RETHINKING CORPORATE GOVERNANCE FOR A BONDHOLDER FINANCED, SYSTEMICALLY RISKY WORLD

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ABSTRACT

This Article makes two arguments that, combined, demonstrate an important synergy: first, including bondholders in corporate governance could help to reduce systemic risk because bondholders are more risk averse than shareholders; second, corporate governance should include bondholders because bonds now dwarf equity as a source of corporate financing and bond prices are increasingly tied to firm performance.

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INTRODUCTION

Based on several critical but heretofore uncorrelated developments in financial markets, this Article calls for a fundamental change in the governance of systemically important firms.[1] Traditional corporate governance views a firm's managers as acting primarily on behalf of the firm's shareholders.[2] Only in very limited circumstances do managers have a duty to others, such as creditors.[3] Shareholder primacy effectively obliges managers to engage the firm in risk-taking in order to make profits.[4]

Although that risk-taking can cause externalities, they are usually minor.[5] This changes, however, when the risk-taking causes "systemic" externalities—such as the failure of a systemically important firm,[6] which triggers a domino-like collapse of other firms

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1. *See infra* note 6 and accompanying text (describing systemically important firms).

2. *See, e.g.*, RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 7 (11th ed. 2014) ("A smart and effective manager makes decisions that increase the current value of the company's shares and the wealth of its stockholders."). By "manager," this Article means the most senior managers who have ultimate responsibility to manage the firm, such as a corporation's directors.

3. Managers of an insolvent firm, and perhaps also of a firm that is in the "vicinity of insolvency" or contingently insolvent, should additionally take creditor interests into account. *See* Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 665-69 (1996) [hereinafter Schwarcz, *Rethinking a Corporation's Obligations to Creditors*] (expanding "insolvent" firms to those near insolvency).

4. *See infra* notes 39-41 and accompanying text (explaining the shareholder-primacy model of corporate governance). Shareholder primacy has become the dominant corporate governance approach not only in the United States but also worldwide. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, Essay, 89 GEO. L.J. 439, 443-48 (2001).

5. *See* Lawrence E. Mitchell, *The Legitimate Rights of Public Shareholders*, 66 WASH. & LEE L. REV. 1635, 1665-66 (2009) (discussing these externalities); *see also* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 585 n.182 (2003) (explaining that maximizing shareholder wealth can cause negative externalities on "nonshareholder constituencies," but "it is easy to overstate the significance of those externalities").

6. By "systemically important firm," I mean a firm, such as a bank, whose failure could trigger the type of domino-like collapse referenced in the text. Section 113 of the Dodd-Frank Act authorizes the Financial Stability Oversight Council to also designate certain nonbank financial firms as systemically important financial institutions, or "SIFI"s, subjecting them to Federal Reserve oversight. Dodd-Frank Wall Street Reform and Consumer Protection Act § 113, 12 U.S.C. § 5323(a) (2012); *see also* Press Release, Bd. of Governors of the Fed. Reserve Sys. (April 3, 2013), http://www.federalreserve.gov/newsevents/press/bcreg/20130403a.htm

or markets, harming the real economy.[7] That threat is real, as the Federal Reserve recently observed, because shareholder primacy "lack[s] sufficient incentives [for systemically important firms] to take precautions against their own failures."[8]

In response to the financial crisis of 2007-08 (the "financial crisis"), regulators have been experimenting with contingent capital regulation to attempt to harness risk-averse creditors as a check on corporate risk-taking.[9] Such regulation would require certain debt claims against systemically important firms to convert to equity upon specified (deteriorating) financial conditions.[10] To reduce the

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[https://perma.cc/UVD8-WWLW].

7. *See* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 202 (2008). The "real economy" means the economic reality, such as a recession, that people actually experience. *Id.* at 202 n.41.

8. BD. OF GOVERNORS OF THE FED. RESERVE SYS., CALIBRATING THE GSIB SURCHARGE 1 (2015), https://www.federalreserve.gov/aboutthefed/boardmeetings/gsib-methodology-paper-20150720.pdf [https://perma.cc/3DF4-WB9V]; *cf.* Steven L. Schwarcz, *Misalignment: Corporate Risk-Taking and Public Duty*, 92 NOTRE DAME L. REV. 1, 4-5, 23 (2016) [hereinafter Schwarcz, *Misalignment*] (explaining the relationship between that insufficiency and a tragedy of the commons, and arguing that the law should impose a public governance duty to take systemic externalities into account).

9. In the United States, section 115 of the Dodd-Frank Act authorizes the Federal Reserve Board of Governors to issue regulations that "require any nonbank financial company ... to maintain a minimum amount of contingent capital that is convertible to equity" when such a company fails to meet prudential standards or the Federal Reserve determines that threats to financial system stability make regulation necessary. 12 U.S.C. § 5325(c)(3)(A) (2012). No regulations have yet been issued. The Financial Stability Oversight Council currently takes the position that contingent capital regulation should be "an area for continued private sector innovation" because "[t]he United States experience with instruments similar to contingent capital is quite limited" and there are potential concerns that could be associated with them. FIN. STABILITY OVERSIGHT COUNCIL, REPORT TO CONGRESS ON STUDY OF A CONTINGENT CAPITAL REQUIREMENT FOR CERTAIN NONBANK FINANCIAL COMPANIES AND BANK HOLDING COMPANIES 19 (2012) [hereinafter FIN. STABILITY OVERSIGHT COUNCIL, *Report to Congress*], https://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/Co%20co%20study[2].pdf [https://perma.cc/7TH7-2XEX]. However, several foreign jurisdictions, including the European Union, Switzerland, and the United Kingdom, have more actively pursued regulatory initiatives in this area, *see id.* at 26-29, in response to recommendations of the Financial Stability Board (FSB) that global systemically important financial institutions "should have loss absorption capacity beyond the minimum Basel III standards, and depending on national circumstances, this additional capacity could be drawn from a menu of viable alternatives including ... a quantitative requirement for contingent capital instruments," *id.* at 23.

10. Debt securities that are required to convert to equity securities upon certain conditions, such as the debtor-firm's equity capital falling below a pre-set minimum, are often called contingent convertible securities or, more simply, "CoCos." *See, e.g.*, John Glover & Tom Beardsworth, *Contingent Convertibles*, BLOOMBERG QUICKTAKE (July 29, 2016, 4:31 PM),

chance those conditions will occur, holders of the convertible debt claims are expected to impose strict loan covenants on their debtor-firms' ability to take risks.[11]

Contingent capital regulation can be costly, however, and its efficacy is uncertain. It is costly because debt issued as contingent capital is riskier, and thus may be more expensive, than non-convertible debt.[12] Its efficacy is uncertain because it operates indirectly, incentivizing holders of debt issued as contingent capital to influence corporate governance through strict covenants.[13] Strict covenants may not always be imposed, however. Firms customarily offer creditors higher interest rates as a quid pro quo to allow looser covenants,[14] especially if the debt is sold to the public, which makes it difficult to later obtain covenant waivers.[15] Experience shows that

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http://www.bloomberg.com/quicktake/contingent-convertible-bonds [https://perma.cc/S42J-4GV7].

11. *See* Marcel Kahan & David Yermack, *Investment Opportunities and the Design of Debt Securities*, 14 J.L. ECON. & ORG. 136, 138 (1998) ("Restrictive covenants, such as debt or dividend limitations, represent a common means for reducing agency costs.... [C]ovenants control investment and financing decisions ex ante by prohibiting the company from taking actions expected to lower a firm's value."); *cf.* Simone M. Sepe, *Corporate Agency Problems and Dequity Contracts*, 36 J. CORP. L. 113, 127 (2010) ("[A]lthough the law grants creditors no special rights against managers, creditors can acquire substantial control powers over corporate operations by bargaining for both positive and negative covenants." (footnote omitted)).

12. *See, e.g.*, Eric S. Halperin, *Coco Rising: Can the Emergence of Novel Hybrid Securities Protect from Future Liquidity Crises?*, 8 BYU INT'L L. & MGMT. REV. 15, 21-23 (2011) (explaining why issuing CoCos to investors may be more expensive than issuing ordinary debt); Christopher Whittall & Juliet Samuel, *Buyer Beware: The Vulnerability of One Complex Debt Investment*, WALL STREET J. (Feb. 20, 2016, 5:30 AM), http://www.wsj.com/articles/buyer-beware-the-vulnerability-of-one-complex-debt-investment-1455964204 [https://perma.cc/Z57J-VJRX] (observing "[t]he sharp drop in prices" of debt issued as contingent capital and suggesting that investors may have underestimated their risks).

