

BONDHOLDER-STOCKHOLDER CONFLICT:

CONTRACTUAL COVENANTS VS COURT-MEDIATED EX-POST SETTLING-UP

P.V. VISWANATH
Lubin School of Business
Pace University
861 Bedford Road
Pleasantville, NY 10570
Tel: (212) 346-1817
Fax: (212) 346-1573
E-mail: pviswanath@pace.edu
Web: <http://webpage.pace.edu/pviswanath>

and

WAYNE EASTMAN
Graduate School of Management
Rutgers University
92 New Street
Newark, NJ 07102

Abstract: Bondholders have failed to respond to corporate restructurings by demanding more protective provisions; in fact, the trend has been toward fewer rather than more restrictive covenants. In this article, we model the use of contractual covenants by as a trade-off between contract implementation costs and the avoidance of deadweight efficiency losses. We find that the current lack of restrictive covenants is arguably consistent with rational investor behavior. The key to this conclusion is the recognition that there is an implicit ex-post settlement component to debt contracts, which is enforced by the courts. A look at the behavior of the courts and of bondholders supports to our point of view.

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Abstract

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I. Introduction

In the aftermath of the 1980s wave of corporate capital restructurings through leveraged buyouts and other means, bondholders did not respond by demanding more protective provisions in their contracts with corporations. In fact, if anything the trend was in the other direction, toward fewer rather than more restrictive covenants.¹ Traditional covenants that restrict additional debt and limit dividend payments, which had declined to negligible levels by the mid-1980s, did not rebound.² Sinking funds designed to ensure debt repayment, which had appeared in the overwhelming majority of new issues through 1987, have appeared in only around 5% of new issues since then. Overall, bondholders are not demanding more protection now than they were during the mid-1980s; and compared to the period before 1978,³ they are demanding less.

¹ Asquith and Wizman (1990) note '... the reduction in the use of traditional covenants during the 1980s (is) anomalous,' while Long and Malitz (1995) state, "Like dinosaurs, covenants are extinct, but we do not know why." See also Malitz (1994) and Euromoney (August 1994). From 1988 to 1990 there was a surge in event risk and deferred put covenants designed to protect bondholders against takeovers and other corporate restructurings, but after 1991 these provisions declined, with only around 10% of new issues containing such covenants (Long and Malitz, 1995; Malitz, 1994).

² 6 out of 65 issues in Long and Malitz's (1995) sample from 1983-1986 contained at least one of these traditional restrictions, while none out of 106 issues from 1987-1993 did.

³ In that period, over half of Long and Malitz's (1995) sample included covenants restricting additional debt and dividends.

The current low level of bond covenants presents an intriguing puzzle. Why did the wave of corporate restructurings, some of them with negative consequences for bondholders, not produce a rush to protective provisions? In this article, we suggest that corporate and bondholder actions can be explained on the basis of an implicit component in debt contracts involving ex-post settlement to be mediated by the courts.⁴ We suggest that the basic impulse driving such an implicit contract is economic efficiency.^{5,6}

⁴ Park (2000) raises a related problem about the seeming insufficiency of covenants; if, he asks, covenants are used to reduce contracting costs (as suggested by Smith and Warner (1979)), we would expect junior debt contracts to have more restrictive covenants, since junior debt is inherently riskier. Park's answer to this question has to do with maximizing the incentive to monitor, which requires senior bondholders to be able to recover their monitoring costs. However, another possible answer to this question is that junior bondholders' claims are more similar to equity – they have more to benefit from the firm's exploitation of (potentially risky) positive NPV projects – hence they are more willing to rely on ex-post court-mediated protection.

⁵ A recent incident is illustrative. On October 19, 1998, Greyhound Lines and Laidlaw, Inc. announced a merger. The merger seemed desirable to most of the parties involved, except to investors who held \$60 million of Greyhound's convertible preferred shares (Sherer, 1998). These preferred shares were call protected until May 3, 2000 and investors were expecting to receive the generous 8.25% yield on their securities. However, under the terms of the merger, Laidlaw would take over the convertibles and pay the holders in a combination of stock and cash. Hence, if the merger were to be consummated as planned, investors would forego approximately \$3.19 a share. Greyhound argued that legally they were allowed to go through with the merger, but agreed, nevertheless, to keep the convertible preferreds in existence, at the option of the holders. Why? Did Greyhound simply misread the contract; or did they back down because they recognized the possibility of the bondholders prevailing in court, in spite of a correct reading of the express terms in the bond contract?

⁶ A suggestive measure of such increased economic efficiency is provided by Rao and Edmunds (2001). Using simulation, they find that fixed-rate bond financing with less restrictive covenants, adds 17.4% to the stock price, compared to bank financing with more restrictive covenants. However, they do not explain why bondholders should be satisfied with less restrictive covenants.

There is suggestive evidence that court rulings go beyond explicit contractual language. A small literature partly in finance, and partly in law discusses the appropriateness of such court rulings. On one side of the debate, academics, primarily economists, contend that judicial interventions in favor of bondholders should be based solely on the express language of contracts between bondholders and corporations (Kanda, 1992; Lehn and Poulsen, 1990, 1991; Scott, 1992; Harvey, 1991; Hurst and McGuinness, 1991). On the other side, there are arguments that the law should respond to managerial incentives to transfer wealth away from bondholders by recognizing a broad fiduciary duty of management toward bondholders, and compensating bondholders for losses from risky management actions (Barkey, 1986; McDaniel, 1986, 1988; Mitchell, 1990). In practice, while most courts have rejected arguments for imposition of a fiduciary duty to bondholders, some have suggested that management does have such a duty. And, significantly, even courts that accept the prevailing position against imposing general management duties to bondholders have found ways to protect bondholders against perceived management overreaching.

The main point that we make in this article is this: covenants cannot always be depended upon to resolve debt-related agency problems and to provide firm managers with an incentive to act optimally. This is because the information necessary to determine the economically efficient action is not always available at the time that the bond indenture is drawn up. Consequently, it can make sense to wait until more information is available, before determining what the obligations of the firm vis-à-vis bondholders. Also, given the ubiquitous nature of the bondholder-stockholder conflict, it makes sense that the resolution to the conflict be achieved in a way that also helps to set precedents. Hence, court intervention is often perceived by the parties as the cheapest way of achieving such an ex-post settling up. Furthermore, since the ex-ante efficient action can be difficult and costly to establish in a court of law, the parties might well prefer that this ex-post efficiency-based settling-up be done in an *implicit* manner through the interpretation of legal standards such as good faith and full disclosure. We do not claim that

the courts explicitly and consciously enforce this implicit bond contract; our contention is simply that the approach of the courts effectively results in the enforcement of the implicit ex-post component.⁷

The organization of the paper is as follows. In Section II, we analyze the form of the contract between bondholders and stockholders and discuss the different factors that influence the means by which efficiency losses are minimized. In Section III, we discuss the role of the courts in the bondholder contract. Section IV evaluates the theory in the light of available empirical evidence, while Section V concludes.

