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

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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.\(^2\) Traditional corporate governance views a firm’s managers as acting primarily on behalf of the firm’s shareholders.\(^3\) Only in very limited circumstances do managers have a duty to others, such as creditors.\(^4\) Shareholder primacy effectively obliges managers to engage the firm in risk-taking in order to make profits.\(^5\)

Although that risk-taking can cause externalities, they are usually minor.\(^6\) This changes, however, when the risk-taking causes “systemic” externalities—such as the failure of a systemically important firm\(^7\) which triggers a domino-like collapse of other firms or markets, harming the real economy.\(^8\) That threat is real, as the Federal Reserve

\(^2\) See infra note 7 and accompanying text (describing systemically important firms).

\(^3\) See, e.g., Richard A. Brealey, Stewart C. Myers, & Franklin Allen, 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 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.

\(^4\) 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, e.g., Steven L. Schwarcz, Rethinking A Corporation’s Obligations to Creditors, 17 Cardozo L. Rev. 647 (1996).


\(^8\) Steven L. Schwarcz, Systemic Risk, 97 Geo. L.J. 193, 204 (2008). The “real economy” means the economic reality, such as a recession, that people actually experience. Id.
recently observed, because shareholder primacy lacks sufficient “incentives [for systemically important firms] to take precautions against their own failures.”

In response to the financial crisis of 2008-09 (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. Such regulation would require certain debt claims against systemically important firms to convert to equity upon specified (deteriorating) financial conditions. To reduce the chance those conditions

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10 In the United States, § 115 of the Dodd-Frank Act authorizes the Federal Reserve Board of Governors to issue regulations “that require a financial holding company to maintain a minimum amount of long-term hybrid debt that is convertible into equity” when such a company fails to meet prudential standards or the Federal Reserve determines that threats to financial system stability make regulation necessary. No regulations have yet been issued. The Financial Stability Oversight Council currently takes the position that contingent capital regulation should be an area for private sector innovation because the U.S. experience with similar instruments is limited and there are potential concerns that could be associated with them. See Financial Stability Oversight Council, Report to Congress on Study of a Contingent Capital Requirement for Certain Nonbank Financial Companies and Bank Holding Companies 18 (July 2012). 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 26–27) in response to recommendations of the Financial Stability Board (FSB) that global systemically important financial institutions “should have loss absorption capacity beyond 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 22.

11 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, Contingent Convertibles, Bloomberg Quicktake (Mar. 22, 2015, 5:52 PM), http://www.bloombergview.com/quicktake/contingent-convertible-bonds.
will occur, holders of the convertible debt claims are expected to impose strict loan covenants on their debtor-firms’ ability to take risks.\textsuperscript{12}

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.\textsuperscript{13} Its efficacy is uncertain because it operates indirectly—increasing the ability of holders of debt issued as contingent capital to influence corporate governance through strict covenants.\textsuperscript{14} Strict covenants may not always be imposed, however. Firms customarily offer creditors higher interest rates as a quid pro quo to allow looser covenants,\textsuperscript{15} especially if the debt is sold to the public which makes it

\textsuperscript{12} Cf. Simone M. Sepe, \textit{Corporate Agency Problems and ‘Dequity’ Contracts}, 36 J. CORP. L. 113, 127–28 (2010) (observing that “although 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”).


\textsuperscript{14} 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. \textit{Cf. supra} note 11 and accompanying text (discussing the conversion to equity). That could potentially enhance financial stability. \textit{See Financial Stability Oversight Council, supra} note 10, at 5.

\textsuperscript{15} \textit{Rethinking A Corporation’s Obligations to Creditors, supra} note 4, at 651 n.12.
difficult to later obtain covenant waivers. Experience shows that creditors usually “go for the gold,” choosing the higher rates over strict covenants.

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. 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.”

This article argues that law could more effectively temper the risk-taking of systemically important firms by directly engaging shareholder primacy. One way to do

\footnote{Cf. Marcel Kahan & David Yermack, \textit{Investment Opportunities and the Design of Debt Securities}, 14 J. L. ECON. \& ORG. 136, 140 (1998) (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, up to approximately 87 percent of corporate bonds appear to be publicly issued. \textit{See TRAC Market Aggregate Information, FINANCIAL INDUSTRY REGULATORY AUTHORITY, http://finra-markets.morningstar.com/BondCenter/TRACEMarketAggregateStats.jsp?bondType=1} (assuming that most corporate bonds not issued under the Rule 144A exemption from registration are publicly issued).

