DIRECTORS' DUTY TO CREDITORS AND OPTIMAL DEBT CONTRACT

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ABSTRACT

Under the current model of corporate fiduciary law, informational asymmetry between directors and creditors makes the debt contract inadequate to govern efficiently the debtor-creditor relationship. In particular, as currently devised, the debt contract fails to prevent managerial opportunism; i.e., the managers' tendency to increase the investment's risk ex-post. Anticipating the contract's failure, creditors ask higher interest rates. Moreover, because of the scarcity of observable information, creditors tend to pool firms together and price debt on the basis of the average risk increase. As a result, credit capital is inefficiently allocated.

A default duty of directors to creditors, paired to a regime of textualist interpretation of the debt contract, would redress the existing inefficiency. By sanctioning directors' with personal liability for increasing the level of risk contractually accepted by creditors, the duty would serve as a bonding mechanism against managerial opportunism and induce directors to fulfill the contract. In addition, the adoption of a textualist interpretative regime would prompt a Nash bargaining between the parties, which would give both of them the right incentives to write more state-contingent contracts. In this way, not only would monitoring and opportunity costs be reduced, but also credit capital would be more efficiently allocated. Indeed, the higher level of specification of debt contracts would induce creditors to price debt on the basis of such specification, rather than through a pooling mechanism. As a result, a Pareto improvement in the market equilibrium could be achieved.

- 1 -

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TABLE OF CONTENTS

INTRODUCTION

PART I

THE ACADEMIC DEBATE

- 1. THE RATHER DIFFERENT VIEWS OF CONTRACTARIANS AND COMMUNITARIANS
- 2. A CRITICAL ASSESSMENT
 - 2.1. THE INEFFICIENCY OF THE MULTIFIDUCIARY MODEL
 - 2.2. THE LIMITS OF THE CONTRACTARIAN PERSPECTIVE

PART II

THE POSITIVE ANALYSIS

- 1. THE CORPORATE CONSTITUENCY STATUTES
- 2. CREDIT LYONNAIS BANK NEDERLAND, N.V. V. PATHE COMMUNICATIONS CORP.
 - 2.1. FROM THE INSOLVENCY EXCEPTION TO THE FINANCIAL DISTRESS EXCEPTION
 - 2.2. THE INADEQUACY OF THE NPV TEST

PART III

A NORMATIVE THEORY

- 1. DIRECTORS' DUTY TO CREDITORS
- 2. CONTRACT AND DUTY: THE BONDING MECHANISM FUNCTION
- 3. The Enforcement of the Duty and the Need for a Textualist Interpretative Regime
- 4. EXEMPTION FROM LIABILITY
- 5. THE DISTINCTION BETWEEN CAPITAL PROVIDERS AND OTHER FIXED CLAIMANTS
- 6. Some Policy Considerations

CONCLUSION

Introduction

Both courts and scholars have long interpreted the directors' duty to pursue the interest of the corporation as an exclusive obligation to maximize shareholder wealth. This view of corporate fiduciary law is commonly referred to as *shareholder primacy* rule.¹ As a consequence, a fiduciary duty of directors to creditors has been traditionally

¹ The landmark decision on the shareholder primacy rule is Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919), in which the court expressly established that: "[a] business corporation is organized and carried on primarily for the profit of the stockholders." More recent judicial opinions reinforcing the

denied in American corporate law,² but for one exception: the insolvency of the corporation. In this special circumstance, creditors would take the place of shareholders as the parties with an equitable interest in the corporate assets and this would justify the shift of fiduciary duties³ in their favor. In the past twenty years, however, the shareholder primacy rule has undergone mounting criticism. Largely beginning with the concerns caused by the takeover explosion of the 1980s, legal scholars have widely discussed whether directors should pursue also the interests of other corporate constituencies, in particular that of company creditors. The enactment by most American states of corporate constituency statutes, which authorize directors to consider non-shareholder interests in the corporate decision-making, has further challenged the conventional framework. The turning point of the debate over directors' duties, however, has been the 1991 Credit

legacy of the shareholder primacy rule include, among others, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986); and Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986). As to the scholarly contributions on the matter, see, e.g., Bernard Black & Reinier Kraakman, A Self-Enforcing Model of Corporate Law, 109 HARV. L. REV. 1911, 1921 (1996) ("The efficiency goal of maximizing the company's value to investors [is] the principal function of corporate law."); Sthephen M. Bainbridge, In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green, 50 WASH. & LEE L. REV. 1423, 1423 (1993) ("Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers."); Michael E. DeBow & Dwight R. Lee, Shareholders, Non-shareholders, and Corporate Law: Communitarians and Resource Allocation, 18 DEL. J. CORP. L. 393, 393 (1993) ("It has been the dominant American conception of the corporation for many years that a corporation's primary goal is, and should be, the maximization of shareholder welfare."); D. Gordon Smith, The Shareholder Primacy Norm, 23 J. CORP. L. 277, 280 (1998) ("The shareholder primacy norm is considered fundamental to corporate law."); Jonathan C. Lipson, Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation, 50 UCLA L. REV. 1189, 1214 (2003) ("The shareholder maximization norm is the dominant theoretical approach to directorial duties.") In addition, Professors Hansmann and Kraakman note that "the dominance of a shareholder-centered ideology of corporate law" is not limited to the American experience, but is the rule "in key commercial jurisdictions." Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 GEO. L.J. 439, 439 (2001).

² The decisions on the matter are copious. *See, e.g.*, Harff v. Kerkorian, 324 A.2d 215 (Del. Ch. 1974) (dismissing bondholders' suit which alleged breach of directors' fiduciaries duties on the ground that such duties do not exist); Simons v. Cogan, 549 A.2d 300 (Del. 1988) (stating that creditors of solvent corporations are not entitled to directorial fiduciary duties because they do not hold any existing property right or equitable interest which supports the imposition of such duties); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989) (affirming that the rights of corporate debtholders are limited to those arising from the contract governing debtor-creditor relationships).

³ Managers' fiduciary duty to shareholders is composed of the duty of care and the duty of loyalty. Thus, the discourse on the extension of managers' accountability to other corporate constituencies has alternatively referred to (the) duty or duties of directors.

Lyonnais decision.⁴ In that case, it was first established that directors' duties shift to creditors upon the financial distress of the corporation, rather than upon its insolvency.

In this essay, I argue that the problem of directors' duty to creditors is basically a problem of contract efficiency. Under the current paradigm of corporate fiduciary law, the contract fails to govern the debtor-creditor relationship pursuant to a welfare maximization criterion.⁵ To enable parties to write better debt contracts, I propose to adopt a corporate governance model providing for a permissive regime of directors' duty to creditors and a textualist interpretation of the debt contract. Such a model would increase efficiency by serving two basic functions: (i) discouraging managerial opportunism; and (ii) inducing directors to disclose credible information. This would result not only in a reduction of monitoring and opportunity costs, but also in a more efficient allocation of credit capital. Finally, the proposed model would also limit uncertainty in legal relationships.

In a corporate governance system dominated by the shareholder primacy rule, informational asymmetry between managers and creditors makes the debt contract inadequate to govern efficiently the parties' relationship and, in particular, to prevent managerial opportunism. Not only do managers have information on the investment's underlying risk that is not observable to creditors; but also, under the current paradigm of corporate fiduciary law, they have weak incentives to disclose this information. Furthermore, since creditors expect managers to act in the shareholders' interest, they may be reluctant to consider disclosed information credible. These informational asymmetry problems and the absence of a strong bonding mechanism inducing directors to fulfill the contract result in the credit agreement's failure to deter managerial opportunism. The latter is the tendency of managers, acting as shareholders' fiduciaries, to increase the investment's level of risk as the company incurs indebtedness (what is

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⁴ Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 Del. Ch., LEXIS 215, (Del. Ch. Dec. 30, 1991), reprinted in 17 DEL. J. CORP. L. 1099.