II. The Contract Between Bondholders And The Firm

Management, acting on behalf of shareholders, has an incentive to dispossess bondholders. Such dispossession can be carried out in four ways (Smith and Warner, 1979): i) reducing the asset base that bondholders depend on for repayment by paying excessive dividends; ii) diluting bondholder claims by issuing additional debt of equal or higher priority; iii) adopting excessively risky projects (Jensen and Meckling, 1976); and iv) underinvestment (Myers, 1977). To the extent that these acts involve deadweight efficiency losses, it is important for both bondholders and stockholders to reduce the probability of such acts.

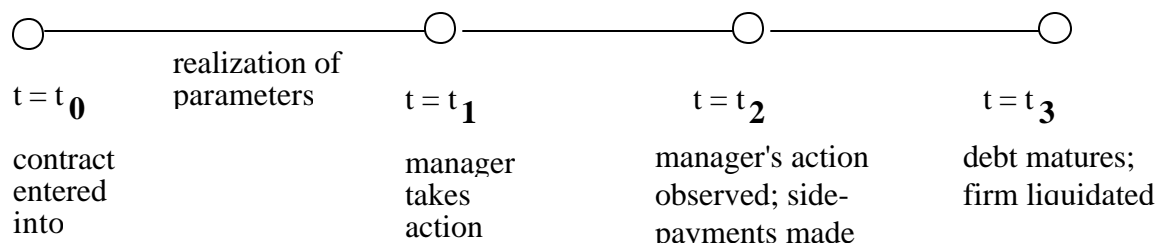
Overall, bondholders can protect themselves against dispossession in the following major ways: 1) through indirectly influencing management actions by changing their incentives to take particular actions; 2) through directly restricting management from engaging in certain

⁷ Alternatively our paper could be interpreted as arguing that legal standards such as the implied covenant of good faith and fair dealing and various aspects of securities law lead to an efficient ex-post resolution of the stockholder-bondholder conflict.

actions; 3) through receiving an advance premium based on expected dispossession; and 4) through an agreement for ex-post compensation of dispossession.

The first method has been discussed in great length in the finance literature (see e.g. Jensen and Meckling, 1976). The alternatives suggested there have been mainly of the nature of capital structure modifications to align managerial incentives with bondholder objectives (such as including convertibility provisions that allow debt to benefit from successful risk-taking). Other protections available to debtholders are diversification and the effect of reputational considerations on management behavior. However, there are two reasons why we must look further. First, it is unlikely that such methods will provide an inexpensive and complete solution to the problem; and second, capital structure modifications may not work in equilibrium if investors have access to capital markets, because investors can create home-made securities to undo the modifications (Frierman and Viswanath, 1994). For these reasons, we now turn to a formalized exploration of the circumstances under which the latter three strategies make sense for bondholders and stockholders.

A. The Formalization



We consider four points in time: $t = t_0$, the time that the contract is entered into; $t = t_1$, the time that the manager takes action; $t = t_2$, the time that the manager's action is observed by the market, and $t = t_3$, the time that the debt matures, action outcomes are realized, and the firm

is liquidated.⁸ $A = \{a\}$ denotes the set of actions that the manager can take at t_1 subsequent to the realization of the set $P = \{p\}$ of mediating parameter vectors. An example of a parameter vector is a vector representing the state of the economy. The manager chooses an action $a \in A$, as a function of the parameter set P and the contract, q , between bondholders and equityholders, defined below. The action is observed by the market at $t = t_2$ and the appropriate steps taken according to the contract between the parties; for example, if there is a covenant violation, the prescribed penalty payments are made to bondholders. Let $f = (f_e, f_b)$ be a mapping from the product of the action space and the parameter space to the outcome space at time t_3 , where f_b describes the contractual principal repayment at $t = t_3$ to bondholders. The function, f_e , is equal to the payoff from the firm's projects at $t = t_3$ less f_b , and is the payoff to the equityholders. Hence $f_e + f_b$ is the payoff from the firm's projects at t_3 .

A contract, q , between bondholders and equityholders is described by a side-payment $s^q(a, p)$, which is to be made at t_2 . Denote by E_t , the risk-adjusted present value (or market value, if a market exists) at time $t = t_i$. Then, the total value of the firm at $t = t_0$ can be written as $E_0 \{f_e(a, p) + f_b(a, p) + C(q, P)\}$, where C represents implementation costs.⁹ Since neither party is assumed to have any bargaining advantage, it is in their joint interests to maximize this quantity. Assuming, without loss of generality, that the initial contract is offered to the firm by the bondholders, we can write the bondholder problem as:

$$\text{Max}_q E_0 \{f_e(a^*, p) + f_b(a^*, p) + C(q, P)\}$$

⁸ In practice, there may be several points in time where the manager takes action, as well as intermediate promised coupon payments to bondholders. Introducing these complications will not alter the essentials of the structure being presented here.

⁹ Implementation costs include all costs associated with a given contract, such as costs of drawing up the contract, monitoring managerial actions, and invoking legal measures to enforce the contract.

$$s.t. a^*(p, q) = \underset{a}{\text{Arg max}} \text{Max}[E_2 f_e(a, p) - s^q(a, p), 0], \text{ for each } p \in P$$

i.e. the manager's action $a = a(p, q)$ is incentive-compatible. The expectation in the objective function is taken at time $t = t_0$, over the risk-adjusted probability distributions of the parameter vector p . The cost of implementing the agreement, C , is a function of the nature of the agreement as well as the nature of the parameter set. For example, the implementation cost may depend on the probability distribution of the parameter vector. A crucial point in the formalization is that the manager chooses his action subsequent to the realization of the mediating parameters, but prior to the side-payments to be made at $t = t_2$. This allows the parties to choose the side-payments in such a way that the manager has an incentive to maximize the payoffs to the firm.