13. Some contingent capital regulation, however, may have an additional argument in favor of its efficacy: even if the stricter covenants fail to avert a default, a conversion to equity of the debt issued as contingent capital might cure the default. *Cf. supra* note 10 and accompanying text (discussing the conversion to equity). That could potentially enhance financial stability. *See* FIN. STABILITY OVERSIGHT COUNCIL, *Report to Congress*, *supra* note 9, at 5.

14. *See* Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, *supra* note 3, at 651 n.12.

15. Kahan & Yermack, *supra* note 11, at 142-43 (observing that publicly issued corporate bonds typically have only minimal covenants because of the difficulty of obtaining waivers, if needed). As of October 9, 2015, assuming that most corporate bonds not issued under the Rule 144A exemption from registration are publicly issued, up to approximately 87 percent of corporate bonds appear to be publicly issued. *See Bonds: FINRA TRACE Market Aggregate*

creditors usually "go for the gold," choosing the higher rates over strict covenants.[16]

Choosing higher rates over strict covenants not only reduces the efficacy of contingent capital regulation; it also has the unintended effect of making debt issued as contingent capital even more expensive. And contingent capital regulation can have other unintended consequences. For example, capitalizing a systemically important firm with contingent capital in order to make the firm less likely to fail might motivate the firm's managers to take even greater corporate risks.[17] Furthermore, because covenants are relatively inflexible—any change requires a formal waiver—they can "impair[ ] the managers' ability to pursue value-maximizing projects, [which would] reduce the likelihood of increases in cash-flow production and ... enhance the risk of debtor payment defaults."[18]

This Article argues that the law could more effectively temper the risk-taking of systemically important firms by directly engaging shareholder primacy. One way to do that, the Article contends, would be to require the corporate governance of those firms to include bondholders—that is, the holders of long-term corporate debt securities ("corporate bonds" or simply "bonds"[19])—in addition to shareholders, thereby harnessing the more risk-averse bondholders as a check on corporate risk-taking.[20] This would not be a perfect

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Information, FIN. INDUSTRY REG. AUTHORITY (Oct. 9, 2015), http://finra-markets.morningstar.com/BondCenter/TRACEMarketAggregateStats.jsp [https://perma.cc/TK9P-BXZD].

16. Larry Light, *Bondholder Beware: Value Subject to Change Without Notice*, BLOOMBERG (Mar. 29, 1993, 12:00 AM), http://www.bloomberg.com/news/articles/1993-03-28/bondholder-beware-value-subject-to-change-without-notice [https://perma.cc/T5EQ-NKV2] ("Bondholders can—and will—fuss all they like. But the reality is, their options are limited: Higher returns or better protection [in the form of stronger covenants]. Most investors will continue to go for the gold.").

17. *See* George Pennacchi, *A Structural Model of Contingent Bank Capital* 30 (Fed. Reserve Bank of Cleveland, Working Paper No. 10-04, 2011), https://business.illinois.edu/gpennacc/ConCap030211.pdf [https://perma.cc/3F2L-PXZC] ("A bank that issues contingent capital faces a moral hazard incentive to increase its assets' jump risks.").

18. Sepe, *supra* note 11, at 145-46.

19. Bonds technically are long-term corporate promissory notes issued directly by firms to investors. *See* WILLIAM F. SHARPE ET AL., INVESTMENTS 367 (6th ed. 1999).

20. *See infra* Part I.C; *cf.* Peter O. Mülbert & Alexander Wilhelm, *CRD IV Framework for Banks' Corporate Governance*, *in* EUROPEAN BANKING UNION 155, 196-97 (Danny Busch & Guido Ferrarini eds., 2015) ("[I]t seems that in jurisdictions which prioritize shareholder

solution to the problem of systemic risk because bondholder interests are not fully aligned with the interests of the public.[21] Only something like a "public governance" duty of managers—not to engage firms in excessive risk-taking that could lead to systemic externalities[22]—could fully align those interests.[23] Nonetheless, including bondholders in the corporate governance of systemically important firms should reduce systemic risk by reducing risk-taking: the less such a firm engages in risk-taking, the less likely that firm would be to fail, with potentially systemic consequences.

The rationale for proposing this fundamental change in corporate governance is not merely its potential to reduce systemic risk. This Article identifies two critical but heretofore uncorrelated market changes that themselves should justify the change in governance. First, modern financial markets have minimized the traditional rationale for differentiating bondholders and shareholders for corporate governance purposes. Like shareholders, bondholders often realize their investment value not by holding onto the securities, but by selling them to other market investors.[24] They therefore view their investment decisions from a market pricing standpoint, rather than from a priority-of-claim standpoint.[25] Because that market pricing depends on the financial condition and operations of the firm issuing the bonds, which is determined largely through managerial decision-making, bondholders, like shareholders, now rely heavily on management. Second, bonds increasingly exceed equity shares as the source of corporate financing.[26]

This Article proceeds as follows. Part I.A describes the traditional corporate governance distinction between creditors and shareholders. Part I.B explains why modern financial markets have mini-

supremacy, bank managements are indeed encouraged to take significantly more risk.").

21. *See* Schwarcz, *Misalignment*, *supra* note 8, at 9-10.

22. I propose and analyze such a public governance duty elsewhere. *See id.* at 29-56.

23. *See id.* at 27-28.

24. This is sometimes referred to as trading the bonds. *See* SHARPE ET AL., *supra* note 19, at 374, 376 (describing bond trading).

25. *See* Steven L. Schwarcz, *Compensating Market Value Losses: Rethinking the Theory of Damages in a Market Economy*, 63 FLA. L. REV. 1053, 1056-58 (2011) (arguing that viewing a bond only in terms of periodic payments of principal and interest is "formalistic" and "questionable").

26. *See infra* notes 55-58 and accompanying text.

mized that distinction for bondholders. Part I.C then shows why including bondholders in the corporate governance of systemically important firms would not only be logical from a governance perspective, but also would help to reduce systemic risk. Thereafter, Part II examines how corporate governance could include bondholders. To that end, Part II.A analyzes whether bondholders and shareholders should share governance, Part II.B analyzes whether managers should have a dual duty to both bondholders and shareholders, and Part II.C compares these approaches.

I. SHOULD CORPORATE GOVERNANCE INCLUDE BONDHOLDERS?

A. The Traditional Corporate Governance Distinction Between Debt and Equity

Traditionally, the corporate governance distinction between debt and equity turns on the supposition that only shareholders have a direct stake in their firm's future performance.[27] According to that distinction, creditors have much less of a stake because, as senior claimants of the firm, they should be paid in full their fixed investment plus an agreed rate of interest[28] unless the firm becomes insolvent.[29] Creditors can contractually protect against the firm's insolvency by negotiating covenants in their loan agreements.[30] The traditional view also assumes that creditors do not trade their claims.[31] For bond markets, that assumption has historical support: most corporate bonds used to be held by investors to maturity,[32]

27. *See* Greg Nini et al., *Creditor Control Rights, Corporate Governance, and Firm Value*, 25 REV. FIN. STUD. 1713, 1714 (2012) (explaining that traditional corporate governance literature views equity holders as active and direct influences on managers, while creditors remain passive participants until the firms default).

28. *See* Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 656-57 (2006).

29. *See* Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1192-93 (2002).

30. *See, e.g.*, Nini et al., *supra* note 27, at 1714-15; Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, *supra* note 3, at 651.

31. *Cf.* Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1518 (S.D.N.Y. 1989) (arguing that the "substantive 'fruits' [of a bond only] ... include the periodic and regular payment of interest and the eventual repayment of principal").

32. 2 JANE W. D'ARISTA, THE EVOLUTION OF U.S. FINANCE: RESTRUCTURING INSTITUTIONS AND MARKETS 124 (1994).

with investors expecting to receive their value through the periodic receipt of principal and interest payments.[33]

In contrast, shareholders are residual claimants of the firm, holding equity interests.[34] As such, they are not entitled to a fixed return. Instead, they may look for income streams in the form of dividends, payable from a portion of the firm's profits.[35] Shareholders also place significant value on increasing the stock price, which enables them to sell their shares at a profit.[36] Because covenants "can never restrict or determine all the operating and investment decisions necessary to run the firm efficiently,"[37] shareholders must rely on the firm's management.[38]

As a result, the law traditionally assigns corporate governance rights to shareholders, not creditors. This assignment is sometimes referred to as the shareholder-primacy model,[39] in which a corporation is "organized and carried on primarily for the profit of the

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33. MAUREEN BURTON ET AL., AN INTRODUCTION TO FINANCIAL MARKETS AND INSTITUTIONS 56 (2d ed. 2010).

