Contractual Protection: An Existing Remedy for Bondholder Distress

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CONTRACTUAL PROTECTION: AN EXISTING REMEDY FOR BONDHOLDER DISTRESS

The interests of bondholders have traditionally conflicted with the interests of stockholders. Recently, as companies have be-

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1 See Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 Wis. L. Rev. 667, 667 n.2. Literature has classified bonds and debentures under the generic name of bonds. *Id.* A “bond” typically refers to a “long term promissory note issued pursuant to a trust indenture” and secured by a lien on some or all of the issuer’s property. *Id.* A “debenture” is a “long term promissory note issued pursuant to a trust indenture” and is usually not secured by a mortgage or lien upon any specific property. *Id.* Debentures generally involve only the personal obligation of the obligor. H. Henn & J. Alexander, *Laws of Corporations* 388 (1983). See also *American Bar Foundation, Commentaries on Indentures* 1-2 (1971) [hereinafter Commentaries]. For a discussion of trust indentures, see *infra* notes 20-28 and accompanying text.

2 See Bratton, *supra* note 1, at 667-68 & n.1. Because bondholders and stockholders have distinct interests in the corporate enterprise, their relationship is often characterized as adverse. *Id.* The phrase “conflicting interests” describes the conflict that exists between “the self interest of an individual or legal entity and its legal or moral obligations to others.” *Id.* See also N.Y.L.J., June 5, 1989, at 39, col. 2 (“It is widely recognized that the fiduciary obligation of a corporate director to enhance shareholder value may often conflict with the interests of bondholders.”); Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. Rev. 738, 738 & n.1 (1978) (explains reasons for conflict of interests in market transactions).

The bondholder is often referred to as a creditor of the issuing corporation, while the stockholder is viewed as the debtor. See H. Henn & J. Alexander, *supra* note 1, at 380, 383. See also Norte & Co. v. Manor Healthcare Corp., Nos. 6827 and 6831 (Del. Ch. Nov. 21, 1985) (LEXIS, States library, Del file) (debentureholders, in contrast to stockholders, are creditors of the corporation). Due to this debtor-creditor relationship, bondholders and stockholders have an adverse interest “with respect to the manner in which the enterprise
come more heavily debt-laden, this conflict has become increasingly pronounced in the face of what some economists describe as an unprecedented transfer of wealth from bondholders to stockholders. Today's most notable example of wealth transfer is the leveraged buyout (LBO), in which corporate management or other investors take on new debt to buy out stockholders at a premium above the market value of their shares. In an LBO, the outstanding bonds are devalued due to the increased risk that the issuing corporation will not be able to meet its additional interest obligations.

Dissatisfaction over wealth transfer has led one group of bondholders to file suit against RJR Nabisco (RJR) in New York federal district court. The bondholder plaintiffs, Metropolitan Life In-

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3 See McDaniel, Bondholders and Corporate Governance, 41 BUS. LAW. 413, 414 (1986) (quoting Bleakley, Business Bets on Bonds Again, N.Y. Times, July 7, 1985, § 3, at 1, col. 5). A recent study of debt-to-equity ratios of nonfinancial corporations showed that at the end of the first quarter of 1985, debt ratios rose to 6.2-to-1, from less than 4-to-1 one year earlier. Id.


The leveraged buyout produces a wealth transfer from existing bondholders to stockholders when the bond market adversely reacts to additional debt obligation incurred by the issuing corporation. A Bruising Battle Over Bonds, N.Y. Times, Nov. 27, 1988, § 3, at 1, col. 2 (studies show bondholder loses four percent of holdings in highly leveraged buyouts). See Recapitalizations Are a Bonanza for Some, But Bondholders Can Take a Terrific Beating, Wall St. J., June 1, 1987, at 53, col. 3 ("Regardless of what recapitalizations do for stockholders, they're almost never good for bondholders").

5 N.Y. Times, supra note 4, § 3, at 21. See Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., No. 88-8266 (S.D.N.Y. May 31, 1989) (LEXIS, Genfed library, Dist file). "A leveraged buy-out occurs when a group of investors, usually including members of a company's management team, buy the company under financial arrangements that include little equity and significant new debt." Id. See also Farrell, Takeovers and Buyouts Clobber Blue-Chip Bondholders, Bus. Wk., Nov. 11, 1985, 113, 113 (stock owners benefit from stock buybacks, acquisitions, and leveraged buyouts, but debt holders suffer).

6 N.Y. Times, supra note 4, § 3, at 21. See McDaniel, supra note 3, at 419 (sharing equity cushion with new bondholders increases risk to old bondholders causing price of outstanding bonds to decline); Farrell, Bondholders Are Mad As Hell - And They're Not Going To Take It Anymore, Bus Wk., Feb. 6, 1989, 82, 82 ("The prospect that [a] company will have to take on more debt sends its bond prices plummeting.").

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surance Company and Jefferson Pilot Life Insurance Company, charged that RJR’s management initiated a leveraged buyout that violated the fiduciary and good faith obligations RJR owed to its existing bondholders. Metropolitan claimed that it alone lost $40 million on its RJR bond portfolio as a result of RJR’s proposed LBO and the subsequent bond fallout.

The facts in Metropolitan Life Ins. Co. v. RJR Nabisco, Inc. reveal that from January through April, 1988, the investment banking firm of Shearson Lehman Hutton sold $1 billion of RJR Nabisco bonds. In October, 1988, Shearson then helped RJR’s Chairman, F. Ross Johnson, plan a leveraged buyout of the company, which drove the market value of the bonds down by more than $100 million. Bonds with a par value of $100, which were trad-

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* Sloan, The Rape of the Bondholder, FORBES, Jan. 23, 1989, 67, 67. In 1988, RJR Nabisco “issued $1.4 billion in blue chip debt.” Plaintiff's First Amended Complaint at 9. Metropolitan Life Ins. Co., (No. 88-8266). Metropolitan asserted that as early as September, 1987, RJR management was exploring the possibility of a leveraged buy-out. Id. at 8. Yet, despite the effect that a buy-out would have on the company, “RJR Nabisco continued to issue its investment grade debt securities.” Id. at 9. RJR’s “long term bonds were issued in a market environment in which ‘leveraged buy-outs’ of $25 billion were not expected.” Id. at 6-7. “RJR Nabisco’s investment grade rating did not reflect the possibility that management of one of America’s leading companies would, in order to amass personal fortunes, put the Company’s future at risk and strip the Company of substantially all the value of its assets in a ‘leveraged buy-out’ . . . .” Id. at 7.

9 Sloan, supra note 10, at 67. On October 20, 1988, F. Ross Johnson “proposed a $17 billion leveraged buy-out . . . of the company’s shareholders, at $75 per share.” Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., No. 88-8266 (S.D.N.Y. May 31, 1989) (LEXIS, Genfed library, Dist file). “Within a few days, a bidding war developed among the investment group led by Johnson and the investment firm of Kohlberg Kravis Roberts & Co. (“KKR”), and others.” Id. RJR directors “recommended that the company accept the KKR
ing at $85, fell to $71 upon news of the proposed buyout. Stocks, however, fared better. While bond prices plummeted, stock prices climbed as high as $89, from $55.

Metropolitan is not the first case in which bondholders have alleged a violation of a fiduciary duty arising from a corporate policy obligation. Nor is this the first time that bondholders have asserted a duty of good faith and fair dealing as a matter of contractual right. However, Metropolitan is significant because it represents a compelling challenge to traditional bondholder doctrine at a time when bondholder dissatisfaction is acute. This case is timely because recent losses registered by bondholders have prompted many courts and scholars to reexamine the traditional contractual protection found in the bond agreement. With clear proposal, a $24 billion LBO that called for the purchase of the company’s outstanding stock at roughly $109 per share.”