Rather than deal with an arbitrary contract q , let us identify three generic kinds of agreements: agreements with ex-ante compensation for dispossession (activated at $t = t_0$ and denoted q^{ante}), agreements involving covenants restricting managerial actions (activated at $t = t_2$, when the manager's actions are observed, and denoted q^{cov}), and ex-post agreements (again activated at $t = t_2$ and denoted q^{post}). The simplest contract is an agreement for ex-ante compensation has a simple side payment s^{ante} , which is a constant, and is the amount of the agreed upon ex-ante compensation; implementation costs for such a contract should be minimal.

An agreement that involves restrictive covenants has side payments $s^{cov}(a, p)$ that satisfy: $s_i^{cov}(a, p) \geq s_i(a, p) - (A \times P)_i$; $s_i^{cov}(a, p) \geq 0$; $(a, p) \in \bigcap_{i=1}^k (A \times P)_i$. Such an agreement defines sets $(A \times P)_i$, $i = 1, \dots, k$ which are subsets of $A \times P$, and mandates a particular side payment, s_i , to the bondholders if the action taken by management, a , under given circumstances, p , satisfies $(a, p) \in (A \times P)_i$ for some $i = 1, \dots, k$. If $(a, p) \notin (A \times P)_i$ for any $i = 1, \dots, k$, then there are no side payments. Such side payments may involve an acceleration of the principal amount of the loan, or some penalty payment to the bondholders. In principle, the payments s_i are chosen with a view to making the relevant action a , as incentive

incompatible for the manager as possible; in practice, however, costly and imperfect observation of the manager's actions and of the parameter vector make this an imperfect exercise.

An ex-post agreement specifies a compensation function $s^{post}(a, p)$, which, again, depends on the action taken by the manager and the realization of the parameter vector. The ex-post element in this third form of agreement is not so much in terms of when the side-payment is made, but rather in terms of when the determination is made as to what types of actions require compensation and how much.¹⁰ This compensation is determined (and paid) at $t = t_2$, subsequent to the action having been taken at $t = t_1$.¹¹ Consequently, the implementation costs would probably exceed the implementation costs of a covenant based contract, where conditional compensation amounts are already determined as of $t = t_0$. In other words, $0 = C(q^{ante}) ? C(q^{cov}) ? C(q^{post})$.

It is clear from the discussion above that there is a tradeoff between contract implementation costs and deadweight efficiency losses. The optimal contract can, in principle, be any one of the three kinds described above; however, one can reasonably draw the conclusion that the ex-post settling up model will be optimal under some circumstances. In addition, the model described above can be used to predict which contract type will be used

¹⁰ In practice, the time at which an ex-post contract side-payment is triggered may be later than the time at which a covenant-based side-payment is triggered. This is because the issues involved in determining what kind of actions trigger compensation are more complex, since they are not explicitly stated.

¹¹ The bondholders may, in fact, not receive the entire amount of the side-payment, if the firm is bankrupt, at t_3 , the date that the debt is to be repaid. This is true, whether the side-payment is mandated by a covenant-based contract or by an ex-post contract. However, to the extent that covenant-based contractual compensation is paid earlier than ex-post contract compensation, bondholders bear less risk.

under different circumstances and what factors will play a part. The choice of the optimal contract is presented below in the context of a simple model that will highlight the role of these different factors.

B. An Illustrative Example

For simplicity, we assume that there are two alternative actions ($A = \{a_1, a_2\}$) and the value of a single parameter determines which one is optimal. Define $V(a, p) = f_e(a, p) - f_b(a, p)$. Then, we assume that there is a critical parameter value p_c , such that a_1 is optimal when $p > p_c$, and a_2 is optimal otherwise. In other words, $V(a_1; p > p_c) > V(a_2; p > p_c)$ and $V(a_2; p < p_c) > V(a_1; p < p_c)$. However, from the point of view of the equityholders, a_2 is always optimal.¹² This sets up the bondholder-stockholder conflict.

An example of this would be a covenant that restricts the amount of debt that a firm might take on. We know from capital structure theory that the optimal amount of debt is a decreasing function, inter alia, of the level of bankruptcy costs. If we let a_1 represent a lower debt level, and a_2 a higher debt level, then the conditional covenant described in the text would attempt to require that the debt level be low (a_1) when bankruptcy costs are higher than the critical level p_c and high (a_2) when bankruptcy costs are lower than p_c . Equityholders would, in general, always find it optimal to issue additional debt to decrease the value of existing debt.

¹² In practice, bondholders may find not such conditioning of covenants useful, particularly if the uncertainty regarding the value of p_c is high. In this case, an unconditional covenant may be used (in which management will be required to perform a certain action regardless of the value of the parameter), or the covenant may be withdrawn entirely. This is probably what happened with the case of event-risk covenants, which were popular in the immediate aftermath of the 80s boom in leverage, but then decreased in frequency of use. See Malitz (1994).

We assume further that the parties do not know p_c precisely at time $t = t_0$; it is known only at time $t = t_1$. Hence, if a covenant is to be drawn up at $t = t_0$ restricting the manager's actions at $t = t_1$, there will be some error in determining the correct value of p_c . Consequently, the best that can be done is to choose a 'best' estimate p_c^* and to base covenant restrictions on the realization of p relative to this estimate p_c^* ; in other words, the covenant requires that a_1 be chosen whenever $p \geq p_c^*$ and a_2 otherwise. In practice, p_c^* will be selected based on the loss functions of the parties, the precision of the information available regarding p_c , and the observability of p , itself. The precise procedure is irrelevant for our purposes; what is important is to note that p_c , in general, $\neq p_c^*$. Given the above structure, the efficiency losses in different states of the world under the three different contracts are tabulated in Table 1. Column 2 gives the optimal action from the equityholders' perspective, and column 3 gives the consequent efficiency losses for the q^{ante} contract. Columns 4 & 5 and 6 & 7 do the same for the two other contracts.