34. BREALEY ET AL., *supra* note 2, at 4.

35. *Id.* at 4-5.

36. *See, e.g.*, William W. Bratton, *Shareholder Value and Auditor Independence*, 53 DUKE L.J. 439, 452-56 (2003) (observing that shareholders speculate, or at least place significant value, on the ability to resell their stock at a profit). This resale ability is especially important for large institutional investors, who are responsible for more than 50 percent of stock ownership. *See, e.g.*, Paul A. Gompers & Andrew Metrick, *Institutional Investors and Equity Prices*, 116 Q.J. ECONOMICS 229, 257 (2001). Over time, large institutional investors have also moved towards investing in riskier stocks. *See* James A. Bennett et al., *Greener Pastures and the Impact of Dynamic Institutional Preferences*, 16 REV. FIN. STUD. 1203, 1204, 1223-25, 1233-36 (2003); *see also id.* at 1203 (observing that although institutional investors account for 50 percent of stock ownership, they are responsible for seventy percent of trading volume, which suggests that they are more concerned about stock prices than long-term dividend expectations).

37. BREALEY ET AL., *supra* note 2, at 352.

38. *Cf.* Fisch, *supra* note 28, at 658 (arguing that shareholders therefore have a direct stake in the firm's future performance).

39. The overwhelming acceptance for the shareholder-primacy model can be traced to a debate in the 1930s between two academics, Adolph A. Berle, Jr. and E. Merrick Dodd, Jr. Berle argued that "all powers granted to a corporation or to the management of a corporation ... [are] at all times exercisable only for the ratable benefit of all the shareholders as their interest appears." A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931). Dodd, in contrast, argued that the business corporation should be viewed as "an economic institution which has a social service as well as a profit-making function." E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932).

stockholders."[40] Under that model, managers have a fiduciary obligation to shareholders to try to achieve and maximize profitability, which in turn can enhance welfare by generating jobs and purchasing power.[41]

I next show that the traditional corporate governance distinction between debt and equity investing has greatly diminished because bondholders now invest with the intention of selling their bonds before maturity.

B. Modern Financial Markets Have Minimized that Distinction for Bondholders

In today's financial markets, bondholders often sell their bonds prior to maturity and therefore, like investors in equity securities, view their investment decisions more from a market-pricing standpoint than from a priority-of-claim standpoint.[42] In 2014, for

40. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919); *see also* Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32.

41. *See, e.g.*, Bainbridge, *supra* note 5, at 547-48, 572-73. This fiduciary relationship is also explained as resulting from the shareholders' legal status as "owners" of the corporation. *See* BREALEY ET AL., *supra* note 2, at 5, 7. *But see* Fisch, *supra* note 28, at 650 (noting that the fact that shareholders are owners does not address the question of whether other stakeholders can partake in the ownership interest in the corporation).

42. Even though investors often likewise sell other types of debt securities prior to maturity, the governance imperative should be greater for investors in bonds. For example, investors in a firm's asset-backed debt securities are much more likely to look to the value of the underlying assets, which are the source of payment, rather than to the firm's governance. *See, e.g.*, Andrew A. Silver, *Rating Asset-Backed Securities*, *in* INVESTING IN ASSET-BACKED SECURITIES 17, 25-27 (Frank J. Fabozzi ed., 2000) ("Analysis of the credit quality of any structured security that is backed by assets typically begins with an assessment of the risk in the underlying asset pool."). Similarly, although bank loans are widely traded, their investors are more likely to look to the protection afforded by bank-loan covenants, which are much stronger than bond covenants. *See* Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. CORP. L. 641, 656-57 (2009). Banks are able to bargain for stronger covenants because bank loans are generally bought and sold only between banks, making it much easier for firms to obtain waivers, if needed. *Compare* Sandeep Dahiya et al., *Bank Borrowers and Loan Sales: New Evidence on the Uniqueness of Bank Loans*, 76 J. BUS. 563, 565 (2003) (observing that the bank-loan investor community is limited to banks), *with* Kahan & Yermack, *supra* note 11 (observing that bonds have minimal covenants because of the difficulty of obtaining waivers). Bank lending has also become much less significant than bonds as a source of U.S. corporate financing. *See infra* note 61 (observing the fall of bank lending to 10 percent of corporate debt financing). Outside of the United States, however, firms sometimes rely more on bank loans than bonds to raise

example, the average daily trading volume of corporate bonds reached a record of $26.7 billion, a 50 percent increase from 2002's average trading volume of $17.8 billion.[43] That same year, the average turnover rate for corporate bonds, computed as bond trading volume as a percentage of total outstanding, was 86.0 percent.[44] That effectively means that the amount of bonds traded almost equaled the amount outstanding—a turnover rate approximately twice that of equity securities.[45]

Mutual funds, foreign investors, and insurers—investor classes that currently hold almost two-thirds of outstanding U.S. corporate bonds—account for most of this increase in bond trading.[46] Since the 1980s, for example, there has been a stark increase in mutual funds' investments in bonds.[47] In contrast to insurance companies and pension funds, which often "buy and hold" bonds, mutual funds actively trade their bonds and view their investments from a market-price standpoint.[48] In part, this reflects that mutual funds must periodically sell bonds in order to pay fund-investors redeeming their shares.[49]

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financing. SIFMA RESEARCH, U.S. CAPITAL MARKETS DECK 7-8 (2015), https://www.sifma.org/research/item.aspx?id=8589956851 [https://perma.cc/6G9J-F7AR] (discussing European Union and Japan firms).

43. Statistics, US Bond Markets Average Daily Trading Volume, SIFMA RES., https://www.sifma.org/research/statistics.aspx [https://perma.cc/NP8L-E72Y] (updated Feb. 3, 2017). Besides a slight dip in trading volume during the financial crisis, the volume of corporate bond trades has steadily increased. *See id.*

44. I calculated 86.0 percent using the $26.7 billion average daily turnover rate for corporate bonds, *see id.*, times 252 trading days per year, divided by $7,826.0 billion corporate bonds outstanding, *see Outstanding U.S. Bond Market*, SIMFA RESEARCH, https://www.simfa.org/research/statistics.aspx [https://perma.cc/Z224-SW52] (UPDATED Jan. 5, 2017).

45. Itay Goldstein et al., Investor Flows and Fragility in Corporate Bond Funds 8 (June 25, 2015) (unpublished manuscript), http://ssrn.com/abstract=2596948 [https://perma.cc/5MDW-BHK6] (concluding that bond investors trade their securities more frequently than equity investors).

46. Nabila Ahmed & Sonali Basak, *The $3 Trillion Bond Trade Citigroup Says Investors Should Fear*, BLOOMBERG (June 10, 2015, 8:57 AM), http://www.bloomberg.com/news/articles/2015-06-10/a-3-trillion-traffic-jam-is-seen-looming-in-credit-by-citigroup [https://perma.cc/6GGD-TLME].

47. Bruno Biais & Richard C. Green, *The Microstructure of the Bond Market in the 20th Century* 45 (IDEI, Working Paper No. 482, 2007), http://idei.fr/sites/default/files/medias/doc/wp/2007/bondmarket.pdf [http://perma.cc/2HJZ-3GMP].

48. Goldstein et al., *supra* note 45, at 2-3, 7-8.

49. *See* Ahmed & Basak, *supra* note 46.

The incentives of bond investors thus more closely parallel the incentives of equity investors: both types of investors now invest in their respective securities with the primary intention of re-selling them, and the resale price of both types of securities is tied to firm performance. Bond investors and equity investors thus both have a direct stake in that performance.[50]

C. Corporate Governance Should Include Bondholders

The fact that bondholders now have a direct stake in their firm's performance suggests that corporate governance should take their interests into account. One might nonetheless counter that a longstanding corporate governance model, shareholder primacy, should not be altered merely to benefit a single class of creditors.[51] There are, however, two additional reasons for including bondholders in corporate governance: bonds have become the principal source of corporate financing, dwarfing equity issuances; and including bondholders would help to reduce systemic risk.

