), at 368 *et seq*.

[86] *See* Andrew Keay, *Directors' Duties and Creditors' Interests*, 130 L. Q. REV. 443 (2014); *see* also Andrew Keay, *Formulating a Framework for Directors' Duties to Creditors: An Entity Maximisation Approach*, 64 CAMB. L.J. 614 (2005); Anil Hargovan & Jason Harris, *For Whom the Bell Tolls: Directors' Duties to Creditors after Bell*, 35 SYDNEY L. REV. 433 (2013); Langford, *id.*

[87] *See* Walker v. Wimborne (1976) 137 CLR 1 (Austl.); Nicholson v. Permakraft (NZ) Ltd [1985] 1 NZLR 242 (CA) (N.Z.).

> The duties of directors are owed to the company. On the facts of particular cases this may require the directors to consider inter alia the interests of creditors. For instance creditors are entitled to consideration, in my opinion, if the company is insolvent, or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency.[88]

This idea gained momentum in the Australian case of *Kinsela v. Russell Kinsela Pty Ltd (in liq)*.[89] *Kinsela* was subsequently adopted in the English *West Mercia Safetywear Ltd v. Dodd*.[90] The U.K. Companies Act now codifies this obligation in section 172(3). In English law, *West Mercia* spawned a whole body of case law, the content and contours of which are extensively debated.[91] Keay, among others, has pointed out the fuzziness of this doctrine, especially with regard to the stage at which the duty to consider creditors' interests is triggered, and, crucially, whether this duty, when it arises, operates in lieu of or in tandem with the duty to focus on shareholders' interests, i.e., whether creditors' interest becomes paramount to shareholders' interest or not.[92] The latter point goes to the heart of conceptualizing the purpose of the company as monist or a pluralist. Recent court of appeals decisions in several jurisdictions have adopted different views about this point such that it is anything but settled.[93]

What has been largely neglected in this judicial and academic discourse is the *manner* in which directors are to consider creditors' interest if they are to do more

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[88] *Permakraft*, at 249.

[89] (1986) 4 NSWLR 722 (Austl.); *see* also Spies v. The Queen (2000) 201 CLR 603 (Austl.).

[90] (1988) 4 BCC 30 (U.K.).

[91] For a piercing critique of the basic doctrine, *see* K.M. Hayne, *Directors' Duties and a Company's Creditors*, 38 MELBOURNE U. L. REV. 795 (2014). Van Zweiten argues that the rule in *West Mercia* has been applied in conventional circumstances of unlawful preferences or breach of fiduciary duties. *See* Kristin van Zwieten, *Director Liability in Insolvency and Its Vicinity*, 38 OXFORD J. L. STUD. 382 (2018). For an a discussion, *see* Andrew Keay, *Financially distressed companies, preferential payments and the director's duty to take account of creditors' interests*, 13 L.Q. REV. 52 (2020).

[92] *See* Keay, *supra* note 86, for a comprehensive review of authorities; *see* also Andrew Keay, *Financially Distressed Companies, Restructuring and Creditors' Interests: What is a Director to do?*, 2019 LLOYD'S MARITIME & COMM. L. Q. 297.

[93] *Compare* BTI 2014 LLC v. Sequana S.A. [2019] EWCA Civ 112 (U.K.), at para 222 ("[I]t is hard to see that creditors' interests could be anything but paramount"); Cooper v. Debut Homes Limited (in liquidation) [2019] NZCA 39 (N.Z.), at para. 26 ("When a company is nearing insolvency, the interests of the company extends to encompass the interests of the company's creditors."); Westpac Banking Corp. v. Bell Group Ltd. (in liq.) [No. 3], [2012] WASCA 157 at para. 2031 (Austl.) ("[D]irectors in discharging their fiduciary duties to their company must, if the company is sufficiently financially distressed, have regard and give proper effect to the interests of creditors."); Moulin Global Eyecare Holdings Ltd. v. Mei [2014] HKCFA 63 (H.K.), at paras. 41, 57. *See* Rosemary Teele Langford & Ian Ramsay, *The 'Creditors' Interests Duty': When Does It Arise and What Does It Require?*, 135 L. Q. REV. 385 (2019). As of this writing, *Sequana* is under appeal to the U.K. Supreme Court.