Table 1: Efficiency Losses under the Three Alternative Contracts

State	q^{ante}		q^{cov}		q^{post}	
	Indicated action	Efficiency losses	Indicated action	Efficiency losses	Indicated action	Efficiency losses
$p \geq p_c \geq p_c^*$	a_2	0	a_2	0	a_2	0
$p_c \geq p \geq p_c^*$	a_2	$V(a_1; p \geq p_c) - V(a_2; p \geq p_c)$	a_2	$V(a_1; p \geq p_c) - V(a_2; p \geq p_c)$	a_1	0
$p_c \geq p_c^* \geq p$	a_2	$V(a_1; p \geq p_c) - V(a_2; p \geq p_c)$	a_1	0	a_1	0
$p \geq p_c^* \geq p_c$	a_2	0	a_2	0	a_2	0
$p_c^* \geq p \geq p_c$	a_2	0	a_1	$V(a_2; p \geq p_c) - V(a_1; p \geq p_c)$	a_2	0
$p_c^* \geq p_c \geq p$	a_2	$V(a_1; p \geq p_c) - V(a_2; p \geq p_c)$	a_1	0	a_1	0

p_c^* is as likely to be greater than p_c as less, and further that;

For convenience, assume that the efficiency loss from choosing a_1 when a_2 is optimal is the same as from choosing a_2 when a_1 is optimal. In other words, let

$V(a_2; p \neq p_c) - V(a_1; p \neq p_c) = V(a_1; p \neq p_c) - V(a_2; p \neq p_c) = D$. Let $\theta = \text{Prob}\{p_c \neq p \neq p_c^*\} + \text{Prob}\{p_c \neq p \neq p_c^*\}$ and let $\phi = \text{Prob}\{p \neq p_c\}$; then $\theta \geq \phi$.¹³ Then, the expected

efficiency losses and the implementation costs for the three contract options can be summarized as follows:

Contract	q_a	q_c	q_o
Expected Efficiency Losses	θD	θD	0
Implementation Costs	0	$C(q_c)$	$C(q_o)$

It is clear that the efficiency losses of the q^{ante} contract are highest, followed by q^{cov} and then q^{post} , while the ranking by implementation costs is exactly the reverse. Whichever contract leads to the lowest sum of efficiency and implementation costs will be chosen. While the particular contract that would be optimal in any given situation obviously depends on the size of the various parameters in the model, it is obvious that all three contracts are likely to be in use in different circumstances. In particular, the ex-post contract will be optimal, whenever $C(q_o) - C(q_c) < \theta D$ and $C(q_o) < \theta D$.

In the above simplified model, we consider a single managerial action, whereas in fact, there would be a whole host of managerial actions impinging upon the value of the debt. To take this into account, we would need to expand the action and parameter spaces into vector spaces, allowing for a given action to be affected by more than one parameter, and for the

¹³ The inequality follows, since p_c^* is chosen optimally by the bondholders. For example suppose p_c^* were chosen to be so high that $\text{Prob}\{p_c \neq p \neq p_c^*\} = 0$. Then $\theta = \text{Prob}\{p_c \neq p \neq p_c^*\}$. But this is then simply equal to $\text{Prob}\{p_c \neq p\} = \phi$. But bondholders are free to make a better choice of p_c^* . Hence $\theta \geq \phi$.

payoffs to be functions of all actions. While this would increase the complexity of the model, it would not affect the fundamental conclusions that we draw from the model.

C. Determinants of the Optimal Contract

We now discuss the effect of changes in the model parameters on the optimal contract. Our discussion focuses on five different model parameters:

- ? uncertainty regarding the optimal action (divergence of p_c^* from p_c , measured by δ).
- ? efficiency losses from taking a suboptimal action (denoted by D),
- ? the likelihood of a conflict of interests between shareholders and bondholders (measured by λ),
- ? implementation costs of covenant contracts (denoted by $C(q^{cov})$), and
- ? implementation costs of ex-post contracts (denoted by $C(q^{post})$).

Uncertainty regarding the Optimal Action:

The greater the uncertainty regarding the optimality of an action, the less desirable would it be to use a covenant to restrict that action. This would be the case, in particular, for long-term debt contracts, where some of the managerial actions would be taken long after the covenants were put in place. Similarly, at times when economic uncertainty is great, we would not expect covenant based contracts to be of much use in aligning stockholder and bondholder incentives. On the other hand, if a given action is clearly suboptimal from a bondholder point of view, it can be excluded by a bond covenant. For example, it is quite common to include covenants restricting simultaneous sale and leaseback of assets. The act of selling an asset and

leasing it back is easily observable, and it is usually to the detriment of bondholders because it erodes the asset base that creditors rely on.¹⁴

Efficiency Losses from Taking a Suboptimal Action:

Covenants frequently affect managerial flexibility. The cost of restricting flexibility in a rapidly changing times can be high. For example, covenants that restrict firms' investment strategies to prevent excessive risk-taking are likely to result in high efficiency losses; this may be the reason why such covenants are rarely seen, even though the problem of excessive risk taking is frequently referred to in the finance literature. Where the cost of forgoing managerial flexibility is high, ex-post agreements may allow the parties to reach a more preferred position. Since the desired action need not be specified beforehand with ex-post contracts, efficiency losses are least. Finally, we have ex-ante compensation contracts, which obviously have no way of affecting future managerial actions. If the set of managerial actions is small, and their respective effects on the value of the firm are not very different, the efficiency loss from taking suboptimal actions is low, and ex-ante compensation contracts work reasonably well.

The Likelihood of a Conflict of Interests between Stockholders and Bondholders:

One scenario where a conflict of interests is likely is if the firm is already highly leveraged. This situation has been extensively discussed in the finance literature. In addition, if the economic environment is complex, the probability of equityholder interests diverging from bondholder interests is larger, and managers, acting on behalf of shareholders, are more likely to take actions that are value-reducing. *Ceteris paribus*, ex-ante compensation would then be

¹⁴ Rutherford (1992) found no abnormal negative reaction to bondholders from the announcement of sale-leaseback transactions, which the author interpreted in terms of bondholders protecting themselves through covenants.

suboptimal. Rather, bondholders and stockholders would rely more on covenant-based contracts. If, in addition to being complex, the environment is also rapidly changing, ex-post contracts would be indicated, as discussed above (Crocker and Masten, 1991; Williamson, 1979; Macneil, 1978). This would allow the parties to ensure that inefficient managerial activities are prohibited ex-post, even if their deleterious impact for firm value had not been understood at the time the bond contract was written ($t = t_0$).

Implementation Costs of Covenant Contracts:

Finally, it is obvious that the greater the implementation costs of any contract, the less will the parties rely on that type of contract. In some situations, the manager's actions may be costly to observe, as in cases where strategic information would be revealed to competitors by making such information public; alternatively, other factors on which the parties would want to condition the restrictive covenant may be unobservable or costly to observe. These considerations make covenants difficult to enforce effectively. In complex environments, the number of factors that need to be monitored as well as the difficulty of monitoring them rises, and this tradeoff is steeper. Consequently, one would expect less reliance on covenant-based contracts.

