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ARE BONDHOLDERS OWED A FIDUCIARY DUTY?

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IN the last few years, a previously unheard of doctrine has taken hold in the corporate world—corporate directors owe a duty to a host of constituencies beyond shareholders. This doctrine is in sharp contrast to the traditional model of corporate governance, wherein the directors of a publicly held corporation owe a duty to only one constituency, their shareholders. In this Article, the focus will be on one other constituency, the bondholder.

Bondholders are only one class of parties interested in a corporation, the most significant other such class being shareholders. Conflicts of interests between these classes arise because actions by management on behalf of shareholders may come at the bondholders' expense. Since no fiduciary duty is presently owed to bondholders, bondholders protect their interests with bond indentures. But the bond indenture has over time become simplified, affording bondholders fewer protections. Therefore, arguments have emerged that the same fiduciary duty owed to shareholders should be extended to bondholders.¹

Through a discussion of bondholder-shareholder conflicts, this Article will explore potential reasons why a fiduciary duty should be owed to bondholders. The Article will also discuss alternative sources of bondholder protection, such as bond indenture covenants, market forces, bondholder voting rights, and bond insurance.

Thereafter, three different views, each promoting changes in the current system, are contrasted: (1) debtholders should be extended the same fiduciary duties as stockholders; (2) the indenture trustee should be given power to oversee indenture negotiations and managerial discretion; and (3) corporate directors should pursue a "global" wealth maximization strategy, in which directors attempt to maximize total

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1. See McDaniel, *Bondholders and Stockholders*, 13 J. CORP. LAW 205 (1988); McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413 (1986) [hereinafter McDaniel, *Corporate Governance*]. But see Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667.

corporate value rather than attempting to maximize shareholder value even where that does not yield maximum total value. Pertinent court decisions are then presented as evidence that the courts have concluded that bonds are contracts and that the holders of such bonds are not owed any fiduciary duties by corporate directors.

I. BONDHOLDER-SHAREHOLDER CONFLICTS

The market value of a firm's debt is the present value of the promised payments discounted to reflect the risk that those payments will not be made. That risk is a function of the extent to which the value of the firm's assets exceeds the amount of its liabilities, which amount represents shareholder equity: debtholders are protected against declines in the value of the corporation's assets to the extent of this "pad" of shareholder equity.² Thus, wealth can be transferred from debtholders to shareholders by increasing debt or by distributing assets to shareholders—in other words, by increasing the firm's debt-to-equity ratio.³ For example, if new debt is issued with an equal claim on the firm's assets and the proceeds are used to retire outstanding equity, then current bondholders experience a loss of wealth. These bondholders are left with only a partial claim to the firm's assets, whereas before the new debt was issued, they had a complete claim on the assets. In this case, total assets remain the same, but the debt to equity ratio and therefore the firm's financial risk have increased. Thus, the current bondholders experience a decline in the value of the debt they hold, even though the firm's market value remains unchanged. Shareholders profit to the extent their equity, which is contingent on payment of the firm's debts, is converted to non-contingent cash payments.⁴

2. McDaniel, *Corporate Governance*, *supra* note 1, at 418 (a firm's market value equals the market value of its debt plus the market value of its stock).

3. See Galai & Masulis, *The Option Pricing Model and the Risk Factor of Stock*, 3 J. FIN. ECON. 53 (1976) (citing R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 294 (2d ed. 1984)).

4. T.E. COPELAND & J.F. WESTON in *FINANCIAL THEORY AND CORPORATE POLICY* 508 (3d ed. 1988). Corporate law does place some limitation on the shareholders' ability to do this, essentially at the point that equity hits zero, although this characterization is an oversimplification. REV. MODEL BUSINESS CORP. ACT § 6.40 (1984). This treatment roughly tracks the law's treatment of any other type of unsecured creditor: fraudulent transfer law and bankruptcy preference law usually do not come into play until a debtor is insolvent. See, e.g., UNIF. FRAUDULENT CONVEYANCES ACT (1918); 11 U.S.C. §§ 544(b) (1988) (enforcement of state fraudulent transfer law by bankruptcy trustee); *id.* § 548 (bankruptcy fraudulent transfer law); *id.* § 547 (bankruptcy preference law). Unsecured creditors encounter many of the same problems as those discussed in this Article and thus charge a higher rate of return than secured creditors. In this Article, the terms "bondholders" and "debtholders" mean holders of unsecured corporate debt unless otherwise specified. Both the availability of secured corporate debt and the desirability of consistency between the law of corporate finance and general creditor law strengthen the arguments in this Article against extending corporate fiduciary duties to bondholders.

Potential conflicts then exist because bondholders have prior but fixed claims on a firm's assets, while shareholders have limited liability for the firm's debt and unlimited claims on a firm's assets.⁵ As the corporation's debt to equity ratio increases, the probability and magnitude of these conflicts increase.⁶ The three major sources of conflict between bondholders and shareholders are: (1) dividend payments; (2) claim dilution; and (3) asset substitution.⁷

Dividend payments to shareholders reduce the value of a corporation's bonds. When a corporation issues bonds and the bonds are priced on the assumption that the firm's dividend policy will remain unchanged, the value of the bonds is reduced when the dividend rate is increased so that the pad of shareholder equity is reduced.⁸ In fact, in many cases, any distribution of assets to stockholders, either in cash or otherwise, will result in a loss to bondholders because the debt to equity ratio increases and fewer total assets remain to satisfy bondholder claims.⁹

Shareholders can achieve the functional equivalent of a distribution with a voluntary spin-off, where a corporation moves part of its assets to a newly-created separate entity.¹⁰ In a spin-off, a parent company distributes its subsidiary's shares pro rata only to its shareholders. The spin-off creates abnormal gains for the shareholders since they have appropriated part of the equity pad which previously afforded protection to bondholders.¹¹ The parent company's bondholders lose in a spin-off because they no longer have a claim on the assets spun-off to the shareholders of the new firm.¹²

5. McDaniel, *Corporate Governance*, *supra* note 1, at 418.

6. *Id.*

7. Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118 (1979).