1. Bonds Have Become the Principal Source of Corporate Financing

The shareholder-primacy model originated during the 1930s,[52] when the equity markets far outshadowed the size of the corporate bond market.[53] That dominance of equity appears to be one of the

50. This contrasts with the traditional view that only shareholders have a direct stake in their firm's future performance. *See supra* notes 29-41 and accompanying text. I later observe that because bondholders do not have as much of a direct stake in their firm's future performance as shareholders, bondholders' inclusion in governance should be less than that of shareholders. *See infra* notes 83-87 and accompanying text.

51. That counterargument would be more compelling if there were a mechanism to give bondholders more protective covenants, because bond covenants are relatively weak. *See supra* note 42 and accompanying text. One such mechanism, beyond the scope of this article, would be the "super trustee" idea advanced in Yakov Amihud et al., *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 450-51 (1999) (arguing that such a trustee could represent the interests of the bondholders with authority, among other things, to renegotiate covenants).

52. *See* Berle, *supra* note 39, at 1049; Dodd, *supra* note 39, at 1147-48.

53. *See, e.g.*, Biais & Green, *supra* note 47, at 1 (stating that in the 1930s, the corporate bond trading volume "was between one fifth and one third of the trading volume in stocks").

justifications for shareholder primacy.[54] In recent years, however, there has been a radical shift in the relative amount that bond investors and equity investors put at risk.

Bonds have now become the "principal source of external financing for U.S. firms,"[55] dwarfing equity issuances.[56] In 2014, for example, newly issued corporate bonds raised approximately $1.49 trillion, compared to only $175 billion (that is, $0.175 trillion) raised by newly issued shares of stock.[57] Since 2006, new corporate bond issuances have exceeded new issuances of equity more than eight-fold.[58]

Moreover, today's bond-market dominance of corporate financing is unlikely to be temporary.[59] At least part of the reason for the

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54. *Cf.* A.A. Berle, Jr., *For Whom Corporate Managers are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367-68, 1370 (1932) (observing that "[p]robably half the entire savings of the country are now represented by passive property" in the form of shares of stock, and that corporate shareholding "directly affect[s] not less than half of the population of the country").

55. Hendrik Bessembinder & William Maxwell, *Markets: Transparency and the Corporate Bond Market*, J. ECON. PERSP., Spring 2008, at 217, 217-19; *cf.* Hugh Thomas & Zhiqiang Wang, *The Integration of Bank Syndicated Loan and Junk Bond Markets*, 28 J. BANKING & FIN. 299, 302 (2004) (observing the shift of corporate debt markets "from a bank liquidity orientation to a capital markets orientation").

56. This compares the proceeds of newly issued corporate bonds and equity shares, excluding any increase of balance sheet equity resulting from retained earnings—the portion of a firm's net income (primarily built up through income from operations) that is retained by the firm rather than being distributed to shareholders as dividends. The reason for this exclusion is that categorizing retained earnings as equity is an accounting convention; even the retained net income of a firm financed primarily by debt would be categorized as equity under that convention. Any comparison between debt and equity proceeds is inherently imprecise, however, because debt securities have fixed maturities whereas equity securities are generally coterminous with the firm's existence.

57. *See New Security Issues, U.S. Corporations*, BD. OF GOVERNORS OF THE FED. RES. SYS., https://www.federalreserve.gov/econresdata/releases/corpsecure/current.htm [https://perma.cc/XAV4-CYQT] (LAST UPDATED Jan. 27, 2017).

58. Between 2006 and 2015, newly issued corporate bonds raised approximately $14 trillion, while newly issued equity raised about $1.7 trillion. *See generally New Security Issues, U.S. Corporations: Release Dates*, BD. OF GOVERNORS OF THE FED. RES. SYS, https://www.federalreserve.gov/econresdata/releases/corpsecure/corpsecure2016.htm (use dropdown menu to access data from different years) (collecting bond and stock issuance data for 2006 through 2015).

59. Even if that bond-market dominance were temporary, the diminishing distinction between debt and equity securities calls into question equity's control of corporate governance. *Cf.* Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1311 (2008) (noting that "with the right package of derivatives, a debtholder can enjoy the same cashflow rights as an equityholder and vice versa.... As financial innovation has accelerated over the past two decades, the terms 'shareholder' and 'debtholder' or 'creditor'

increase in bond financing is the costs saved by disintermediation,[60] making bond financing often less expensive than bank financing.[61] Of even greater relevance, bond financing is less expensive than equity financing. In transaction costs alone, there is a cost saving. On average, a firm making an initial public offering of stock pays about 11 percent of the proceeds in expenses,[62] and even a seasoned issuer of stock pays about 7 percent in expenses.[63] In contrast, a firm issuing bonds pays on average just over 2 percent of the proceeds in expenses.[64] Even aside from transaction costs, bond financing is less expensive than equity financing. Tax law, for example, typically allows firms to deduct the interest paid on their debt as a business expense, but does not permit them to deduct the

have become less meaningful"). Professors Baird and Henderson thus argue that privileging "equity and the rights of equityholders in corporate law ... is now completely out of step with modern finance." *Id.* at 1342; *see also* Benedict Sheehy, *Scrooge—The Reluctant Stakeholder: Theoretical Problems in the Shareholder-Stakeholder Debate*, 14 U. MIAMI BUS. L. REV. 193, 216-217, 221 (2005) ("[W]ith the rise of more complex funding instruments the traditional distinction between debt and equity fails to accord with economic reality and looks artificial, arbitrary, and increasingly passé." (quoting Jennifer Hill, *Public Beginnings, Private Ends—Should Corporate Law Privilege the Interests of Shareholders*, 9 AUSTL. J. CORP. L. 21, 27 (1998))).

60. Disintermediation refers to "getting rid of the banking middle man." Stanley Pignal, *Companies Get Rid of the Banking Middleman*, FIN. TIMES (Jan. 9, 2012, 4:44 PM), http://www.ft.com/cms/s/0/6d5f6780-2d5e-11e1-b985-00144feabdc0.html [https://perma.cc/W3FR-GCBT]. Bond financing is a direct form of disintermediation; securitization is an indirect form.

61. *See* Silvio Contessi et al., *Bank vs. Bond Financing Over the Business Cycle,* ECON. SYNOPSES (Fed. Reserve Bank of St. Louis, St. Louis, Mo.), Nov. 15, 2013, at 1-2, https://research.stlouisfed.org/publications/es/13/ES_31_2013-11-15.pdf [https://perma.cc/KF5S-9T2A] (observing that, as a share of total credit market instruments, corporate bonds rose from 37 percent in the 1980s to 58 percent by 2013, whereas the share of bank loans fell from 26 percent to less than 10 percent during that same period). They also observe that the rise of institutional investors and corporate bonds coincides with the diminishing traditional relationship between banks and borrowers. *Id.* Another reason why bank financing diminished in relative importance was that unregulated finance companies could lend more cheaply than banks. D'ARISTA, *supra* note 32, at 274; *see also* Whitehead, *supra* note 42, at 654 (discussing the costs of bank regulatory compliance).

62. *See* Inmoo Lee et al., *The Costs of Raising Capital*, 19 J. FIN. RES. 59, 62 tbl.1 (1996).

63. *Id.*

64. *Id.* Although the differential between the transaction costs of a bond offering and an initial public offering/seasoned equity offering generally decreases relative to the size of the offering, bond financing is less expensive than equity financing at all size levels. *See id.*

dividends paid on their stock.[65] Bond financing also avoids diluting the equity interest of shareholders.[66]

Furthermore, the costs of bond financing are continuing to decrease. Greater technology, information exchange, and transparency are stimulating the bond market by reducing information asymmetry and enabling prices to more accurately reflect credit quality,[67] even on a real-time basis.[68] This is increasing the bond market's attractiveness to institutional investors. As more institutional investors buy bonds, the bond market becomes larger and more liquid,[69] thereby further reducing funding costs.[70]

2. Including Bondholders in Corporate Governance Would Help to Reduce Systemic Risk

Another important reason for including bondholders in corporate governance is that, being more risk averse than shareholders, bondholders could help to reduce a firm's systemic risk-taking. In the world of bond trading, as explained below, the reason why bondholders are more risk averse than shareholders goes beyond the traditional view (associated with holding bonds to maturity) that a bondholder is only entitled to principal and interest and therefore does not benefit from the firm's profitability. Instead, bondholder risk aversion is more closely tied to bond ratings.