Implementation Costs of Ex-Post Contracts:

Implementation costs of ex-post contracts are generally high, particularly since the details of the managerial actions governed by these contracts are likely to be left unspecified. However, as we will argue later, some of these costs can be spread out among investors by the use of the judicial system to create appropriate precedents that could be used by parties to all

bond contracts. Furthermore, the threat of a costlier side-payment may be sufficient in many cases to get the parties to reach an informal and far less expensive out-of-court settlement.¹⁵

In summary, in a complex, rapidly changing competitive environment where flexibility is at a premium, bondholder contracts are likely to contain implicit components allowing for ex-post compensation.

III. The Role of the Courts

Once an ex-post component to the bond agreement is accepted, there are several interrelated questions to consider: what should be the nature of this ex-post component; how should it be specified in the bond contract (explicitly or implicitly); and who should administer it? We now address these questions.

A. The Role of the Judicial System as Arbitrator

Managerial actions that are not regulated by bond covenants may be treated in two different ways. Either they are completely unrestricted and any bondholder losses resulting from those losses are presumed to have been compensated for, ex-ante, in the price paid for the bonds; or, alternatively, they are implicitly restricted, and presumed to be subject to an ex-post compensation agreement. As discussed earlier, if efficiency losses resulting from a suboptimal managerial choice of an action variable are low, and/or enforcement costs for ex-post compensation contracts are high, then it is more likely that that action fell under an ex-ante compensation contract. On the other hand, if the environment is complex, dynamic and quick to

¹⁵ The model for this is debt renegotiation in financial distress situations, where the existence of the Chapter XI procedure is often sufficient to prod the parties to reach a settlement through informal workouts.

change, then bondholder losses caused by inefficient managerial actions were probably intended by the parties to be subject to ex-post compensation.

Given this subjective element in the bond contract, how, in practice, would ex-post compensation be incorporated in the contractual relationship? Clearly, it would defeat the purpose of ex-post settlement if one had to explicitly list all prohibited actions. Under the circumstances, recourse to arbitration would be natural. Assuming an unbiased arbitrator, such a procedure would be ex-ante optimal for both parties. Private arbitration, however, would be an inefficient solution, given the universal nature of the problem of potential dispossession. The possibility of clarifying the meaning of the non-inefficient dispossession standard through the setting of precedents introduces a public good aspect to whatever third party intervention is utilized. Consequently, as in other arenas, the use of the judicial system to arbitrate is optimal. This also resolves any question of arbitrator bias due to the market power of bond issuers, and the collective action problems of bondholders. The implication is that economic systems will evolve towards the development of anti-inefficient dispossession principles in contract law.^{16,17}

¹⁶ As has been noted by Posner (1986), one of the functions of a legal system is to induce economically efficient behavior whenever private negotiation fails to achieve such a solution, for one reason or another.

¹⁷ Another reason for reliance on the courts emerges from Marcel Kahan and Bruce Tuckman (1993). Through a game-theoretic model, they show that bondholders may be compelled to consent to covenant changes sought through consent solicitations even when it is not in their interests. Hence even explicit covenants may not provide the intended protection. Kahan and Tuckman's empirical data does show that in cases where covenants are included, bondholders are able to organize to defeat undesirable covenant solicitations; however, this does not prove the general ability of bondholders to resist management coercion, since their sample may be self-selected for such ability.

B. The Need for Ex-post Settling-up to be Implicit

Our argument, at this point, seems to have brought us to a legal efficiency standard enforced by the courts. However, an overt specification of efficiency in the courts' standard is undesirable from the viewpoint of both parties because an explicit determination of efficiency is likely to be costly. If legislation or precedent were to mandate the application of an efficiency standard, the courts would be legally required to distinguish between efficient and inefficient managerial actions, which may involve substantial difficulty in many cases. In such a setting, the courts cannot simply infer from the fact that a management action was followed by an increase in equity prices of $\$x$ and a decline in bond prices of $\$y > \x , that the action was inefficient. They must consider other factors that could have caused the price changes, as well as the possibility of alternative management actions (which is complicated by imperfect observability of parameter realizations p and hence of the appropriate management action a). There are some cases in which a determination of efficiency or inefficiency can be made in a relatively unproblematic fashion--but if the parties' contract (or statutory or common law) requires determination of the efficiency of management conduct, the courts must presumably do so across the board. In doing so, judges are stuck with a task of financial analysis that is in many situations intractable and expensive for the litigating parties.

There is, however, an alternate solution, based on other existing standards. For example, courts have often applied the implied covenant of good faith and fair dealing in the interpretation of bond contracts. In deciding whether management has violated (or not violated) the implied covenant of good faith and fair dealing, the courts may be able to incorporate an implicit efficiency judgment, without engaging in an explicit financial analysis that may be costly to do properly even in relatively straightforward cases. However, in addition to this, the courts can use other legal doctrines, such as common law fraud, securities law disclosure requirements, etc. with efficiency as an implicit, background consideration. In other words, the implicit contract between bondholders and stockholders, designed to reduce value-decreasing

managerial actions, can be enforced by the courts through a combination of various legal doctrines.

C. Judicial Enforcement of the Implicit Contract

An implicit contract analysis allows courts to read into the bond indenture, management's commitment to avoid inefficient dispossession, even if the dispossession in question could have been prevented by an explicit provision. Suppose, for example, that the indenture contains no language restricting dividend payments, and that bondholders claim that a high dividend payment is unlawful, arguing in essence that it exploits them.¹⁸ Under an implicit contract analysis, the absence of such a covenant might simply mean that the parties agreed that inefficient dispossession could be deterred more cheaply through judicial application of the efficiency standard contained in the implicit contract than through an explicit contractual provision. Of course, the lack of a covenant does not mean that ex-post compensation is necessarily indicated; ex-ante compensation may have been agreed to, for circumstances where ex-post verification costs are expected to be high. A court's job is, in the first instance, one of determining the costs of establishing the circumstances surrounding the managerial action; if those costs are low, as in a case of fraud by management, the court should intervene ex-post.¹⁹

Proponents of exclusively explicit contractual provisions to safeguard bondholder rights fail to appreciate the parties' shared interests in having open-textured, legal standards such as good faith and fraud available to deal with dispossession. At the same time, the parties would

¹⁸ These are the facts of *Harff v. Kerkorian*, 347 A.2d 133 (Del. 1975).

¹⁹ Which is, in effect, what the Delaware Supreme Court did in allowing the suit in *Harff* to proceed on fraud grounds. See Appendix.

not want the courts to apply an overarching, explicit efficiency standard, given the costs of administering such a standard.

IV. Subjecting the Theory to Empirical Evidence

A. Court Decisions

We now examine some court decisions in cases of bondholder dispossession in the last couple of decades. We will argue that the courts' discussions and decisions can be better viewed as upholding an implicit contract based on efficiency rather than supporting an explicit contract based market regime.