\footnote{Larry Light, \textit{Bondholder Beware: Value Subject to Change Without Notice}, BUSINESS WEEK, Mar. 29, 1993, at 34, available at http://www.bloomberg.com/bw/stories/1993-03-28/bondholder-beware-value-subject-to-change-without-notice (“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.”).}


\footnote{Sepe, \textit{supra} note 12, at 145–146.}
that, the article contends, would be to require the corporate governance of those firms to include bondholders—i.e., the holders of long-term corporate debt securities (“corporate bonds” or simply “bonds”\(^\text{20}\) )—in addition to shareholders, thereby harnessing the more risk-averse bondholders as a check on corporate risk-taking.\(^\text{21}\) This would not be a perfect solution to the problem of systemic risk because bondholder interests are not fully aligned with the interests of the public.\(^\text{22}\) Only something like a “public governance” duty of managers—not to engage firms in excessive risk-taking that could lead to systemic externalities\(^\text{23}\) —could fully align those interests. 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 would that firm 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.\(^\text{24}\) They therefore view their investment decisions from a market-pricing standpoint, rather than from a priority-of-claim standpoint.\(^\text{25}\) Because that market pricing depends on the financial condition and

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\(^{20}\) Bonds technically are long-term corporate promissory notes issued directly by firms to investors. WILLIAM F. SHARPE, ET AL., INVESTMENTS 367 (6th ed. 1999).

\(^{21}\) Cf. Peter O. Muelbert & Alexander Wilhelm, CRD IV Framework for Banks’ Corporate Governance, in EUROPEAN BANKING UNION 196-97 (Danny Busch & Guido Ferrarini, eds., 2015) (observing that “it seems that in jurisdictions which prioritize shareholder supremacy, bank managements are indeed encouraged to take significantly more risk”).

\(^{22}\) See Misalignment, supra note 9, at [cite].

\(^{23}\) I propose and analyze such a public governance duty in Misalignment, id.

\(^{24}\) This is sometimes referred to as trading the bonds. See SHARPE, supra note 20, at 374 (describing bond trading).

\(^{25}\) 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
operations of the firm issuing the bonds, which is determined largely through managerial decisionmaking, bondholders, like shareholders, now rely heavily on management. Second, bonds increasingly exceed equity shares as the source of corporate financing.

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 minimized 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. 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 unless the firm becomes insolvent. Creditors can contractually protect against the firm’s insolvency by negotiating covenants in their loan agreements.

The traditional view also assumes that creditors do not trade their claims.\textsuperscript{29} For bond markets, that assumption has historical support: most corporate bonds used to be held by investors to maturity,\textsuperscript{30} with investors expecting to receive their value through the periodic receipt of principal and interest payments.\textsuperscript{31}

In contrast, shareholders are residual claimants of the firm, holding equity interests.\textsuperscript{32} 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.\textsuperscript{33} Shareholders also place significant value on increasing the stock price, which enables them to sell their shares at a profit.\textsuperscript{34} Because covenants “can never restrict or determine all the operating and investment decisions necessary to run the firm efficiently,”\textsuperscript{35} shareholders must rely on the firm’s management.\textsuperscript{36}

As a result, the law traditionally assigns corporate governance rights to shareholders, not creditors. This assignment is sometimes referred to as the shareholder-

