Bondholders' Rights and the Case for a Fiduciary Duty

David M.W. Harvey
BONDHOLDERS' RIGHTS AND THE CASE FOR A FIDUCIARY DUTY

DAVID M.W. HARVEY*

INTRODUCTION ................................................................................. 1023

I. RELATIONSHIP WITH SHAREHOLDERS ........................................ 1026
   A. Historic Distinction .................................................................. 1026
   B. Market Realities ....................................................................... 1028
   C. Conflicting Interests .................................................................. 1028
      1. Conservation of Value .......................................................... 1029
      2. Incentives ............................................................................. 1030
   D. Cases of Expropriation .............................................................. 1030

II. TRADITIONAL REMEDIES ............................................................ 1032
    A. Priority .................................................................................. 1032
    B. Legal Capital .......................................................................... 1033
    C. Fraudulent Transfers ............................................................... 1034
    D. Alternative Theories ............................................................... 1035
    E. Bond Contract ......................................................................... 1036

III. THE CASE FOR A FIDUCIARY DUTY ............................................ 1037
    A. Basic Economic Case .............................................................. 1037
    B. Rebuttal to Economic Case ...................................................... 1037
       1. Optimal Bond Contract ......................................................... 1037
       2. Comparative Costs ............................................................... 1039
       3. Conflicting Obligations ........................................................ 1040
    C. Legal Case .............................................................................. 1041
       1. Background .......................................................................... 1041
       2. Metropolitan Life v. RJR Nabisco ......................................... 1042

CONCLUSION ..................................................................................... 1044

INTRODUCTION

In an environment of mergers, acquisitions, leveraged recap-

* B.A., U.C. Davis; M.B.A., George Washington; J.D., Tulane Law School. The author is a member of the New York Bar practicing in the areas of restructurings, venture capital, and securities. Formerly he was a Vice President in the Venture Division at Silicon Valley Bank and an Assistant Vice President in Corporate Banking at Security Pacific National Bank.
talizations, and spinoffs, the sufficiency of the traditional bond indenture has been put to the test.\(^1\) As a result of some of these transactions, the market value of selected bonds has been substantially harmed.\(^2\) Metropolitan Life lost approximately $40 million on RJR Nabisco, Inc. bonds as a result of a leveraged buy-out ("LBO").\(^3\) Bondholders lost as much as $105 million in the market value of their holdings of Quantum Chemical debt as a result of a leveraged recapitalization.\(^4\) Even investors in the "High Yield" bonds of E-II Holdings, Inc. lost $50 million as a result of declining value after the entity announced its intention to sell certain core assets.\(^5\) In the wake of these types of losses, new attention has been directed at the sufficiency of traditional bondholder remedies.\(^6\)

\(^1\) An example of the traditional bond indenture is offered in Comm. on Devs. in Bus. Fin., ABA Section of Corporation, Banking & Business Law, Model Simplified Indenture, 38 bus. Law. 741 (1983).

\(^2\) See Hector, The Bondholders' Cold New World, FORTUNE, Feb. 27, 1989, at 83. Moody's Investors Service estimates that as much as $13 billion was lost by bondholders as a result of these types of transactions between 1984 and 1988. During that same period, the rating agency downgraded 254 issues in connection with such extraordinary events. Id. While not a subject of this paper, the evidence suggests that on balance "corporate takeovers generate positive gains." See Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J. Fin. Econ. 5, 5 (1983).

\(^3\) Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1506 (S.D.N.Y. 1989); see also Farrell, Bondholders are Mad as Hell—and They're Not Going to Take It Anymore, Bus. Wk., Feb. 6, 1989, at 82. However, Metropolitan Life conceded that it earned as much as $11 million in its equity portfolio in connection with the same transaction. Id. One recent study valued total shareholder gains from this LBO at $9 billion. See Mohan & Chen, A Review of the RJR-Nabisco Buyout, 3 J. Applied Corp. Fin. 102, 104 (Summer 1990).


\(^5\) This spinoff case is especially interesting since presumably astute investors purchased original issue junk debt. See Sloan, supra note 4. High yield bonds (often referred to as "junk bonds") are those rated BB/Bal and lower by Standard & Poor's and Moody's respectively. Bonds rated "Ba" are "viewed to have some speculative elements; their future cannot be considered well assured." Moody's Investors Service, Statistical Handbook, at iii (Feb. 1990).

\(^6\) In 1988 the Institutional Bondholders Rights Association was established. See Bleiberg, supra note 4. Bondholders have also moved as a group in demanding innovative protective covenants. See Star, supra note 4.
Amongst those who conclude that traditional remedies are inadequate, the proposed solution is often the establishment of a fiduciary duty on the part of management for the benefit of bondholders.7

This Article provides an overview of the economic conflicts that fuel the debate over bondholder remedies, an examination of the sufficiency of traditional remedies, and a consideration of the need for the imposition of a fiduciary duty.8 Spurred by recent proposals for establishing a fiduciary duty for bondholders,9 this Article traces the economic arguments favoring a fiduciary duty through to the most recent legal decisions on the issue. It concludes that while the bond indenture is an imperfect instrument, fiduciary duty is not a panacea for protection of bondholders from market value expropriations. Part One considers traditional distinctions and economic conflicts between shareholders and bondholders, setting forth the economic wisdom on shareholder-bondholder conflicts and the mechanisms by which bondholder value may be expropriated. Part Two discusses the scope and sufficiency of traditional remedies for managing those conflicts, including fraudulent transfer and legal capital statutes as well as various alternative theories and the bond contract. Part Three considers the wisdom of the economic and legal arguments for a fiduciary duty.