than merely give their mind to it, keep calm, and carry on. It is submitted that when this duty is enlivened, directors should shift corporate strategy to "survival mode" - that is, abandon any entrepreneurial strategy the company may have been pursuing and implement a custodial, caretaking strategy with a view to protecting the company's core strategic assets. Such a strategy need not be similar to strategies that a liquidator could implement in order to sell the firm as a going concern.[94] According to the present analysis, the purpose of such a creditor-considering duty is to help directors break out of the escalation of commitment trap by forcing a reconsideration of the business strategy in light of current circumstances. The purpose is not to make the company a "dead man walking" - namely, a not-yet-in-bankruptcy insolvent company that is nonetheless heading for bankruptcy. As long as the directors believe that there is a viable business strategy for the company, with creditors' interest taken into account, they should be allowed to pursue it. Their discretion, however, may not be shielded by the protection of the business judgment rule. As argued above, when directors operate in the vicinity of insolvency, they should become subject to a duty of caution or a close equivalent to that duty. Unlike the duty of care under the business judgment rule, the duty of caution is subject to substantive judicial review and intervention. Dicta in several cases are consistent with this view.[95]

The second prong in the Anglo approach comprises statutory provisions that impose liability on directors of nearly-, virtually-, or practically insolvent companies for failing to take action in order to minimize the loss to creditors. Known as wrongful trading in U.K. parlance, these statutes come under different titles and in different textual formulations.[96] Their underlying logic has been contested and their track record in terms of achieving their purpose is subject to extensive debates, the discussion of which exceeds the present scope.[97] It would not be an exaggeration to

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[94] *Compare Moulin*, *id.*, at paras. 57-58 ("The duty may extend to not prejudicing the interests of creditors and preserving the assets of the company so that those assets may be dealt with in accordance with ordinary principles of insolvency law").

[95] *See*, e.g., *Westpac*, *supra* note 93, at para. 2031 ("[C]ourts will now intervene in an appropriate case, irrespective of the directors' beliefs and business judgments, to ensure that creditors are properly protected.").

[96] *See* sections 214 and 246ZB of the U.K. Insolvency Act 1986 (wrongful trading); sections 588G-588GA of Australia's Corporations Act 2001 (Cth) (insolvent trading); sections 135-136 of New Zealand's Companies Act 1993 (reckless trading).

[97] For scholarly analyses *see*, e.g., Paul Davies, *Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency*, 7 EUR. BUS. ORG. REV. 301 (2006); Andrew

say that these are the statutes that everybody loves to hate. So much so, that when the Covid-19 pandemic hit the world in 2020, the governments in the United Kingdom, Australia, and New Zealand passed laws to suspend these provisions for periods of several months - a move that is somewhat perplexing when one recalls that other sources of director liability, including the duty to consider creditors' interest, remain intact.[98]

The theory advanced in this paper could help in rationalizing wrongful trading statutes. In this view, liability for wrongful trading should not aim to provide creditors with a direct cause of action against directors for the former's losses; neither should it be viewed as a deterrent against taking excessive risks ("gambles") with a view to shifting risk to creditors. An equally plausible rationale for these laws is to prod directors out of the escalation of commitment corral. This is particularly salient with regard to the Australian insolvent trading provision, to which a 2017 amendment added a set of safe harbors for directors that includes obtaining appropriate advice, keeping themselves informed of the financial position of the company, and maintaining proper financial records.[99] These steps echo the mechanisms suggested in the escalation-of-commitment literature as means for de-escalation.