⁵ Indeed, I share the idea that "the state should choose the rules that regulate commercial transactions according to the criterion of welfare maximization." Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 544 (2003). Under this view, social welfare would be measured by the number of contracts that maximize ex-ante the gains of contracting parties.

⁶ In this work, the terms managers and directors are indifferently used to indicate the parties who are in charge of the company business and control.

commonly referred to as asset substitution).⁷ Given the limited liability of shareholders for corporate debts, this may lead to the expropriation of creditor value.⁸ Creditors, however, anticipate the contract's failure and charge higher interest rates. In addition, because of the lack of observable information on the risk underlying corporate assets, creditors are unable to distinguish between *good firms* (i.e., firms that do not engage in asset substitution) and *bad firms* (i.e., firms that engage in asset substitution). Thus, they tend to pool firms in risk categories and price debt on the basis of the average risk increase pursued within that category. As a result of this mechanism of debt pricing, credit capital is inefficiently allocated.

A default duty to creditors, which I conceive as the directors' obligation not to increase unilaterally the risk contractually accepted by creditors, and a regime of textualist interpretation of the debt contract are the legal instruments that I propose to redress the existing contractual inefficiency. The basic assumption underlying the duty's existence is that if directors want to reserve an option to increase the investment's risk ex-post, they must pay for it. This requires that they disclose information on the investment's underlying risk so that creditors can price that option. By threatening directors with personal liability for increasing the level of risk accepted by creditors, the proposed duty would, thus, deter managers from acting opportunistically. Put differently, it would prevent them from exercising an option for which they have not paid. In addition, the duty would remedy the current lack of directors' incentives to disclose information. Under the rule I propose, to be able to undertake profitable business opportunities without incurring liability to creditors, managers should opt for disclosure. Finally, the liability threat would serve as a mechanism to signal credible information. Knowing that directors bear personal losses for the duty's breach, creditors would be induced to deem credible the information made available to them. Thus, the duty's overall effect would be to make creditors able to screen firms depending on their specific risk. This, however, would have only limited effect for inducing creditors to change the

⁷ The substitution of the firm's existing assets with riskier assets is also described as overinvestment when it results in the undertaking of negative net present value projects.

⁸ Indeed, creditors do not benefit from the potential high expected rewards deriving from the undertaking of risky projects, because they are entitled only to a fixed payment. If the project fails, however, they will be the first to bear the consequences of such failure.

way they price debt. As a matter of economic theory, 9 creditors' payoffs are the same under a system in which they price debt by pooling good and bad firms together (and calculate the average risk increase) and in one in which they price debt on the basis of separating equilibria. For this reason, I argue that, in order to achieve a Pareto improvement in the market equilibrium, a regime of textualist (or literal) interpretation of the debt contract should be adopted together with the duty to creditors.

As a default rule of law, the actual scope and content of the duty would be determined by contract. Parties themselves would set the boundaries of directors' obligations to creditors depending on the investment's risk they negotiate. In this context, adopting a literal interpretative regime of the debt contract would mandate to consider accepted by creditors any risk they have not contractually excluded or limited. Even if apparently counterintuitive, the existence of this interpretative rule would prompt a strategic game between the parties ultimately leading to efficiency. Under such a regime, creditors would bear the unspecified risk. As a result, they would have incentives to specify the risk they accept. On the other hand, however, this regime might appear to induce directors to conceal information. By doing so, directors could limit the risk of personal liability and reserve additional investment options. Yet, such a behavior would ultimately prove self-defeating. Uninformed creditors would react by imposing general covenants. Because of the scarcity of observable information, such covenants would be low state-contingent on the external state (i.e., the corporate activity). 10 This means that they would tend to exclude a large set of investment options and, therefore, to broaden directors' liability. Consequently, rational managers would seek to restrain their liability

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⁹ See Andreu Mas-Colell, Michael D. Whinston & Jerry R. Green, Microeconomic Theory (1995 ed.); Jeffrey Banks & Joel Sobel, Equilibrium Selection in Signaling Games, 55 Economica 647 (1987); Charles A. Wilson, The Nature of Equilibrium in Markets with Adverse Selection, 11 Bell Journal of Economics 108 (1980); Michael Spence, Market Signaling (1974); George G. Akerlof, The Market for Lemons, 89 Quarterly Journal of Economics 488 (1970).

¹⁰ By low state-contingent covenant, I mean a covenant which tends to provide for a low number of possible contingencies, such as a covenant establishing that the company must not undertake any new line of business. On the contrary, a highly state-contingent covenant specifies in detail the parties' obligations depending on the possible contingencies which may take place. For instance, rather than a general no-new-lines-of-business covenant, the contractual restriction would specify in detail which new activities the company can or cannot undertake. *See* Pierpaolo Battigalli & Giovanni Magli, *Rigidity, Discretion, and the Cost of Writing Contracts*, 92 AM. ECON. REV. 798, 799 (2002). *Cf. also* Karen Eggleston, Eric A. Posner, & Richard Zeckhauser, *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 Nw. U. L. REV. 91, 108, 122 (2000).

risk by disclosing information and bargaining for more state-contingent covenants. Finally, under a textualist interpretative regime, both parties would have incentives to specify the contract, and creditors would be induced to price debt on the basis of such specification.

The suggested model would also have the effect of reducing monitoring and opportunity costs. To begin with, it would serve as a bonding mechanism inducing directors to fulfill contractual obligations. Because the level of risk accepted by creditors would be determined by contract, directors would become sort of guarantors of the company's obligations concerning creditors' accepted risk (i.e., CAR). Still, this does not mean that the breach of the duty would automatically follow the breach of the contract. Two different kinds of contractual provisions should be distinguished: those setting the CAR and those establishing the terms of repayment of debt. Directors could be held liable to creditors only for the breach of a CAR provision that resulted also in the breach of a provision on the terms of payment. Moreover, the duty would avoid the risk that the maximization of corporate welfare might be compromised by sub-optimal covenants (i.e., not sufficiently state-contingent covenants). Under the current regime, because of the lack of credible information, creditors tend to draft covenants which inefficiently constrain managerial discretion. This results in significant opportunity costs for the firm. By enabling parties to devise optimal covenants (i.e., highly state-contingent covenants), the duty to creditors would reduce also such costs. 11

Finally, the proposed model would eliminate the uncertainty currently surrounding directors' fiduciary duties, especially in the case of financial distress of the corporation.¹²

¹¹ Cf. Clifford W. Smith, Jr. & Jerold B. Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 J. FIN. ECON. 117 (1979) (arguing that, for each firm, would exist a unique optimal set of protective covenants "which maximize[s] the value of the firm.")

¹² Much of this uncertainty is due to the "vicinity of insolvency standard", which was devised by the Credit Lyonnais decision as the paradigm of the shift of directors' duties to creditors. See, e.g., Roy de R. Barondes, Fiduciary Duties of Officers and Directors of Distressed Corporations, 7 GEO. MASON L. REV. 45, 65-71 (1998); Richard M. Cieri, et al., The Fiduciary Duties Of Directors of Financially Troubled Companies, 3 J. BANKR. L. & PRAC. 405, 417-20 (1994); C. Robert Morris, Directors' Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais, 19 J. CORP. L. 61 (1993); Ramesh K.S. Rao, Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance In a Financially-Distressed Firm, 22 J. CORP. L. 53 (1994); Mike Roberts, The Conundrum of Directors' Duties in Nearly Insolvent Corporations, 23 MEM. St. U. L. REV. 273, 286-90 (1993); Gregory V. Varallo and Jesse A. Finkelstein, Fiduciary Obligations of Directors of the Financially Troubled Company, 48 Bus. LAW. 239 (1992).