8. *Id.*

9. McDaniel, *Corporate Governance*, *supra* note 1, at 419.

10. Galai & Masulis, *supra* note 3, at 69.

11. *Id.*

12. *Id.* However, the effects of a spin-off can be difficult to identify, because even where the loss to debtholders is negligible, shareholders may still experience a gain. In Hite & Owers, *Security Price Reactions Around Corporate Spin-off Announcements*, 12 J. FIN. ECON. 409 (1983), the authors examine the security price reaction around the announcement of 123 voluntary spin-offs by 116 firms between 1963 and 1981 involving a pro-rata distribution of the parent firm. The median spin-off in the sample is 6.6% of the original equity value and is associated with an abnormal return of 7.0% for common stockholders from 50 days prior to the announcement through completion of the spin-off. No evidence is found to indicate the gains to stockholders represent wealth transfers from senior security holders. In a related paper, Schipper & Smith, *Effects of Recontracting on Shareholder Wealth: The Case of Voluntary Spin-Offs*, 12 J. FIN. ECON. 437 (1983), investigate the effect of voluntary corporate spin-off announcements on shareholder wealth. Professors Schipper and Smith find a significant positive share price reaction for 93 voluntary spin-off announcements between 1963 and 1981. The gains do not appear

The same reduction in the value of bonds occurs with claim dilution. When a corporation sells bonds and the bonds are priced on the assumption that no additional debt will be issued, the existing bondholders will incur a loss if additional debt of equal or higher priority is issued.¹³ Even though the borrowing increases the firm's assets, the debt to equity ratio likewise increases, and the old bondholders must share the equity with the new bondholders. Because the old bonds are riskier, their price declines.¹⁴ If the additional debt is incurred to finance an extraordinary distribution, as in the case of a cash self-tender, the debt to equity ratio increases even more.¹⁵ In either case, bond value will decline, causing a loss to the bondholders.

Furthermore, when the company markets its bonds with the stated use to be in low-risk (low-variance) investments and the bonds are priced accordingly, the value of the firm's stock will increase, while the value of the bonds will decrease if the company switches from low- to high-risk investments.¹⁶ The corporation's shareholders have an incentive for asset substitution, since by increasing the firm's risk, the value of their position increases.¹⁷

Hence, conflicts between bondholders and shareholders arise when management acts to maximize shareholder wealth by maximizing the firm's value and by making dividend, financing, and investment decisions that lead to an expropriation of wealth from bondholders.¹⁸ Like ordinary unsecured creditors, bondholders have no inherent guarantee

to come at the expense of bondholders; they suggest that the gains to shareholders may arise from tax and regulatory advantages and/or improved managerial efficiency resulting from the spin-off.

13. Smith & Warner, *supra* note 7, at 118.

14. McDaniel, *Corporate Governance*, *supra* note 1, at 419.

15. *Id.*

16. Smith & Warner, *supra* note 7, at 118.

17. Green & Talmor, *Asset Substitution and the Agency Costs of Debt Financing*, 10 J. BANK. & FIN. 391, 391 (1986); see also Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

18. See Smith & Warner, *supra* note 7, at 118. For one of the best explanations of the bondholder wealth expropriation hypothesis, see COPELAND & WESTON, *supra* note 4. But see Marais, Schipper & Smith, *Wealth Effects of Going Private for Senior Securities*, 23 J. FIN. ECON. 155 (1989). Marais, Schipper, and Smith suggest that increasing leverage does not harm existing bondholders. The authors investigated the effects of going-private buyout proposals made from 1974 to 1985 on the value and default risk of convertible and non-convertible debt and preferred securities. Positive average price reactions are documented for public convertible securities and non-convertible preferred stock. Most non-convertible debt securities remain outstanding without re-negotiation after buyouts, and minimal average price reactions are documented for public non-convertible debt. See generally Masulis, *The Effect of Capital Structure Change on Security Prices: A Study of Exchange Offers*, 8 J. FIN. ECON. 139, 169-171 (1980) (analysis on the effects of leverage changes using exchange offer (where debt is swapped for equity)). Masulis found that 49 non-convertible bonds suffered losses of 0.3% when leverage was increased, and the loss increased to 0.8% for 18 bonds not protected by covenants.

that their debtors will not consume the assets on which the creditors rely for protection, at least not until the debtor becomes insolvent. Like ordinary creditors, if bondholders choose to remain unsecured, they must look for some means of restricting asset appropriation by shareholders.

II. SOURCES OF BONDHOLDER PROTECTION

Because management is bound to a fiduciary duty of care to shareholders alone,¹⁹ bondholders must rely on other protective mechanisms to safeguard their interests. Bondholders can strengthen their position with the use of bond indenture covenants, voting rights, and bond insurance. Market forces can also serve to protect bondholders against adverse managerial behavior. However, even with these protective measures, bondholders may still find themselves in need of more protection.

A. Bond Indenture Covenants

The indenture contract largely determines a debtholder's rights. The contract governs the rights and obligations of the debt securities and attempts to anticipate all possible contingencies that might call into question the operation of those rights and obligations.²⁰ By the inclusion of various covenants in the indenture contract, bondholders can limit managerial behavior that results in the reduction of bond value.²¹ Bond covenants are generally categorized into four major areas: 1) covenants restricting new debt issues, 2) covenants restricting mergers, 3) covenants restricting dispositions of the corporation's assets, and 4) covenants restricting the payment of dividends.²² These covenants are designed to reduce some of the costs associated with bondholder-shareholder conflicts.²³

19. REV. MODEL BUSINESS CORP. ACT § 8.30 (1984).

20. *Broad v. Rockwell Int'l Corp.*, 614 F.2d 418 (5th Cir. 1980), *vacated*, 642 F.2d 929 (5th Cir. Apr. 1981), *cert. denied*, 454 U.S. 965 (1981).

21. Jensen & Meckling, *supra* note 17, at 337-38.

22. See Smith & Warner, *supra* note 7 (discussion of bond covenants commonly imposed on debt issuers); see also Kalay, *Stockholder-Bondholder Conflict and Dividend Constraints*, 10 J. FIN. ECON. 211 (1982) (examining a large randomly chosen sample of bond indentures focusing on the constraints they set on dividend payments, which have the potential to transfer wealth from bondholders). Kalay finds that the nature of these restrictions supports the hypothesis that bond covenants are structured to control the conflict of interest between stockholders and bondholders. He further finds that the empirical evidence suggests that these constraints are non-binding, that is, stockholders do not pay themselves as much in dividends as they could.