Metropolitan claimed that upon news of management’s LBO offer “the value of RJR Nabisco’s outstanding long-term debt [was reduced] . . . by almost $1 billion.” Plaintiff’s First Amended Complaint at 2, Metropolitan Life Ins. Co., (No. 88-8266).


See Van Gemert v. Boeing Co., 520 F.2d 1373 (2d Cir.) (court found covenant of good faith and fair dealing implied in convertible debenture indenture), cert. denied, 423 U.S. 947 (1975); Katz v. Oak Indus., Inc., 508 A.2d 873 (Del. Ch. 1986) (terms of the indenture, not broad concepts such as fairness, define issuer’s obligation to bondholder). See also Kessler v. General Cable Corp., 92 Cal. App. 3d 591, 155 Cal. Rptr. 94 (1979) (no implied covenant of good faith where subject is covered by indenture).

See Bleiberg, Bondholders Until Issuers are Getting Away with Highway Robbery, Barron’s, Nov. 24, 1986, 9, 9 (courts and SEC have failed to respond to plight of bondholders). See also Sloan, supra note 10, at 67 (bond covenants fail to protect bondholders); Farrell, Bondholders are Mad as Hell - and No Wonder, Bus. Wk., Dec. 5, 1988, 28, 28 (bondholders begin to fight companies that turn high-grade debt into junk bonds); Boland, When Bonds Lose Their Convertibility, N.Y. Times, Jan. 31, 1988, § 3, at 10, col. 3 (bond investors should take care to read terms of bond indenture); Weberman, Redmail, Forbes, Oct. 7, 1985, 173, 173 (takeovers adversely affect bondholders).

See Simons v. Cogan, 542 A.2d 785, 788-89 (Del. Ch. 1987), aff’d, 549 A.2d 300 (Del. 1988). The recognized view, that “[c]ourts traditionally have directed bondholders to protect themselves against . . . self-interested issuer action with explicit contractual provi-
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evidence indicating that excessive debt has claimed real victims, bondholder litigation may become a standard feature of leveraged buyouts. Despite the difficulties that bondholders face in demonstrating that a fiduciary or good faith duty should run from corporate management to bondholders, it is likely that bondholder

sions," has been challenged in modern cases. Id. at 789 (quoting Bratton, supra note 1, at 668). Contra Broad, 642 F.2d at 957 (although New York contract law guarantees implied covenant of good faith, such covenant could not give bondholders rights inconsistent with indenture).

Traditionally, bondholder protection has been found in a contractual covenant called a negative pledge clause. McDaniel, Are Negative Pledge Clauses in Public Debt Issues Obsolete?, 98 Bos. Law. 867, 867-68 (1983). This covenant, "found even in the debentures of triple-A companies, limits a company's ability to create secured debt that will rank ahead of unsecured debentures." Id. at 867. It has been asserted that the negative pledge clause is an outdated restrictive covenant that offers no protection to today's bondholder. See id. at 868. See also infra notes 106-09 and accompanying text.

Metropolitan has asserted that its contract with RJR, like most contracts for the purchase of blue chip securities, did not "limit dividends or debt; nor [did it] contain other express covenants, found in indentures for weaker companies, that are intended to guard against financial deterioration." Plaintiff's First Amended Complaint at 7, Metropolitan Life Ins. Co., (No. 88-8266).

18 N.Y.L.J., supra note 2, at 40, col. 2. See infra note 27 (junk bond revolution has hurt bondholders).

19 See Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., No. 88-8266 (S.D.N.Y. May 31, 1989) (LEXIS, Genfed library, Dist file). The Metropolitan court recently rejected Metropolitan's claim that RJR breached either a fiduciary or good faith duty owed to bondholders, and granted RJR's motion for summary judgment on both counts. Id. The case is currently pending on other counts. Id.

In rejecting Metropolitan's claim that RJR breached an implied covenant of good faith and fair dealing, the court first "examine[d] the indentures to determine the fruits of the agreement between the parties." Id. The court then "decide[d] whether those fruits [had] been spoiled." The court held that:

[T]he "fruits" of these indentures do not include an implied restrictive covenant that would prevent the incurrence of new debt to facilitate the recent LBO. To hold otherwise would permit these plaintiffs to straightjacket the company in order to guarantee their investment. These plaintiffs do not invoke an implied covenant of good faith to protect a legitimate, mutually contemplated benefit of the indentures; rather, they seek to have this Court create an additional benefit for which they did not bargain.

Id.

The Metropolitan court also summarily rejected plaintiff's claim that RJR management breached a fiduciary duty owed to its bondholders. The court stated that:

Before a court recognizes the duty of a "punctilio of an honor the most sensitive," it must be certain that the complainant is entitled to more than the "morals of the market place," and the protections offered by actions based on fraud, state statutes or the panoply of available federal securities laws. This Court has concluded that the plaintiffs presently before it—sophisticated investors who are unsecured creditors—are not entitled to such additional protections.

Id. (citing Meinhard v. Salmon, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928) (Cardozo, J.).)
dissatisfaction will cause the current debt-driven market to reexamine the bond as a source of capital.

This Article will address the demand for greater bondholder protection and evaluate the need to expand protection beyond traditional contractual foundations. Part I will examine the bond indenture and its use within the context of the stockholder-bondholder conflict. Part II will weigh the expansive fiduciary duty theory of protection against the traditional contractual approach. Finally, this Article will reject a fiduciary duty theory of protection and suggest that bondholder protection should be found within the contractual framework of the bond indenture.

I. THE BOND INDENTURE

A. Contractual Protection

Until recently, the only protection afforded the bondholder was that found in the bond agreement between the corporate issuer and the bondholder. The bond agreement, called a trust indenture, sets out the rights available to protect the interests of each party. Traditionally, if a bondholder was not protected by a cov-

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20 See Broad, 642 F.2d at 940. Debt securities, more so than equity securities, are "creatures of contract law." Id. The American Bar Foundation characterized the protection offered by the indenture agreement as follows:

The second fundamental characteristic of long-term debt financing is that the rights of the holders of the debt securities are largely a matter of contract. There is no governing body of statutory or common law that protects the holder of unsecured debt securities against harmful acts by the debtor except in the most extreme situations. Short of bankruptcy, the debt security holder can do nothing to protect himself against actions of the borrower which jeopardize its ability to pay the debt unless he takes a mortgage or other collateral or establishes his rights through contractual provisions set forth in the debt agreement or indenture. Commentaries, supra note 1, at 1-2, quoted in Broad, 642 F.2d at 940 n.10. See also Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (relationship between corporation and holders of their debt securities is contractual in nature).

21 See Bratton, supra note 1, at 667 n.2. "A trust indenture is a contract entered into between the corporation issuing the bonds and a trustee for the benefit of the holders of the bonds." Id. The rights of the bondholder and the issuer are stated in the indenture, as are the mechanics of payment, the role of the trustee, and the issuer's sinking fund obligations and redemption rights. Id. The indenture also regulates the conduct of the issuer's business and defines events of default. Id.

The contract determines the rights of the bondholder. See Commentaries, supra note 1, at 1-2, quoted in Broad, 642 F.2d at 940 n.10.