\textsuperscript{29} Cf. Metropolitan Life Insurance 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”).
\textsuperscript{31} MAUREEN BURTON, REYNOLD NESIBA, & BRUCE BROWN, AN INTRODUCTION TO FINANCIAL MARKETS AND INSTITUTIONS 56 (2d ed. 2010).
\textsuperscript{32} BREALEY ET AL., supra note 3, at 347.
\textsuperscript{33} Id. at 5.
\textsuperscript{34} See, e.g., William W. Bratton, Shareholder Value and Auditor Independence, 53 DUKE L. J. 439, 452–456 (2004) (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% of stock ownership. See, e.g., Paul A. Gompers & Andrew Metrick, Institutional Investors and Equity Prices, 116 Q. J. ECON. 229, 257 (2001). Over time, large institutional investors have also moved towards investing in riskier stocks. See James A. Bennett, Richard W. Sias, & Laura T. Starks, Greener Pastures and the Impact of Dynamic Institutional Preferences, 16 REV. FIN. STUD. 1203, 1204, 1225, 1233 (2003). See also id. (observing that although institutional investors account for 50% of stock ownership, they are responsible for 70% of trading volume, which suggests that they are more concerned about stock prices than long-term dividend expectations).
\textsuperscript{35} BREALEY ET AL., supra note 3, at 352.
\textsuperscript{36} Cf. Fisch, supra note 26, at 658 (arguing that shareholders therefore have a direct stake in the firm’s future performance).
primacy model, in which a corporation is “organized and carried on primarily for the
profit of the stockholders.” 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.

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. In 2014, for

The overwhelming acceptance for the shareholder-primacy model can be traced to a
debate in the 1930s between two academics, Adolph A. Berle and Merrick Dodd. 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.” See Adolph A. Berle, 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.” See Merrick Dodd, For Whom Are Corporate Managers Trustees? 45 HARV. L. REV. 1145, 1148 (1932).


Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 NW. U. L. REV. 547, 573 (2003). This fiduciary relationship is also explained as resulting from the shareholders’ legal status as “owners” of the corporation. BREALEY ET AL., supra note 3, at 7. But see Fisch, supra note 26, 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).

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 25–26 (Frank J. Fabozzi ed., 2000) (“Analysis of the credit quality of any structured security that is backed by assets typically begins
example, the average daily trading volume of corporate bonds reached a record of $26.7 billion, a 50% increase from 2002’s average trading volume of $17.8 billion. That same year, the average turnover rate for corporate bonds, computed as bond trading volume as a percentage of total outstanding, was 85.7%. That effectively means that the amount of bonds traded almost equaled the amount outstanding—a turnover rate approximately twice that of equity securities.

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. Since the 1980s, for example, there has been a stark increase in mutual

with the 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. Charles K. Whitehead, The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance, CORNELL LAW FAC. PUBLICATIONS, 641, 656–657 (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, Manju Puri, & Anthony Saunders, 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 16 (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 59 (observing the fall of bank lending to 10% of corporate debt financing). Outside of the United States, however, firms sometimes rely more on bank loans than bonds to raise financing. U.S. Capital Markets Deck, SIFMA Research (Oct. 7, 2015) (discussing European Union and Japan firms).


42 Id. (calculating 85.7% as $26.7 billion average daily turnover rate for corporate bonds, times 252 trading days per year, divided by $7,845.3 billion corporate bonds outstanding).

43 Itay Goldstein, Hao Jiang, & David T. Ng, Investor Flows and Fragility in Corporate Bond Funds, 8 (June 25, 2015) (unpublished manuscript, on file with author) (concluding that bond investors trade their securities more frequently than equity investors).

funds’ investments in bonds. 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. In part, this reflects that mutual funds must periodically sell bonds in order to pay fund-investors redeeming their shares.

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.

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. 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.

46 Goldstein, Jiang, & Ng, supra note 43, at 2.
47 Ahmed & Basak, supra note 44.
48 This contrasts with the traditional view that only shareholders have a direct stake in their firm’s future performance. See supra notes 26-36 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 80 & 86-87 and accompanying text.
49 That counter-argument would be more compelling if there were a mechanism to give bondholders more protective covenants, because bond covenants are relatively weak. See supra note 40 and accompanying text. One such mechanism, beyond the scope of my article, would be the “super trustee” idea advanced in Yakov Amihud, Kenneth Garbade, & Marcel Kahan, A New Governance Structure for Corporate Bonds, 51 STAN. L. REV. 447, 450–451 (1999) (arguing that such a trustee could represent the interests of the bondholders with authority, among other things, to renegotiate covenants).
1. Bonds Have Become the Principal Source of Corporate Financing. The shareholder-primacy model originated during the 1930s, when the equity markets far out-shadowed the size of the corporate bond market. That dominance of equity appears to be one of the justifications for shareholder primacy. 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, dwarfing equity issuances. In 2014, for example, newly issued corporate bonds raised approximately $1.49 trillion, compared to only $175 billion (i.e., $0.175 trillion)