23. Smith & Warner, *supra* note 7, at 152.

Debt covenants have evolved into "undoubtedly the most involved financial document that has been devised."²⁴ While the bond contract once carried numerous restrictive covenants and was once seen as unwieldy, a "Frankenstein monster,"²⁵ this is no longer true. A study conducted over the years 1974 and 1975 found that over ninety percent of a sample of public debt contained new debt issuance provisions, over forty percent restricted merger activity, over thirty-five percent restricted the disposition of the company's assets, and twenty-three percent restricted the payment of dividends.²⁶

However, a more recent study by *Fortune*²⁷ magazine of the 100 largest industrial companies during 1984 reports that virtually all of the companies with senior issues had restrictions on secured debt and sale-leaseback transactions, but fewer than twenty percent of the new issues had any other restrictions. This study suggests that the current trend is away from including too many restrictions in bonds. The exception to this trend is the "negative pledge clause," which prevents companies from incurring debt with a higher priority than that already in place.²⁸

The retreat from bond covenants can be attributed to the life of the issue, often twenty or more years, and the near impossibility of amending a covenant. Usually indentures are either too lenient or too strict. When too lenient, wealth transfers may occur from bondholders to stockholders (although existing empirical evidence from the financial economics literature indicates that this does not happen). When too strict, indentures impose high opportunity costs on the firm's earning capacity, which could cause an alteration of risk. Both bondholders and shareholders have incentives to prepare indentures with few covenants.

B. *Voting Rights and Insurance*

Although bondholders do have an incentive to seek representation on the firm's board of directors, voting bonds are rarely used. A board of directors' main concern is to protect those constituencies who face significant risks of expropriation because their investment is not linked to specific assets and cannot be protected in a specific way

24. *Id.* at 122 (citing J. KENNEDY, *CORPORATE TRUST ADMINISTRATION* 1 (1961)).

25. Garrett, *A Borrower's View of the Model Corporate Debenture Indenture Provisions*, 21 *BUS. LAW.* 675, 675 (1966).

26. Smith & Warner, *supra* note 7, at 123.

27. *FORTUNE*, Apr. 29, 1985, at 266.

28. McDaniel, *Are Negative Pledge Clauses in Public Debt Issues Obsolete?*, 38 *BUS. LAW.* 867 (1983).

through bilateral safeguards.²⁹ Bondholders do not fit this description. Thus, the board of directors could be seen as a governance instrument of the stockholders.³⁰

The potential costs of bondholder voting rights outweigh the value of board representation. First, if bondholder directors become control persons under the federal securities laws, they are potentially liable for false and misleading statements of the company. Second, trade creditors and stockholders might seek to recoup their losses by charging bondholder directors with mismanagement or breaches of fiduciary duty. Finally, a bondholder with control may have claims subordinated to other creditors upon bankruptcy.³¹

A superior alternative to voting rights is to have a corporation insure its bonds.³² With insured bonds, bondholders receive better protection from risk alteration since the risk is shifted from the bondholder to the insurer.³³ Insurance companies can negotiate for protective covenants in the bond indenture and can monitor the firm in meeting its contractual obligations. For instance, if the indenture is found to be too restrictive to the firm, the insurance company can amend it with ease by having negotiations with a single insurer rather than with thousands of bondholders.³⁴

Insurance companies also have a higher stake in the corporation. Unlike bond trustees, who have no stake and no duty until default, the insurance company has a substantial stake in the company and a vested interest to monitor the firm.³⁵ In sum, insured bonds combine the advantages of both a public borrowing and a private placement.³⁶

Portfolio insurance can also be used by bondholders to insure their bonds. Protection will be obtained, but this insurance is only practical for those investors with a buy-and-hold strategy rather than those investors with a trading strategy.³⁷ When bonds are resold, portfolio insurance does not protect against risk alteration since the insurance

29. Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1210 (1984).

30. *Id.*

31. 15 U.S.C. § 78t(a) (1988) (control person liability under federal securities law), 11 U.S.C. § 510 (subordination of claims in bankruptcy); see DeNatale & Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417 (1985).

32. Easterbrook & Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 101-03 (1985) (discussion of debt insurance purchased by corporation from third party insurers for benefit of creditors).

33. McDaniel, *Corporate Governance*, *supra* note 1, at 436.

34. *Id.* at 436-437.

35. *Id.* at 437.

36. *Id.*

37. *Id.* at 439; see Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1150-51 & n.36 (1979).

does not run with the bonds.³⁸ Therefore, such insurance is not as effective as when a corporation insures its own debt.³⁹

C. Market Forces

Market forces may constrain managerial behavior that is adverse to bondholders. However, market forces are only effective if more bonds are offered in the future. For example, a company that expects to sell bonds from time-to-time has an incentive to avoid inflicting losses on existing bondholders, since a company with a reputation for hurting its bondholders will find it more difficult to sell bonds in the future.⁴⁰ New investors will either not buy the bonds or demand a higher return as compensation.⁴¹ As Brealey and Myers put it, "A company that makes a killing today at the expense of a creditor will be coldly received when the time comes to borrow again."⁴² While market forces may help to dissuade management from mistreating bondholders, additional alternatives are needed to protect bondholders.

III. THREE POSSIBLE SOLUTIONS TO BONDHOLDER-SHAREHOLDER CONFLICTS

Many solutions to bondholder-shareholder conflicts have been offered for bondholders when they find themselves isolated and unprotected from shareholder expropriations. Such solutions include: (1) equal fiduciary duties should be owed to shareholders and bondholders; (2) the indenture trustee or another third party should have a fiduciary duty to represent and to protect bondholder interests during negotiation of the indenture contract and to subsequently monitor corporate decisions; and (3) wealth maximization should be pursued in the interest of all classes of security holders, bondholders and shareholders alike. Because these alternatives require significant changes in the current system of corporate governance, they are unlikely to be implemented.

38. McDaniel, *Corporate Governance*, *supra* note 1, at 438.

39. Portfolio insurance would approximate the insurance by a corporation of its own debt if all bondholders in the market have portfolio insurance: on resale, the bonds would be covered by the new bondholder's portfolio insurance. However, this is unlikely to be the case.

40. McDaniel, *Corporate Governance*, *supra* note 1, at 434.

41. *Id.*

42. *Id.* (citing R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 399 (2nd ed. 1984)).