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65. Samuel David Cheris, Note, *Stockholder Loans and the Debt-Equity Distinction*, 22 STAN. L. REV. 847, 851 (1970).

66. *Id.*

67. *See* Bessembinder & Maxwell, *supra* note 55, at 232 (observing that in 2002 the TRACE system introduced transaction price reporting for corporate bond trades, resulting in increased transparency in a previously murky market); *see also* Whitehead, *supra* note 42, at 655, 658-59. Greater competition and the growing loan sales market also made "long-term [banking] relationships with borrowers less valuable." *Id.* at 656.

68. Whitehead, *supra* note 42, at 677.

69. "Liquid" in this sense refers to an investor's ability to sell bonds to another investor for an attractive price.

70. D'ARISTA, *supra* note 32, at 12-13 (noting that secondary markets for securities complement long-term financial markets by providing "flexibility for investors in long-term financial assets and help[ing] minimize the risk of changes in financial and economic conditions"). The cost comparison in the text accompanying notes 62-67 does not compare bond funding costs (the rate of return firms must pay as interest on their bonds) with the equivalent for shares (presumably the rate of return firms must pay as dividends on their shares).

A bond's rating signals the issuing firm's creditworthiness[71] and therefore is critical to the bond's trading price.[72] The rating agency providing the rating, such as Moody's or Standard & Poor's, typically monitors the firm issuing the rated bond.[73] If the firm's creditworthiness remains stable, the bond rating should be preserved.[74] But if the firm's creditworthiness declines, the bond rating could be downgraded,[75] causing the bond to fall in value.[76]

Although theoretically a firm whose creditworthiness increases should see an upgrade in its bond rating,[77] that seldom happens in practice. For example, Moody's reports that in an average year only 9 percent of bonds it rated investment grade[78] were upgraded.[79] In contrast, just over 40 percent of such bonds were downgraded over the same period.[80] That differential holds constant for bonds rated non-investment grade: in an average year, less than 13 percent of

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71. *See, e.g.*, *Understanding Moody's Corporate Bond Ratings and Rating Process*, SPECIAL COMMENT (Moody's Investor Service, New York, N.Y.), May 2002, at 7, [hereinafter *Moody's*] https://www.moodys.com/sites/products/ProductAttachments/eeSpecialComment.pdf [https://perma.cc/D8VH-R8N6] ("Moody's bond ratings are predictions of relative creditworthiness.").

72. *See* Gregory Husisian, Note, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411, 412-13 (1990) ("[B]ond rating services are popular with investors because they can rate securities' riskiness far less expensively than can an individual investor.").

73. *E.g.*, *Moody's*, *supra* note 71, at 5.

74. *See id.* at 7.

75. *See id.* (explaining that "[i]f changing circumstances contradict the assumptions or data supporting the current rating," that bond will be placed "on review for possible upgrade, downgrade, or direction uncertain").

76. *See* Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 578 (1995).

77. *See Moody's*, *supra* note 71, at 7.

78. *Cf.* Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 7 [hereinafter Schwarcz, *Private Ordering of Public Markets*] (explaining "investment grade" as ratings on debt securities of BBB- and above, indicating that full and timely payment is expected).

79. *Moody's*, *supra* note 71, at 11 exhibit 8.

80. *Id.* (reporting data for the period 1970-2001). During that same period, U.S. GDP increased by an average of over 3 percent annually. *See U.S. Real GDP Growth Rate by Year*, MULTPL.COM http://www.multpl.com/us-real-gdp-growth-rate/table/by-year [https://perma.cc/D8P7-CQSJ]. That statistic in an expanding economy suggests that the differential between rating downgrades and upgrades may be even larger in a static or declining economy. Also note that of the "just over 40 percent" of bonds being downgraded, approximately half are downgraded to another investment grade and half are either downgraded below investment grade or have their ratings withdrawn. *See Moody's*, *supra* note 71, at 11-12.

those bonds were upgraded[81] whereas over 60 percent of those bonds were downgraded or had their ratings withdrawn.[82]

These data indicate that a bond's trading price is more likely to fall if the firm issuing the bond does poorly than to rise if the firm does well, making bondholders less likely to share in the upside of success than in the downside of failure.[83] This suggests that bondholders should be more risk averse than shareholders, not wanting their firm to take risks if those risks carry a realistic chance of the firm failing even if the expected value of such risk-taking to the firm is positive.[84] Including bondholders in corporate governance should therefore help to reduce systemic risk by making systemically important firms less likely to engage in risk-taking.

For example, consider a systemically important firm with BBB-rated (investment grade) bonds[85] that is contemplating investing in $100 million of highly leveraged but high interest rate mortgage-backed securities that have (only) a 10 percent chance of defaulting. The anticipated rate of return on the mortgage-backed securities should increase the firm's profitability. However, in the event of those securities defaulting, assume the rating on the bonds will be downgraded below investment grade. Shareholders may find the investment attractive because it is likely to be profitable. But bondholders may have a different perspective. As empirical data indicate, the anticipated profitability is unlikely to result in an increase in the bonds' credit rating.[86] Therefore bondholders have no

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81. Of these upgraded bonds, less than 1 percent are upgraded to investment grade; the remainder are upgraded to merely another non-investment grade rating.

82. *See Moody's*, *supra* note 71, at 11 exhibit 8.

83. This means that bondholders do not have as much of a direct stake in the firm's future performance as shareholders. I am not arguing, however, that bondholders should be included in the firm's governance to the same extent as shareholders. *See infra* Part II.

84. Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27, 44-45 (1996); *cf. In the Eye of the Bondholder*, ELECTRIC PERSP., Jan./Feb. 2004, at 22, 23 ("Equity analysts can take some risk, even some volatility, because they can see an upside. Bondholders, wary of risk of default on debt, want to keep things slow and steady. Equity analysts want to be made rich. Bondholders want to be made whole."); George S. Corey et al., *Are Bondholders Owed a Fiduciary Duty?*, 18 FLA. ST. U. L. REV. 971, 974 (1991) (explaining that if a firm moves from low- to high-risk projects, the value of its bonds will decrease).

85. Schwarcz, *Private Ordering of Public Markets*, *supra* note 78, at 7 (defining "investment grade").

86. *See supra* notes 77-82 and accompanying text.

upside from the firm's contemplated investment. On the other hand, they face a 10 percent chance of losing value in their bonds. Bondholders are therefore likely to oppose the investment.[87]

For these reasons, the corporate governance of systemically important firms should include bondholders if the benefits of such inclusion are likely to exceed its costs.[88] Part II next examines how that inclusion could occur. The principal cost would be that the same bondholder risk aversion that helps to reduce systemic risk might also reduce profitability.[89] To minimize that potential cost,[90] Part II will assume that even though bonds now exceed equity as a corporate financing source, bondholders should have a minority say in their firm's governance except when governance decisions could significantly harm them.[91]

87. Furthermore, the gap between bondholder and shareholder perspectives on the investment may widen as the risk of default increases, so long as shareholders find the risk of default acceptable.

88. Any actual cost-benefit analysis of including bondholders in corporate governance should offset any costs saved by substituting for the existing government policy requiring minimum levels of convertible contingent debt; such debt can reduce profitability by imposing stricter loan covenants on the firm's operations. *See supra* notes 11-12 and accompanying text.

89. *See supra* note 84 and accompanying text (observing that because bondholders would not share in the upside of success as much as would shareholders, bondholders would be less likely to be interested in the firm taking risks to profit); *see also* Van Der Weide, *supra* note 84, at 44-45. Van Der Weide posits a firm with $1 million of debt facing two investment opportunities: "Project Alpha, providing a fifty percent probability of a $2 million return and a fifty percent probability of a $1 million return; and Project Beta, providing a fifty percent probability of a $3 million return and a fifty percent probability of a $500,000 return." *Id.* at 44. He concludes that bondholders will prefer that the firm pursue Project Alpha because it guarantees that the firm will be able to repay debt. *Id.* By contrast, shareholders will prefer that the firm invest in Project Beta because it "maximizes the expected value of shareholder gains." *Id.*

90. Another potential cost is that including bondholders in corporate governance might make them less likely to bargain for and enforce indenture covenants. *Cf.* Amihud et al., *supra* note 51, at 455 (noting that "covenants ... entail costs," including "the costs of enforcing" them).