50 Berle, supra note 37; Dodd, supra note 37.
51 See, e.g., Biais & Green, supra note 45, at 1 (stating that in the 1930s, the trading volume of corporate bonds was between one-fifth and one-third of the trading volume in stocks).
52 Cf. Adolph A. Berle, For Whom Corporate Managers are Trustees, 45 HARV. L. REV. 1365, 1370 (observing that “Probably 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”).
54 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 co-terminus with the firm’s existence.
raised by newly issued shares of stock.\textsuperscript{55} Since 2006, new corporate bond issuances have exceeded new issuances of equity more than eight-fold.\textsuperscript{56}

Moreover, today’s bond-market dominance of corporate financing is unlikely to be temporary.\textsuperscript{57} At least part of the reason for the increase in bond financing is the costs saved by disintermediation,\textsuperscript{58} making bond financing often less expensive than bank financing.\textsuperscript{59} Of even greater relevance, bond financing is less expensive than equity financing.


\textsuperscript{57} 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. \textit{Cf.} Douglas G. Baird & M. Todd Henderson, \textit{Other People’s Money}, 60 STAN. L. REV. 1309, 1311 (2008) (noting that “with the right package of derivatives, a debt holder can enjoy the same cashflow rights as an equity holder and vice versa . . . . As financial innovation has accelerated over the past two decades, the term ‘shareholder’ and ‘debt holder’ or ‘creditor’ has become less meaningful.”). Professors Baird and Henderson thus argue that privileging “equity and the rights of equity holders in corporate law . . . is now completely out of step with modern finance.” \textit{Id. See also} Benedict Sheehy, \textit{Scrooge—The Reluctant Stakeholder: Theoretical Problems in the Shareholder-Stakeholder Debate}, 14 U. MIAMI BUS. L. REV. 193, 216-217, 221 (“With 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 . . . .”).

\textsuperscript{58} Disintermediation refers to “getting rid of the banking middle man.” Stanley Pignal, \textit{Companies Get Rid of the Banking Middleman}, FIN. TIMES, Jan. 9, 2012, at http://www.ft.com/cms/s/0/6d5f6780-2d5e-11e1-b985-00144feabde0.html#axzz41OdfPaTs. Bond financing is a direct form of disintermediation, securitization is an indirect form.

\textsuperscript{59} Silvo Contessi, Li Li, & Katheryn Russ, \textit{Bank v. Bond Financing Over the Business Cycle}, ECONOMIC SYNOPSIS 1 (2013), https://research.stlouisfed.org/publications/es/13/ES_31_2013-11-15.pdf (observing that, as a share of total credit market instruments, corporate bonds rose from 37% in the 1980s to 58% by 2013 whereas the share of bank loans fell from 26% to 10% during that same period; and also observing that the rise of
financing. In transaction costs alone, there is a cost saving. On average, a firm making an initial public offering of stock pays about eleven percent of the proceeds in expenses,\textsuperscript{60} and even a seasoned issuer of stock pays about seven percent in expenses.\textsuperscript{61} In contrast, a firm issuing bonds pays on average just over two percent of the proceeds in expenses.\textsuperscript{62} 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 dividends paid on their stock.\textsuperscript{63} Bond financing also avoids diluting the equity interest of shareholders.\textsuperscript{64}

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,\textsuperscript{65} even on a real-time basis.\textsuperscript{66} This is increasing the bond market’s attractiveness institutional investors and corporate bonds coincides with the diminishing traditional relationship between banks and borrowers). Another reason why bank financing diminished in relative importance was that unregulated finance companies could lend more cheaply than banks. JANE D’ARISTA, EVOLUTION IN U.S. FINANCE, VOL. II RESTRUCTURING INSTITUTIONS AND MARKETS 274 (1994). See also Whitehead, supra note 40, at 654 (discussing the costs of bank regulatory compliance).