A. *Equal Fiduciary Duties Needed*

Generally, bondholders are protected by the indenture and stockholders are protected by directors.⁴³ Some argue that this tidy concept cannot be expected to serve modern corporate finance because the indenture "does not and cannot protect bondholders."⁴⁴ Recent changes in the bond market further demonstrate the need for enhanced bondholder protection, including enormous market growth, increased trading, lower-quality issues, and increased participation by less sophisticated individual investors.⁴⁵

A point in favor of enhanced bondholder protection is limited bond value information. In an efficient market, all available information about a company is reflected in the prices of its securities. With bonds, public access to value information is limited by the "nine-bond rule," New York Stock Exchange ("NYSE") rule 396, which allows trades of over ten bonds to occur in off-floor transactions.⁴⁶ Since almost all trades are over ten bonds, dealers can monopolize information on bond prices and can create market inefficiencies.⁴⁷ Bond prices that do not reflect actual values, particularly in such a growing market, advance the need for increased bondholder protection.

Another significant point is that distinctions between debt and equity securities are "increasingly blurred." Many high-yield, low-rated bonds trade like equity, while many preferred stocks resemble debt. Hybrid securities, such as convertibles, combine both debt and equity features. Also, distinctions between bondholders and stockholders are correspondingly blurred, particularly for the investor with a trading strategy. Today's stockholder is tomorrow's bondholder, switching from an equity-weighted portfolio, to a debt-weighted portfolio, and then to a mixed portfolio as interest rates and stock prices fluctuate.

The blurring of securities and of investors may be a signal for a reconsideration of fiduciary boundaries. The changes in the bond market and the inefficiencies created by bond price monopolization send a similar signal. These signals, coupled with the lack of protection afforded to bondholders by the indenture,⁴⁸ suggest that bond-

43. *Id.* at 413; see AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURES 2 (1971) (a bondholder's rights are contractual; they are protected only from extremely harmful acts and in bankruptcy).

44. McDaniel, *Corporate Governance*, *supra* note 1, at 413.

45. *See id.* at 414-15.

46. Rule 396(c)(i), 2 N.Y.S.E. Guide (CCH) ¶ 2396 (1982).

47. *See* Quint, *Antitrust Study of U.S. Bond Trading*, N.Y. Times, Apr. 4, 1983, at D1, col. 3 (Justice Department investigation into antitrust violations by banks and brokerage houses in trading).

48. *See infra* notes 49-55 and accompanying text.

holders and stockholders are all security holders in the enterprise and are equally deserving of board protection through fiduciary duties.

B. Indenture Trustee as Protector

The bondholder indenture agreement is designed to protect the bondholder through restrictive covenants while the corporation is solvent and through its trustee upon the corporation's default. While the oversight powers of the trustee upon the corporation's default are substantial and sufficient to protect bondholder interests, the trustee has few or no oversight powers or duties over the corporation while it is solvent.

The Trust Indenture Act of 1939 ("TIA")⁴⁹ established the duties and responsibilities of the indenture trustee. The Act, however, provided no role for the trustee during negotiations and for few monitoring responsibilities during the solvency of the corporation. Moreover, the Act's mandatory provisions offer little to help debtholders control, prevent, or even dissuade managerial opportunism prior to default.

An indenture trustee can be charged with the responsibilities of managerial oversight to ensure the terms of the indenture are met as well as to take part in the negotiation of those terms.⁵⁰ Bondholders need better representation in the negotiation process of the indenture contract because the contract is more often than not negotiated and finalized between the issuer and the underwriter, and the debtholders, as a widely dispersed class, are effectively prevented from participating in the negotiation. One commentator writes:

In a publicly placed issue the terms, including the protective provisions, are usually set by the issuer or by his agents [the underwriter]. Their primary concern is to get the best possible terms for the issuer, with protection for the investor a decidedly secondary consideration. The purchaser, if he buys, has to accept the terms set by the seller.⁵¹

The issuer is further concerned with obtaining a low interest rate and few restrictive covenants, and the underwriter wants the best rating possible to enhance marketability. Since the underwriter must resell the securities, it is thought that the underwriter will protect its own

49. 15 U.S.C. § 77aaa (1982).

50. Robertson, *Debenture Holders and the Indenture Trustee: Controlling Managerial Discretion in the Solvent Enterprise*, 11 HARV. J.L. & PUB. POL'Y. 461 (1988).

51. E. COREY, DIRECT PLACEMENT OF CORPORATE SECURITIES 90 (1951).

name by protecting the buyer, but "the law can hardly leave investors subject to the doubtful protection of private consciences."⁵² Clearly, better representation is needed.

As an alternative to imposing a fiduciary duty on corporate officers, and thereby rejecting contract law, such a duty could be imposed on a trustee or a third party. Requiring a fiduciary duty to both bondholders and stockholders could create substantial difficulties in making managerial decisions. For instance, how would management decide between the two classes when a decision benefitting one class harms the other (for example, a decision to pay a dividend on common shares), or how would a court supervise such a decision?⁵³ Therefore, establishing duties for the trustee or a third party to monitor both indenture negotiations and management decisions could be preferable. As set forth in the indenture, the trustee or third party could act as a board member with the power to enjoin actions, by suit if necessary, if management interferes with indenture protections or attempts to endanger bond value. Third party "trustees" could be representatives of the underwriter, an accounting firm, or a law firm.⁵⁴ As one commentator noted, "[w]hile the debenture holder's best insurance against loss is to invest in companies that are financially sound, the debenture holder is nonetheless entitled to a legal system that protects its interests against managers who favor shareholders' interests."⁵⁵

C. *Wealth Maximization for All Security Holders*

As an additional alternative to imposing fiduciary duties on corporate officers to protect bondholder interests, a general duty to maximize "global" wealth could be imposed on management.⁵⁶ Aristotle said that "the house is there that men may live in it, but it is also there because the builders have laid one stone upon another."⁵⁷ The corporation is built or financed by both equity and debt. It may well be an anomaly in the system of corporate governance that equity takes precedence over debt in wealth maximization.

52. Palmer, *Trusteeship Under the Trust Indenture*, 41 COLUM. L. REV. 193, 213 (1941) (quoting BERLE, *STUDIES IN THE LAW OF CORPORATION FINANCE* 44-45 (1928)).

53. See Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1264 (1982).

54. The alternatives of third-party accounting firms or law firms as trustees are especially noteworthy because of the expertise of such firms and because of their own professional rules that would reduce chances of conflicts of interest.