91. That assumption is also partly supported by the fact that bondholder claims are protected to some extent by covenants. *See* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE: IN THEORY AND PRACTICE 50 (2008). *But cf.* ARENT LIJPHART, DEMOCRACY IN PLURAL SOCIETIES: A COMPARATIVE EXPLORATION 64-65 (1977) (arguing in the political science context that when a state has major internal divisions and none of the divisions is large enough to form a majority group, successful democracy requires proportional representation); Lawrence E. Mitchell, *On the Direct Election of CEOs*, 32 OHIO N. U. L. REV. 261, 281 (2006) (arguing that when firms elect chief executive officers bondholders should have the right to vote, and discussing a proportional allocation of voting power between bondholders and shareholders).

II. HOW COULD CORPORATE GOVERNANCE INCLUDE BONDHOLDERS?

There are at least two ways to include bondholders in corporate governance. Part II.A examines a direct approach in which bondholders and shareholders share governance (the "sharing-governance" approach). Thereafter, Part II.B examines an indirect approach in which managers have a duty to both bondholders and shareholders (the "dual-duty" approach). Finally, Part II.C compares these approaches.

A. The Sharing-Governance Approach

The precedents for sharing governance focus on allowing different constituencies—which in this Article would be bondholders and shareholders—to elect management representatives.[92] The constituencies would thus share governance by communicating their interests to their representatives.[93]

In the United States, the most applicable precedent for minority sharing of governance is the preferred shareholder model, discussed

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92. Bondholders should be prohibited from contracting away this right of election. If they could contract it away, some bondholders might try to do so in exchange for a higher interest rate. *Cf. supra* notes 15-17 and accompanying text (discussing bondholders bargaining for higher yield in lieu of protective covenants). If systemic risk considerations were not involved, that negotiated tradeoff would be fine. But here there are systemic externalities that should limit free contracting. Freedom of contracting is not, and should not be, absolute. Government should be able to limit it in at least three scenarios, including on the basis of statutory policy—the policy here being to limit systemic risk—and also when the contracting causes externalities. *See* Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 520-21 (1999). In the latter case, the key question is which externalities should count in limiting that freedom. MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 58-59 (1993) (raising that question). Although there is no general answer to that question, *see id.* at 59-61 (explaining that different value judgments have different implications for answering that question), systemic externalities should certainly count in limiting freedom of contract because they not only harm the public, who cannot contract to protect themselves, but also cause much more harm than non-systemic externalities, such as widespread poverty and unemployment. *See* Schwarcz, *Misalignment*, *supra* note 8, at 16-17.

93. Bondholders, for example, should communicate their interests *as bondholders*. This might present potential conflicts if an investor is both a bondholder and a shareholder of the same firm. To resolve similar conflicts that arise in voting on bankruptcy reorganization plans, Congress gives bankruptcy judges flexibility to disqualify the votes of investors who do not vote in good faith. *See* 11 U.S.C. § 1126(e) (2012).

below in Part II.A. Preferred shareholders who are not paid scheduled dividends have the right to elect one or more directors to the board.[94] Outside the United States, the most applicable precedent appears to be the German co-determination model, discussed in Part II.A, in which employees have the right to elect certain directors to the supervisory board.

1. The Preferred Shareholder Model

Preferred shares, sometimes called "compromise securities" because they have both equity and debt characteristics, are contractually based shares that usually have specified rates of return and, in a liquidation of the firm, have priority of payment over common shares of stock.[95] If expressed in their contract with the firm, preferred shareholders enjoy contingent voting rights to elect a minority of directors if the firm fails to pay dividends that achieve the specified rate of return.[96]

Because of that minority representation, preferred shareholders "rarely prevail over common shareholders" in a dispute.[97] Nonetheless, the diversity provided by preferred shareholder representation on the board, just like that which could be provided by bondholder representation on the board, can provide perspectives that the board will find valuable. In a deliberative governance process, minority representatives may persuade others to change their minds, thus resulting in better long-term decision-making.[98]

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94. *See infra* note 96 and accompanying text.

95. 3 JAMES D. COX & THOMAS LEE HAZEN, TREATISE ON THE LAW OF CORPORATIONS § 18:4, Westlaw (database updated Dec. 2015).

96. *Id.* § 18:12. Companies listed on the New York Stock Exchange are mandated to guarantee such voting rights for preferred shares after failure to pay dividends for at least six quarters. *See* NYSE, LISTED COMPANY MANUAL § 313.00(C), http://wallstreet.cch.com/LCM/sections (follow "Section 3" hyperlink; then follow "313.00 Voting Rights" hyperlink). Preferred shareholders' rights and remedies depend on the express and implied terms of their contract with the firm. 11 CAROL A. JONES, FLETCHER CYCLOPEDIA ON THE LAW OF CORPORATIONS § 5295 (rev. vol. 2011).

97. Melissa M. McEllin, Note, *Rethinking* Jedwab*: A Revised Approach to Preferred Shareholder Rights*, 2010 COLUM. BUS. L. REV. 895, 905. McEllin also observes that there is a "current trend of favoring fiduciary duties owed to the common shareholders over contractual obligations owed to the preferred shareholders," *id.* at 898, and that the "solely contractual preferential rights of preferred stockholders are ... very limited." *Id.* at 915.

98. *See* Grant Hayden & Matthew T. Bodie, *Shareholder Democracy and the Curious Turn*

2. The German Co-Determination Model

Employees in all large German firms have the right to elect half of the members of their respective supervisory board of directors.[99] Shareholders maintain a voting majority, however, because the chairman of the supervisory board, who is elected by and accountable to shareholders, has the decisive vote in the case of a deadlock.[100]

Although their minority voting power has raised concern that employee board representatives merely have a consultative function, the actual impact of employee representation on corporate decision-making is unclear.[101] Many have criticized employee representation as being inefficient, potentially paralyzing the board's decision-making.[102] A leading comparative law scholar counters, however, that although co-determination "may delay such decisions ... it does not prevent them."[103] Moreover, co-determination is believed to help curb corporate risk-taking because, in contrast to shareholder focus on dividends and profit, employees are concerned with their firm's survival in order to protect their employment.[104]

3. Assessment of the Models for Sharing Governance

The preferred shareholder model and the German co-determination model face two main criticisms. First, minority voting power

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Toward Board Primacy, 51 WM. & MARY L. REV. 2071, 2103 (2010). *Compare* Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 252 (finding that even supposedly "independent" directors "are members of the board of directors and ... are likely to be biased in favor of other directors"), *with* William B. Stevenson & Robert F. Radin, *Social Capital and Social Influence on the Board of Directors*, 46 J. MGMT. STUD. 16, 17 (2009) (discussing factors that make individual directors more influential than others in the boardroom).

99. *See* Hansmann & Kraakman, *supra* note 4, at 445.

100. *See* STEEN THOMSEN, AN INTRODUCTION TO CORPORATE GOVERNANCE: MECHANISMS AND SYSTEMS 195 (2008).

101. *See* Sean J. Griffith, *Governing Systemic Risk: Towards a Governance Structure for Derivatives Clearinghouses*, 61 EMORY L.J. 1153, 1230-32 (2012).

102. *See* Hansmann & Kraakman, *supra* note 4, at 445-46.

103. Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 163, 188 (Margaret M. Blair & Mark J. Roe eds., 1999).

104. *See* THOMSEN, *supra* note 100, at 197.

may constrain the minority representatives to merely consultative roles. Second, the misaligned interests of heterogeneous management representation creates inefficiencies. The sharing-governance approach could be designed to avoid both these criticisms.

Although bondholders in the sharing-governance approach would elect only a minority of management,[105] the bondholders' representatives need not, and in the circumstances explained below, should not, be constrained to a merely consultative role. Instead, management decisions that could significantly harm bondholders—a determination that could be made on a case-by-case basis by the bondholders' representatives—should require some form of supermajority voting.[106] For example, consent of at least one or more of the bondholders' representatives should be needed to approve a transaction that, if unsuccessful, would be likely to cause the firm's bond rating to be downgraded. Absent this requirement for supermajority voting, the shareholders' majority representatives should be able to outvote the bondholders' minority representatives, thereby avoiding a paralysis of board decision-making.[107]

B. The Dual-Duty Approach

Next I will examine whether managers should have a duty to both bondholders and shareholders. Because that duty would be filtered through managerial discretion, it would be less direct than if bondholders actually communicated their interests to representatives.