[There is no body of law governing the procedures by which the holders of debt securities may take collective action to protect their interests]. These procedures, as
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enant expressly stated in the indenture, courts were loath to look beyond the indenture for a remedy. It was incumbent upon the bondholder to demonstrate that his contractual protection could be found in the indenture.

Today's corporate environment involves LBOs, takeovers, mergers, spin-offs and recapitalizations, all of which played a smaller part in yesterday's economy when bond indentures were first utilized. The use of high yield bonds, also called junk bonds, has become an increasingly popular means of financing or defending against takeovers. However, the increased use of

well as the mechanics of transfer and exchange of the securities, are matters of contract which are usually set out in the indenture and sometimes in the debt instrument. Thus the situation is quite unlike that involved in the issuance of stock where various substantive rights and procedural matters are in effect incorporated in the certificate of incorporation of the issuer by operation of the applicable corporation laws.

Id. See Simons v. Cogan, 542 A.2d 785, 786-87 (Del. Ch. 1987), aff'd, 549 A.2d 300 (Del. 1988). "It is elementary that rights of bondholders are ordinarily fixed by and determinable from the language of documents that create and regulate the security. In a publicly distributed debenture the notes themselves and a trust indenture serve this function . . . ." Id. See Wolfensohn v. Madison Fund, Inc., 253 A.2d 72, 75 (Del. 1969) (whether holder of instrument is stockholder or creditor is determined by terms of his contract). But cf. PA. STAT. ANN. tit. 42, § 8363 (Purdon 1987) (recent statutory amendment enacted in Pennsylvania offers extra-contracual bondholder protection by requiring directors to consider the interests of creditors); OHIO REV. CODE ANN. § 1701.59 (Page 1985) (Ohio provides that directors "may" consider the interests of creditors).

See Broad, 642 F.2d at 963 (debentureholders received all to which they were contractually entitled under the indenture); Gardner & Florence Call Cowles Found. v. Empire, Inc., 589 F. Supp. 669, 675 (S.D.N.Y. 1984) (no liability for breach of fiduciary duty where defendants have fully complied with their obligations under the indenture, vacated on other grounds, 754 F.2d 478 (2d Cir. 1985); Norte & Co. v. Manor Healthcare Corp., No. 6827 and 6831 (Del. Ch. Nov. 21, 1985) (LEXIS, States library, Del file).


See Leveraged Takeovers, supra note 24, at 165 n.1. Junk bonds are described as follows: High yield debt (junk bonds) are corporate bonds that are rated below investment grade by the major rating agencies - Standard and Poor's and Moody's Investor Service. These ratings reflect each agency's estimate of the firm's ability to repay its debt obligation (i.e., to pay interest and repay principal when due). The highest rating is AAA (Aaa) for Moody's). These firms have an extremely strong ability to pay interest and repay principal. The bonds are then ranked by this ability on the following scale: A(Aa), A(A), BBB(Baa), BB(Ba), B(B). Some bonds are even rated below B. Bonds rated BB(Ba) and below are regarded as speculative bonds and are also referred to as high-yield bonds or junk bonds.

debt as a means of fueling corporate maneuvering has had a significant impact on bondholders. Bondholders claim that this impact has been detrimental to their interests and that any resulting benefit of excessive debt comes at the expense of the existing bondholder. In asserting its fiduciary and good faith claims, Metropolitan impliedly claimed that the indenture failed to provide adequate protection in today’s takeover environment. Metropolitan had asked the court to look beyond the indenture in order to prevent the transfer of wealth from existing bondholders to stockholders.

B. Stockholder-Bondholder Conflict

Stockholders and bondholders are the largest and perhaps the most important of the different groups comprising the corporation. Each of the two may be viewed as a supplier of capital to the enterprise, possessing distinct claims against the cash flow and assets of the corporation.


SEC Study, supra, found that internal funds of acquiring firms financed only 6.8 per cent of takeovers in the first half of 1985, down from 47.1 per cent in 1981. Leveraged Takeovers, supra note 24, at 163.

See Leveraged Takeovers, supra note 24, at 185. Critics of leveraged takeovers argue that such transactions cause bondholders and preferred stockholders significant loss of wealth. Id. Although it is premature to conclude that junk bonds “imperil the stability of any class of financial institutions,” available evidence strongly suggests that the junk bond revolution has adversely affected outstanding bondholders. Coffee, supra note 26, at 47, 49.

28 N.Y. Times, supra note 4, at 21, col. 3. But cf. N.Y.L.J., supra note 2, at 39, col. 2 (issuers claim no breach or injury to bondholders if all required payments to bondholders are made).

See Kalay, Stockholder-Bondholder Conflict and Dividend Constraints, 10 J. Fin. Econ. 211, 211 (1982) (“bond covenants are structured to control the conflict of interests between stockholders and bondholders.”).

H. Henn & J. Alexander, supra note 1, at 384. The totality of the corporation’s debt and equity securities is called the corporate “capital structure.” Id. Yet, because of their different claims against the corporation, bondholders and stockholders share an adverse interest in corporate management. Comment, supra note 2, at 462.

See also Commentaries, supra note 1, at 1-2. The American Bar Foundation made the following distinctions between long term debt-financing and equity financing:

In general, funds needed for financing private corporate enterprises are obtained in exchange for interests of two essentially different kinds: (1) those of the “equity”
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Stockholders, as the corporate debtors, are the equitable owners of the corporation and are entitled to a proportional interest in earnings, assets and control. However,stockholders do not have a fixed claim on corporate assets or cash flow and are not entitled to regular cash distributions.

Bondholders, on the other hand, are creditors of the corporation with fixed interests in corporate assets and cash flow. The bondholder is generally viewed as more risk averse than the stockholder and has a direct interest in preserving corporate capital and earnings in order to maximize firm value. By concurrently maximizing firm value and reducing the firm's debt to equity ratio, the bondholder optimally ensures an adequate equity cushion so as to avoid a decline in outstanding bond value.

owners or shareholders, whose securities represent certain rights of ownership, control and profit accompanied by a relatively greater risk of loss, and (2) those of the "lenders," who classically forego control and profit in return for periodic payments (interest and often sinking fund) without regard to profits and for repayment of principal at a fixed date, ahead of the equity owners.

Id. See Norte & Co. v. Manor Healthcare Corp., Nos. 6827 and 6831 (Del. Ch. Nov. 21, 1985) (LEXIS, States library, Del file). The corporation is the legal owner of its property. Id. Stockholders do not have a specific interest in the assets of the corporation, but they have a right to share in the firm's profits and in the distribution of its assets upon liquidation. Id. Equity securities generally create the stockholder relationship, with the stockholders acting as the insiders who own the corporation. H. Henn & J. Alexander, supra note 1, at 383. The debt security holders are considered outsiders who are owed by the corporation. Id. 32 Comment, supra note 2, at 463. Corporate management has the discretion to determine the timing, amount and nature (cash or noncash) of any distribution to stockholders. McDaniel, supra note 3, at 419.

See supra note 29. See also Norte & Co. v. Manor Healthcare Corp., Nos. 6827 and 6831 (Del. Ch. Nov. 21, 1985) (LEXIS, States Library, Del file) (debentureholders, in contrast to stockholders, are creditors of the corporation); Comment, supra note 2, at 463 (debentureholders have fixed and prior claim on cash flow and assets of firm; their rights are determined at time of investment).