Under this model, as long as they respect the boundaries of the contract, directors are free to pursue any strategy they might deem beneficial, regardless of the company's financial conditions. Thus, the duty would exclude that the fear of liability's exposure might paralyze managers' decision-making when their resolute action is most needed. From this perspective, my proposal would set the parties free to negotiate privately the allocation of risk that maximizes the value of their exchange. (Following this logic, the parties could permit directors to undertake risky corporate projects even in the case of financial distress of the corporation. Similarly, the parties could decide to exclude the duty altogether.) This would increase efficiency, since the contracting parties are in the best position to devise the optimal risk allocation. Also for this reason the contract should be interpreted literally: to avoid that the court's subjective interpretation of creditors' accepted risk might inject uncertainty in legal relationships and reduce the expected value of the parties' exchange.¹³

In Part I of this essay, I offer a critical assessment of the dominant academic views of directors' duty to creditors and illustrate the reasons of the present inadequacy of the debt contract to govern the parties' relationship pursuant to a welfare maximization criterion. In Part II, I discuss the positive elaborations of the duty to creditors formulated by the corporate constituency statutes and the Credit Lyonnais decision. In particular, in the context of the discussion on Credit Lyonnais, I explain why the insolvency exception is an incomplete doctrine of directors' duty to creditors and why the net present value test devised by the Lyonnais court is an inefficient test of directors' liability. In Part III, I expound the new model of corporate fiduciary law I propose. First, I describe the function of the proposed default duty to creditors and clarify why a legal intervention for a diverse distribution of the parties' entitlements is necessary. Second, I illustrate the mechanism of contractual determination of the default duty and explain why it would serve as a bonding mechanism inducing directors to fulfill the contract. Third, I clarify

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¹³ See Schwartz & Scott, supra note 5, 549-50 (arguing that textualist interpretation maximizes the ex-ante value of contractual relationships). See also Alan Schwartz, Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies, 21 J. LEGAL STUD. 271, 277, 280 (1992) (affirming that, because of the non-verifiability of parties' information, courts are not able to enforce value-maximizing terms and, thereby, suggesting that a textualist approach to contract interpretation would be more efficient).

how the interaction between duty and textualist interpretation of the contract would lead to a Pareto improvement in the credit market equilibrium. Fourth, I set out the several options that the proposed model would offer to the company's directors for escaping liability. Fifth, I explain why only creditors-capital providers should be owed a default directors' duty. Sixth, I make some policy considerations as to the effect of directors' liability insurance over the contractual determination of the duty and the firm's capital structure. Finally, in the Conclusion, I summarize why my proposal is desirable.

PART I

THE CURRENT STATUS OF THE DEBATE ON DIRECTORS' FIDUCIARIES DUTIES TO CREDITORS

1. The Rather Different Views of Contractarians and Communitarians

Fiduciary law has been defined as "one of the most elusive concepts in Anglo-American law." This seems especially true in the case of corporate fiduciary law. While it is common knowledge that directors (and other corporate officers) owe a duty of care and a duty of loyalty to the corporation, not much else is uncontroversial in this field. The fierce academic debate and the large number of judicial opinions that have focused on directors' duties attest to the complexity of the matter.

In particular, in the past twenty years, commentators have widely discussed whether directors, in pursuing the corporate benefit, should take into account also the interests of company creditors.¹⁶ Two dominant views have emerged from such a debate:

¹⁴ Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 879 (1988).

¹⁵ This essay, however, will not discuss the duties and responsibilities of corporate officers because of the too vast array of offices that, depending on the size of the corporation, such a qualification may cover. For instance, in merchant banks, nearly everybody above the employee-level tends to be denominated a *vice-president*. This qualification, however, does not imply any of the traditional powers attributed to corporate officers. Franklin A. Gevurtz, Corporation Law § 3.1.1, 180 (2003) (quoting Merril Lynch, Pierce, Fenner & Smith, Inc. v. Livingston, 566 F.2d. 1119 (9th Cir. 1978)).

¹⁶ The problem of the beneficiary of directors' fiduciary duties finds its origins in the debate around the excessive formalism of the academic view that considered the corporate entity itself as such a beneficiary. For some early discussion on the matter, see the debate developed in the 1930s between the shareholder-centered vision of the corporation backed by Columbia Professor Adolf A. Berle and the opposed stakeholder-centered perspective supported by Harvard Professor E. Merrick Dodd. *See* Adolf A.

those of contractarians and communitarians. Contractarian scholars oppose the extension of directors' duties to creditors, arguing that the latter's interests can be adequately protected by contract.¹⁷ By contrast, communitarians claim that informational and bargaining disparities make non-shareholders unable to achieve self-protection through contract.¹⁸ In turn, they advocate a *multi-fiduciary model*¹⁹ where all corporate stakeholders benefit from the attribution of directors' fiduciary duties.²⁰

Berle, For Whom Corporate Managers Are Trustees: A Note, 45 HARV. L. REV. 1365 (1932); and E. Merrick Dodd, For Whom Are Corporate Managers Trustees?, 45 HARV. L. REV. 1145 (1932).

¹⁷ From the contractarian perspective, since creditors have only a fixed claim over the corporate revenues, the contract would be a sufficient instrument to control current and future contingencies, and, therefore, to ensure the repayment of creditors' claims. By contrast, as residual claimants, shareholders are interested in the overall economic performance of the firm and, therefore, "to protect their interests, (...) [they should] be given the right to control the firm." Hansmann & Kraakman, *supra* note 1, at 449-52 (2001). Under this view, fiduciary duties serve essentially to fill in the unspecified terms of the shareholders' corporate contract. In these terms, see RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 100-101 (3d. ed. 1986); FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 68 (1991); Bainbridge, *supra* note 1, at 1443-44; Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 28-32 (1990); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991); Jonathan. R. Macey & Geoffrey P. Miller, *Corporate Stakeholders: A Contractual Perspective*, 43 U. TORONTO L.J. 401 (1993); Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholder*, 21 DEL. J. CORP. L. 27, 34-36 (1996).

¹⁸ In particular, employees and lower level corporate officers would be the parties mostly disadvantaged in terms of contractual bargaining. See Katherine Van Wezel Stone, Employees as Stakeholders Under State Nonshareholder Constituency Statutes, 21 STETSON L. REV. 45 (1991); Joseph W. Singer, Jobs and Justice: Rethinking the Stakeholder Debate, 43 U. TORONTO L.J. 475 (1993); Marleen A. O'Connor, How Should We Talk About Fiduciary Duty?: Directors' Conflict-of-Interest Transactions and the ALI's Principles of Corporate Governance, 61 GEO. WASH. L. REV. 954 (1993). More generally, see Victor Brudney, Corporate Governance: Agency Costs, and the Rhetoric of Contract, 85 COLUM. L. REV. 1403 (1985).

¹⁹ As reported by Professor Bainbridge, the expression multi-fiduciary model was coined by Professor Green. *See* Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1419 (1993) (quoted in Bainbridge, *supra* note 1, at 1425, fn. 6).