55. Robertson, *supra* note 50, at 486.

56. Barkley, *The Financial Articulation of a Fiduciary Duty to Bondholders with Fiduciary Duties to Stockholders of the Corporation*, 20 CREIGHTON L. REV. 47, 74 (1986).

57. D. THOMPSON, *On Growth and Form* 5 (1961) (providing a statement of the parable).

A central dogma of corporate practice views the corporation as seeking to maximize the value of its stock without direct regard for the value of other classes of securities.⁵⁸ This dogma operates with three assumptions: (1) a managerial fiduciary duty to stockholders does not also imply corresponding duties to the corporation's other classes of security holders; (2) equitable ownership of the corporation's assets by stockholders does not also imply corresponding ownerships by other classes of security holders; and (3) maximizing the value of the corporation's stock is equivalent to maximizing the value of the corporation's assets.⁵⁹

The anomaly in the rule of equity-preference in market value maximization and the resulting stockholder expropriations creates conflicts between stockholders and bondholders.⁶⁰ Stockholder-appointed directors determine production and investment policy that maximize shareholder wealth. However, the inequity would not be resolved if the indenture contract required bondholders rather than stockholders to decide investment policy, since bondholders would choose investments that maximized bond value rather than share value.⁶¹ Furthermore, additional costs would be imposed if bondholders assume control of the corporation.⁶²

One solution to the inequity between bondholders and stockholders is to require the corporation through its officers and directors to: (1) make decisions that maximize the wealth of all security holders, not specifically shareholders; and (2) make corporate side payments so that all classes of security holders would receive the same amount of wealth as those classes would otherwise attain through the current system. This new fiduciary "articulation" could theoretically benefit all security holders by implicitly forbidding corporate decisions that would substantially increase the risk of corporate bankruptcy without correspondingly maximizing the present value of the corporation's assets. This articulation would inherently subsume protective contractual provisions for bondholders and fiduciary duties to shareholders.

D. Summary of the Three Alternatives

The three alternatives propose replacing the current system with one that would insure protection to all security holders. The recurring

58. See Norris, *Not the Preferred Treatment: Proposed Uniroyal Buyout Hurts One Class of Securities*, BARRON'S, June 17, 1985, at 45, col. 1.

59. Barkley, *supra* note 56, at 48.

60. *Id.*

61. Smith & Warner, *supra* note 7, at 130; see also, Jensen & Meckling, *supra* note 17.

62. *Id.*

theme of these and other alternatives is that in a world of agency costs and shareholder expropriations, bondholders are insufficiently protected.

In the current system, corporate governance allows for investing in instruments with various degrees of risk. Bondholders enjoy far lower level of risk than shareholders because, in the event of liquidation due to insolvency or otherwise, they enjoy priority over shareholders for the corporation's assets until their claims are satisfied. Bondholders look to the indenture to protect themselves from increases in the debt-to-equity ratio prior to liquidation. The shareholders trust the directors, acting in accordance with their fiduciary duties, to make every effort to maximize shareholder wealth.

Equating debt to equity for purposes of director fiduciary duties could eliminate or homogenize the differences in risks that various financial instruments create, particularly if it led to the equation of debt with equity for purposes of priority for corporate assets. The capital market system necessitates a certain amount of freedom from external regulation. Too much external control over corporations, either by government or by security holders, could interfere with legitimate corporate decisions to make risky investment decisions. Also, corporations and security holders could be denied profits associated with facing and circumventing risks in investment decisions. Therefore, any attempts to change the control of corporate governance could deny investors the freedom of choosing the amount of risk they wish to bear and could also deny corporations the freedom to choose among investment policies with varying degrees of risk.⁶³

The notion of creating a risk-free debt market brings to mind the story of Mark Twain meeting with Members of the Fabian Society in England. When they explained to him their picture of a world without harm or danger, Twain replied that it sounded like a meadow full of cows after the last wolf had been shot. A corporate world in which directors owe fiduciary duties to bondholders might be well-intended but might also interfere with legitimate risk-taking by shareholders. And after all, the problems faced by unsecured bondholders are identical to the problems faced by ordinary unsecured creditors, and like ordinary creditors, bondholders have the alternative of purchasing secured debt.

63. Another problem in eliminating differences between equity and debt would be in losing favorable tax treatment for debt interest under the IRS code to both the corporation and debt-holders. See I.R.C. §§ 301, 302 (1988).

IV. JUDICIAL TREATMENT OF THE FIDUCIARY-DUTY-TO-BONDHOLDERS ISSUE

Despite some challenges to the traditional model of corporate governance, most courts hold that fiduciary duties do not extend to debtholders. By applying contract principles, the courts refuse to go beyond the express terms of the indenture contract to provide additional protection for bondholders. The courts find that the indenture contract adequately delineates bondholder rights. In some cases, courts do imply a covenant of good faith and fair dealing to protect the bondholders' express, bargained-for rights when a violation of a contractual term has been found. Yet, the courts do not reach far beyond the terms of the contract to imply this covenant. The message being sent is that debtholders are the corporation's creditors and as such are directed to engage in self-protection.

A. *The Delaware Courts*

In Delaware, the courts have consistently recognized that neither an issuer of debentures nor a controlling shareholder owes a fiduciary duty of loyalty and fairness to holders of the company's debt securities.⁶⁴ The Delaware courts have found "that a debenture holder has no independent right to maintain a claim for breach of fiduciary duty and in absence of fraud, insolvency or statutory violations, a debenture holder's rights are defined by the terms of the indenture."⁶⁵

Delaware courts also do not assign any significance to the fact that the debentures in question are convertible into stock at the option of the holder. In *Simons v. Cogan*,⁶⁶ the court cited a quote by Justice Holmes from 1889 stating that the convertibility feature was "simply an option to take stock as it may turn out to be when the time for choice arrives. The bondholder does not become a stockholder by his contract, in equity any more than at law."⁶⁷ The court in *Simons* concluded:

While the convertibility feature of convertible [debt instruments] creates an economic interest in an issuers stock price, so long as the

64. *Mann v. Oppenheimer Co.*, 517 A.2d 1056 (Del. 1986); *Simons v. Cogan*, 542 A.2d 785 (Del. Ch. 1987), *aff'd*, 549 A.2d 300 (Del. 1988); *Continental Illinois Nat'l Bank & Trust Co. v. Hunt Int'l Resources Corp.*, No. C.A. 7888 (Del. Ch. Feb. 27, 1987) (Westlaw No. 1987 WL 55826); *Norte & Co. v. Manor Health Care Corp.*, No. C.A. 6827 (Del. Ch. November 21, 1985) (Westlaw No. 1985 WL 44684); *Harff v. Kerkorian*, 324 A.2d 215 (Del. Ch. 1974), *aff'd in part and rev'd in part*, 347 A.2d 133 (Del. 1975).