The arguments will demonstrate that while the proponents of a fiduciary duty are correct in arguing that much of the basis for distinctions between stockholder and bondholder remedies is outdated, recent decisions in the courts have elected the better course in rejecting the imposition of a fiduciary duty for bondholders. Re-

---

7 See Met-Life, 716 F. Supp. at 1524 (classic case proposing fiduciary duty involving LBO of RJR Nabisco, Inc.).

8 Analysis is limited to the sufficiency of remedies for bondholders facing an expropriation of market value. Because of the scope of involvement between trade or other creditors and the corporation, they may enjoy greater protections at law. Therefore, the fiduciary duty argument applicable to bondholders is not easily transferable. See, e.g., 11 U.S.C. § 507(a)(3) (1988) (priority for wage creditors in bankruptcy).

9 The principal proponent of the fiduciary duty argument has been Morey W. McDaniel. See McDaniel, supra note 4; McDaniel, Bondholders and Stockholders, 13 J. Corp. L. 205 (1988). McDaniel's position is clearly set forth in his 1983 article. Since fiduciary duties are a substitute for costly contracts, directors should have fiduciary duties to bondholders as well as to stockholders. The exclusive focus of corporate law on stockholders is too narrow for modern corporate finance. Bondholders and stockholders are all security holders in the enterprise and equally deserving of board protection.

McDaniel, supra note 4, at 456.
jecting such a duty is preferable for several reasons. First, bondholders' claims are priced at inception to reflect existing agreed upon covenant protections. Therefore, absent fraud or other market imperfections, the "optimal bond contract" is achieved. Second, cost savings from the use of corporate law over express contracts may be illusory. If expropriation risk is addressed in the indenture, net reduction in agency costs will be minimal, since both fiduciary and contract actions may be equally expensive to bring. Lastly, if a fiduciary duty is imposed for the benefit of bondholders, directors will be called to the impossible task of resolving conflicts between their dual obligations to both stockholders and bondholders. Thus, this Article will conclude that the negotiation of improved covenants and careful credit pricing is a better objective than a revolution in bondholder remedies.

I. RELATIONSHIP WITH SHAREHOLDERS

The primary argument in favor of a fiduciary duty for bondholders is that historical distinctions between stockholders and bondholders are outmoded. This position is based on increasing similarities in the function and character of the two claimants and the opportunities and incentives stockholders enjoy to expropriate wealth from bondholders.11

A. Historic Distinction

The historic distinction at the root of the bondholder remedies issue is that shareholders are owners and bondholders are lenders. This difference is the basis for the use of separate bodies of law for the protection of each holder's respective interests. As owners, the shareholder's relationship with the firm is assumed to be dynamic and to require flexibility.12 Although shareholders might enter into contracts with the firm, the unpredictability of future events would

10 Smith and Warner conclude that dividend and financing policy covenants can be written to control the conflict between shareholders and bondholders and to give "stockholders . . . incentives to follow a firm-value-maximizing production/investment policy." In sum, there is a theoretically "optimum bond contract." Smith & Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 J. Fin. Econ. 117, 124 (1979).
12 However, contemporary financial wisdom has it that the firm does not in fact have owners in any meaningful sense. See Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288 (1980).
render this approach costly and uncertain. Therefore, the relationship of a shareholder to the firm is best governed by a flexible corporate law concept of duty. This duty is effectuated through the board of directors as agent for the shareholders. Corporate law imposes an unwritten duty of loyalty and fiduciary duty on the directors’ management of the firm for the benefit of their agents and beneficiaries, the shareholders. Therefore, shareholders rely on the common-law duty of loyalty and fiduciary duty which are imposed on directors to protect shareholders’ interests in the firm.

Unlike shareholders, bondholders theoretically do not play the same role in the management of corporate affairs. Therefore, the legal mechanisms that have evolved for bondholder protection are less flexible. Furthermore, in many cases these protections simply do not apply in the absence of fraud, distress, or bankruptcy. These doctrines include priority rules in bankruptcy, legal capital requirements, prohibitions on fraudulent conveyances, good faith, tort, and equity theories, and the bond indenture or bond contract. Because of the narrow application of many of these

---

13 See Fischel, The Corporate Governance Movement, 35 VAND. L. REV. 1259, 1264 (1982). Corporate law is viewed as a more efficient approach to reducing the agency cost of capital than is the express contract approach: “Investors and managers could enter into contractual arrangements designed to minimize divergence of interests. But . . . this type of contracting would be very costly. The imposition by the law of fiduciary duties serves as an alternative or a supplement to hiring direct monitors . . . .” Id.

14 The need for flexibility in the law that governs the shareholder-firm relationship is emphasized by Fischel. See id.

15 See Committee of Corporate Laws, ABA Section of Corporation, Banking & Business Law, Corporate Director’s Guidebook, 33 BUS. LAW. 1591, 1601 (1978) [hereinafter Corporate Director’s Guidebook] (shareholder-designated corporate director in position of stewardship for owners of enterprise).

16 REV. MODEL BUS. CORP. ACT § 8.30 (1984); see also Corporate Director’s Guidebook, supra note 15. Note, however, that contemporary wisdom finds this agency itself to be costly in spite of fiduciary duties. See Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 308-09 (1976).

17 5 COLLIER ON BANKRUPTCY ¶ 1129.03 (15th ed. 1991) [hereinafter Collie].

18 See B. MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL 59 (2d ed. 1988) (discussing statutory legal capital schemes that regulate flow of assets to shareholders). “The legal apparatus built by common law and statute around the concept of ‘legal capital’ is fundamentally aimed at striking a partial accommodation of [the conflict of interests between owners and creditors].” Id. at 1.


21 See B. MANNING, supra note 18, at 96. The terms “bond indenture” and “bond con-
remedies, as a general rule the bondholder relies on the bond indenture for protection.\textsuperscript{22}

B. Market Realities

A key aspect of the argument for extension of fiduciary duty to bondholders is that the historic distinctions between stock and bond investors no longer exist. The function of shareholders and bondholders has become increasingly similar. Both groups supply capital to the corporation in return for an expected stream of income.\textsuperscript{23} The only difference between these investors is in their varying risk/return objectives and expectations.\textsuperscript{24} Additionally, the character of many stock and bond types of instruments is often indistinguishable, as firms increasingly rely on mezzanine tranches for funding.\textsuperscript{25} Mezzanine instruments provide a financing layer between senior debt and common stock by combining cash flow and risk characteristics of both.\textsuperscript{26} Because these instruments have become increasingly homogeneous, it may be argued that legal distinctions in available remedies also have become outmoded.