See McDaniel, supra note 3, at 419. The interests of bondholders and stockholders clash in a highly leveraged corporation where the bondholder stake is large and the stockholder stake is small. Id. Contributing to this conflict is the stockholder's incentive to invest in risky projects. Id. See also Kalay, supra note 29, at 211 (the "firm is a collection of groups whose interest can, and do, conflict.").

Comment, supra note 2, at 466. The reduction of corporate assets diminishes the ability of the firm to pay bondholder claims. Id.

McDaniel, supra note 4, at 229. A firm with a high ratio of debt to equity is considered highly leveraged. Id. When leverage increases, bond prices decrease. Id. Under zero sum theory, bondholder loss is then transformed into stockholder gain. Id.

See id.; Comment, supra note 2, at 465 (bondholders seek to limit distributions to shareholders, dilution of cash flow and assets, and increase in risk). See also infra note 40.
The traditional economic assumption is that the stockholder, as the controller of the firm, will choose investments and make decisions that maximize his own wealth.\(^8\) Pursuant to this goal, the stockholder, acting through management, has the ability to transfer wealth from the bondholder to himself by enacting policies that increase the risk of outstanding bonds.\(^9\) Toward this end, the stockholder may choose to increase his dividend rate, decrease the rate at which he reinvests earnings, incur additional debt or simply substitute riskier assets for those presently held.\(^4\) Regardless of the means used to effect the wealth transfer, whether in the form of a dividend or increased debt, the net effect to the bondholder is the same: an increased ratio of debt to equity which

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\(^{8}\) See Kalay, supra note 29, at 211 (stockholder expected to maximize his own wealth); Barkey, supra note 4, at 49 (corporate assets efficiently used when present value maximized).

\(^{9}\) See Bratton, supra note 1, at 668 n.3. Distribution to shareholders is not in bondholder's best interest. Id. "Management, if left unconstrained, could use the proceeds of a debenture issue to declare a dividend to shareholders . . . ." Comment, supra note 2, at 466. See also Kalay, supra note 29, at 211 (shareholders control firm and are expected to maximize own wealth); Note, Fiduciary Duties of Directors: How Far Do They Go?, 23 Wake Forest L. Rev. 163, 173 (1988) ("directors must seek to maximize the value of the corporation's stock without direct regard for the value of other classes of its securities.").

\(^{4}\) See Bratton, supra note 1, at 667-68. Incurring additional debt or substituting riskier assets for existing ones reduces the value of the bonds without "reducing the value of the stockholders' participation in the issuer." Id. at 668.

Stockholder wealth is maximized if the issuer distributes to the stockholders all capital which the issuer cannot invest for a rate of return higher than that available to the stockholder elsewhere. Such a distribution might take any one of a number of forms - an ordinary cash dividend, a spin-off or other distribution in kind, or a payment in connection with a redemption or other repurchase of outstanding shares. In contrast, the issuer maximizes bondholder wealth if it retains all earnings and other capital which it can reinvest for a positive return. Distributions to stockholders are not in the bondholder's interest because any decrease in the value of the issuer’s assets increases the likelihood of default on the bonds. Id. at 668 n.3.

See McDaniel, supra note 3, at 418-21. Any increase in debt increases a corporation's debt to equity ratio. Id. at 418. In a business downturn when earnings are reduced, debt increases the risk of default because as a fixed cost it can not be reduced. Id. Stockholder-bondholder conflict exists because bondholders have prior fixed claims on corporate assets, while stockholders have limited liability for corporate debt and unlimited claims on its remaining assets. Id.

For a contrasting view of stockholder self-interest, see Kalay, supra note 29, at 227. Evidence suggests that stockholders of leveraged firms choose to limit the ability to pay dividends. Id. Surprisingly, stockholders do not pay out as much in debt financed dividends as they otherwise might, in effect, causing a transfer of wealth from themselves to the bondholders. Id. at 227.
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ciauses a subsequent decline in bond value.\textsuperscript{41}

The problem of stockholder-bondholder adversity becomes more acute when one focuses on the role of corporate management. In theory, the director manages the affairs of the corporation.\textsuperscript{42} In carrying out his responsibilities, the director acts as a fiduciary for the corporation and its shareholders.\textsuperscript{43} As such, he is bound by the strict duties of care and undivided loyalty.\textsuperscript{44}

Traditionally, fiduciary and good faith theories of protection have been reserved for stockholders.\textsuperscript{45} Bondholders, because they were viewed as contractually protected creditors of the corporation, were not deemed to be entitled to the benefit of this protection.\textsuperscript{46} However, recent case law signifies a changing viewpoint.\textsuperscript{47}

\textsuperscript{41} See McDaniel, supra note 3, at 419 (new debt drives down existing bond prices).


\textsuperscript{44} See Wilshire Oil Co. of Tex. v. Riffe, 381 F.2d 646, 650 (10th Cir.) ("corporation is entitled to have its officers and directors actively promote its interests, and not to place themselves in a position where their personal interests conflict or could conflict, with those of the corporation."), cert. denied, 389 U.S. 822 (1967); Norte & Co. v. Manor Healthcare Corp., Nos. 6827 and 6831 (Del. Ch. Nov. 21, 1985) (LEXIS, States Library, Del file) (director's fiduciary duty is one of undivided loyalty).

\textsuperscript{45} E.g., Simons v. Cogan, 542 A.2d 785, 788 (Del. Ch. 1987), aff'd, 549 A.2d 300 (Del. 1988). Delaware courts have "consistently recognized that neither an issuer of debentures nor a controlling shareholder owes to holders of the company's debt securities duties of the special sort characterized as fiduciary in character." Id.

\textsuperscript{46} See Browning Debenture Holders’ Comm. v. DASA Corp., 560 F.2d 1078, 1084 (2d Cir. 1977) (no federal fiduciary duties exist to deal fairly with corporate debentureholders): Norte & Co. v. Manor Healthcare Corp., Nos. 6827 and 6831 (Del. Ch. Nov. 21, 1985) (LEXIS, States Library, Del file) (interprets prior Delaware case law as strongly suggesting convertible debentureholder may not state claim for breach of fiduciary duty).

\textsuperscript{47} See Simons, 542 A.2d at 786 ("Broad and abstract requirements of a 'fiduciary' character . . . have little or no constructive role to play in the governance of such a negotiated, commercial relationship."). See also cases cited supra note 45.

II. THEORIES OF BONDHOLDER PROTECTION

Recent decisions reveal that some courts have taken an innovative approach to establish bondholder protection. The most unconventional of the innovative views is the theory that a fiduciary duty is owed to both stockholders and bondholders.48 Fiduciary law springs from agency doctrine, and has long been recognized as a fundamental element of corporate policy.49 To a lesser extent, protection has also been established under a theory of good faith and fair dealing, arising as an implied contractual covenant.50 Courts that have recognized these theories have not restricted bondholder protection to the provisions of the indenture. Instead, they have ventured beyond the four corners of the indenture and have utilized expansive remedial measures in an effort to aid the bondholder.