Among the scholars embracing such a view of the corporation, see, for example, Melvin A. Eisenberg, New Modes of Discourse in the Corporate Law Literature, 52 GEO. WASH. L. REV. 582 (1985); Victor Brudney, Contract and Fiduciary Duty in Corporate Law, 38 B.C.L. REV. 595 (1997); Brudney, supra note 18; Lyman Johnson, Corporate Takeovers and Corporations: Who are They For?, 43 WASH. & LEE L. REV. 781 (1986); Lyman Johnson, The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law, 68 TEX. L. REV. 865 (1990) [hereinafter, Johnson, The Delaware Judiciary]; Lawrence E. Mitchell, A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes, 70 TEX. L. REV. 579, 585 (1992) [hereinafter, Mitchell, Corporate Constituency Statutes]; Lawrence E. Mitchell, The Fairness Rights of Corporate Bondholders, 65 N.Y.U. L. REV. 1165 (1990) [hereinafter, Mitchell, Corporate Bondholders]; David Millon, Redefining Corporate Law, 24 IND. L. REV. 223 (1991) [hereinafter Millon, Redefining Corporate Law]; David Millon, Communitarians, Contractarians and the Crisis in Corporate Law, 50 WASH. & LEE L. REV 1373 (1993) [hereinafter Millon, Communitarians, Contractarians].

These divergent views of directors' duties are explained by the radically different conception of the corporate entity of the two groups. For communitarians, the corporation is a social institution tied to all its diverse components by means of trust and mutual interdependence.²¹ Thus, they conceive directors as a means to pursue social welfare and prevent potential shareholders' abuses against non-shareholders. Contractarians, instead, see the corporation as a nexus for a set of contracting relationships among individuals gathered together to the sole purpose of maximizing their profits.²² From this perspective, the exclusive commitment of directors toward shareholders is viewed as the most efficient way to achieve the profit-maximization goal.²³

2. A Critical Assessment

Both the communitarian and the contractarian theories have been the object of fierce, reciprocal criticism. In such a dispute, two major arguments have been advanced by one group against the other. Contractarians claim that the communitarian idea boosts inefficiency. Communitarians reply that the contractarian view leads to social injustice. ²⁴

²¹ See, e.g., Millon, Communitarians, Contractarians, supra note 20, at 1379-83; David Millon, Theories of the Corporation, 1990 DUKE L.J. 201, 261-62 (1990). On the special importance of trustworthiness among corporate participants, see, among others, Margaret M. Blair & Linn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, 149 U. PA. L. REV. 1735 (2001); Lawrence E. Mitchell, Fairness and Trust in Corporate Law, 43 DUKE L.J. 425 (1993).

Although the contractarian theory was developed after the 1980s by legal scholars, its origins can be traced back to the early 1970s, when the new idea of the firm as a nexus for a set of contracting relationships among individuals emerged among economists. Among the seminal economic references, see Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. ECON. Rev. 777 (1972); OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975); Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

²³ In this sense, see Hansmann & Kraakman, *supra* note 1, at 441.

²⁴ For a very detailed analysis of the ideological and political differences between the contractarian and communitarian visions of the corporation, see Paul N. Cox, *The Public, The Private and the Corporation*, 80 MARQU. L. REV. 391 (1997) (speaking of a conflict between the public-egalitarian claim of communitarians and the private-individualistic claim of contractarians). For a fierce critique of the communitarian model, see, for example, Bainbridge, *supra* note 1; and also Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856 (1995). For a communitarian critique of the contractarian position, see, among others, Millon, *Communitarians, Contractarians, supra* note 20. For an *independent* review of the contractarian view, see also William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives From History*, 41 STAN. L. REV. 1471 (1989); and William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989).

In this context, one may thus reasonably believe that a rule of directors' liability to creditors must necessarily embrace social and/or moral considerations. On the contrary, my proposal is grounded on a contractarian view of the firm and is designed to increase corporate and social efficiency.

2.1. The Inefficiency of the Multi-Fiduciary Model

Although I share the communitarian idea that directorial fiduciary duties should not be a tool at shareholders' disposal to expropriate wealth from other corporate constituencies, I dismiss the multi-fiduciary model of directors' duties as inefficient for four reasons. First, I argue that should directors maximize creditor value, as advocated by communitarians, the only choice at their disposal would be to underinvest. This means that they should avoid any course of action entailing a risk of reducing the assets available to satisfy creditors' claims. But corporations need to take risks to exploit potentially lucrative ventures. Hence, imposing on directors a duty to maximize creditor value would ultimately result in the reduction of corporate value.

Second, as argued by contractarians, when fiduciary duties are owed to two or more sets of persons who have conflicting (i.e., not identical) interests, they are so difficult to administer that they practically become no duties at all. (This is commonly known as the *too many masters argument.*)²⁵ Thus, should directors owe duties to all stakeholders, not only would they be able to exercise unfettered discretion, but they are also likely to become self-serving. Directors could justify virtually any of their actions on the basis of the benefits accruing to one or the other group of corporate constituents.²⁶

Third, the multi-fiduciary model would tend to increase litigation since a larger

²⁵ However, among the same contractarians, some have noticed that the too many masters argument is overstated nowadays. Modern corporations are characterized by a multilayered structure that counts not only different classes of stakeholders, but also multiple classes of common and preferred stock. And the interests of these different classes of stockholders may conflict as can the interests of one class of stakeholders with the other. Yet, directors have traditionally been able to manage their duties to the different categories of stockholders in ways beneficial to the corporation. *See* Macey, *supra* note 17, at 33. In addition, modern financial instruments have further complicated the corporate scenario. In particular, as regards directors' duties, hybrid securities (i.e., securities having both characteristics of debt and equity) pose problems which are analogous to those implied by a potential extension of such duties to creditors. *Cf.* Henry T.C. Hu, *New Financial Products, The Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEXAS L. REV. 1273 (1991) (who argues that the increasing complexity of the corporate capital structure might challenge shareholder primacy in the future.)

²⁶ In this terms, see, for example, Macey & Miller, *supra* note 17, at 412; William J. Carney, *Does Defining Constituencies Matter*?, 59 U. CIN. L. REV. 385, 424 (1990).

number of parties would have title to commence legal action against directors for the perceived breach of fiduciary duties. As a result, the judicial system would risk being slowed down by the increase in law suits against directors. Moreover, litigation could be abused by creditors seeking to extract extra-profits from debtor companies.

Finally, the interests of corporate constituencies other than shareholders and creditors are protected by specific areas of law. For instance, employees' rights are secured by labor law; those of consumers, by consumer law; and so on. Hence, directors' action in favor of these other constituencies could overlap the specific legal means of protection at the latter's disposal. This would be likely to generate more damage than benefits.