By and large, the courts have rejected the position that corporations owe a fiduciary duty to bondholders. While a few cases (see McDaniel, 1988), take the position that there is such a fiduciary duty, many more have held that no such duty exists and that bondholder rights are solely contractual.²⁰ However, the frequent judicial invocations of the contractual nature of bondholder rights does not mean that courts believe that bondholders can only assert rights against the corporation based on explicit contractual provisions. The oft-repeated statement that bondholder rights are contractual is consistent with an implicit contract approach. Such an approach is suggested in the test imposed by Chancellor Allen in *Katz v. Oak Industries*.²¹

(I)s it clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith--had they thought to negotiate with respect to that matter. If the answer to this question is yes, then, in my opinion, a court is justified in concluding that such act constitutes a breach of the implied covenant of good faith.

²⁰ See, e.g., *Mann v. Oppenheimer & Co.*, 517 A.2d 1056 (Del. 1986); *Simons v. Cogan*, 549 A.2d 300 (Del. 1988).

²¹ 508 A.2d 880 (Del. Ch. 1986).

Furthermore, contract law allows for broad interpretation of explicit provisions, notably through the covenant of good faith and fair dealing, and some courts have taken this route to protect bondholders (Bratton, 1984a,1984b; Tauke, 1989). However, in addition to broad approaches to contract law, courts have also applied various legal doctrines that, though not directly focused on the relationship between bondholders and the corporation, can be applied to that relationship. These have been interpreted to provide protection for bondholders beyond express contractual language, in accord with an implicit contract analysis. Some cases in which the courts have considered extra-contractual legal doctrines in addressing classic types of bondholder dispossession are summarized in Table 2, and discussed in the Appendix.

Table 2: Extra-Contractual Legal Doctrines in Bondholder Dispossession Cases

Type of bondholder conflict	Cases	Legal doctrine employed
Reducing asset base by payment of excessive dividends	Harff v. Kerkorian	Common Law Fraud
Exploitation of information asymmetry	Pittsburgh Terminal Corp. v. Baltimore & Ohio Railroad; Van Gemert v. Boeing Co.	Federal Securities Law Disclosure Requirements
Reducing asset base by spin-offs	PPM Am. Inc. v. Marriott	Federal Securities Law Disclosure Requirements
Reducing asset base through leveraged buyouts	U.S. v. Tabor Court Realty Corp.; Wieboldt Stores Inc. v. Schottenstein	Fraudulent Conveyancing
Acquisition of risky assets	Federated Dept. Stores and Allied Stores Corporation	Fraudulent Conveyancing
Reducing asset base through lease modification	Morse v. Howard Park Corp.	Fraudulent Conveyancing

We suggest that the approach of the courts is consistent with our hypothesis of an efficiency-based legal regime that enforces an implicit contract between the parties. One may argue that the observed court rulings are also consistent with the hypothesis that the courts are not concerned with efficiency and implicit contracts. Rather, they simply administer the particular legal provisions under which bondholders are potentially entitled to relief, such as fraud, full disclosure, and the implied covenant of good faith and fair dealing. We do not

necessarily wish to argue that courts consciously enforce an implicit contract; just that their actions are consistent with the enforcement of such a contract. Moreover, courts necessarily work within a legal framework, and our point is that it is precisely through the application of these provisions that the courts enforce the implicit contract between bondholders and stockholders. Furthermore, the courts clearly do not apply these provisions in a simplistic manner. In fact they have to be interpreted, and our argument goes to the manner in which courts have interpreted these provisions in cases of bondholder dispossession.²²

A more exhaustive investigation of court cases would be useful in shedding more light on the courts' attitude towards cases of bondholder dispossession. We can use the analysis in section II to predict instances where courts might be expected to grant relief even in the absence of a particular covenant violation. Examples of such instances might be:

- ? The exclusion of a covenant in the particular case is consistent with industry practice.
- ? The firm is an established one. This may be used to imply the existence of a relational contract underlying the formal explicit contract.
- ? The circumstances of the company and/or the industry make it expensive to include restrictive covenants, e.g. because of the cost of reduced managerial flexibility.
- ? It is expensive for bondholders to generate the information used by management in its decision-making.

B. Bondholder Reactions to Expropriation

As mentioned above, despite the instances of bondholder dispossession in the 1980s, bondholders have not, by and large, responded by negotiating for explicit protective provisions in contracts, such as, for example, event-risk provisions allowing the bondholder to put the

²² For example, Bratton (1984b) for examples of cases where a "plain meaning" interpretation is difficult. Bratton also cites the *Sharon Steel v. Chase Manhattan Bank*, 691 F. 2d 1039 (2d Cir. 1982) as an example of judicial reliance on good faith principles, giving them determinative weight over a literal reading of the bond indenture.

bond to the firm under specified circumstances (Malitz, 1994). Indeed, overall the use of specific protective provisions in bond contracts is on the decline, not on the increase. In this section, we will consider how the implicit contract model we have proposed in this paper explains this pattern.

Under an explicit contract model, ex-post settlement is not seen as a feasible component of the bondholder contract.²³ Under this model, the increased employment of leverage by management to dispossess bondholders in the 1980s should have led to an increased bondholder recourse to explicit protective covenants. To the extent that bondholders have not in fact demanded such protection, an explicit contract model would predict that courts would rule against bondholders seeking compensation for expropriation by corporations.

Under the implicit contract model, the use of covenants is not indicated to the extent there are high costs in terms of reduced managerial flexibility--e.g., in circumstances in which economic uncertainty renders excessive the costs of verifying parameters at t_1 , the time the manager takes action.²⁴ To the extent that the economic circumstances that have attended the increased use of leverage have been characterized by a higher systemic level of uncertainty, we would expect a decline in the use of restrictive covenants, as has actually occurred. The implicit contract model would predict that courts would, in specific instances, be willing to intervene on behalf of bondholders.

The predictions of the models in regard to bondholder responses to management use of leverage to dispossess bondholders in the 1980s are summarized in the first row of Table 3.

²³ The presumption, in this model, would be that the costs of ex-post settlement are too high.

²⁴ See Section II for a more detailed discussion of circumstances where ex-post settlement is favored over the use of covenants.