A. Fiduciary Duty

The notion that corporate directors owe a fiduciary duty to bondholders originated in Pepper v. Litton.81 In Pepper, a controlling stockholder obtained a judgment against the issuing corporation after it became insolvent, but before it was adjudicated bank-
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rupt. When Pepper, a creditor, filed a claim against the corporation he found that the remaining assets were insufficient to satisfy his claim.\(^5\)

Justice Douglas, writing for the Supreme Court, subordinated the controlling stockholder's claim to that of Pepper's.\(^6\) The Court held that the defendant stockholder occupied a fiduciary position and, as such, was prohibited from taking action which was for his own benefit and to the detriment of creditors.\(^7\) The Court declared that a "fiduciary obligation is designed for the protection of the entire community of interests in the corporation - creditors as well as stockholders."\(^8\)

Justice Douglas's comment from *Pepper* is cited frequently as a basis for recognizing a fiduciary duty between directors and bondholders.\(^9\) While it is true that the Court includes creditors among those who have an interest in the corporation, a fair interpretation of *Pepper* should not venture beyond the actual facts of the case. The facts in *Pepper* speak to a fiduciary duty within the context of bankruptcy. Despite the expansive interpretation often

\(^5\) Id. at 297.
\(^6\) Id. at 298.
\(^7\) Id. at 302.
\(^8\) Id. at 311. In recognizing the fiduciary status of a director or controlling stockholder, Justice Douglas stated the following:

[A fiduciary] cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the [beneficiaries].

\(^9\) Id. at 307.

\(^5\) See United States v. AT&T, 552 F. Supp. 131 (D.D.C. 1982), aff'd sub nom. Maryland v. United States, 460 U.S. 1001 (1983). Incident to the corporate reorganization of AT&T, a consent decree established the terms for the division of assets and liabilities between AT&T and its subsidiaries. Id. at 208. The terms of the decree were challenged in court. Id. The court held that AT&T, as majority stockholder of the operating subsidiaries, "has the fiduciary duty to protect all those with interests in these companies, including creditors." Id. at 205. The court cited *Pepper* as authority for extending the fiduciary duty to creditors, including bondholders. Id. See also McDaniel, supra note 4, at 275 (discussing cases which cite *Pepper* as authority). But see Kessler v. General Cable Corp., 92 Cal. App. 3d 531, 545, 155 Cal. Rptr. 94, 103 (1979) (court refused to extend fiduciary obligations to creditors of corporation); Wolfensohn v. Madison Fund, Inc., 253 A.2d 72, 75 (Del. 1969) (court found that bondholders, as creditors, possessed rights determined by their contract, not by fiduciary duty); see infra notes 58 & 59 and accompanying text (interpreting *Pepper* as only applying to bankruptcy cases).
given to Justice Douglas's words, the holding in *Pepper* declares that a director or controlling stockholder has a duty to distribute equitably the assets of an insolvent or bankrupt enterprise. Given this narrow reading, it would be difficult to construe *Pepper* as supporting the notion that directors are charged with a fiduciary duty to bondholders, or other creditors, in any situation prior to insolvency.

Nevertheless, a number of cases have given *Pepper* an expansive reading, extending corporate management's fiduciary duty to bondholders. One such case is *Green v. Hamilton Int'l Corp.* In *Green*, the plaintiffs were convertible bondholders who alleged that the issuer's directors deliberately concealed merger negotiations in order to prevent the bondholders from exercising their conversion privileges. The court held that the bondholders'...
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complaint adequately stated a cause of action based on fraud. As justification for this dicta, the court cited Pepper and stated that the bondholders were part of “the entire community of interests in the corporation.”

In Broad v. Rockwell Int'l Corp., the Fifth Circuit added a unique twist to the concept of fiduciary obligation. The plaintiffs in Broad were convertible bondholders who claimed a breach of both a fiduciary duty and of the underlying bond indenture. The plaintiffs alleged that they were harmed by the elimination of their conversion rights under a merger agreement. Like Green, the court cited Pepper as authority for its determination that a fi-

manded rescission of the redemption transaction so that they could instead convert to stock and receive $4.00 per share in the merger. Defendant Hamilton refused to rescind the transaction. Id.

In Green, the court interpreted Delaware law as recognizing that fiduciary duties to convertible bondholders may exist because the convertible bonds create an equity interest in the corporation similar to stock. See supra note 39, at 179 (discussing Green). But see Simons v. Cogan, 542 A.2d 785, 790 (Del. Ch. 1987), aff'd, 549 A.2d 300 (Del. 1988). The court in Simons rejected the analysis of the Green court for two reasons. Id. First, the Green court was said to have simply misinterpreted Delaware law. Id. The Green court recognized a fiduciary duty to convertible bondholders where, in fact, the Delaware courts have expressly disavowed such a notion. Id. Secondly, the Simons court stated that Green incorrectly afforded equity status to convertible bondholders. Id. at 791.

The Simons court restated the status of convertible bondholders as follows:

‘[T]he holder of a convertible bond is and only is a corporate creditor to whom contractual but not fiduciary duties are owed unless he acts to end his entitlement to the legal protection his contract affords him and to assume the risks of stockholder status through exercise of the power of conversion.

Id. See also Parkinson v. West End St. Ry., 173 Mass. 446, 448, 53 N.E. 891, 892 (1899) (convertible bondholder has mere creditor status, not stockholder status).’

Green, 437 F. Supp. at 729 n.4.


Id. at 933. Collins Radio Co. sold convertible bonds due 1987 with a conversion price of $72.50. Id. at 934. In 1967, when the bonds were issued, Collins' stock traded at $60. Id. Subsequently, Collins became financially troubled; as a result its stock traded for as low as $9.75. Id. Thereafter, Rockwell invested $35 million in Collins and gained control of its board of directors. Id. Rockwell then acquired Collins in a cash merger. Id. Prior to the merger, the bonds were traded at a substantial discount. Id. at 935. Following the merger, the market value increased dramatically due to Rockwell's superior credit rating. Id. But pursuant to a provision in the original bond indenture, the bondholders could “convert the Debenture into the amount of cash that would have been payable with respect to the number of shares of Collins Common Stock into which the Debenture could have been converted immediately prior to effectiveness of the proposed merger.” Id. at 936. “Thus, after the merger, a $1000 Debenture [was worth] . . . $344.75 in cash.” Id.

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duciary duty ran from a controlling stockholder to bondholders. However, the court held that while the controlling shareholder owed a fiduciary duty to the bondholders, that duty was fully discharged by complying with the terms of the bond indenture. Therefore, only in the event of a contractual breach could there be a breach of fiduciary duty.\(^6^7\)

The court in *Gardner & Florence Call Cowles Found. v. Empire Inc.*\(^6^8\) followed the rationale of the *Broad* court,\(^6^9\) stating that "[f]iduciary duties in a debenture contract . . . do not exist in the abstract, but are derived from the Indenture itself."\(^7^0\) The court's statement equates a contractual breach to a breach of fiduciary duty.\(^7^1\)

*Green, Broad and Gardner* indicate that some courts have been willing to recognize a fiduciary relationship between corporate management and the holders of corporate debt. However, the rationales invoked in these cases are both confusing and unpersuasive. The *Broad* court, for example, created a new standard of fiduciary responsibility by arbitrarily requiring a contractual breach before recognizing a breach of fiduciary duty. In holding that

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\(^6^7\) Id. at 958. Cf. *Pittsburgh Terminal Corp. v. Baltimore & O. R.R. Co.*, 680 F.2d 933 (3d Cir.), *cert. denied*, 459 U.S. 1056 (1982). Judge Gibbons, writing for the majority, opined that "we would be very much surprised if Maryland or any other state would today hold that no [fiduciary] obligations were owed by an issuer of [convertible] securities and its directors." Id. at 941. *See also* McDaniel, *supra* note 4, at 293. McDaniel interprets *Pittsburgh Terminal* to hold that directors owe a fiduciary duty to convertible bondholders. Id. *But see* *Pittsburgh Terminal*, 680 F.2d at 943. McDaniel's conclusion is questionable given that Judge Gibbons's statement was dictum. *See id.* Judge Garth concurred in the judgment, but refused to speculate on whether a fiduciary duty to bondholders existed under Maryland law. Id. at 946 (Garth, J., concurring). Judge Adams, dissenting, disagreed with Judge Gibbons's recognition of a fiduciary duty and stated that convertible bondholders are "mere creditor[s] until conversion, whose relationship with the issuing corporation is governed by contract and statute." Id. at 947 (Adams, J., dissenting). *See also* Simons v. Cogan, 542 A.2d 785, 790 (Del. Ch. 1987), *aff'd*, 549 A.2d 300 (Del. 1988) (discussion of Judge Gibbons's unpersuasive recognition of fiduciary duty in *Pittsburgh Terminal*).