\textsuperscript{60} Inmoo Lee, Scott Lochhead, Jay Ritter, & Quanshui Zhao, The Costs of Raising Capital, 19 J. Fin. Res. 59, 62 (Table 1) (1996).
\textsuperscript{61} Id.
\textsuperscript{62} 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.
\textsuperscript{64} Id.
\textsuperscript{65} See Bessembinder & Maxwell, supra note 53, 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 40, at 655, 658–659. Greater competition and the growing loan sales market also made “long-term [banking] relationships with borrowers less valuable.” Id. at 656.
\textsuperscript{66} Id. at 677.
to institutional investors. As more institutional investors buy bonds, the bond market becomes larger and more liquid,67 thereby further reducing funding costs.68

2. Including Bondholders in Corporate Governance Would Help to Reduce Systemic Risk. An important further 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 a world of bond trading, as explained below, the reason why bondholders are more risk averse than shareholders goes beyond the traditional view (which is 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.

A bond’s rating signals the issuing firm’s creditworthiness69 and therefore is critical to the bond’s trading price.70 The rating agency providing the rating, such as Moody’s or Standard & Poor’s, typically monitors the firm issuing the rated bonds.71 If the firm’s creditworthiness remains stable, the bond rating should be preserved.72 But if

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67 Liquid in this sense refers to an investor’s ability to sell bonds to another investor for an attractive price.
68 D’ARISTA, supra note 59, 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 59-64 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. Consider whether the finance literature makes that comparison.]
70 See Gregory Husisian, 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 (1991) (noting that “bond rating services are popular with investors because they can rate securities’ riskiness far less expensively than can an individual investor”).
71 MOODY’S, supra note 69, at 5.
72 Id. at 7.
the firm’s creditworthiness declines, the bond rating could be downgraded,\textsuperscript{73} causing the bonds to fall in value.\textsuperscript{74}

Although theoretically a firm whose creditworthiness increases should see an upgrade in its bond rating,\textsuperscript{75} that seldom happens in practice. For example, Moody’s reports that in an average year only nine percent of bonds it rated investment grade\textsuperscript{76} were upgraded, in contrast to just over forty percent of such bonds being downgraded.\textsuperscript{77} That differential holds constant for bonds rated non-investment grade: in an average year, less than thirteen percent of those bonds were upgraded\textsuperscript{78} whereas over sixty percent of those bonds were downgraded or had their ratings withdrawn.\textsuperscript{79}

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

\textsuperscript{73} \textit{Id.} (explaining that “[i]f changing circumstances contradict the assumptions or data supporting the current rating,” that bond will be placed “under review . . . for possible upgrade, downgrade, or direction uncertain”).

\textsuperscript{74} \textit{See, e.g.}, Marcel Kahan, \textit{The Qualified Case Against Mandatory Terms in Bonds}, 89 NW. U. L. REV. 565, 578 (1995) (observing that downgraded bonds generally fall in value).

\textsuperscript{75} MOODY’S, supra note 69, at 7.


\textsuperscript{77} MOODY’S, supra note 69, at 7 & 11 (Exhibit 8) (reporting data for the period 1970-2001). During that same period, U.S. GDP increased by an average of over three percent annually (see http://www.multpl.com/us-gdp-inflation-adjusted/table); that 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 forty 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.

\textsuperscript{78} Of these upgraded bonds, less than one percent are upgraded to investment grade; the remainder are upgraded to merely another non-investment grade rating.

\textsuperscript{79} MOODY’S, supra note 69, at 11 (Exhibit 8).
likely to share in the upside of success than in the downside of failure.\textsuperscript{80} This suggests that bondholders should be more risk averse than shareholders, not wanting their firm to take risks to profit 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.\textsuperscript{81} 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\textsuperscript{82} that is contemplating investing in $100 million of highly leveraged but high interest rate mortgage-backed securities that have (only) a 10\% 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,\textsuperscript{83} the anticipated profitability is unlikely to result in an increase in the bonds’ credit rating. Therefore bondholders have no upside from the firm’s contemplated investment. On the other hand, they face a 10\% chance of losing value in their bonds. Bondholders are therefore are likely to oppose the investment.\textsuperscript{84}

\textsuperscript{80} 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 they should be included in the firm’s governance as much as shareholders. \textit{See infra} Part II.