The actual bondholder response is inconsistent with the predictions of the explicit contract model. The predictions of the models in regard to judicial responses to bondholder claims of wealth loss is given in the second row. We suggest that the actual judicial response is closer to the implicit contract model predictions. Furthermore, given the continued uncertainty in the economic climate, the model would continue to predict reduced covenant use, as well as judicial decisions that selectively protect bondholders. From this point of view, the backing down of Greyhound, in spite of their adherence to the explicit bond contract, is evidence precisely of their expectation that the courts would support the bondholders.²⁵

Table 3: Predictions of Bondholder Expropriation Theories

Theory	Explicit Contract	Implicit Contract
Prediction on covenant use in the '90s.	Increased use of covenants.	Decrease in use of covenants if environment is characterized by higher uncertainty.
Predicted judicial action.	Judicial decisions against bondholders, except where covenants prevail.	Interpretation of implicit contract.

V. Conclusion

We argue that, under certain circumstances, bond contracts will optimally rely on ex-post settlement to deter inefficient managerial actions. Underlying this is an implicit management commitment not to engage in inefficient dispossession of bondholders. Furthermore, bondholders and corporations prefer that this ex-post component be enforced by the courts, using an implicit efficiency standard. Such a standard will be implicit for a number of reasons, including its universality, its amenability to being upheld through existing legal doctrines, and the

²⁵ See the description of the Greyhound case in footnote 5

substantial difficulty involved in making an efficiency criterion an explicit, mandatory judicial standard. The recent decline in restrictive covenants, which would be anomalous if the courts were solely enforcing explicit contracts, can be explained under an implicit contract analysis.

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Appendix: Bondholder Cases Involving Extra-Contractual Doctrines

Common Law Fraud. In *Harff v. Kerkorian*, 324 A.2d 215 (Del. Ch. 1974), rev'd, 347 A.2d 133 (Del. 1975), bondholders sued Kerkorian, the controlling shareholder of MGM, on the basis that a large dividend was improvident; no specific provision of the indenture precluded the dividend in question. Delaware Chancery and the Delaware Supreme Court both rejected the plaintiffs' claim of a violation of fiduciary duty, stating that no such duty was owed. However, the Supreme Court stated that the bondholders' complaint stated a cause of action against the corporation based on a common law fraud theory.

The Delaware decision allowing bondholders to challenge the allegedly excessive dividend as fraudulent opened the door to bondholder claims not based on an express covenant, even as the court simultaneously renounced the idea of a fiduciary duty to bondholders. In doing so, Delaware acted inconsistently with a pure regime of standards and also with a regime of rules, which would have found the absence of a readily available dividend restriction dispositive against the bondholder plaintiffs. It acted consistently, on the other hand, with a complex legal regime under which standards are strategically employed by the courts to deal with inefficient dispossession.

Federal securities law disclosure requirements. *Pittsburgh Terminal Corp. v. Baltimore & Ohio Railroad*, 680 F.2d 933 (3d Cir. 1982), and *Van Gemert v. Boeing Co.*, 520 F.2d 1373 (2d Cir.), cert. denied, 423 U.S. 947 (1975), both involved bondholders losing a lucrative conversion opportunity under circumstances in which the corporation failed to notify bondholders of the conversion opportunity (which the bondholders could nonetheless have been aware of otherwise, through the indenture agreement along with other sources). By doing so, stockholders were benefited; no explicit notice requirements in the indenture were violated by the corporation's inaction. The court in *Pittsburgh Terminal Corp.* did not accept the bondholders' claim of a violation of fiduciary duty, but nevertheless held for them on the basis that the corporation's conduct violated the disclosure requirements of federal securities law, 680 F.2d at 943-44. Without reaching the fiduciary duty issue, the court in *Van Gemert* also ruled for the bondholders based on the same rationale, 520 F.2d at 1383. Given management's ex-ante interest in having bondholders not charge premiums to compensate them for anticipated costs in searching for information that can be more cheaply obtained through management disclosure, the decisions in *Pittsburgh Terminal* and *Van Gemert* accord with an implicit contract analysis, as well as with the complex legal regime such an analysis suggests.

After the announcement of a spin-off by Marriott of its debt-laden hotel and real estate operations from its relatively unencumbered and profitable hotel management operations, holders of bonds issued shortly before Marriott's announcement sued based on federal securities law disclosure arguments, *PPM Am. Inc. v. Marriott Corp.*, 820 F. Supp. 970 (D. Md. 1993). Marriott modified its spin-off to improve protection for creditors of the hotel-real

estate spin-off as part of a settlement with some of the bondholders who objected to the original proposal; other bondholders continued litigation against Marriott's revised plan. The Marriott modification, like the settlement RJR Nabisco reached with Metropolitan Life (New York Times, Jan. 25, 1991), supports the position that bondholders in practice do receive protection from the law beyond the express language of their contracts.

Given the fact that bond contracts are accompanied by prospectuses, the broad disclosure requirements of federal securities law constitute a significant doctrinal basis for judicial intervention on behalf of bondholders. Of course, the facts of a particular case may not be conducive to making an effective disclosure argument. (For an example of a case in which bondholders stretched in making a disclosure argument, see *Hartford Fire Insurance Co. v. Federated*, 723 F.Supp 976 (S.D.N.Y. 1989), in which plaintiff relied on the claim that a prospectus contained material omissions by virtue of its failure to mention the possibility of Federated's being taken over and the impact of such a takeover on the company's leverage and the position of debt. In rejecting plaintiff's claim, the court noted that no actual or potential takeover attempt was known to management and that the mere possibility someone might try to take over Federated in a leveraged transaction was a matter of public knowledge.) But the potential availability of a federal securities law claim, like the potential availability of a common law fraud claim, counters the position that legal protection for bondholders is narrowly limited to the express language of indenture agreements, and supports a contention that in practice courts have set forth, if not directly articulated, a complex legal regime under which multiple standards are available to deal with exploitation and distrust.

Fraudulent conveyancing. The leveraged buyout wave of the '80s led to renewed scrutiny of whether debt obligations incurred in connection with such buyouts can be attacked as fraudulent conveyances by corporate bondholders. For a successful example of such litigation, see *U. S. v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d. Cir. 1986). For a more recent example of how the prospect of fraudulent conveyance litigation is a factor in the aftermath of leveraged buyouts, see *In the Matter of Federated Department Stores and Allied Stores Corporation*, 1990 Bankr. LEXIS 2270 (discussing procedural aspects of potential litigation by the bondholders of Allied Stores claiming that their company's risky purchases of stock of Federated Department Stores constituted fraudulent conveyances.) However, the availability to bondholders of fraudulent conveyance and fraudulent transfer claims against corporate management is by no means a novel phenomenon. In *Central R.R. & Banking Co. of Georgia v. Pettus*, 113 U.S. 116 (1885), the Supreme Court decided an issue of liability for counsel fees in which the underlying suit involved a successful claim by unsecured bondholders of a railroad that a transfer of the railroad's property to another corporation was improper to the extent it prejudiced the bondholders. In *Morse v. Howard Park Corp.*, 272 N.Y.S.2d 16, 22 (Sup. Ct. Queens Co. 1966), the court assumed that a lease modification by management that was to the detriment of bondholders but that did not in itself render the corporation insolvent was a fraudulent conveyance. (Assuming that the lease modification violated the terms of the indenture agreement, which appears to have been the case in *Morse*, a classical contract law approach would also have gone in favor of the bondholders).