\(^6^9\) Id. at 673. The plaintiffs, who were convertible bondholders, alleged that the merger "effectively destroyed the value of their conversion right because the new Empire stock into which they are now entitled to convert is worth considerably less than the old Empire stock." Id. Plaintiffs contended that this constituted a breach of the directors' fiduciary duty owed to them as bondholders. Id.

\(^7^0\) Id.

\(^7^1\) Id. at 674 (fulfillment of contract terms satisfies fiduciary duties). *See also* McDaniel, *supra* note 4, at 279 (discussion of *Gardner* and its reliance on *Broad*).

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contractual and fiduciary obligations are intertwined, the court clearly confused its doctrinal analysis. Broad mistakenly applied a contractual obligation of implied good faith to corporate fiduciary law. Rather than applying the more burdensome fiduciary obligation, the court apparently intended to impose the lesser contractual standard of implied good faith and fair dealing.

In light of this apparent intention, Broad should be construed as actually recognizing only a contractual relationship between management and creditor. So construed, Broad conforms to the majority view that bondholder protection is contractual in nature.

B. Contract Law

As discussed in subsection A of Part I, the bondholder has traditionally found protection only within the provisions of the indenture. The most influential case espousing the traditional view is Parkinson v. West End St. Ry. In Parkinson, Justice Holmes unequivocally stated that the holder of a convertible bond “does not become a stockholder, by his contract, in equity any more than at law.” In so stating, Justice Holmes established that contract law, rather than corporate fiduciary law, should form the basis of

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72 See Bratton, supra note 1, at 720 (discussion of court’s doctrinal confusion).
73 See Broad, 642 F.2d at 958. Indicative of the court’s doctrinal confusion is the following statement made by Judge Randall: “[I]f . . . Rockwell had fully complied with its obligations under the Indenture, its fiduciary obligations also would have been discharged as a matter of law.” Id.
74 See Simons v. Cogan, 542 A.2d 785, 789 (Del. Ch. 1987), aff’d, 549 A.2d 300 (Del. 1988). The Broad court’s assumption that a fiduciary duty existed between directors and bondholders can only be interpreted as supporting the traditional contractual relationship between directors and bondholders. Id. This is so because the court incorrectly confused the fiduciary duty with the implied covenant of good faith. Id. When this issue was decided by the Second Circuit, the court was careful to explain that the good faith owed to the bondholders originated in the contract and not in a newly born fiduciary duty to bondholders. Van Gemert v. Boeing Co., 553 F.2d 812, 814 (2d Cir. 1977). The Van Gemert court indicated that the “appellants’ right to damages arose out of their contract with Boeing.” Id.
75 See Simons, 542 A.2d at 790 (majority of jurisdictions refuse to extend fiduciary concept to relationship between directors or corporations and bondholders); see supra notes 19-23 and accompanying text (discussion of cases which utilize contract law, not corporate law, to determine rights and duties of bondholders and directors).
76 See supra notes 19-23 and accompanying text (discussion of traditional contractual protection).
77 173 Mass. 446, 53 N.E. 891 (1899).
78 Id. at 448, 53 N.E. at 892.
bond-holder protection.\textsuperscript{79}

The Delaware courts, which exert considerable influence in the area of corporate law, have consistently held that no fiduciary duties exist between corporate directors and holders of debt securities.\textsuperscript{80} A clear expression of Delaware's refusal to accord fiduciary status to bondholders can be found in Simons v. Cogan.\textsuperscript{81} In Simons, a merger of two related companies resulted in the execution of a supplemental indenture which crucially altered the convertibility

\textsuperscript{79} See Wolfensohn v. Madison Fund, Inc., 253 A.2d 72, 75 (Del. 1969) (no breach of fiduciary duty because bondholders are creditors and their rights are determined by their contract). See also Barkey, supra note 4, at 64 (bondholders are not equitable owners and thus have no standing to sue for breach of fiduciary duty); Bratton, supra note 1, at 731 (bondholder remedy is strictly contractual).


Another significant Delaware case is Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986). In Revlon, Pantry Pride, in an attempt to acquire Revlon, made a hostile tender offer for all of Revlon's shares. \textit{Id.} at 176. In response, Revlon bought back approximately one-third of its common stock in exchange for subordinated notes. \textit{Id.} at 177. The notes contained covenants restricting Revlon's ability to incur debt, sell assets or pay dividends. \textit{Id.} This action was taken in order to deter Pantry Pride from acquiring Revlon with junk bond financing. \textit{Id.} However, Pantry Pride persisted and Revlon subsequently negotiated for a leveraged buyout by Forstmann Little & Company. \textit{Id.} at 178. Revlon waived the restrictive covenants in the notes in order to enable Forstmann Little to finance the leveraged buyout by incurring new debt. \textit{Id.} The waiver of the restrictive covenants caused the market value of the notes to drop. \textit{Id.} Due to the prospect of litigation by noteholders, Forstmann Little agreed to exchange the old notes for new notes with a higher interest rate. \textit{Id.} at 179. However, Pantry Pride ultimately topped Forstmann's offer. \textit{Id.} Pantry Pride sued to enjoin the issuance of the notes to Revlon shareholders. \textit{Id.} The trial court held that the Revlon directors breached their fiduciary duty to their shareholders "by making concessions to Forstmann, out of concern for their liability to the noteholders, rather than maximizing the sale price of the company for the stockholders benefit." \textit{Id.} With respect to noteholders, the Revlon court stated that their rights were determined by contract, not by any fiduciary duties. \textit{Id.} at 182-83. The court also recognized an implied contractual obligation of good faith. \textit{Id.} See also McDaniel, supra note 4, at 287-89 (detailed discussion of Revlon).

\textsuperscript{81} 542 A.2d 785 (Del. Ch. 1987), aff'd, 549 A.2d 300 (Del. 1988). Chancellor Allen succinctly restated Delaware law as follows:

It has now become firmly fixed in our law that among the duties owed by directors of a Delaware corporation to holders of that corporation's debt instruments, there is no duty of the broad and exacting nature characterized as a fiduciary duty. Unlike shareholders, to whom such duties are owed, holders of debt may turn to documents that exhaustively detail the rights and obligations of the issuer.

\textit{Id.} at 786. As support for this statement, the Simons court cited Harff, Wolfensohn, Revlon, and Katz. \textit{Id.} at 786 n.1. See also supra note 63 (discussion of Simons).
option of the surviving corporation's bondholders. The bondholders sued for breach of contract, breach of fiduciary duty, and fraud. The *Simons* court stated that the rights of bondholders are determined by their contract and, in limited situations, by implied covenants of good faith and fair dealing arising out of their contract. Significantly, the court determined that good faith and fiduciary obligations were not intertwined. The court concluded that the plaintiff bondholders were not the beneficiaries of a fiduciary obligation and therefore had no right to maintain a claim for breach of fiduciary duty.