105. *Cf. supra* notes 90-91 and accompanying text (assuming that bondholders should not necessarily have even an equal say with shareholders in their firm's governance).

106. *Cf.* Brett W. King, *The Use of Supermajority Voting Rules in Corporate America: Majority Rule, Corporate Legitimacy, and Minority Shareholder Protection*, 21 DEL. J. CORP. L. 895, 896, 919 (1996) (observing that "the inherent conflict between protecting the rights of the minority while allowing the democratic majority to rule has been used to justify implementation of voting supermajority).

107. Compare the tie-breaking power of the chairman in German corporations. *See supra* notes 99-100 and accompanying text. In the United States, another way to try to alleviate potential deadlock would be to have a lead director who facilitates discussion, serves as a liaison with other directors and corporate officers, and chairs board meetings. *See* PRICEWATERHOUSECOOPERS, LEAD DIRECTORS: A STUDY OF THEIR GROWING INFLUENCE AND IMPORTANCE 3 (2010), http://www.pwc.com/us/en/forensic-services/assets/lead-director-survey.pdf [https://perma.cc/4EJ8-7YF7].

The most applicable precedent for a dual-duty approach is the insolvency model, discussed below in Part II.B.1. Managers of insolvent, and possibly also of contingently insolvent, firms owe a duty not merely to shareholders but also to creditors. A related precedent, discussed in Part II.B, is the "public governance" dual duty to both shareholders and the public, which I have separately argued should apply to managers of systemically important firms.[108]

1. The Insolvency Model

Managers of a solvent firm owe a fiduciary duty primarily to shareholders, as the firm's residual claimants.[109] When a firm becomes insolvent, managers switch their primary duty to creditors, who become the firm's senior residual claimants.[110] The insolvency model becomes more relevant to analyzing this Article's dual-duty approach, however, when a firm is not actually insolvent but merely in the so-called "vicinity of insolvency."[111] The firm's managers are arguably then required to consider a "community of interests," which includes both the shareholders and creditors.[112] Managers are not required to prioritize one group over the other; instead, they must maximize value for the entire corporate enterprise.[113] That approach to balancing potentially conflicting shareholder and creditor interests parallels this Article's balancing of potentially conflicting shareholder and bondholder interests.

In that context, the insolvency model reveals that a dual duty poses two critical questions: When does the duty arise? How do managers balance the duty in their decision-making? In the

108. *See generally* Schwarcz, *Misalignment*, *supra* note 8, at 23-28.

109. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101-02 (Del. 2007).

110. *See id.* at 102; Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992).

111. *See* Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, *supra* note 3, at 669-72.

112. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613, at *26 n.55 (Del. Ch. Dec. 30, 1991).

113. *See* Gregory V. Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239, 241-42 (1992) (citing *Credit Lyonnais*, 1991 WL 277613, at *26). Although shareholders of a firm in the vicinity of insolvency can still bring derivative claims against directors, creditors have the right to bring derivative claims only in actual insolvency.

insolvency context, the duty would arise when a firm enters the vicinity of insolvency because that is when creditors could be impacted.[114] In the context of this Article's dual-duty approach, the duty should arise, by analogy, when a management decision could significantly harm bondholders—the same test that would trigger a supermajority voting requirement under the sharing-governance approach. In the context of the sharing-governance approach, this Article has proposed that the bondholders' representatives would determine, on a case-by-case basis, when that test is triggered.[115] Because the dual-duty approach does not contemplate bondholders' representatives per se, any manager subject to the dual duty should have the right to determine (again, on a case-by-case basis) when the test is triggered.

The question of how managers should balance a dual duty in their decision-making remains unsettled in the insolvency context. Normatively, however, I have argued that managers of a firm in the vicinity of insolvency should protect creditors from harm unless the overall benefit to shareholders is expected to considerably outweigh the harm (or there is some other compelling reason to favor shareholders).[116] This balancing also follows a weak form of the precautionary principle,[117] which requires "a margin of safety" to demonstrate that a potentially systemically risky activity is justified.[118] Because part of the justification for the dual-duty approach is to reduce systemic risk by harnessing the more risk-

114. *See* Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1492-94 (1993) (discussing how creditors of insolvent firms could be impacted).

115. *See supra* note 106 and accompanying text.

116. *See* Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, *supra* note 3, at 664, 678, 697 (noting that managers should have the latitude to make their own good faith weighing of benefit and harm).

117. Although precautionary principles have been mostly applied in assessing environmental regulation, they also can apply to financial regulation. *See, e.g.*, JAMES SALZMAN & BARTON H. THOMPSON, JR., ENVIRONMENTAL LAW AND POLICY 16 (2d ed. 2007); Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63, 84 (2012) ("[A]dopting and operationalizing the general *concept of precaution* in the context of post-crisis financial systemic risk regulation may be a worthwhile, and even necessary, exercise.").

118. *See* Schwarcz, *Misalignment*, *supra* note 8, at 36 (quoting Cass R. Sunstein, *Beyond the Precautionary Principle*, 151 U. PA. L. REV. 1003, 1014 (2003)).

averse bondholders as a check on corporate risk-taking,[119] managers making a decision that could significantly harm bondholders should likewise favor bondholders unless the overall benefit to shareholders is expected to considerably outweigh that harm or there is some other compelling reason to favor shareholders.[120]

2. The "Public Governance" Dual Duty

As mentioned, managers of systemically important firms ideally should have a dual duty: to shareholders to maximize profits, and to the public to control systemic externalities. This public governance dual duty (hereinafter "public governance" duty) is less specifically applicable to this Article than the insolvency model because bondholders, like creditors in the insolvency model, are identifiable stakeholders, whereas the public is a more diffuse concept of a stakeholder.[121] Nonetheless, certain practical questions that are engaged in discussing the public governance duty can inform this Article's dual-duty approach.[122]

For example, how should a dual duty be created?[123] In the public governance duty context, courts could judicially create such a duty or legislatures could amend corporation laws to require such a duty. To the extent the dual-duty approach is legislated, that could (in the United States) be done "either by state legislatures (especially the Delaware legislature, because most domestic firms are incorporated under Delaware law) or by the U.S. Congress."[124] State legislatures, however, would not want to impose a dual duty to bondholders and shareholders if it could discourage firms from incorporating in their states;[125] requiring managers to try to balance that dual duty might

119. *See id.* at 36-41.

120. *See id.* at 22 n.112.

121. *See id.*, at 21-22, 22 n.112, 23-26.

122. In the public governance duty context, I analyzed the following questions which are applicable to this Article: how should a public governance duty be legally imposed; and weighing the goals of protecting the public against systemic externalities and encouraging the best people to serve as managers, to what extent should managers performing their public governance duty have the protection of the business judgment rule as a defense to liability. *See id.* at 23-26.

123. This discussion is based in part on Part III.B.1 of *id.*

124. *Id.* at 29.

125. *See id.* at 29-30.

discourage some firms who see that as increasing potential director liability.[126] Furthermore, to the extent that dual duty is imposed to reduce systemic risk, it addresses a national problem. The "internalization principle" recognizes that regulatory responsibilities should generally be assigned to the unit of government that best internalizes the full costs of the underlying regulated activity.[127] That would be Congress.

Another relevant question considered in the public governance duty context is the extent to which managers performing that duty should have the protection of the business judgment rule as a defense to liability.[128] Under the business judgment rule, managers making business decisions, including risk-taking decisions, are protected from personal liability for negligent decisions made in good faith and without conflicts of interest—and in some articulations of the business judgment rule, also without gross negligence.[129] Even in a public governance duty context, I concluded that managers should be protected by the business judgment rule, so as not to discourage the best people from serving as managers and to avoid requiring courts to exercise inappropriate discretion, among other reasons.[130] I nonetheless questioned whether that protection should be modestly weakened because the interest of a manager who holds significant shares or interests in shares, or whose compensation or retention is dependent on share price, has a conflict of interest in favor of the firm's shareholders.[131] Managers with a dual duty to

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126. *See* John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35, 75 (2014) (observing that "systemically important firms might be expected to incorporate away from jurisdictions adopting a [director] liability rule").