65. *Continental Illinois*, No. C.A. 7888, slip op. at 5.

66. 542 A.2d 785.

67. *Id.* at 788-789.

right to convert is not exercised, it remains merely an option, and the holder of it retains all of the benefits of his creditor status. Until the moment of exercise, his investment is not held subject to the risks that the fiduciary duty concept was designed to address, but is held pursuant to a negotiated contract detailing rights and duties and conferring upon the creditor a legal right to repayment.⁶⁸

The Delaware courts have clearly held that holders of convertible debt are not considered shareholders either.⁶⁹ In *Norte & Co. v Manor Healthcare Corp.*,⁷⁰ the Delaware Chancery stated:

Inasmuch as ownership of a convertible debenture does not give the holder the rights of a shareholder, the holder of a convertible debenture would have almost no protection against acts by the Company which would adversely affect the value of the common stock issuable on conversion, such as a split-up of shares, stock dividends, distribution of assets, . . . merger, sale of assets or dissolution and liquidation of the Company. Events of this type are customarily described as "diluting" the value of the conversion privilege, and if protection is desired against such dilution, appropriate provisions must be included in the indenture.⁷¹

The Delaware Chancery also concluded in *Harff v. Kerkorian*⁷² that the holders of a corporation's convertible debt were not stockholders in equity, entitled to have standing to maintain a derivative suit. The court added that the holders of convertible debt instruments were not beneficiaries of any fiduciary duties. Therefore, the holders of convertible debentures were treated only as corporate creditors to whom contractual duties but no fiduciary duties were owed, unless they assumed the risks of stockholder status through the exercise of the power of conversion.

B. Decisions Rejecting the Extension of Fiduciary Duties

In *Simons v. Cogan*,⁷³ a class action was brought on behalf of the holders of 8-1/8% Convertible Subordinated Debentures of Knoll In-

68. *Id.* at 791.

69. *Id.*; *Continental Illinois Nat'l Bank & Trust Co. v. Hunt Int'l Resources Corp.*, No. C.A. 7888 (Del. Ch. Feb. 27, 1987) (Westlaw No. 1987 WL 55826); *Norte & Co. v. Manor Health Care Corp.*, No. C.A. 6827 (Del. Ch. November 21, 1985) (Westlaw No. 1985 WL 44684).

70. No. C.A. 6827.

71. *Id.* at 4 (quoting AMERICAN BAR FOUNDATION, *supra* note 43, at 527).

72. 324 A.2d 215, 219 (Del. Ch. 1974).

73. 542 A.2d 785 (Del. Ch. 1987), *aff'd*, 549 A.2d 300 (Del. 1988).

ternational, Inc. ("Knoll"). The defendants named were Knoll and Marshall S. Cogan, who controlled Knoll. The complaint alleged that the issuer owed a fiduciary duty of entire fairness to the holders of its convertible debentures and that the defendants breached this duty in structuring the proposed merger. The two-step transaction involved a \$12 cash tender-offer followed by a cash-for-stock merger at the same price. In the second step of the merger, a Supplemental Indenture was executed by the issuer, which provided that each convertible debenture previously convertible into one share of Knoll Class A Common Stock would henceforth be convertible into the consideration received by the public Class A shareholders in the merger, \$12 cash. While the principal amount of each debenture was \$19.20, the tender was for \$12 a share of common stock, which resulted in a substantial loss to the debtholders. Regardless of this loss, the court found that neither the issuer nor the directors owed a fiduciary duty to the convertible debtholders.

The court opined that the law in Delaware was firmly fixed in that bondholders are owed no duty of the broad and exacting nature characterized as a fiduciary duty.⁷⁴ Unlike shareholders, to whom such a duty is owed, debtholders must turn to documents that exhaustively detail the rights and obligations of the issuer and of the holders of securities.⁷⁵ These documents are carefully negotiated at arms-length wherein the purchaser of such debt is offered, and voluntarily accepts, a security whose myriad of terms are highly specified. Therefore, the broad abstract requirements of a fiduciary character have little use in the governance of such a negotiated, commercial relationship. Accordingly, the debtholder's rights are fixed and determined from the language of the documents that create and regulate the security.⁷⁶

As in Delaware, the California courts have refused to impose fiduciary responsibilities upon corporations with respect to bondholders. In *Kessler v. General Cable Corp.*,⁷⁷ the holders of convertible debentures issued by a Massachusetts corporation filed an action against a New Jersey corporation, which had substantially acquired all of the Massachusetts corporation's stock. The court held that the Massachusetts corporation did not breach any fiduciary duty to the holders of its convertible debentures by selling its stock to the New Jersey corporation, even though the sale resulted in the delisting of those debentures from the New York Stock Exchange. The court reasoned that

74. *Id.* at 786.

75. *Id.*

76. *Id.* at 786-787.

77. 155 Cal. Rptr. 94 (1979).

imposing a fiduciary duty would constitute an expansion of the present law in contradiction of current case law.⁷⁸

C. Challenges to the Delaware Rulings

Some jurisdictions have challenged the traditional Delaware view. A body of judicial opinion exists that demonstrates a willingness to extend the protection offered by the fiduciary concept to the relationship between an issuer and the holder of convertible debt securities.⁷⁹ However, none of the appellate opinions represent a holding that actually extends the fiduciary concept, and in fact, prevailing judicial opinion remains to the contrary.⁸⁰

A few circuits have considered whether a fiduciary duty may exist under certain circumstances.