Another example of Delaware's denial of bondholder fiduciary protection is *Harff v. Kerkorian*. In *Harff*, bondholders brought a derivative action against Kerkorian, a director and controlling shareholder of Metro-Goldwyn-Mayer (MGM). The bondholders contended that the board of directors of MGM declared a cash dividend for the financial benefit of Kerkorian. The plaintiffs alleged that the dividend caused a loss to them by forcing a decline in the market value of their convertible bonds. In denying the bondholders' claim that the dividend declaration was a breach of the directors' fiduciary duty to the bondholders, the court echoed the words of Justice Holmes in *Parkinson*, holding that "debentureholders are not stockholders and their rights are determined..."

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82 Id. at 787-88 ($12 consideration given in place of right to convert to class A shares).
83 Id. at 788.
84 Id. at 787. Although obligations of good faith and fair dealing are sometimes found, it is rare because of the extensively detailed nature of the agreements themselves. See id. See, e.g., Van Gemert v. Boeing Co., 520 F.2d 1373 (2d Cir.), cert. denied, 423 U.S. 947 (1975). The court found an implied covenant of good faith in the bond contract. Id. at 1387. Subsequently, the holding in *Van Gemert* has been construed as wholly contractual. Cf., *Simons*, 542 A.2d at 789-90. But see *Van Gemert*, 520 F.2d at 1382-83 n.19. One of the judges stated that the corporation or directors may have owed a fiduciary duty to the bondholder. Id.
85 *Simons*, 542 A.2d at 791. In justifying this conclusion, the court wrote that "[c]ourts traditionally have directed bondholders to protect themselves against... issuer action with explicit contractual provisions. Holders of senior securities, such as bonds, are outside the legal model of the firm for protective purposes: a heavy black-letter line bars the extension of corporate fiduciary protection to them." Id. at 789 (quoting Bratton, *supra* note 1).
87 324 A.2d at 217.
88 Id.
89 Id.
90 Id. at 219. See *supra* notes 77-79 and accompanying text (discussion of *Parkinson*).
by their contract."

Despite the established tradition of contract law as the only protection available to bondholders, many scholars and commentators insist that today's takeover atmosphere requires more effective bond-holder protection. In arguing for expanded protection, they contend that the contract measure of protection, because of its complexity, is too costly and is inadequate in its ability to foresee, and therefore guard against, potential bondholder hazards.

While it is recognized that the contract theory of protection has its shortcomings, the imposition of a fiduciary duty would complicate, rather than solve, existing problems. Given the conflict

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91 Harff v. Kerkorian, 324 A.2d 215, 219 (Del. Ch. 1974), aff'd in part, rev'd in part, 347 A.2d 133 (Del. 1975). See also Katz v. Oak Indus., Inc., 508 A.2d 873 (Del. Ch. 1986). In Katz, Oak Industries was in financial trouble. Id. at 875. As a result, the corporation's bonds were trading at a large discount. Id. at 875 n.2. As part of a recapitalization, Oak offered to exchange stock and "payment certificates" for its bonds and solicited consents to delete restrictive covenants in the bonds. Id. at 876-77. Plaintiff, a bondholder, sought to enjoin the consummation of the exchange offer and consent solicitation. Id. at 878. The court relied, inter alia, on Harff and the ABF COMMENTARIES ON INDENTURES, supra note 1, and held that the relationship between a bondholder and a corporation or director is contractual in nature. Id. at 879. The court refused to recognize a fiduciary duty. Id. However, the court did recognize that there is an implied covenant of good faith in every contract, including a bond indenture. Id. at 880.

92 See supra note 43 and accompanying text (discussion of director's fiduciary duty).

93 See McDaniel, supra note 4, at 236-37 (provides empirical evidence which shows decline in use of restrictive covenants due to their high costs); McDaniel, supra note 3, at 424-26 (same); Prokesch, Merger Wave: How Stock and Bonds Fare, N.Y. Times, Jan. 7, 1986, at D4, col. 2 ("Unfortunately for investors in publicly traded debt securities, the trend in the past decade or so has been toward fewer covenants."). But cf. Broad v. Rockwell Int'l Corp., 642 F.2d 929, 947-48 n.20 (5th Cir. Apr. 1981) (en banc) (use of covenants preserves expectation and promotes certainty), cert. denied, 454 U.S. 965 (1981); Bratton, supra note 1, at 688 (even though contracting can be costly, it is preferred over fiduciary duty theory because it creates consistent and predictable results).

94 See Bratton, supra note 1, at 688. The bond indenture is inadequate because it fails to address a sufficient number of contingencies. Id. at 689. Much of the past litigation has arisen out of the failure of the bond contract to protect against unforeseen events. Id. See also McDaniel, supra note 4, at 235. Bond contracts are inadequate because they cannot contain a complete set of restrictions since it is impossible to foresee every contingency. Id. at 235-36. Also, bond contracts are inadequate because management will resist the inclusion of the covenants because they impinge upon its flexibility. Id. at 236. But see Comment, supra note 2, at 469. In private debt issues, large institutional lenders have sufficient bargaining power to counteract management's resistance. Id.

95 See McDaniel, supra note 4, at 237. Restrictive covenants are crude constraints at best, and are ineffective at reducing the agency costs of debt. Id. Complex contracts are too costly. See McDaniel, supra note 3, at 428-29.

96 See Comment, supra note 2. Imposing a fiduciary duty on management to act in the best interest of bondholders ignores the fundamental differences that exist in the nature of
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between the interests of stockholders and bondholders, it would be difficult to reconcile the agency entanglements that would necessarily arise if director loyalty were divided between stockholder and bondholder. In terms of efficiency, serving two masters with vastly different interests would impair management’s ability to make critical business decisions.

It is suggested that a more rational and practical solution to the problem of bondholder wealth transfer lies within the means of available contractual protection. Where arms-length bargaining determines the resulting contractual obligations, there is no need to create a fiduciary relationship. Rather, the imposition of a fiduciary duty on bargain transactions should be limited to those transactions in which an arms-length bargain is not possible.

Generally, the issuer-bondholder transaction is an arms-length transaction and, as such, management should not be encumbered by fiduciary restraints.

Today’s bondholder, whether a large enterprise or an individual, is not constrained to accept unreasonable risk. The bond in-

bondholder and stockholder claims which are asserted against the corporation. Id. at 483. Similarly, the nature of the relationship between bondholders and the corporation and stockholders and the corporation are themselves fundamentally distinct. Id. Corporate directors are agents of the stockholders, but not of the bondholder. Id. See also Bratton, supra note 1, at 732. The basis for the imposition of corporate fiduciary duties is the existence of an agency relationship. Id. Since the relationship between bondholders and directors is contractual, not one of trust or agency, no fiduciary duties arise. Id. at 731.

From a contractual standpoint, the investment community relies upon a uniform interpretation of bond indentures. Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1048 (2d Cir. 1982). To include good faith or fiduciary requirements in bondholder transactions would disrupt the efficiency of the marketplace and upset investor expectation. See Id.

See also supra notes 26-44 and accompanying text (discussion of conflicts between bondholders and stockholders). But see McDaniel, supra note 3, at 442-50 (advocates imposition of fiduciary duty to bondholders); Note, supra note 65, at 173-80 (same).


See Farrell, supra note 16, at 28 (serving two masters with different interests is tricky at best). “No man can serve two masters. He will either hate one and love the other or be attentive to one and despise the other.” Matthew 6:24.