Stated otherwise, wrongful trading liability could be imposed - in legal systems that recognize this type of liability - for failing to endeavor to replace an entrepreneurial strategy with a custodial strategy. It would not be imposed if directors took steps to address the situation. Despite textual challenges in the wording of those provisions, such liability could be assessed like a breach of trustees' duty of caution and, consequently, without the immunity of the business judgment rule. Denying directors of the business judgment rule protection does not render wrongful trading

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Keay, *Wrongful Trading: Problems and Proposals*, 65 N. IR. LEGAL Q. 63 (2014); Jason Harris, *Director Liability for Insolvent Trading: Is the Cure Worse than the Disease?*, 23 AUSTL. J. CORP. L. 266 (2009); Firew Kebede Tiba, *Safe Harbor Carve-Out for Directors for Insolvent Trading Liability in Australia and Its Implications*, 53 U.S.F. L. REV. 43 (2019). For empirical studies *see* with regard to the U.K., Australia, and New Zealand, respectively, Richard Williams, *What Can we Expect to Gain from Reforming the Insolvent Trading Remedy?*, 78 MODERN L. REV. 55 (2015); Stacey Steele & Ian Ramsay, *Insolvent Trading in Australia: A Study of Court Judgments from 2004 to 2017*, 27 INSOL. L.J. 156 (2019); Lynne Taylor, *Directors' Duties on Insolvency in New Zealand: An Empirical Study*, 28 N.Z.U. L. REV. 171 (2018).

[98] For short discussions, *see* Amir Licht, *What's so Wrong with Wrongful Trading? On Suspending Director Liability during the Coronavirus Crisis*, in COVID-19 AND BUSINESS LAW 57 (Horst Eidenmüller *et al*., eds 2020); Kristin van Zwieten, *The Wrong Target? COVID-19 and the Wrongful Trading Rule*, *id.*, at 53.

[99] *See* section 588GA of the Corporations Act 2001 (Cth) (Austl.).

liability strict, however. Like trustees, directors can still show that they acted in good faith and reasonably in the circumstances, but their decisions would be subject to substantive judicial review. Much depends on courts' understanding of the conundrum faced by managers of financially distressed companies. Judicial statements in this regard provide some comfort. In *Re Continental Assurance Co of London plc*, Park J famously said that "[c]easing to trade and liquidating too soon can be stigmatised as the coward's way out."[100] In *Cooper*, the Court of Appeal of New Zealand recently confirmed that "[d]irectors do not become liable under [section 135] simply because they continue trading after a company becomes insolvent."[101]

Finally, the present theory could also provide a justification for the suspension of wrongful trading liability for a limited period after the outbreak of the Covid-19 pandemic. The pandemic exerted a systemic shock to entire economies, the features of which could not have been foreseen. Inasmuch as financial distress and subsequent insolvency are related to the pandemic, there is scant basis to assume that they could have been avoided but for escalation of commitment by corporate leaders and their failure to de-escalate. The same cannot be said about the rationale from shifting risk, which is theoretically applicable also in times of corona.[102] One may wonder, however, if this logic does not also militate for suspending the common law duty to consider creditors' interest in the vicinity of insolvency in the same circumstances.

VI. CONCLUSION

The legal zone at the vicinity of insolvency has attracted much attention from scholars and judges alike. That this zone exists as a matter of business reality cannot be denied. Many firms experience financial distress at certain stages of their operations; some overcome it and some don't. Whether the condition of close proximity to insolvency should change the legal regime that applies to directors has received very different answers across common law jurisdictions, however. This paper advances a new account for motivating special legal treatment of fiduciary

[100] Re Continental Assurance Co of London plc (in liq) [2007] 2 BCLC 287 (U.K.), at para. 281.

[101] Cooper v. Debut Homes Limited (in liquidation) [2019] NZCA 39 (N.Z.), at para. 31.

[102] For a broader argument, that bankruptcy proceedings are inappropriate for resolving Covid-19-related insolvencies, *see* Kristin van Zwieten, Horst Eidenmüller, & Oren Sussman, Bail-outs and Bail-ins are better than Bankruptcy: A Comparative Assessment of Public Policy Responses to COVID-19 Distress, working paper (2020).

duties in the vicinity of insolvency, in addition to the conventional account of risk shifting. This account points to escalation of commitment to motivate the imposition of a custodial duty of caution in the vicinity of insolvency. It is hoped that this analytical framework would be helpful in clarifying the law on this difficult subject.

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