C. Conflicting Interests

A second aspect of the argument for a fiduciary duty is that...

-------------------

\textsuperscript{22} Bondholders are limited to contract remedies in “the absence of fraud, insolvency, or a violation of a statute.” Harif v. Kerkorian, 347 A.2d 133, 134 (Del. 1975); see also Am. B. Found., \textit{Commentaries on Indentures} 2 (1971).

\textsuperscript{23} Fischel, \textit{supra} note 13, at 1262. This view is best appreciated in the context of the “nexus of contracts” model of the firm. See Jensen & Meckling, \textit{supra} note 16, at 311. “The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization . . . .” Id. (emphasis removed).

\textsuperscript{24} The investor that takes a stock rather than a bond position in the firm has made the decision to surrender priority in a liquidation and the security of fixed interest and principal payments in favor of the hope of greater but uncertain dividends and capital gains. See B. Manning, \textit{supra} note 18, at 8.

\textsuperscript{25} The distinction between debt and equity is also fading in private transactions and term bank debt. See, e.g., Harvey, \textit{Warrants Expand Credit Pricing Options}, Bankers Mag., May-June 1990, at 44 (equity kickers in senior bank debt).

\textsuperscript{26} The mezzanine layer lies between senior debt and common equity in the hierarchy of priority, cash flow, risk, and tax characteristics. It includes such instruments as senior subordinated, subordinated, debt with warrants, convertibles, options notes, convertible preferreds, and preferreds. For a discussion of the financing decision with hybrids, see Jones & Mason, \textit{Equity-Linked Debt}, 3 Midland Corp. Fin. J. 47, 47-58 (Winter 1986); see also R. Brealey & S. Myers, \textit{supra} note 11, at 306-11.
because of the interdependence of stock and bond values, shareholders have the ability to expropriate wealth from bondholders. Therefore, some argue that bondholders should enjoy the same level and type of protections as stockholders in order to eliminate the possibility that stockholders will expropriate wealth from bondholders.

1. Conservation of Value

The interdependence of values that provides shareholders with opportunities for expropriation is generally explained by the theory of "conservation of value" of the firm. Under this theory, transfers of firm value between shareholders and bondholders may arise as a result of the relationship between the value that these two parties claim on the fixed value of the firm.\(^\text{27}\) The paradigm for the valuation of the firm begins with the proposition that the value of an asset is independent of the value of claims against it. Therefore, the value of the firm is determined independently of the financing decision.\(^\text{28}\) Value is neither created nor destroyed by the financing decision; it has been "conserved." Firm value is calculated by capitalizing the value of sustainable "free cash flows" generated by operating assets. Free cash flows are those occurring after required capital expenditures and tax payments are made but before interest and dividends are paid.\(^\text{29}\) The second proposition that describes the interrelationships between claim values is that the sum of all claims against the asset cannot exceed the value of the asset.\(^\text{30}\) Therefore, the value of any single claim is simply the difference between the value of the firm and the value of other claims.\(^\text{31}\) The value of other claims is best determined on the basis of a current market value that captures the benefits of favorable

\(^{27}\) This was first described in an early paper by Modigliani-Miller. See Modigliani & Miller, The Cost of Capital, Corporation Finance, and the Theory of Investment, 48 Am. Econ. Rev. 261, 264 (June 1958). The Modigliani & Miller model was further refined in a later paper. See Modigliani & Miller, Dividend Policy, Growth, and the Valuation of Shares, 34 J. Bus. 411, 411 (Oct. 1961).

\(^{28}\) This proposition was the basis for a revolution in corporate financial theory and the basis for the Free Cash Flow model for valuation of the firm. See G.B. Stewart, Stern-Stewart Corporate Finance Handbook 4-1 to 4-8 (Nov. 1986). That model later became the intellectual basis for the mergers and acquisitions "wave" of the 1980's.

\(^{29}\) Free cash flow is net operating profit after taxes and reinvestment required for sustainability but before financing costs. Id. at 4-2.

\(^{30}\) R. Brealey & S. Myers, supra note 11, at 386.

\(^{31}\) Id. at 386-87.
financing terms. For example, if the value of the firm is 100 and the market value of the bondholder's claim is 60, the value of the shareholder's residual claim is 40. If stockholders have an opportunity to restructure capitalization such that their value rises from 40 to 70, the value of the bondholder's claim must necessarily drop from 60 to 30. Thus, bondholder value has been expropriated.

2. Incentives

Incentives to expropriation of bondholder value arise as a result of the shareholder's potential for unlimited gain with the risk of loss limited to the amount invested. Although bondholders' risk of loss is also limited to the amount invested, they do not similarly enjoy the unlimited potential for gain. Therefore, unlike bondholders, shareholders enjoy what amounts to an option on the value of the firm whose exercise price is equal to the payoff costs of all senior debts. Unlike commonly traded options, however, shareholders enjoy control over corporate policy. Shareholders are therefore able to fashion strategies that increase the possibility of realizing additional value on their residual claims. In contrast, bondholders who value the security of their fixed claim are not in a position to direct or control the affairs of the corporation.

D. Cases of Expropriation

Examples of expropriation of bondholder value include LBOs, leveraged recapitalizations, spinoffs, and certain business risk decisions. In each of these cases, shareholders have elected to pursue a debt, dividend, or business policy, presumably for the enhance-

---

32 The market value of debt or preferred claims is subtracted in order to provide for the effect of changes in interest rate or required return on the value of that claim and therefore the value of the residual. As a result, fixed rate debt financing leads to a floating residual value, and floating rate debt financing leads to a fixed residual value. Similarly, increases in the risk of outstanding debt reduce the value of that claim and therefore enhance the value of the residual. See G.B. Stewart, supra note 28, at 4-3.