In *Broad v. Rockwell International Corp.*,⁸¹ the Fifth Circuit Court of Appeals held that an issuer of convertible debentures does owe a duty of good faith and fair dealing to its debenture holders.⁸² The court noted that if the issuer had fully complied with the terms of the debenture agreement then the issuer had discharged its contractual obligation and the fiduciary duty claim should not be reached.⁸³ On rehearing *en banc*, the Fifth Circuit assumed, without deciding, that the panel's conclusion was correct that the issuer was charged with a fiduciary duty to the debenture holders. The court found that the earlier court should not have considered the existence of any fiduciary duties since the issuer had fully complied with its obligations under the indenture.⁸⁴

In *Van Gemert v. Boeing Co.*,⁸⁵ the Boeing corporation failed to provide its debenture holders with adequate notice of a redemption. The Second Circuit Court of Appeals, applying New York law, found an implied covenant of good faith and fair dealing in the debenture contract and found that convertible debentures have a special nature due to the expectation of the holder that the stock will rise sufficiently in value to make the debenture worth more than the debt.⁸⁶ The court

78. *Id.* at 103.

79. *Simons*, 542 A.2d at 790.

80. *Id.*

81. 614 F.2d 418 (5th Cir. 1980), *vacated*, 642 F.2d 929 (5th Cir. Apr. 1981), *cert. denied*, 454 U.S. 965 (1981).

82. *Id.* at 430.

83. *Id.* at 431.

84. *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929 (5th Cir. Apr. 1981), *cert. denied*, 454 U.S. 965 (1981).

85. 520 F.2d 1373 (2d Cir.), *cert denied*, 423 U.S. 947 (1975).

86. *Id.* at 1385.

noted that "an award against Boeing will in effect tend to reduce pro tanto the equity of shareholders in the corporation and thus to a large extent those who were benefitted, one might almost say unjustly, will be the one who pay [debentureholder's] loss."⁸⁷

Only one judge indicated a willingness to go further and find an "underlying duty of fair treatment[]owed by the corporation or majority stockholders or controlling directors and officers" to bondholders.⁸⁸ However, in a later phase of the case, another panel of the Second Circuit emphasized that the rationale for the result reached in *Van Gemert* was based on a breach of contract and not on a breach of a fiduciary duty.⁸⁹

In *Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R.*,⁹⁰ the holders of convertible debentures brought an action against the corporation, alleging that the corporation's failure to notify the debenture holders of a dividend payment to shareholders violated federal securities laws. Circuit Judge Gibbons noted in his opinion that although no Maryland case had been presented addressing the issue of fiduciary obligations to holders of securities containing stock options, he "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."⁹¹ The other two members of the panel, however, specifically disavowed such a conclusion.⁹²

Ultimately, the court's decision was based on the contractual doctrine of an implied covenant of good faith and fair dealing.

In *Green v. Hamilton International Corp.*,⁹³ the owners of convertible debentures alleged common law fraud and violations of the Securities Exchange Act for the corporation's concealment of purported merger negotiations, which prevented the owners from acquiring information that would have encouraged a conversion rather than redemption. In a footnote, the court asserted another ground for relief, the breach of a fiduciary duty by the corporation. Quoting from the United States Supreme Court's opinion in *Pepper v. Litton*,⁹⁴ the court added:

87. *Id.*

88. *Id.* at 1382 (dicta by Oakes, J., author of majority opinion, emphasizing that the other members of the panel did not base their decision on this ground).

89. *Van Gemert v. Boeing Co.*, 553 F.2d 812 (2d Cir. 1977).

90. 680 F.2d 933 (3d Cir.), *cert. denied* 459 U.S. 1056 (1982).

91. *Id.* at 941.

92. *Id.* at 943-46 (Garth, J., concurring); *id.* at 946-54 (Adams, J., dissenting).

93. 437 F. Supp. 723 (S.D.N.Y. 1977).

94. 308 U.S. 295 (1939).

As holders of convertible debentures, plaintiffs were part of "the entire community of interests in the corporation—creditors as well as stockholders" to whom the fiduciary duties of directors and controlling shareholders run.⁹⁵

The district court construed the Delaware Supreme Court's reversal in *Harff v. Kerkorian*⁹⁶ as permitting a conclusion that a fiduciary duty to convertible debenture holders may exist. In a slip opinion, the district court made a statement that does not appear in the reported decision:

If wrongs alleged impinged upon the equity aspects [of convertible debt], then the analysis would more properly treat plaintiffs like shareholders to whom the majority shareholders and directors of the corporation owe a duty of honest, loyalty, good faith and fairness.⁹⁷

According to the court in *Simons*, the analysis in *Green* was flawed in two respects. First, the court in *Green* misread the court's conclusion in *Harff*, and second, the court's analysis regarding fiduciary duties was unpersuasive. The court in *Simons* stated:

[That] a convertibility feature of a debt security creates an economic interest in the issuer's stock price that the holder of a straight debt instrument would not have is plain. But, it does not follow at all that from such additional economic interest, fiduciary duties of loyalty, etc. necessarily or properly flow. Such duties . . . have been imposed upon those to whom property has been entrusted to manage for the benefit of another But, it has not been extended to negotiated commercial transactions where the original property owner transfers it with a contractual right to repayment. Thus, for example, no case holds that the relationship between a bank and its borrower involves a fiduciary duty running from the borrower⁹⁸

After its decision in *Green*, the Southern District of New York agreed with the Delaware Supreme Court's affirmance in *Simons* that "a bondholder acquires no equitable interest and remains a creditor of the corporation whose interests are protected by the contractual terms of the indenture."⁹⁹ Thus, it is unlikely that a court today would find

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

96. 347 A.2d 133 (Del. 1975).

97. *Green v. Hamilton*, No. 76-5433, slip op. at 14 (S.D.N.Y. July 13, 1981).

98. *Simons v. Cogan*, 542 A.2d 785 (Del. Ch. 1987), *aff'd*, 549 A.2d 300 (Del. 1988).

99. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524 (S.D.N.Y. 1989) (citing *Simons*, 549 A.2d at 304).

that corporate directors and officers owe fiduciary duties to the holders of convertible debentures.