2.2. The Limit of the Contractarian Perspective

Endorsing a contractarian view of the corporation, I maintain that creditors' rights, including any obligations directors might bear toward them, should be determined by contract. I also claim, however, that, under the current model of corporate governance, managerial opportunism and informational asymmetry compromise parties' ability to write *optimal debt contracts*, which regulate the debtor-creditor relationship pursuant to a welfare-maximization criterion.²⁷

From an economic viewpoint, the problem arises from the intrinsic conflict between shareholders and creditors. Because of their limited liability for corporate obligations, as a corporation incurs indebtedness, shareholders have incentives to design the firm's operating characteristics and financial structure in ways that maximize their benefit to the detriment of creditors.²⁸ The shareholder primacy rule, then, extends these

²⁷ See *supra* note 5

Among the seminal works on the shareholder-creditor conflict, see Jensen & Meckling, *supra* note 22, at 308 (first to suggest that an owner-manager, who issues debt before deciding on the investment policy, can transfer wealth to himself from bondholders by taking on excessive risk); Smith & Warner, *supra* note 11 (analyzing the efficacy of the debt contract to solve the conflict). *See also* Fischer Black & John C. Cox, *Valuing Corporate Securities: Some Effects of Bond Indenture Provisions*, 31 J. FIN. 351 (1976); Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977); Merton H. Miller, *The Wealth Transfers of Bankruptcy-Some Illustrative Examples*, 41 LAW AND CONTEMPORARY PROBLEMS 39 (1977); Eugene F. Fama, *The Effect of a Firm's Investment and Financing Decisions on the Welfare of Its Security Holders*, 68 AM. ECON. REV. 272 (1978).

incentives to managers.²⁹ Rational creditors, however, anticipate this risk and specify ex ante contractual provisions to prevent it. In particular, debt contracts are designed to regulate three main sources of conflict between shareholders and creditors: (i) dividend payment—the expropriation of creditor value determined by the pay-out of corporate assets, in form of dividends, to shareholders; (ii) claim dilution—the devaluing of prior debt by the issuance of subsequent debt; and (iii) asset substitution—the substitution of riskier assets to the firm's existing assets.³⁰

I argue, however, that while the debt contract is effective in controlling the first two sources of conflict, it fails to curb the managerial tendency to engage in asset substitution—i.e., managerial opportunism.³¹ Unlike dividend payment and claim dilution, asset substitution cannot be prevented through the imposition of readily verifiable

²⁹ Theoretically, managers would be more risk averse than shareholders. Unlike the latter, who can diversify their investments, managers typically make specific investments in one firm. From this perspective, they are also exposed to a significant risk of reputational capital depreciation for the failure of corporate projects. In addition, like creditors, managers do not participate in the upside potential of corporate projects. As a matter of fact, however, managers' position tends to be aligned to those of shareholders. First, the shareholder primacy rule makes managers liable to shareholders and, therefore, give them incentives to pursue shareholders' interests. See, e.g., Smith & Warner, supra note 11, at 118 (arguing that managers might behave opportunistically "acting in the stockholders' interest"); Myers, supra note 28, at 149 (referring to "firm with risky debt outstanding, and which act in its stockholders' interests"). Second, in the modern corporation, the interest of managers and shareholders tend to be aligned as a result of equity-based compensation plans; e.g., stock options. See, e.g., Günter Strobl, Managerial Compensation, Market Liquidity, and the Overinvestment Problem, The Wharton School University of Pennsylvania Working Paper 31, at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=567085 (last visited February 2, 2005); Ming Nmi Fang & Rui Zhong, Default Risk, Firm's Characteristics, and Risk Shifting, YALE ICF WORKING PAPER N. 04-21, May 1, 2004; Ajay Subramanian, Managerial Flexibility, Agency Costs and Optimal Capital Structure, (January 2002), AFA 2003 Washington, DC Meetings.

³⁰ Directors, acting on behalf of shareholders, are induced to adopt increasingly risky corporate strategies. At the extreme, they might even have incentives to undertake strategies having a negative net present value. This is commonly known as overinvestment. Equally, directors might be induced to reject positive net present value projects simply because the benefits of such projects would accrue exclusively to the firm's bondholders; in such a case, financial theorists talk about underinvestment. The result of overinvestment and underinvestment, however, is identical. Both transfer wealth from creditors to shareholders.

³¹ Cf. Smith & Warner supra note 11, at 153 (arguing that "to go very far in directly restraining the firm's production/investment policy" might prove inefficient and proposing to use dividend policy and financing policy restrictions to indirectly curb the problem of managerial opportunism. Such a solution, however, might imply extremely high opportunity costs). See also Myer, supra note 28, at 161-62 (confirming that contractual solutions to the asset substitution problem might be so costly to be unfeasible). For an analysis limited to the case of bondholders, see also Morey W. McDaniel, Bondholders and Stockholders, 13 J. CORP. L. 205, 236-238 (1988) (arguing that bond covenants are inadequate to protect bondholders from the risk of value expropriation arising from managerial opportunism).

financial parameters.³² Instead, to bargain for the right investment policy restrictions, creditors need detailed information on the investment's underlying risk. Yet, the informational asymmetry between managers and creditors, paired to the existing shareholder-centered model of corporate governance, makes it unlikely that creditors may have such information (and/or can rely on it).³³

Informational asymmetry takes place when information is differently observable to parties.³⁴ Thus, in the relationship between managers and creditors, the former have information on the investment's underlying risk that is not observable to the latter. Being held to the exclusive maximization of share value, managers then have no incentives to disclose this information to creditors. On the contrary, they might well be induced to conceal it to borrow at a lower cost and reserve a costless option to invest in riskier projects. In addition, because creditors expect managers to act in shareholders' interest, they might be reluctant to consider disclosed information credible.³⁵

As a consequence, creditors would draft sub-optimal covenants, which fail to maximize the ex-ante value of the parties' relationship. In particular, they would tend to bargain for general, rather than analytical covenants. General covenants limit the firm's

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³² The breach of accounting and financial covenants, which are designed to control, respectively, the problems of dividend payment and claim dilution, would always involve an explicit act (like, for instance, the payment of dividends in violation of a provision requiring the previous deposit by the debtor of a specified amount as cash reserve). Consequently, their breach would be readily observable and verifiable by creditors. In practice, however, ascertaining the violation of these types of covenants might prove more difficult than it might prima facie appear. First, there would be "many possible channels for transferring capital to the firm's owners." *See* Myers, *supra* note 28, at 160 (quoting Jensen & Meckling, *supra* note 22). In addition, as evidenced by the recent wave of corporate scandals, inefficiencies in the gatekeeping system might make it difficult to verify the breach of the financial parameters established by the parties. *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Legal Reforms*, 84 B.U. L. REV. 101 (2004).

³³ Even if creditors might have (some) information on the current status of corporate assets, they commonly lack ex-ante information on the projected risk of the firm, which is what really matters to price debt.

³⁴ The seminal work on the problem of asymmetric information is that of George G. Akerlof. *See* Akerlof, *supra* note 9. The result of the asymmetric information between market participants is that market equilibria often fail to be Pareto optimal. In turn, adverse selection problems may arise.

³⁵ For the same reason, managers' information might not be totally credible even if made observable to creditors by gatekeepers (i.e., auditors, securities analysts, investment bankers, etc.). This seems especially true after the wave of corporate scandals and accounting irregularities that have shaken the trustworthiness of the gatekeeping system in the past few years.

investment policy by providing for low state-contingent restrictions,³⁶ such as the obligation not to engage in new lines of business. Such covenants offer the advantage of being easily verifiable, but bear high opportunity costs for the debtor. They are, thus, inefficient.³⁷ Analytical covenants, instead, specify in details the courses of action that managers can or cannot undertake (that is, they are more state-contingent on the external state). Hence, such covenants deter managerial opportunism at a lower opportunity cost. However, being not as easily verifiable as general contractual restrictions, they tend to imply higher monitoring costs. To enforce this type of covenants, creditors need updated information on the investment's risk and the corporate activity, which is both expensive and difficult to gather. Indeed, managers have even stronger incentives not to disclose private information when such a disclosure may trigger a contractual breach.³⁸ Finally, absent a bonding mechanism inducing directors to fulfill the contract, even analytical covenants would not be efficient in governing managerial opportunism.³⁹

The matter, however, is not only about the contract's failure to govern the asset substitution problem efficiently. Anticipating this failure, creditors charge higher interest

³⁶ See supra note 10.