33 This concept was first described by Fisher Black and Myron Scholes in their description of an option pricing model. The option pricing model was originally conceived of in the corporate balance sheet context. As residual claimants, shareholders are in effect holders of an option whose exercise price is the payoff cost of senior claims. However, unique to the corporate context, holders of this option have control over the value of the underlying asset (the firm). See Black & Scholes, The Pricing of Options and Corporate Liabilities, 21 J. Pol. Econ. 35 (1973).

34 R. Brealey & S. Myers, supra note 11, at 305.

35 See, e.g., supra notes 3-5 and accompanying text (discussing LBOs, leveraged recapitalizations, and spinoffs).
ment of their upside value. Therefore, consistent with the principle of conservation of value, shareholder value is achieved through expropriation of bondholder value. Financial theorists divide expropriation cases into four general categories: (1) extraordinary dividends; (2) spinoffs; (3) increased debt financing (leveraging); and (4) increased business risk.

Extraordinary dividends and spinoffs expropriate shareholder value by "stealing away" assets of the firm. Extraordinary dividends include self tenders, share repurchase programs, and cash distributions. These extraordinary dividends increase the financial leverage of the firm by reducing total assets and shareholders' equity. Because the bondholder's claim is fixed, it represents a greater percentage of the remaining asset base. Therefore, credit risk for bondholders is increased and their claims are discounted. Again, consistent with the theory of conservation of value, the market value of the firm's stock decreases by less than the amount of the distribution. This is because the decline in the firm's value is shared with the bondholders. As a result, shareholders enjoy a transfer or expropriation of value from bondholders. Spinoffs may operate in much the same way as extraordinary dividends since they also involve a distribution to shareholders. In most spinoff transactions, financial leverage increases and the bondholder's claim is made more risky. Therefore, the bondholder's claim is discounted for the benefit of the post-spinoff shareholder, who holds shares of two entities, the sum of which is presumably more valuable than is the single pre-spinoff claim.

Increased leveraging and certain business decisions may also expropriate bondholder value. Financial leveraging expropriates

56 Because bondholder losses may be offset with stockholder gains, some have suggested that investors "immunize" their positions by holding both. This suggestion has led some issuers to structure claims in "strips" or "units" of both debt and equity that are not separable/detachable. Interview with Joel Stern, President, Stern-Stewart Management Company, in Tarrytown, New York (June 1987).

57 Smith and Warner classify these as (1) dividend policy, (2) claim dilution, (3) asset substitution, and (4) under-investment. See Smith & Warner, supra note 10, at 119.

58 In each case, assets of the firm are distributed to shareholders. See R. BREALEY & S. MYERS, supra note 11, at 358-60.

59 Id. at 390-94.

60 See id. at 358-60; see also Kalay, Stockholder-Bondholder Conflicts and Dividend Constraints, 10 J. Fin. Econ. 211, 212 (1982).

61 This occurs because assets are stolen away from the corporation while bondholders' claims remain the same. See Galai & Masulis, The Option Pricing Model and the Risk Factor of Stock, 3 J. Fin. Econ. 53, 69-70 (1976).
value from bondholders in the same way as extraordinary dividends by increasing the proportion of debt to total assets.\textsuperscript{42} Again, the credit risk of the original bonds is increased, and their market value is reduced.\textsuperscript{43} Therefore, the market value of the shareholder's claim is enhanced by the amount of value lost by bondholders.\textsuperscript{44} Value is expropriated from bondholders for the benefit of shareholders. Lastly, certain business decisions that alter business risk may operate in the same way as does leveraging.\textsuperscript{45} In this case, because the bondholder's claim is fixed, any benefits of the more risky venture accrue to the shareholders.\textsuperscript{46} The bondholder's claim is discounted with the increased risk-adjusted capitalization rate and therefore reduced in value. The shareholder enjoys the benefit of both the possibility of gain from the success of the risky new venture as well as the expropriated bondholder value occurring as a result of credit deterioration.\textsuperscript{47}

II. TRADITIONAL REMEDIES

As a result of the modern relationship between bondholders and stockholders, new attention has been given to bondholders' remedies against market value expropriation. A central aspect of the argument for a fiduciary duty to bondholders is that those traditional remedies are now insufficient.\textsuperscript{48}

A. Priority

A basic assumption in pricing and structuring dealings in bonds is that bondholders are senior in rank to shareholders. Bondholders' claims to the firm enjoy priority over those of shareholders. In its most basic form, the rule of priority provides that bondholders will be paid before residual values are distributed to

\textsuperscript{42} R. Brealey & S. Myers, supra note 11, at 421-26, 431-36; see also Myers, Determinates of Corporate Borrowing, 5 J. Fin. Econ. 147, 147 (1977) ("paper predicts that corporate borrowing is inversely related to the proportion of market value accounted for by real options"). Losses to bondholders as a result of unanticipated leveraging abound. See Hector, supra note 2.

\textsuperscript{43} R. Brealey & S. Myers, supra note 11, at 390.

\textsuperscript{44} See supra note 32 and accompanying text.

\textsuperscript{45} Smith and Warner point out that this phenomenon may be strong enough to induce stockholders to engage in new business ventures that actually reduce the value of the firm. See Smith & Warner, supra note 10, at 119 n.4.

\textsuperscript{46} See supra note 33 and accompanying text.

\textsuperscript{47} Smith & Warner, supra note 10, at 119 n.4.

\textsuperscript{48} See McDaniel, supra note 4, at 434-35.
shareholders. Therefore, shareholders will not be permitted to "steal away" the assets of the corporation upon which the bondholders rely. Although the rule has been invoked time and again in the bankruptcy context, its simplicity is deceptive. Application in bankruptcy is appropriate because bankruptcy law requires that assets be valued and claims retired according to priority. However, this rule is of less use in the case of an ongoing business in which residual values are only an intellectual concept. In this case, assets are not valued or liquidated and claims are intended to remain outstanding. Therefore, priority rules offer bondholders little protection against expropriation of value in the case of a going concern.