127. *See* Robert D. Cooter & Neil S. Siegel, *Collective Action Federalism: A General Theory of Article I, Section 8*, 63 STAN. L. REV. 115, 137 (2010); *see also* Clayton P. Gillette, *Who Should Authorize a Commuter Tax?*, 77 U. CHI. L. REV. 223, 233 (2010). The internalization principle's rationale is that government entities will have optimal incentives to take into account the full costs and benefits of their regulatory decisions only if the impacts of those decisions are felt entirely within their jurisdictions. *See* WALLACE E. OATES, FISCAL FEDERALISM 46-47 (1972).

128. This discussion is based in part on Part III.B.5 of Schwarcz, *Misalignment*, *supra* note 8, at 39-43.

129. *See* Christine Hurt, *The Duty to Manage Risk*, 39 J. CORP. L. 253, 257-59 (2014). *But cf. In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 65 (Del. 2006) ("[G]rossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith.").

130. Schwarcz, *Misalignment*, *supra* notes 8, at 40-41.

131. *See id.* at 41-43 (observing that the business judgment rule assumes that managers

bondholders and shareholders would, if they hold such equity interests or receive such equity-based compensation, have a similar conflict of interest.[132]

Because of that conflict, I argued that managers performing a public governance duty should in fact be subject to a gross negligence standard, requiring them to use at least slight care.[133] Conflicted managers whose duty is to both bondholders and shareholders should likewise be subject to that requirement.[134] As I explained in the public governance duty context, that requirement would not require courts to exercise inappropriate discretion because courts routinely review whether other types of actions are grossly negligent.[135] And that requirement should not discourage the best people from serving as managers because it would be consistent with the business judgment rule's actual application in such leading jurisdictions as Delaware.[136] Even though Delaware does not formally articulate a gross negligence standard as part of its rule,[137] it disallows business judgment rule protection for managers who act in "bad faith,"[138] which is broadly defined as including conduct that "is *known to constitute* a violation of applicable positive law,"[139] which in turn is interpreted to include a manager failing to take "steps in a good faith effort to prevent or remedy" such a violation.[140] A manager's failure to use even slight care when assessing the manager's legally mandated duty to both bondholders and shareholders would appear to be bad faith under those interpretations.

have no conflict of interest).

132. *See id.* at 39-42. This assumes the norm that managers do not also hold significant amounts of the firm's bonds. *Cf.* Alex Edmans & Qi Liu, *Inside Debt,* 15 REV. FINANCE 75, 76 (2011) (observing the "long-standing belief that, empirically, executives do not hold debt").

133. *See* Schwarcz, *Misalignment*, *supra* note 8, at 42-43.

134. *See id.* at 41-43.

135. *See id.* at 42-43.

136. *See id.*

137. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 65 (Del. 2006).

138. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005) (explaining that "[t]he presumption of the business judgment rule creates a presumption that a director acted in good faith" and that "[t]he good faith required of a corporate fiduciary includes ... duties of care and loyalty"), *aff'd*, 906 A.2d 27 (Del. 2006).

139. Gagliardi v. TriFoods Int'l, Inc., No. 14725, 1996 Del. Ch. LEXIS 87, at *11 n.2 (Del. Ch. 1996) (unpublished portion of opinion).

140. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996).

These answers—that the dual-duty approach might need to be created on a federal level and that managers performing that duty should have the protection of the (theoretically but not practically modified) business judgment rule—should also inform the sharing-governance approach.

C. Comparing the Approaches

Finally, compare the sharing-governance approach with the dual-duty approach. The sharing-governance approach would offer bondholders a more direct voice in management than the dual-duty approach. Although that voice would usually be a minority representation capable of being outvoted, it would have veto power when a management decision could significantly harm bondholders. Under the dual-duty approach, all managers would have a duty to consider bondholder interests. Although the primary duty of managers would usually be to shareholders, that duty would shift (as in the voting-power shift under the sharing-governance approach) when a management decision could significantly harm bondholders.

Both approaches thus face the same practical threshold question: When could a management decision significantly harm bondholders? Under the sharing-governance approach, the bondholders' representatives would make that determination. Under the dual-duty approach, any manager could make that determination. In making their determination, the relevant managers might consider, for example, whether management is contemplating a transaction that could be profitable but, if unsuccessful, would be likely to cause the firm's bond rating to be downgraded. In analyzing that, those managers would presumably take into account rating-agency criteria for downgrading bond ratings.[141] So long as they use at least slight care in this process, the managers should be protected by the business judgment rule.[142]

141. *Cf.* RICHARD S. WILSON & FRANK J. FABOZZI, CORPORATE BONDS: STRUCTURES AND ANALYSIS 226 (1996) (observing that these criteria include a "deterioration in the [bond] issuers' credit fundamentals with a concomitant increase in default risk"). Downgrades may also result from an "increase in default risk due to ... 'special events' ... [such as] 'management actions which result in a leveraging of company financials following treasury stock purchases, leveraged buyouts, or acquisitions financed through borrowings.'" *Id.*

142. *See supra* notes 130-42 and accompanying text.

Once it is determined that a management decision could significantly harm bondholders, the sharing-governance approach would require supermajority voting in which the bondholder minority representatives could exercise veto power.[143] For those same management decisions, the dual-duty approach would require managers to favor bondholders unless the overall benefit to shareholders is expected to considerably outweigh the harm to bondholders (or there is some other compelling reason to favor shareholders over bondholders).[144] That balancing under the dual-duty approach would require managers to exercise discretion, which can create uncertainty.[145] In exercising that discretion, however, managers would again be protected by the business judgment rule so long as they use at least slight care.

Both the sharing-governance approach and the dual-duty approach should therefore be feasible. Because the sharing-governance approach would be simpler and involve less managerial discretion, it would appear to be procedurally preferable.[146] On the other hand, the dual-duty approach might provide more flexibility for profit-making because, as articulated, it would allow a firm to engage in a project that could significantly harm bondholders so long as the overall benefit to shareholders is expected to considerably outweigh the harm to bondholders.[147]

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143. *See supra* notes 106-08 and accompanying text.

144. *See supra* notes 118-22 and accompanying text. For examples of this type of expected value calculation and balancing, see Schwarcz, *Misalignment*, *supra* note 8, at 36-41.

145. *Compare* Kahan, *supra* note 76, at 613 ("[A] fiduciary duty to bondholders ... would be vague and create great uncertainty as to whether a given action would violate it or not. As a result, the duty would be difficult to enforce and would likely result in significant litigation costs."), *with* Morey W. McDaniel, *Bondholders and Corporate Governance,* 41 BUS. LAW. 413, 446 (1986) (arguing that directors already have fiduciary duties to different classes of shareholders and regularly consider and resolve conflicts between the two classes, so extending fiduciary duties to creditors may not result in a detrimental increase in uncertainty and chaos).

146. Another possible advantage of the sharing-governance approach is that managers might not always take their dual duty to bondholders seriously. *Cf.* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (noting that decisions of a board of directors "will not be disturbed if they can be attributed to any rational business purpose").

147. *See supra* notes 118-22 and accompanying text.

CONCLUSION

This Article rethinks the shareholder-primacy model of corporate governance, arguing that bondholders, who are more risk averse than shareholders, should be included in the governance of systemically important firms. The inclusion of bondholders not only could help to reduce systemic risk, but also is merited by two crucial changes in the bond markets.[148]

In contrast to the past century, bond issuances have dwarfed equity issuances as the source of corporate financing for more than a decade.[149] Bondholders, therefore, often have more invested in firms than shareholders. Moreover, bondholders—like shareholders—now typically trade their securities instead of holding them to maturity. That ties bond prices to the firm's performance. Therefore, bondholders, like shareholders, also have a vested interest in that performance.

It therefore is logical to include bondholders in corporate governance if that could be done without impairing legitimate corporate profit-making. This Article examines two ways to accomplish that: by enabling bondholders and shareholders to directly share governance, with shareholder representatives having voting control except as needed to protect bondholders from significant harm; and by requiring a firm's managers to balance a dual duty to both bondholders and shareholders. Both approaches should not only have lower costs but also more effectively reduce systemic risk than post-crisis regulatory experiments to try to harness bondholder risk aversion through the forced issuance of contingent capital.[150]

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148. Because bondholder interests are not fully aligned with the interests of the public, including bondholders in corporate governance could not *eliminate* systemic risk. *See supra* notes 21-23 and accompanying text.

149. *See supra* notes 55-58 and accompanying text.

150. *See supra* notes 9-16 and accompanying text (discussing regulatory efforts to require systemically important firms to issue contingent convertible bonds).