If corporate actions detrimental to bondholders were considered to be fraudulent conveyances only when the transactions made the corporation insolvent, fraudulent conveyancing doctrine would simply reinforce the established principle that fiduciary duties are owed to creditors in insolvency. (Tabor Court Realty Corp., 803 F.2d at 1288, is an example of judicial application of fraudulent conveyancing doctrine in the insolvency context.) But fraudulent conveyancing claims are not limited to conveyances that cause insolvency. A transfer or obligation with intent to hinder creditors is fraudulent under the Uniform Fraudulent Conveyance Act section 7 and the Uniform Fraudulent Transfer Act section 4(a)(1) without regard to whether it resulted in insolvency. A transaction or obligation made without such intent but without fair consideration is fraudulent if it would leave the debtor with an unreasonably small amount of capital. Uniform Fraudulent Conveyance Act section 5; Uniform Fraudulent Transfer Act section 4(a)(2). Given that flexibility, fraudulent conveyancing doctrine provides a basis for bondholder recovery even in situations in which bondholders lack explicit contractual protection against managers siphoning assets from the corporation, and another basis for concluding that in practice courts are employing a complex legal regime to deal with bondholder dispossession rather than a purely rule-based approach or a single overarching standard of fiduciary duty.

Heard on the Street, November 6, 1998
Greyhound, Laidlaw Decide To Alter Merger Agreement
By PAUL M. SHERER
Staff Reporter of THE WALL STREET JOURNAL

There are at least two lessons in Thursday's decision by Greyhound Lines and Laidlaw to rejigger the merger agreement they reached last month.

For chief executives, one lesson might be that it may not be worth angering a group of shareholders in order to squeeze a bit more out of a deal, even if you believe you're on solid legal ground.

For investors, the lesson is that fancy legal footwork may jeopardize rights you may have been taking for granted.

The original \$650 million merger of the bus and ambulance operators, announced Oct. 19, left some investors who hold \$60 million of Greyhound's convertible preferred shares crying foul. They said the plan violated a commitment Greyhound made when it issued the securities in April 1997 not to redeem the shares before May 2000.

The shares, issued for \$25 at a time when Greyhound was recovering from financial woes, offered a lush 8.5% yield. But the Laidlaw merger would have cut short those dividends, costing holders \$3.19 a share in payments -- or roughly 10% of the current share price -- if the deal closes before Feb. 1, 1999.

Greyhound continues to insist that nothing in its legal commitments to investors prohibited it from carrying out its original plan. Still, Greyhound and Laidlaw Thursday caved in to pressure. The Greyhound convertible preferred shares will now remain in existence after the merger, allowing the investors to hold onto them if they prefer.

"We're still quite sure of our legal position," said Craig Lentzsch, president and chief executive officer of Greyhound, in an interview. He said the decision was aimed at avoiding both litigation and ill will among investors.

The dispute is worth noting by anyone holding securities with "call protection." Issuers often seek to call, or redeem, securities before maturity if they can refinance at lower interest rates. And so investors are willing to pay extra for an income-paying security that can't be called before a certain date. The documents for the Greyhound shares state that Greyhound can't redeem the shares until "on or after May 3, 2000."

U.S. companies have \$130 billion in dollar-denominated convertible securities outstanding, \$55 billion of which are convertible preferred shares, according to Ravi Suria, head of convertible research at PaineWebber. Almost every new convertible security is issued with call protection averaging about three years.

If Greyhound and Laidlaw had succeeded in forcing out the shareholders, "the premiums on this kind of security would obviously collapse" in cases of similar mergers, said Anand Iyer, global head of convertible research at Morgan Stanley Dean Witter, who applauded Greyhound's decision to modify the terms.

"If any time a company is taken over, the company can ignore the contract they struck with us when we bought the thing, how do you price a convertible?" asked Jeffrey Cohen, managing director of Silverado Capital Management, a convertible arbitrage hedge fund in Saddle Brook,

N.J. Mr. Cohen's firm, which holds about 150,000 of Greyhound's 2.4 million convertible preferred shares, had threatened to sue Greyhound over the dispute.

In the original deal, Laidlaw would acquire all common and convertible preferred shares of Greyhound, paying \$470 million, and would assume \$180 million in Greyhound debt. (Laidlaw already owns Greyhound Lines of Canada.) Greyhound shareholders would receive \$6.50 per common share, payable either in cash or a combination of cash and Laidlaw stock.

Each convertible preferred share, which is normally convertible into 5.128 Greyhound common shares at any time, would receive 5.128 times the \$6.50 package. As amended Thursday, the deal is optional for this group.

The dispute centers on whether the offering prospectus and other documentation for the security gave Greyhound the right to force out preferred holders in a merger. Two convertible-bond analysts say Greyhound couldn't have. "There's nothing in the prospectus which suggests" that Greyhound can force a conversion, PaineWebber's Mr. Suria said.

Greyhound's legal justification was that nothing in the securities' "Certificate of Designations," similar to a prospectus, the company's articles of incorporation, nor Delaware law where Greyhound is incorporated, said it couldn't force conversion.

Separately, the certificate of designations promised that a merger must be approved by a majority of the convertible preferred holders. Greyhound management said the transaction falls under certain exceptions in the certificate.

Though Laidlaw is Canadian, Greyhound is merging with a Delaware subsidiary of Laidlaw, and Greyhound will be the surviving legal entity-qualifying as an exception under the certificate. After the merger, Greyhound Lines will be a wholly owned subsidiary of Laidlaw.

Greyhound says the main reason for structuring the deal in this way was so that it wouldn't have to change all its leases and contracts, but said that a side effect was that it wouldn't require a separate convertible preferred vote.

Wasn't Greyhound relying on legal loopholes to try to deny investors what they thought they were getting? "Let's not put this in a little old lady in tennis shoes context," Mr. Lentzsch said. "This security was sold to professional investors, and only to professional and sophisticated investors."