\textsuperscript{81} Mark E. Van Der Weide, \textit{Against Fiduciary Duties to Corporate Stakeholders}, 21 \textit{Del. J. Corp. L.} 27, 44–45 (1996). \textit{Cf. In the Eye of the Bondholder, Electric Perspectives} 23 (Jan./Feb. 2004) (“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, M. Wayne Marr, Jr., & Michael F. Spivey, \textit{Are Bondholders Owed a Fiduciary Duty?}, 18 \textit{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).

\textsuperscript{82} \textit{Cf. supra} note 76 (defining “investment grade”).

\textsuperscript{83} \textit{See supra} notes 76-79 and accompanying text.

\textsuperscript{84} 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.
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. Part II next examines how that could occur. The principal cost would be that the same bondholder risk aversion that helps to reduce systemic risk might also reduce profitability. To minimize that potential cost, 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 where governance decisions could significantly harm them.

II. HOW COULD CORPORATE GOVERNANCE INCLUDE BONDHOLDERS?

85 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.

86 See supra note 80 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 81, at 44–45. Van Der Weide posits a firm with $1 million of debt that faces 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.” He concludes that bondholders will prefer that the firm pursue Project Alpha because it guarantees that the debt will be repaid. By contrast, shareholders will prefer that the firm invest in Project Beta because it “maximizes the expected value of shareholder gains.” Another potential cost is that including bondholders in corporate governance might make them less likely to bargain for and enforce indenture covenants. Cf. Amihud, Garbade, & Kahan, supra note 49, at 455 (noting that “covenants . . . entail costs,” including “the costs of enforcing” them).

87 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 (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) (in the context of electing a firm’s chief executive officers, arguing that bondholders should have the right to vote and discussing a proportional allocation of voting power between bondholders and shareholders).
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.88 The constituencies would thus share governance by communicating their interests to their representatives.89

In the United States, the most applicable precedent for minority sharing of governance is the preferred shareholder model, discussed below in subpart 1. Preferred

88 Bondholders should be prohibited from contracting away that right. 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. 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 Trebilcock, The Limits of Freedom of Contract 58, 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, including widespread poverty and unemployment. Misalignment, supra note 9, at [cite].

89 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 any such conflicts, compare the jurisprudence under 11 U.S.C. § 1126(c), (d), & (e) of resolving the voting conflicts of investors who hold both a debt claim against, and an equity interest in, the same debtor firm.
shareholders who are not paid scheduled dividends have the right to elect one or more directors to the board. Outside the United States, the most applicable precedent appears to be the German co-determination model, discussed in subpart 2, 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.\(^90\) 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.\(^91\)

Because of that minority representation, preferred shareholders “rarely prevail over common shareholders” in a dispute.\(^92\) 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. This reflects that in a deliberative governance process, representatives may persuade others and be persuaded to change their minds, resulting in better long-term decision making.\(^93\)

\(^91\) Cox & Hazen, supra note 90, § 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(e)(C). Preferred shareholders’ rights and remedies depend on the express and implied terms of their contract with the firm. William Meade Fletcher, 11 Fletcher Cyclopaedia on the Law of Corporations § 5295 (2015).
\(^92\) Melissa M. McEllin, Rethinking Jedwab: A Revised Approach to Preferred Shareholder Rights, 2010 Colum. Bus. L. Rev. 895, 898 & 903 (2010) (observing a “current trend of favoring fiduciary duty owed to common shareholders over contractual obligations owed to the preferred shareholders”; and also observing, id. at 916, that the “solely contractual preferential rights of preferred stockholders are . . . very limited”).
\(^93\) Cf. Grant Hayden & Matthew Bodie, Shareholder Democracy and the Curious Turn Toward Board Primacy, 51 WM. & MARY L. REV. 2071, 2104 (2010) (arguing that in a
2. The German Co-Determination Model. Employees have the right to elect half of the members of the supervisory board of directors in all large German firms. Shareholders maintain 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.