³⁷ This analysis of general covenants presupposes a textualist interpretative regime of the debt contract. Under such a regime, imposing a general limit on a specific corporate activity is equivalent to forbid that activity altogether. This means that in the case, for instance, of a no-change-of-business-line covenant, the debtor could not undertake any different activity from the one carried out at bargaining, even though the change of activity was not substantial. Instead, under a contextualist interpretative regime, general covenants become *generic covenants*. Indeed, under such a diverse regime, contractual provisions that are low state-contingent may result more or less restrictive than analytical covenants (which are per se more state-contingent) depending on the ex-post interpretation of the third adjudicator. For instance, the conversion of part of a company's industrial production from automobiles to scooters could be held not to represent a violation of a no-change-of-business-line covenant under a contextualist interpretative regime. It follows that generic covenants entail lower opportunity costs than general covenants. Yet, they bear high *uncertainty costs*, which are the costs arising out of the uncertainty over the ex-post completion of the contract by the third adjudicator. *See also infra* Part III, Par. 3.

³⁸ For this reason, under the current regime, creditors tend to discover the undertaking of asset substitution projects only on the verge of insolvency, when it is commonly too late to rescue their position. In addition, some empirical studies confirm that even when creditors are informed on the asset substitution carried out by managers, they often prefer not to bring legal action against the company. Under the current regime of corporate fiduciary law, the costs and uncertainty of the contract's enforcement would, indeed, induce creditors to prefer renegotiation or other out of court settlements to the judicial enforcement of the contract. See Kevin C.W. Chen & K.C. John Wei, Creditors' Decisions to Waive Violations of Accounting Based Covenants, 68 THE ACCOUNTING REVIEW 218 (1993).

³⁹ See Raghuram G. Rajan & Andrew Winton, Covenants and Collateral as Incentives to Monitor, 50 J. Fin. 1113 (1995) (providing evidence that since restrictive covenants are, in practice, often inefficient, creditors frequently write covenants loosely by using standard boilerplate).

rates. ⁴⁰ In addition, because of the scarcity of observable information and credible signals on the risk underlying corporate assets, creditors are unable to distinguish *good firms* (i.e., firms that do not engage in asset substitution) from *bad firms* (i.e., firms that engage in asset substitution). Thus, they tend to pool firms in risk categories and price debt on the basis of the average risk of each category. ⁴¹ As a consequence, credit capital is inefficiently allocated and social costs arise. First, good firms end up subsidizing bad firms. Second, the pooling equilibrium between good and bad firms may create adverse-selection problems. ⁴² Firms pursuing a below-the-average level of asset substitution might be so penalized by the current mechanism of debt pricing as to drop out of the market. Firms pursuing an above-the-average level of asset substitution, instead, would profit from such a mechanism and have all the incentives to stay in the market. Moreover, beyond a certain level of risk, creditors may start to offer less aggregate credit, ⁴³ with the consequence that good firms (and good business projects) might risk going unfunded.

PART II

THE POSITIVE ANALYSIS

1. The Corporate Constituency Statutes

The American legislator has not remained indifferent to the debate on corporate fiduciary duties. Since the 1980s, some thirty American states have enacted statutes,

⁴⁰ See Richard Green & Eli Talmor, Asset Substitution and the Agency Costs of Debt Financing, 10 J. Bank. & Fin. 391 (1986); Hayne E. Leland, Risky Debt, Bond Covenants, and Optimal Capital Structure, 49 J. Fin. 1213 (1994); Hayne E. Leland & Klaus Bjerre Toft, Optimal Capital Structure, Endogenous Bankruptcy, and the Term Structure of Credit Spreads, 51 J. Fin. 987 (1996); Hayne E. Leland, Agency Costs, Risk Management, and Capital Structure, 49 J. Fin. 1213 (1998); Jan Ericsson, Asset Substitution, Debt Pricing, Optimal Leverage and Optimal Maturity, Finance 21 (2000).

⁴¹ Indeed, in credit markets, only debtors can observe the *quality* of the claims they sell. By contrast, creditors can observe just the *distribution* of the quality of the claims that have been issued. As a result, the expected value of financial claims is calculated on the average risk. For an empirical study, *see*, *e.g.*, Artur Morgado & Julio Pindado, *The Underinvestment and Overinvestment Hypotheses: An Analysis Using Panel Data*, 9 EUROP. FIN. MANAG. 163, 165 (2003). *Cf. also* Ericsson, *supra* note 38.

⁴² In general terms, adverse selection arises when the trading decisions of informed market participants depend on privately held information in a manner that may adversely affect uninformed market participants. In the case in question, this means that bad firms will tend to be more willing to bear the average increase of the cost of debt determined by the pooling equilibrium than good firms.

⁴³ See, e.g., Ericsson, supra note 38, at 27 (showing that firms could afford to take an additional 20% of leverage if the incentives to alter the firm's riskiness were not present).

largely known as *corporate constituency statutes*, ⁴⁴ which authorize directors to consider also non-shareholder interests in the corporate decision-making. ⁴⁵ Most of these statutes, however, do not mandate, but simply permit the consideration of the interests of employees, creditors, local communities, and other corporate constituencies. The only notable exception is represented by the Connecticut's statute, which expressly requires directors to consider non-shareholder interests in the management of the corporation. ⁴⁶

This discretionary feature of the statutes, paired with their often vague formulation, has raised doubts as to the impact of such legislation on directors' fiduciary obligations.

⁴⁴ Alternatively, the statutes are also known as *non-shareholder* or *non-stockholder constituency statutes*.

⁴⁵ As reported by the American Bar Association, the statutes typically include one or more of the following provisions:

⁽¹⁾ Directors may consider the interests of, or the effects of their action on, various non-stockholder constituencies. (2) These constituencies may include employees, customers, creditors, suppliers, and communities in which the corporation has facilities. (3) Directors may consider the national and state economies and other community and societal considerations. (4) Directors may consider the long-term as well as the short-term interests of the corporation and its shareholders. (5) Directors may consider the possibility that the best interests of the corporation and its stockholders may best be served by remaining independent. (6) Directors may consider any other pertinent factors. (7) Officers may also be covered.

See American Bar Association (ABA), Committee on Corporate Laws, Other Constituencies Statutes: Potential for Confusion, 45 Bus. Law. 2253, 2261 (1990) [hereinafter ABA Committee on Corporate Laws]. Among the several states that have adopted corporate constituency statutes, see, ARIZ. REV. STAT. ANN. §10-1202(A) (West 1990); CONN. GEN. STAT. ANN. § 33-313(e) (West 1990); FLA. STAT. ANN. § 607-111(9) (1990); GA. CODE ANN. § 14-2-202(5) (1989); HAW. REV. STAT. § 415-35(b) (1990); IDAHO CODE § 30-1602 (Michie 1990); ILL. COMP. STAT. ANN. 32/8-85 (West 1990); IND. CODE ANN. § 23-1-35-1(d)(f)(g) (West 1990); IOWA CODE ANN. § 490-1108 (West 1990); Ky. REV. STAT. ANN. § 271B.12-210(4) (Michie 1990); LA. REV. STAT. ANN. § 12-92(G) (West 1991); ME. REV. STAT. ANN. tit. 13-A, § 716 (West 1990); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West 1990); MINN. STAT. ANN. § 302A-251(5) (West 1991); MISS. CODE ANN. § 79-4-8.30 (1990); MO. ANN. STAT. § 351-347 (West 1991); NEB. REV. STAT. § 21-2035(l) (1988); N.J. STAT. ANN. § 14A:6-14(4) (West 1990); N.M. STAT. ANN. § 53-11-35(D) (Michie 1989); N.Y. Bus. Corp. § 717(b) (1991); OHIO REV.CODE ANN. § 1701-59 (West 1989); OR. REV. STAT. § 60.357(5) (1989); PA. CONS. STAT. ANN. § \$511(d), (e), (g) & 1721(e), (f), (g) (West 1990); R.I. GEN. LAWS § 7-5.2-8 (1990); S.D. CODIFIED LAWS ANN. § 47-33-4 (Michie 1990); TENN. CODE ANN. § 48-35-204 (1988); WIS. STAT. ANN. § 180.305 (West 1990); Wyo. STAT. § 17-16-830 (Mich 1989).