B. Legal Capital

The concept of legal capital is aimed at striking a balance between the interests of shareholders and bondholders in the case of a going concern. Legal capital statutes are embodied in state corporate law. Such statutes generally provide that the firm shall make no distribution to shareholders if "after giving it effect: (1) the corporation would not be able to pay its debts as they became due . . ., or (2) the corporation's total assets would be less than the sum of its total liabilities." While the terms of such statutes are construed broadly for the protection of creditors, they are gener-

---

49 No distribution may be made to shareholders unless there is a surplus of assets over the liabilities of the corporation. Wood v. Dummer, 30 F. Cas. 435, 436 (C.C.D. Me. 1824) (No. 17,944); see also B. Manning, supra note 18, at 27-30 (discussing import of Wood case and limitation on distribution of assets to shareholders). But see Harvey, Application of the New Money Exception in Chapter 11 Reorganizations, 16 T. Marshall L. Rev. 275 (1991) (discussing application of new money exception to rule of absolute priority).


51 See B. Manning, supra note 18, at 30.

52 See B. Manning, supra note 18, at 1. "The legal apparatus built by common law and statute around the concept of 'legal capital' is fundamentally aimed at striking a partial accommodation of that conflict of interests [between owners and creditors]." Id.


55 A "distribution" includes virtually any transfer of money. An inability to pay "debts as they become due," involves a pro forma analysis of expected cash flows ("Equity Insolvency Test"). An insufficiency of assets over liabilities is determined based on any valuation methodology that is reasonable in the circumstances ("Balance Sheet Test"). Id. § 6.40 com-
ally an ineffective means of protection from market value expropriations from bondholders. Because legal capital prohibitions only limit distributions that lead to insolvency, they only come to play in egregious circumstances. In most cases, a bondholder has experienced significant market value expropriation long before the corporation approached either equity or balance sheet insolvency. Therefore, legal capital statutes provide little protection against market value expropriations from bondholders.

C. Fraudulent Transfers

Federal and state laws impose limitations against transfers of assets by firms that are or may become insolvent. Generally, these statutes prohibit transfers of assets by firms for less than adequate consideration when the transferor is either insolvent or becomes insolvent. Fraudulent transfer statutes provide a remedy upon a showing of both a transfer for inadequate consideration and some type of insolvency. The requirement of a transfer for inadequate consideration is satisfied in cases involving share repurchases, dividends, or distributions in which the firm receives no consideration. However, because few expropriations occur when a firm is on the brink of insolvency, the independent requirement of insolvency renders those statutes of little use in market value expropriation scenarios. Furthermore, because borrowings are generally made for fair consideration, in those cases in which expropriation occurs as a result of unanticipated leveraging, fraudulent transfer laws will present the twin hurdles of showing unfair consideration and insolvency.

---


58 Under the Uniform Fraudulent Transfer Act, a transfer is recoverable if it both is made without adequate consideration and causes the transferor to be left with inadequate assets to operate the business, leaves the transferor without adequate assets to pay debt as they become due, or renders the transferor insolvent. Univ. Fraud. Trans. Act § 4, 7A U.L.A. 652 (1985).

59 Id. § 3 comment.

60 As a general rule, this theory requires a showing both that the amount borrowed or advanced was unfair consideration in view of the amount of security given and that this transfer rendered the firm insolvent. In certain extraordinary circumstances, the requirement of unfair consideration has been found to be satisfied in cases involving LBOs. This should, however, be viewed as the exception. See United States v. Glenegles Investment Co., 565 F. Supp. 556 (M.D. Pa. 1983); cf. Galen, Is There Sweet Revenge for Deals that Go Sour?, Bus. Wk., Mar. 19, 1990, at 132 (some bondholders encouraged by recent federal case
D. Alternative Theories

In addition to the several traditional creditors' rights theories, attempts have been made to argue cases on the bases of the implied covenant of good faith, unjust enrichment, and intentional interference with contract. As a general rule, these theories were intended to address much different types of scenarios and thus have failed to provide relief from market value expropriation.

The issue of the implied covenant of good faith, recognized in contract law, has been raised when shareholder actions were contrary to the express terms or purpose of the indenture. However, because these claims must be based on the express terms of the indenture, they often fail. Convertible bondholders have successfully argued this theory when denied express conversion privileges. Convertible bondholders have also successfully argued this theory when denied an interest in shares of a subsidiary being spun-off. However, unlike those cases in which bondholders had an expectancy to the equity of the firm, in most cases a nexus between the action being taken and the purpose or terms of the bond contract is lacking.

Lastly, theories such as unjust enrichment and intentional interference with contract have also been difficult to sustain. Unjust enrichment has been rejected because the absence of a contract between the parties is a prerequisite to such a finding. Intentional interference with contract has failed on the basis of the requirement of a separate showing of breach of contract. In sum, because of the unique requirements of each of these alternative theories, they generally provide bondholders with little protection in classic market value expropriation scenarios.

---

64 See Pittsburgh Terminal Corp., 680 F.2d at 941.
E. Bond Contract

Because of difficulties in utilizing the theories discussed above in cases involving market value expropriation, bondholders typically rely on the bond contract or indenture. The potential sufficiency of the indenture for the protection of interests is the focus of considerable debate. The debate as to the sufficiency of the bond contract turns on two issues: first, whether an indenture can be designed to control adequately the actions of management without unnecessarily constraining its managerial discretion; and second, whether protections or their absence are adequately priced in the credit ultimately extended.67

Modern bond contracts or indentures are often more abbreviated than might be expected.68 Typical covenants in “real world” indentures dealing with the possibility of market value expropriation include: (1) prohibitions against secured or prior debt (including sale-leasebacks) intended to protect against “stealing away” of corporate assets; (2) covenants regarding further indebtedness that protect against increased leveraging; and (3) limitations on distributions to shareholders that protect against payment of extraordinary dividends or share repurchases.69 Although historically many other important covenants that would protect bondholders were often omitted or not fully employed,70 the current trend among investment grade debt issuers has been toward providing an increasing level of protection for bondholders.71 Therefore, the question of the need for a fiduciary duty appears to turn on whether the cur-

67 As to these twin issues, some have posed the possibility of an “optimal bond contract.” See Smith & Warner, supra note 10, at 124; cf. Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 614 (1984) (“more effective contractual provision[s] will secure a higher price [for the issuer]”). However, others reject it as not being “real world.” McDaniel, supra note 4, at 428 n.77 (“pursuit of an optimal bond contract is doomed to failure”).