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. Many have criticized employee representation as being inefficient, potentially paralyzing the board’s decisionmaking. A leading comparative law scholar counters, however, that although co-determination may delay decisions, “it does not prevent them . . . .” 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.

deliberative governance process, representatives may persuade others and be persuaded to change their minds, resulting in better long-term decision making). Also compare William B. Stevenson & Robert F. Radin, Social Capital and Social Influence on the Board of Directors, 46 J. MGMT. STUD. 17 (2009) (discussing factors that make individual directors more influential than others in the boardroom) with Antony Page, Unconscious Bias and the Limits of Director Independence, 2009 U. ILL. L. REV. 237, 252 (2009) (finding that even supposedly “independent” directors “are members of the board of directors and . . . are likely to be biased in favor of other directors”).


95 STEEN THOMSEN, AN INTRODUCTION TO CORPORATE GOVERNANCE 195 (2008).


97 Hansmann & Kraakman, supra note 94, at 38.


99 THOMSEN, supra note 95, at 197.
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 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, 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. 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 decisionmaking.

B. The Dual-Duty Approach

100 Cf. notes 86-87 and accompanying text (assuming that bondholders should not necessarily have even an equal say with shareholders in their firm’s governance).
101 Cf. Brett W. King, The Use of Supermajority Voting Rules, 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 the implementation of . . . supermajority” voting).
102 See infra note 130 and accompanying text (discussing how managers could make that assessment).
103 Compare the tie-breaking power of the chairman in German corporations. See supra note 95 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), available at http://www.pwc.com/us/en/forensic-services/assets/lead-director-survey.pdf.
Next 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.

The most applicable precedent for a dual-duty approach is the insolvency model, discussed below in subpart 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 subpart 2, is the “public governance” dual duty to both shareholders and the public, which I have separately advocated for managers of systemically important firms.104

1. The Insolvency Model. Managers of a solvent firm owe a fiduciary duty primarily to shareholders, as the firm’s residual claimants. When a firm becomes insolvent, managers switch their primary duty to creditors, who become the firm’s senior residual claimants. 105 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.” The firm’s managers are arguably then required to consider a “community of interests,” which includes both the shareholders and creditors. 106 Managers are not required to prioritize one group over the other; instead, they must maximize value for the entire corporate enterprise.107 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

104 Misalignment, supra note 9.
105 See Gheewalla, 930 A.2d 92, 102 (Del. 2007); Geyer v. Ingersoll Publ’ns Co., 621 A.2d 784 787 (Del. Ch. 1992).
107 Fiduciary Duties of Directors of Financially Troubled Corporations, Practical Law Bankruptcy and Practical Law Finance. 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.
decisionmaking? In the insolvency context, the duty would arise when a firm enters the vicinity of insolvency because that is when creditors could be impacted. 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. 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 decisionmaking 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). This balancing also follows a weak form of the precautionary principle, which requires “a margin of safety” to demonstrate that a potentially systemically risky activity is justified. Because part of the justification for the dual-duty approach is to reduce systemic risk by

109 See supra note 101 and accompanying text.
110 See id.
111 Rethinking A Corporation’s Obligations to Creditors, supra note 4, at 664, 678 (noting that managers should have the latitude to make their own good faith weighing of benefit and harm).
112 Although precautionary principles have been mostly applied in assessing environmental regulation, they also can have application 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. 64, 85 (2012) (“adopting 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”).
113 See Misalignment, supra note 9, at [cite] (following Cass R. Sunstein, Beyond the Precautionary Principle, 151 U. PA. L. REV. 1003, 1014 (2003)).
harnessing the more risk-averse bondholders as a check on corporate risk-taking, 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).

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. Nonetheless, certain practical questions that are engaged in discussing the public governance duty can inform this article’s dual-duty approach.

For example, how should a dual duty be created? 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 (“Congress”). 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; requiring managers to try to balance that dual duty might discourage some

114 See supra note 21 and accompanying text.
115 See supra note 104 and accompanying text.
116 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 a business judgment rule as a defense to liability.
117 This discussion is based in part on Part III.B.1 of Misalignment, supra note 9.
firms who see that as increasing potential director liability.\textsuperscript{118} 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\textsuperscript{119}—and that would be Congress.