⁴⁶ The Connecticut statute provides that a director "shall consider (...) (3) the interests of the corporation's employees, customers, creditors and suppliers, and (4) community and societal considerations including those of any community in which any office or other facility of the corporation is located." Conn. Gen. Stat. Ann. § 33-313(e) (West Supp.1990). It should be noted, however, that even though the Indiana's statute does not compel directors to consider non-shareholder interests, its wording is difficultly reconcilable with the idea of shareholder primacy. The statute gives directors "full discretion" in the selection of the corporate interests to pursue and specifies that they may weight each group of interest "as they deem appropriate." In addition, it also provides that directors "are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as a dominant or controlling factor." See Ind. Code Ann. § § 23-1-35-1(d) (f) (g) (West 1989).

Once again, communitarians and contractarians have supported opposite views. For the former, the statutes represent a desirable first step toward a new egalitarian model of corporate law, in which social welfare maximization takes the place of share value maximization as the fundamental corporate governance rule.⁴⁷ For contractarians, instead, the statutes are "an idea whose time should never have come."⁴⁸ Hence, they should be interpreted restrictively.⁴⁹ This means that non-shareholder interests should be taken into consideration only when a simultaneous benefit accrues to shareholders.⁵⁰ Only in this way, would the risk be avoided that incumbent directors might undertake self-driven decisions adducing uncertain non-shareholder interests.

Although in existing law there is no evidence for a communitarian-like interpretation of the statutes, I agree that they are part of a broader trend suggesting a need to review the traditional shareholder centered vision of the corporation.⁵¹ The openness to the case of non-shareholders showed in some circumstances by Delaware courts,⁵² the most influential corporate law courts in this country, could also be regarded

⁴⁷ In this sense, see, among others, Millon, *Redefining Corporate Law, supra* note 20; Johnson, *The Delaware Judiciary, supra* note 20; Mitchell, *Corporate Constituency Statutes, supra* note 20; Marleen O'Connor, *Restructuring the Corporation's Nexus on Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991).

⁴⁸ James. J. Hanks, Jr., *Non-Stockholder Constituency Statutes: An Idea Whose Time Should Never Come*, 3 INSIGHTS 20 (1989).

⁴⁹ See, e.g., Macey & Miller, supra note 17; DeBow & Lee, supra note 1, at 398-405; Hanks, supra note 48; James. J. Hanks, Jr., Playing with Fire: Nonshareholder Constituency Statutes in the 1990s, 21 STETSON L. REV. 97 (1991); James. J. Hanks Jr., Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification, 43 Bus. LAW. 1207, 1230 (1988).

⁵⁰ See ABA Committee on Corporate Laws, supra note 45, at 2268 (1990) ("The Committee believes that the better interpretation of these statutes, and one that avoids ... consequences [on corporate efficiency] is that they confirm what the common law has been: directors must take into account the interests of other constituencies but only as and to the extent that the directors are acting in the best interests, ..., of the shareholders and the corporation.")

⁵¹ In similar terms, but advocating a communitarian-oriented reading of this trend, see Mitchell, *Corporate Constituency Statutes*, *supra* note 20, at 585, who observes that the statutes are "part of a trend suggesting a need for legal recognition of constituent interests within the corporate structure." In my idea, instead, the statutes would signal a more limited need for reviewing, not rebutting, the shareholder primacy rule.

⁵² See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (in which the court dismissed a shareholder derivative action against the company directors, stating that the adoption of antitakeover measures could be justified by the consideration of the interests of "constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)"); Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990) (in which the court upheld the decision of Time's directors to prefer uncertain long-term strategies over short-term shareholders' gains, on

as part of this trend (especially if one considers that Delaware does not belong to the list of states that have enacted corporate constituency statutes). As a matter of positive law, however, the turning moment of the debate on directors' duties to creditors has been the 1991 Credit Lyonnais decision.

2. Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.

2.1. From the Insolvency Exception to the Financial Distress Exception

Traditionally, the *insolvency exception* has represented the only circumstance under which American courts have acknowledged a duty of directors to creditors. Indeed, the idea that corporate insolvency shifts directorial duties toward creditors can be traced back to the *trust fund doctrine* of early American corporate law,⁵³ which established that the corporate assets of a company facing dissolution were to be held in trust for the benefit of its creditors.⁵⁴ From an economic viewpoint, the exception finds its justification in the fact that, when a corporation becomes insolvent, the position of creditors and shareholders exchange, with the former taking the place of the latter as the parties having an equitable interest in the corporate assets.⁵⁵

the basis of the board's duties to maintain the company as an independent enterprise and to protect "Time culture"); Ivanhoe Partners v. Newmont Mining Corp, 535 A.2d 1334 (Del. 1985) (affirming the right of directors to refuse an hostile bid on the ground of the consideration of "broad corporate interests"); TW Services, Inc. v. SWT Acquisition Corp. [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94334 (Del. Ch. Mar. 2, 1989) (upholding the defensive measures adopted by the board in a hostile takeover context, on the basis of the consideration of the "shareholder long-term interests or 'corporate entity interests' or 'multiconstituency interests" as opposed to the "shareholder short term interests' or 'current share value interests").

On the trust fund doctrine, see, among others, Joseph J. Norton, Relationship of Shareholders to Corporate Creditors upon Dissolution: Nature and Implications of the "Trust Fund" Doctrine of Corporate Assets, 30 Bus. Law. 1061 (1975); Norwood P. Beveridge, Jr., Does a Corporation's Board of Directors owe a Fiduciary Duty to Its Creditors?, 25 St. Mary's L.J. 589 (1994); Stephen R. McDonnell, Geyer v. Ingersoll Publications Co., Insolvency Shift Directors' Burden from Shareholder to Creditors, 19 Del. J. Corp. 177, 186-95 (1994); Ann E. Conaway Stilson, Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors, 20 Del. J. Corp. L. Rev. 1, 76-87 (1995). Among the very earliest comments on the doctrine, see Joseph Story, Equity Jurisprudence, Chs. 3, 33, 43 (1886); Note, The "Trust Fund" Theory, 9 Harv. L. Rev. 481 (1896).

⁵⁴ The leading case of the trust fund doctrine is Wood v. Dummer, 30 F. Cas. 435 (C.C.D. Me. 1824). Other well known early cases include Hollins v. Brierfield Coal & Iron Co., U.S. 371 (1893); Mackenzie Oil Co. v. Omar Oil & Gas Co., 120 A. 852 (Del. Ch. 1923); and Asmussen v. Quaker City Corp., 156 A. 180 (Del. Ch. 1931).