68 See generally Comm. on Devs. in Bus. Fin., supra note 1 (discussing traditional indentures).

69 See B. Manning, supra note 18, at 96-98.

70 Some surveys on indentures have found a permissive attitude toward covenant protection. See Am. Bar Found., supra note 22, at 350, 434, 369, 402. In another survey of 87 indentures taken between 1974 and 1975, 91% had restricted the issuance of additional debt, 23% restricted dividends, 39% restricted merger activities, and 36% restricted the disposition of assets. See Smith & Warner, supra note 10, at 122-23; see also McDaniel, supra note 4, at 424-25 (discussing restrictive covenants).

71 A recent survey found that at least 37% of investment grade debt issuers have included some level of protection from market value expropriation in bonds issued during the last two years. Seven percent claimed they provided “strong” protection. Is Anyone Paying Any Heed to Bondholders?, Institutional Investor, Feb. 1991, at 123.
rent and evolving state of the bond contract is an efficient way to
manage the risk of market value expropriation and whether the
risks the parties elect to underwrite are properly priced in the
credit.

III. THE CASE FOR A FIDUCIARY DUTY

The case for a fiduciary duty is being considered on two
fronts. Corporate finance theorists are engaged in an economic
analysis of the efficiency of bond contracting, and the legal com-
munity is arguing the merits of the case.

A. Basic Economic Case

The economic argument for a fiduciary duty is that the new
dynamic in stockholder-bondholder relationships would render a
flexible concept of fiduciary duty the least expensive approach to-
ward protecting all investors' interests. This argument has four
components. First, in modern capital markets, the interrelation-
ships between competing claims of stockholders and bondholders
and the option for unlimited gain that stockholders enjoy provide
stockholders with both the opportunity and the incentive to expro-
priate value from bondholders. Second, the use of existing reme-
dies for the protection of bondholders has failed because tradi-
tional remedies do not address the effect of changes in the risk of
the firm. Third, the bond indenture cannot be adequately adapted
to protect bondholders because of the high cost of express con-
tracting and the lack of perfect foresight.72 Fourth, the inadequacy
of remedies leads to a higher cost of capital that would not be pre-
sent if the lesser cost fiduciary duty were imposed for the benefit
of bondholders.73

B. Rebuttal to Economic Case

Although the first several assumptions in the argument are
well supported, the basis for others is less clear.

1. Optimal Bond Contract

Whether existing remedies can be adapted to address the ex-
propriation problem is largely contingent upon achieving an ade-

72 See infra note 75.
73 See McDaniel, supra note 4, at 447-48.
quate bond contract. This possibility is posed by financial theorists who find that there is, in fact, an optimal level of covenants “which maximize the value of the firm.” This belief conflicts with the component of the economic argument which finds that existing remedies cannot be applied sufficiently to address the stockholder-bondholder conflict. If an optimal level of covenants exists and if both parties price their dealings correctly, the bond contract is by definition being applied sufficiently to address the problem of market value expropriation. The best evidence that debt instruments are being sufficiently priced is that lenders continue to come back for more.

The conflict over the sufficiency of the bond contract may be a distinction without a difference. In some cases, confusion exists over the separate issues of (1) the possibility of an optimal bond contract and (2) the possibility that a fiduciary duty would be less expensive than that optimal bond contract. It is essential to distinguish between these issues in the analysis. Notwithstanding the deficiencies in specific cases, an optimal bond contract is by definition the current state of the art. An optimal bond contract is no more than that unique set of covenants that reflect the cost of contracting, the parties’ expectations for the future, and required re-

---

74 That optimal level of covenant protection occurs when the costs of negotiating, monitoring, and enforcing covenants is equal to the value added to the debt holders’ claim as a result of reduced agency costs accruing from enhanced protections. See Smith & Warner, supra note 10, at 152-53.

75 McDaniel flatly rejects the notion of an optimal bond contract. See McDaniel, supra note 4, at 428.

The possibility of an innovative bond contract that dramatically reduces the potential for opportunism by junior security holders has been implied. If such a bond contract were possible, it surely would have been invented in the last 100 years. The pursuit of an optimal bond contract is doomed to failure. Id. at 428 n.77 (citation omitted).

76 McDaniel commingles the issues of optimal contract and comparative costs. He argues that even a “rough approximation of the optimal bond contract is out of the question.” Id. at 428. He attributes this to costly contracting and lack of perfect foresight. Id. However, costly contracting is not an issue of contracting costs vis-à-vis a less costly nonexistent alternative such as fiduciary duty. It is an issue of at what point the parties will elect to stop demanding covenants and underwrite the risk of expropriation by pricing the credit appropriately. It is a concept of equilibrium and efficiency in the negotiations. Smith and Warner identify “optimum” only within the universe of contract remedies. See Smith & Warner, supra note 10, at 152-53.

77 “It appears that the Costly Contracting Hypothesis, which explains how firms reduce the costs of the bondholder-stockholder conflict, helps to account for the variation in debt contracts across firms.” Smith & Warner, supra note 10, at 124.
turns. The contention that such a contract exists is a statement that the contracting process between the lender and the borrower is efficient. Each bond contract reflects an equilibrium between covenant protections, costs, and required returns. On this narrow issue alone, those arguing for a fiduciary duty offer little in opposition.