Comment, supra note 2, at 483-84. To impose fiduciary obligations on debtor-creditor relationship is to ignore past success in bargaining transactions. Id. at 484. But see Note, supra note 65, at 177-80 (bondholders and stockholders are investors of equal status, so fiduciary duty should be extended to bondholders as well).

See Comment, supra note 2, at 484.

See Bratton, supra note 1, at 708 (since institutions hold most convertible bonds, it is reasonable to infer that most convertible bond holders are well-informed investors).

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denture is available to protect his interests. The ability to demand and obtain concessions from an issuer depends on the bondholder's bargaining power. Metropolitan Life Insurance, for example, is a sophisticated financial institution and is clearly in a better position to demand contractual protection than is a small investor. Yet, even the small investor will reap the contractual benefits of a bond issuance shaped by the demands of large investors.

Contract theory recognizes the practical reality that an investor is able to shop around in the hope of finding an issuer to suit his needs. If an issuer is unwilling to provide additional protection or increased interest rates as compensation for incurring increased risk, investors are free to negotiate elsewhere. At this stage, however, because bondholders have only recently realized the adverse effects of the current debt market, they are only just beginning to flex their economic muscle.

In criticizing the limitations of bond indentures, commentators have attacked the inadequacy of restrictive covenants employed to protect bondholders. The most common restrictive covenant is the negative pledge clause, which restricts a company's ability to create secured debt that will rank ahead of unsecured deben-

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102 See id. In the exercise of his contractual power, the bondholder has available "an arsenal of traditional weapons" to protect his interests. N.Y.L.J., supra note 2, at 40, col. 2.

To counteract the potentially adverse effects of wealth transfer, the bondholder could negotiate additional new indenture provisions. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., No. 88-8266 (S.D.N.Y. May 31, 1989) (LEXIS, Genfed library, Dist file). For instance, the Metropolitan court proposed that:

[Metropolitan could request] new provisions [which] could include special debt restrictions or change-of-control covenants. There is no guarantee, of course, that companies like RJR Nabisco would accept such new covenants: parties retain the freedom to enter into contracts as they choose. But presumably, multibillion dollar investors like plaintiffs have some say in the terms of the investments they make and continue to hold. And, presumably, companies like RJR Nabisco need the infusions of capital such investors are capable of providing.

Id.

103 McDaniel, supra note 3, at 434. The market forces are a source of bondholder protection. Id. As a result of corporate action to the detriment of bondholders, future investors will demand more from that company. Id. For example, investors will seek higher interest rates or more extensive restrictive covenants. Id. at 434-35.

104 Coffee, supra note 26, at 45 (junk bond market is a relatively new institution): see supra note 26 and accompanying text (discussion of recent surge of junk bond financing).

105 See McDaniel, supra note 3, at 424-26. See also Farrell, supra note 5, at 114 (any good lawyer can get around any type of protective covenant). Cf. supra note 93 and accompanying text (use of restrictive covenants is declining).
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tures.\textsuperscript{106} The negative pledge clause prevents “an issuer from preferring future debt holders at the expense of existing debentureholders.”\textsuperscript{107}

Today, the negative pledge clause offers little protection to the bondholder because it only restricts the creation of secured debt.\textsuperscript{108} The fact that modern issuers usually borrow on an unsecured basis has rendered the negative pledge clause ineffective.\textsuperscript{109} While it is true that the negative pledge is outdated, a new type of restrictive covenant called a “poison put” offers increased bondholder protection.\textsuperscript{110} A poison put gives the debtholder the right to cash out at par value if there occurs a significant change in the issuer’s financial structure or management.\textsuperscript{111} Some issuers, rather than providing a cash out option, compensate the bondholder for subsequent issuer changes by increasing the interest rate so that the bond trades at par.\textsuperscript{112}

Poison puts have been criticized as inefficient because they severely restrict management’s control over a company.\textsuperscript{113} It is claimed that these provisions give the bondholder too much control over management.\textsuperscript{114} Yet, despite the loss in control, companies continue to issue bonds with poison put provisions. The presence of this powerful new restrictive covenant is some evidence

\textsuperscript{106} McDaniel, supra note 17, at 867. A “negative pledge clause limits the amount of mortgage debt a company can incur.” McDaniel, supra note 3, at 427. There is little managerial resistance to these clauses because, unless the corporation is in extreme financial trouble, managers do not mortgage their plants to raise money. \textit{Id.} As protection against a merger, many indentures include a provision which says that the debentureholder:

[S]hall have the right thereafter and until the expiration of the period of convertibility to convert such Debenture into the kind and amount of stock, securities or assets receivable . . . by a holder of the number of shares of Common Stock into which such Debenture might have been converted immediately prior to such . . . merger

\textsuperscript{Commentaries, supra note 1, at 549-50.}

\textsuperscript{107} McDaniel, supra note 17, at 871; \textit{see} Comment, supra note 2, at 467 (“negative pledge clause prevents management from creating debt senior to that of the debenture holders”).

\textsuperscript{108} \textit{See generally} McDaniel, supra note 17, at 868-70 (negative pledge clause offers little protection because issuers can borrow on an unsecured basis).

\textsuperscript{109} \textit{Id.}

\textsuperscript{110} \textit{Id.}

\textsuperscript{111} \textit{Id.}

\textsuperscript{112} Farrell, supra note 6, at 83. “It ties too severely the hands of management.” \textit{Id.}

\textsuperscript{113} \textit{Id.}

\textsuperscript{114} \textit{Id.}
that companies are beginning to acquiesce to bondholder demand for greater protection. In the context of the bargaining relationship between issuer and bondholder, the poison put demonstrates that contractual provisions can provide the necessary bondholder protection.

There is one last contractual provision that shows excellent promise as a source of bondholder protection: bond insurance.\textsuperscript{115} This form of protection would shift the risk from the bondholder to the insurer.\textsuperscript{116} However, a number of factors, including the issuer's additional cost of coverage, the issuer's reluctance to give additional covenants required by insurance companies and the possibility that insurers may not extend insurance over the life of a long-term bond, all indicate that bondholders would have to exert considerable pressure on issuers before such a significant change could take place.\textsuperscript{117}

CONCLUSION

Faced with the prospect that their investments involve unforeseeable risk caused by spectacular debt financing, bondholders are demanding expanded protection. Some courts have responded by recognizing certain fiduciary and good faith requirements running to the bondholder. Metropolitan, having suffered a multimillion dollar loss in its bond portfolio, sought to further the burgeoning trend toward fiduciary protection. Yet, despite the cases and commentary to the contrary, no justifiable rationale exists for recognizing a fiduciary relationship between corporate management and bondholders. Their adverse interests in the corporation preclude the imposition of "the finest loyalty"\textsuperscript{118} or equivalent standard of care. Bondholders, therefore, would be well advised to abandon any attempt to redefine traditional notions of agency and corporate policy, and to pursue instead the more readily available

\textsuperscript{115} See McDaniel, supra note 3, at 436-39 (insurance may completely protect bondholders).

\textsuperscript{116} Id. at 436.

\textsuperscript{117} See Id. at 437-38 (bond market will decide whether insurance is effective protection against risk).

\textsuperscript{118} Meinhard v. Salmon, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928). "[T]he rule of undivided loyalty is relentless and supreme . . . ." Id. at 468, 164 N.E. at 548 (citations omitted).
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protection that can be found in the bond indenture.

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