D. *Implied Covenant of Good Faith and Fair Dealing*

A somewhat different question is whether there is an implied covenant of good faith and fair dealing under contract law that can protect bondholders. The relationship between the corporation and the holders of its debt securities, even convertible debt securities, is generally held to be contractual in nature.¹⁰⁰ Therefore, a plaintiff may always allege a violation of an express covenant.¹⁰¹ If there has been a violation, the court need not reach the question of whether or not an implied covenant has been violated:

That inquiry surfaces where, while express terms may not have been technically breached, one party has nonetheless effectively deprived the other of those express, explicitly bargained-for benefits. In such a case, a court will read an implied covenant of good faith and fair dealing into a contract to ensure that neither party deprives the other of the fruits of the agreement. . . . Such a covenant is implied only where the implied term is consistent with other mutually agreed upon terms in the contract. . . . In other words, the implied covenant will only aid and further the explicit terms of the agreement and will never impose an obligations which would be inconsistent with other terms of the contractual relationship.¹⁰²

Implied covenants of good faith and fair dealing are recognized by New York and Delaware law.¹⁰³ In contracts for indentures, "[a]n implied covenant . . . derives its substance directly from the language of the Indenture, and cannot give the holders of Debentures any rights inconsistent with those set out in the Indenture. . . . [Where] plaintiffs' contractual rights [have not been] violated, there can have been no breach of an implied covenant."¹⁰⁴

In *Van Gemert and Pittsburgh Terminal*, the courts used the implied covenant of good faith and fair dealing to ensure that the debt-

100. See *Broad v. Rockwell Int'l Corp.*, 614 F.2d 418 (5th Cir. 1980), *vacated*, 642 F.2d 929 (5th Cir. Apr. 1981), *cert. denied*, 454 U.S. 965 (1981); see also AMERICAN BAR FOUNDATION, *supra* note 43.

101. *Metropolitan Life*, 716 F. Supp. at 1516.

102. *Id.* at 1517; see also *Shenandoah Life Ins. Co. v. Valero Corp.*, No. C.A. 9032 (Del. Ch. June 21, 1988) (Westlaw No. 1988 WL 63491).

103. *Van Gemert v. Boeing Co.*, 520 F.2d 1373 (2d Cir.), *cert denied*, 423 U.S. 947 (1975); *Gardner & Florence Call Cowles Found. v. Empire, Inc.*, 589 F. Supp. 669 (S.D.N.Y. 1984), *vacated on procedural grounds*, 754 F.2d 478 (2d Cir. 1985); *Katz v. Oak Indus.*, 508 A.2d 873 (Del. Ch. 1986).

104. *Gardner*, 589 F. Supp. at 673 (quoting *Broad*, 642 F.2d at 957).

holders received the benefit of their bargain as determined from the face of the contract at issue. In *Van Gemert*, the holders of convertible subordinated debentures alleged inadequate notice of defendant's intention to redeem their debentures. The contract itself provided that notice would be given prior to redemption. While the defendants issued a press release that mentioned the possible redemption of the debentures, the release did not specify any dates for redemption or dates for expiration of the debenture holders' conversion rights.

The court stated:

What one buys when purchasing a convertible debenture in addition to the debt obligation of the company . . . is principally the expectation that the stock will increase sufficiently in value that the conversion right will make the debenture worth more than the debt. . . . Any loss occurring to him from failure to convert, as here, is not from a risk inherent in his investment but rather from unsatisfactory notification procedures.¹⁰⁵

In brief, the court found that an implied covenant protected the debenture holders' reasonable expectation of notice. The court in *Pittsburgh Terminal* held that an implied covenant governed the conditions of the indentures at issue because defendants there "took steps to prevent the bondholders from receiving information, which they needed in order to receive the fruits of their conversion option should they choose to exercise it."¹⁰⁶ In both cases, an implied covenant was applied to protect the bondholder's express rights under the indenture contract.

In the most recent case decided on this issue, *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*,¹⁰⁷ the United States District Court reasoned that the appropriate analysis was first to examine the indenture to determine the "fruits of the agreement" between the parties, and then to decide whether these "fruits" had been spoiled—that is, whether plaintiffs' contractual rights had been violated by defendants.¹⁰⁸ The court held that the "fruits" of Metropolitan's indentures did not include an implied restrictive covenant that would prevent the incurrence of new debt to facilitate the leveraged buyout of RJR Nabisco. The court stated:

105. *Van Gemert*, 520 F.2d at 1385.

106. *Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R.*, 680 F.2d 933 (3d Cir.), cert. denied, 459 U.S. 1056 (1982).

107. 716 F. Supp. 1504 (S.D.N.Y. 1989).

108. *Id.* at 1518.

to hold otherwise would permit these plaintiffs to straight-jacket 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.¹⁰⁹

In addition, the court noted that "where parties are sophisticated investors, well versed in the market's assumptions, and do not stand in a fiduciary relationship with one another,"¹¹⁰ courts are reluctant to imply terms that have been and remain subject to specific, explicit provisions in the contract. This decision suggests that courts will not reach far beyond the contract to imply a covenant of good faith and fair dealing. The court must initially find a violation of a contractual term prior to considering the existence of any implied covenant. This interpretation is a very narrow application of the rule.

In sum, courts are unlikely to find that the holders of convertible debentures are owed a fiduciary duty. A court may be willing to use the implied covenant of good faith and fair dealing if a contractual right has been violated. However, the courts will narrowly apply the concept of implied covenants, as is evidenced by the decision in *Metropolitan Life*. Simply put, the courts do not find it necessary to establish any protections to debtholders beyond that which currently exists, and they are unlikely to do so in the future.

V. CONCLUSION

Financial theory points to conflicts of interest between shareholders and bondholders and problems bondholders encounter in seeking to protect their interests; thus, some commentators suggest that the answer lies in enhancing bondholders' rights. However, the courts have not accepted these arguments. According to the courts, the bond indenture contract is sufficient to defend and to delineate bondholders' rights. The courts have repeatedly ruled that no sufficient reason exists to extend fiduciary duties to bondholders, despite protests of indenture simplicity and shareholder duplicity.

The courts have increased protection to bondholders by finding implied covenants in the indenture contracts. Yet this remedy is available only when an explicit right found in the indenture has been violated. This is purely a contractual right and is not, in any way, a fiduciary duty.

109. *Id.* at 1519.

110. *Id.* at 1522.

The capital market dictates a world of demand for financial instruments with varying degrees of risk and return. Changing the manner of corporate governance could lead to the elimination of differences between financial instruments. This could in turn reduce the range of risk and return available to both security holders and corporations. Further, extending corporate fiduciary duty to bondholders would be difficult to reconcile with the law's treatment of other unsecured creditors. Thus, the approach of the courts has probably been wise.

Bondholders must continue to seek protection in the traditional methods: through indenture covenants and bond insurance. If these methods prove ineffective, bondholders should explore the possibility of purchasing secured debt.