In recent years a number of market developments have added to the evidence in support of the optimal bond contract. Innovative "event risk" clauses increasingly are being negotiated. When protections from expropriation are not provided for in the indenture, optimization is obtained through increased pricing. The institutionalization of this mechanism is reflected in the creation of "event risk" ratings by Moody's Investors Service. Whatever the outcome of the debate, it is unrealistic to conclude flatly that existing remedies such as the indenture are not or cannot be structured to manage expropriation risk adequately. The focus instead should be on what constitutes adequate protection and the comparative costs of that protection.

2. Comparative Costs

Probably the most important component of the fiduciary duty argument is that imposition of the new duty is a cost-effective substitute for costly contracts. Despite this contention, there has been little empirical work on the issue. Cost savings from the use of implied remedies rather than express contracts may be illusory.

---

78 Id. at 119-21.
79 "If such a contract were possible, it surely would have been invented in the last 100 years." McDaniel, supra note 4, at 428 n.77.
80 The use of such covenants has become firm policy for certain institutional lenders. Metropolitan Life requires "event risk" clauses in all new indentures and loan agreements. Interview with John R. Endres, Investment Analyst, Corporate Investments, Metropolitan Life Insurance Company, in Houston, Texas (Feb. 13, 1990).
81 As a result of the magnitude of expropriations that have occurred, see supra note 2, unmanaged "event risk" mandates an incremental premium for high grade corporate issuers. Evidence of that premium includes (a) the pricing of comparable instruments with and without "event risk" clauses and (b) the shift to asset backed paper when "event risk" is less of an issue. Interview with James A. Parrish, Associate Director, Structured Finance, Moody's Investors Service, in New York City (Mar. 2, 1990); see also Perimuth, supra note 4 (more issuers now offer event risk protection).
82 See Perimuth, supra note 4.
83 See McDaniel, supra note 4, at 455-56. "Since fiduciary duties are a substitute for costly contracts, directors should have fiduciary duties to bondholders as well as to stockholders." Id. at 456.
Two components of the comparative costs between express contracting and fiduciary duties are recognized, namely, enforcement costs and agency costs. First, little evidence exists suggesting that contract enforcement costs are greater than fiduciary duty enforcement costs. A shareholders' derivative suit is as expensive as a contract action. Therefore, it is uncertain whether any enforcement cost benefit is derived from imposition of a fiduciary duty. Second, the issue of whether agency costs are greater under a contract-only regimen as opposed to under a fiduciary duty mechanism is also uncertain. Some argue that because of inevitable insufficiencies in the indenture covenants, which are viewed as either too crude or too lenient, agency costs under an exclusive contract remedy are greater. Therefore, some argue that under a fiduciary duty standard managerial deviations would be less.

The argument that agency costs are lower under a fiduciary duty regimen turns on the assumptions that agency costs attributable to the gaps in the indenture are greater than those attributable to the ambiguous unwritten concept of fiduciary duty, and that because no optimal bond contract exists, the bond contract does in fact have significant gaps. Proponents of a fiduciary duty offer little in support of either of these propositions. As to the issue of whether the agency costs attributable to the incomplete monitoring of an indenture are greater than those associated with a fiduciary duty, no clear evidence has been put forth. As to the question of whether a bond contract can be sufficiently drafted and priced, there are at least conflicting views. In sum, the most important components of the fiduciary duty argument either lack support or are at best supported by conflicting evidence.

3. Conflicting Obligations

A final and key aspect of the argument for a fiduciary duty is the assumption that the directors and managers of a firm could simultaneously serve the twin masters of the stockholders and the bondholders. Perhaps the most compelling argument against the imposition of a fiduciary duty for the benefit of bondholders is the practical unworkability of this assumption. In those many decisions in which the interests of both parties conflict, management

---

84 See Jensen & Meckling, supra note 16, at 328-29.
85 See McDaniel, supra note 4, at 429.
86 Cases abound in which the interests of creditors and owners conflict. Owners are
would be paralyzed by its irreconcilable obligations. It is unrealistic to assume that a single fiduciary could concurrently serve the interest of two parties that are so adversarial. The fiduciary duty argument fails to address the practical aspects of the proposed duties.

C. Legal Case

The legal case for a fiduciary duty has evolved through several decisions to its most recent rejection in *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*

1. Background

In the 1980 case of *Broad v. Rockwell International Corp.*, the Fifth Circuit held that while shareholders have a fiduciary duty to holders of convertible bonds, that duty is satisfied when the firm complies with the letter of the bond indenture. The result of this holding is seemingly contradictory. The court found a fiduciary duty on one hand but limited it to the express terms of the indenture on the other. Furthermore, it might be argued that the holding is limited only to cases involving convertible debt. In the 1975 case of *Harff v. Kerkorian*, the Delaware Supreme Court reversed a decision denying fiduciary duty as a remedy for bondholders who had experienced an expropriation. Rather than impose a fiduciary duty, the court elected to provide relief under the theory of fraud. Although this case rejects fiduciary duty, a similar result is achieved through the alternative theory of fraud. In generally in favor of dividends and higher return business strategies. Creditors favor the retention of earnings and the less risky course. See generally R. Brealey & S. Myers, *supra* note 11, at 348.

87 This conflict was described by one commentator as a false premise in the argument for a fiduciary duty to bondholders. "The false premise is that requiring directors to make decisions in the best interests of the 'corporation as a whole' will somehow overcome the inherent tension between investor groups. In fact, the tension cannot be so easily overcome." Tauke, *supra* note 4, at 59.

90 Id. at 430.
91 Id. at 431.
92 347 A.2d 133 (Del. 1975) (per curiam).
93 Id. at 134.
94 Id. Expropriation occurred as a result of an extraordinary dividend executed in compliance with the terms of the indenture. Id. at 133.
the 1977 case of *Green v. Hamilton*, a district court considered whether the deferral of a merger announcement until after the bondholder's equity conversion date was permissible. In ruling for the bondholders, the court held that bondholders were among the community of interests to whom the directors owed a fiduciary duty. In that case, the court suggested that the imposition of a fiduciary duty is not reserved for convertible debt cases.