Another relevant question considered in the public governance duty context is the extent to which should managers performing that duty should have the protection of a business judgment rule as a defense to liability.\textsuperscript{120} 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.\textsuperscript{121} Even in a public governance duty context, I concluded that managers should be protected by the business judgment rule, among other reasons, so as not to discourage the best people from serving as managers and to avoid requiring courts to exercise inappropriate discretion.\textsuperscript{122} 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

\begin{footnotes}
\begin{enumerate}
\item John Armour & Jeffrey N. Gordon, \textit{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”).
\item Robert D. Cooter & Neil S. Siegel, \textit{Collective Action Federalism: A General Theory of Article I, Section 8}, 63 STAN. L. REV. 115, 137 (2010). \textit{See also} Clayton P. Gillette, \textit{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. WALLACE E. OATES, \textit{FISCAL FEDERALISM} 46–47 (1972).
\item This discussion is based in part on Part III.B.5 of Misalignment, supra note 9.
\item Christine Hurt, \textit{The Duty to Manage Risk}, 39 J. CORP. L. 253, 258 (2014). \textit{But cf.} In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 65 (Del. 2006) (stating that “grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith”).
\item Misalignment, supra note 9, Part III.B.5.
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price, has a conflict of interest in favor of the firm’s shareholders. Managers with a dual duty to bondholders and shareholders would, if they hold such equity interests or receive such equity-based compensation, have a similar conflict of interest.

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. Conflicted managers whose duty is to both bondholders and shareholders should likewise be subject to that requirement. 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. 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. Even though Delaware does not formally articulate a gross negligence standard as part of its rule, it disallows business-judgment-rule protection for managers who act in “bad faith,” which is broadly defined as including conduct that “is known to constitute a violation of applicable positive law,” 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. 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.

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123 Cf. supra note 120 (observing that the business judgment rule assumes that managers have no conflict of interest).
124 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. FIN 75, 76 (2011) (observing the “long standing belief that, empirically, executives do not hold debt”).
125 Misalignment, supra note 9, Part III.B.5.
126 See supra note 121 (quoting the lower court opinion in In re Walt Disney Co. Derivative Litig.).
127 See In re Walt Disney Co. Derivative Litigation, 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”).
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 a (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. So long as they use at least slight care in this process, the managers should be protected by the business judgment rule.

130 See supra note 102 and accompanying text.
131 Cf. Richard S. Wilson & Frank J. Fabozzi, Corporate Bonds: Structures and Analysis 226 (1996) (observing that these criteria include a “deterioration in the [bond] issuer’s credit fundamentals with a concomitant increase in default risk”). Downgrades
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.\textsuperscript{133} 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).\textsuperscript{134} That balancing under the dual-duty approach would require managers to exercise discretion, which can create uncertainty.\textsuperscript{135} 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.\textsuperscript{136} On the other hand, the dual-duty approach might provide more flexibility for profit making 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 borrowing.” \textit{Id.} \textsuperscript{132} \textit{See supra} notes 120-129 and accompanying text. \textsuperscript{133} \textit{See supra} notes 101-103 and accompanying text. \textsuperscript{134} \textit{See supra} note 111 and accompanying text. For examples of this type of expected value calculation and balancing, \textit{see Misalignment, supra} note 9, at [cite]. \textsuperscript{135} \textit{Compare} Marcel Kahan, \textit{The Qualified Case Against Mandatory Terms in Bonds}, 89 \textit{NW. U. L. REV.} 565, 613 (1995) (arguing that imposing 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.”) \textit{with Morey M. McDaniel, Bondholders and Corporate Governance}, 41 \textit{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). \textsuperscript{136} Another possible advantage of the sharing-governance approach is that managers might not always take their dual duty to bondholders seriously. \textit{Cf.} Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del.) (noting that managers “decisions will not be disturbed if they can be attributed to any rational business purpose”).
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.

CONCLUSIONS

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.137

In contrast to the past century, bond issuances have dwarfed equity issuances as the source of corporate financing for more than a decade. 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. The 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

137 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 22-23 and accompanying text.
experiments to try to harness bondholder risk aversion through the forced issuance of contingent capital.\textsuperscript{138}

\textsuperscript{138} See supra notes 11-18 and accompanying text (discussing regulatory efforts to require systemically important firms to issue contingent convertible bonds).