Generally, each of these earlier cases was marked by bondholders who held a contingent stockholder's interest (convertible bonds). Therefore, notwithstanding the dictum in *Green* that the theory is not reserved for convertible debt, it is difficult to argue that these cases necessarily stood for the proposition that straight bondholders enjoy the benefit of an unambiguous fiduciary. Whatever the appropriate conclusion, most ambiguity in New York was resolved in 1989 by *Metropolitan Life*.

2. *Metropolitan Life v. RJR Nabisco*

*Metropolitan Life* effectively ended the viability of fiduciary duty as a theory for sophisticated bondholders in New York. The case arose in connection with the decision by the board of directors of RJR Nabisco, Inc. to accept a $24 billion bid for the LBO of the company. The deal was financed with roughly $19 billion in new debt. Metropolitan Life brought suit claiming that as a result of the transaction it had suffered an expropriation of $40 million in the market value of its RJR Nabisco, Inc. bonds.

The suit alleged a host of theories for recovery, including breach of good faith, fraud, unjust enrichment, tortious interference with contract, fraudulent conveyances, and breach of fiduciary duties. The district court held in favor of RJR Nabisco on all counts. First, the court found no breach of good faith since the parties had not been deprived of the benefit of their bargains, and the buy-out was not inconsistent with the terms of the indenture. Second, the issue of fraud was not pleaded with sufficient

---

87 *Id.* at 726.
88 *Id.* at 729 n.4 (citing Pepper v. Litton, 308 U.S. 295, 307 (1939)).
89 *See id.*; *see also* McDaniel, *supra* note 4, at 413-21.
90 716 F. Supp. at 1524-25.
91 *Id.* at 1506.
92 *Id.* at 1507 n.6.
93 *Id.* at 1526.
particularity. Third, no unjust enrichment was found because the plaintiff had “not alleged a violation of . . . the indentures at issue,” and the circumstances were not such that “in equity and good conscience the defendant should make restitution.” Fourth, the court found no tortious interference with contract because there was no evidence of a frustration of either the purpose or terms of the contract, and no event that rendered the contract worthless to any one party. Fifth, the issue of fraudulent conveyances had not been pleaded with sufficient particularity. Last, on the issue of breach of fiduciary duty, the court held that bondholders “are not entitled to such additional protections.”

The analysis of the fiduciary duty issue was brief. In response to the defendants’ attempt to invoke Delaware law, which unambiguously rejected fiduciary duty for bondholders, the court concluded that though the more ambiguous New York law was applicable, Delaware had the better rule. Therefore, the court held that the Delaware rule was persuasive in New York. The court explained its reasoning in favor of bringing the Delaware rule into New York on the basis of what it saw as the extraordinary character of the fiduciary obligation. In its analysis, the court invoked language from the 1928 seminal New York case of Meinhard v. Salmon rendered by then Chief Judge Cardozo.

A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty . . . .

103 Id.
104 Id. at 1523.
105 Id. at 1522 (quoting Chase Manhattan Bank v. Banque Intra, S.A., 274 F. Supp. 496, 499 (S.D.N.Y. 1967)).
106 Id. at 1523.
107 Id. at 1526.
108 Id. at 1525.
109 Id. at 1524 (citing Simons v. Cogan, 549 A.2d 300, 303 (Del. 1988)). In Simons, the Delaware Supreme Court held that the corporate bond represents a contractual entitlement and does not represent an equitable interest that is “necessary for the imposition of a trust relationship with concomitant fiduciary duties.” Simons, 549 A.2d at 303.
110 See Met-Life, 716 F. Supp. at 1524.
111 Id. (citing Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928)).
112 Meinhard, 249 N.Y. at 464, 164 N.E. at 546.
The court in *Metropolitan Life* offered little explanation of its application of Cardozo's view of the fiduciary relationship. It limited its opinion to the following conclusory statement:

Before a court recognizes the duty of a "punctilio of an honor most sensitive," it must be certain that the complainant is entitled to more than the 'morals of the marketplace'. . . . This court has concluded that plaintiffs presently before it—sophisticated investors who are unsecured creditors—are not entitled to such additional protections.¹¹³

There is no explanation why "this court has concluded" that Metropolitan Life as a bondholder is not deserving of a fiduciary duty. In the final analysis, notwithstanding the brevity of its explanation, the court in *Metropolitan Life* effectively eliminated the viability of fiduciary duty as a theory for recovery by sophisticated bondholders in cases governed by New York law.¹¹⁴

**CONCLUSION**

The argument for the imposition of a fiduciary duty to protect bondholders is driven by twin revolutions in financial theory and in the financial markets. These revolutions create substantial incentives for the expropriation of market value from bondholders that are often not addressed by traditional legal remedies. However, the evidence suggests that the imposition of a fiduciary duty for the benefit of bondholders may be unjustified. First, there is evidence that the bond contract may be adapted and priced to address the risk of expropriation of market value without unnecessarily constraining managerial discretion to pursue a wealth-maximizing strategy. Second, the question of whether a fiduciary duty is less costly than a contract remedy has not been sufficiently resolved. Third, and perhaps most importantly, the question of how management would reconcile dual obligations to stockholders and bondholders has not been answered. As a result, the New York decision in *Metropolitan Life*, which rejects fiduciary duty as a theory of recovery for bondholders, offers the better course for other jurisdictions still considering the issue.


¹¹⁴ The proposition that fiduciary duty is no longer a viable theory after *Met-Life* is supported by the fact that in a case occurring six months later before the same court, involving similar facts, bondholders elected not even to plead the theory. See *Hartford Fire Ins. Co. v. Federated Dept' Stores*, 720 F. Supp. 976, 994 (S.D.N.Y. 1989).