⁵⁵ See Stephen L. Schwarcz, Rethinking a Corporation's Obligations to Creditors, 17 CARDOZO L. REV. 647, 667 (1996) (assimilating creditors' rights upon insolvency to that of shareholders of solvent corporations); Laura Lin, Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors'

In 1991, however, a decision of the Delaware Court of Chancery, Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.,⁵⁶ announced that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residual risk bearers, but owes its duty to the corporate enterprise."⁵⁷ And in the court's opinion the concept of corporate enterprise would encompass "the community of interest[s] that sustained the corporation",⁵⁸ including creditors' interests. Then, in a now-famous footnote, the court explained why creditors should benefit from the attribution of directors' fiduciary duty under such circumstances: ""[t]he possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors."⁵⁹

By hinting at the problem of managerial opportunism, the elaboration of directors' duty to creditors formulated in the Lyonnais decision has represented a step forward compared to the traditional insolvency exception approach.⁶⁰ What the Lyonnais court

Duty to Creditors, 46 VAND. L. REV. 1485, 1491 (1993) (defining creditors of insolvent corporations as new residual claimants of the firm); Cristopher. L. Barnett, *Healthco and the "Insolvency Exception": An Unnecessary Expansion of the Doctrine?*, 16 BANKR. DEV. J. 441, 450-51 (2000) (arguing that, upon insolvency, the rights of shareholders and creditors exchange).

⁵⁶ Credit Lyonnais, *supra* note 4. The factual circumstances of the case involved a legal suit commenced by the company's creditors for defending their rights under a restructuring plan and, in particular, the validity of certain provisions that excluded the major shareholder from the management and control of the corporate activity. For a detailed account of the case, see, among others, Schwarcz, *supra* note 55, at 667; Lipson, *supra* note 1, at 1208-11; Vladimir Jelisavcic, *Corporate Law-A Safe Harbor Proposal to Define the Limits of Directors' Fiduciary Duties to Creditors in the "Vicinity of Insolvency": Credit Lyonnais v. Pathe, 18 J. CORP. L. 145, 153-58 (1992).*

⁵⁷ Credit Lyonnais, *supra* note 4, at 1155.

⁵⁸ *Id.*, at 1156. Which corporate constituencies belong to the "corporation's community of interest[s]" and how directors should balance these different interests has been largely debated among commentators. There seem to be no doubts, however, that the ambiguous expression used by the Lyonnais court intended to include corporate creditors.

⁵⁹ *Id.*, fn. 55

⁶⁰ Not surprisingly, the decision has caused upheaval and been extensively reviewed by corporate scholars. See, e.g., John C. Coffee, Jr., Court Has a New Idea on Directors' Duty, 1992 NAT'L L.J. 18 (1992); Lipson, supra note 1, 1208-12; Barondes, supra note 12, at 63-83; Cieri et al., supra note 12, at 417-20; Rima F. Hartman, Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?, 50 WASH. & LEE L. REV. 1761 (1993); Jelisavcic, supra note 56, at 153-58; McDonnell, supra note 53; Morris, supra note 12; Rao, supra note 12; Lin, supra note 55, at 451-56; Roberts, supra note 12, at 286-90; Varallo and Finkelstein, supra note 12; Daniel J. Winnike, Credit Lyonnais: An Aberration or an Enhancement of Creditors' Rights in Delaware?, 6 No. INSIGHTS 31 (1992). The new view of directors' fiduciary duty outlined in Credit Lyonnais was successively confirmed by the decisions in Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992); Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group (In re Buckhead Am. Corp.), 178 B.R. 956, 968 (D. Del. 1994); Brandt v. Hicks, Muse & Co. (In re

has overlooked, however, is that a corporation does not need to be in financial distress (i.e., "in the vicinity of insolvency") for the risk of managerial opportunism to arise. As discussed above, ⁶¹ as long as a firm has outstanding debt, its managers will have incentives to behave opportunistically. Financial distress would merely increase such incentives. ⁶² Therefore, in contrast to most commentators, I argue that the problem with the Credit Lyonnais opinion does not lie in the uncertainty of the vicinity of insolvency standard, ⁶³ but rather in that this opinion still conceives of the duty to creditors as *shifting* upon a determined condition (or its vicinity). If the need for such duty is justified by the risk of managerial opportunism, as the Lyonnais court seems to suggest, creditors should

Healthco Int'l, Inc.), 208 B.R. 288, 300 (Bankr. D. Mass. 1997); Miramar Res., Inc. v. Schultz (In re Schultz), 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997); Official Comm. of Unsecured Creditors of Hechinger Inv. Co. of Del. v. Fleet Retail Fin. Group (In re Hechinger Inv. Co. of Del.), 274 B.R. 71, 89 (D. Del. 2002).

⁶¹ See *supra* Part I, Par. 2.2.

⁶² See, e.g., David A. Skeel, Jr., Corporate Anatomy Lessons, 113 YALE L.J. 1553 (2004); Barry Adler, A Re-Examination of Near-Bankruptcy Investment Incentives, 62 U. CHI. L. REV. 575, 576-77 (1995); Katherine H. Daigle & Michael T. Maloney, Residual Claims in Bankruptcy: An Agency Theory Explanation, 37 J.L. & ECON. 157, 157 (1994); Lin, supra note 55, at 1488-91; Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. PA. L. REV. 669, 684 (1993), But see Barondes, supra note 12, at 48-63, Barondes argues that covenants directly restricting the firm's investment policy, in concurrence with financial covenants that indirectly do so, deter excessive risk-taking by financially-distressed firms. For a discussion of the problems affecting investment policy restrictions, see supra Part I, Par. 2.2. As to the role played by financial covenants, instead, Barondes' analysis seems to neglect that, in most cases, creditors' threat of accelerating the loan might harm rather than benefit them by leading to a paralysis of the cash flaws production. As a result, such a threat would tend to be not very credible and rather ineffective in preventing overinvestment. It seems, therefore, unlikely that "creditors of firms that are nearly insolvent ... may have an incentive to cause the covenants to be triggered." As a matter of practice, creditors cover the risk of a downfall in the interest rate applied to debtors' loans through other legal instruments, such as hedge contracts. In addition, the empirical data offered by Barondes would not be decisive in proving the lack of incentives to overinvest of financially distressed firms' managers. What matters is not that "only forty-six percent [in a survey of reorganized or liquidated firms] ... 'had made acquisitions or started new ventures", but rather which was the average level of asset substitution undertaken by this forty-six percent. As previously discussed, creditors would not be able distinguish between good and bad firms, but tend to price debt by pooling firms together and calculating the average risk. Thus, that forty-six percent (which, anyway, does not seem a low number) would, in fact, have determined an increase in the cost of debt for all firms. See supra Part I, Par. 2.2.

⁶³ Most of the criticisms moved against the Lyonnais decision have focused on the "vicinity of insolvency" standard, arguing that it creates uncertainty and ambiguity both as to its timing and scope. *See, e.g.,* Lipson, *supra* note 1, at 1208 (holding that "Credit Lyonnais moved beyond the event/condition paradigm to an unmapped (perhaps unmappable) coordinate"); Conaway Stilson, *supra* note 53, at 64 (claiming that imposing such a duty on directors of "nearly insolvent corporations provides fertile ground for Monday-morning quarterbacking by competing corporate constituencies"); Schwarcz, *supra* note 55, at 672 (claiming that the vicinity of insolvency standard is too difficult to define and evaluate); Barnett, *supra* note 60, at 465 (defining the vicinity of insolvency standard as "fuzzy concept"); Rao, *supra* note 12, at 62-64 (taking of the vicinity of insolvency standard as "a phrase without any clear significance").

be entitled to it beginning with the signing of the credit agreement, because directors' incentives to behave opportunistically start in that moment.

2.2. The Inadequacy of the NPV Test

The major flaw of Credit Lyonnais, however, is the test of directors' liability it suggests. Pursuant to the analysis carried out by the court, to avoid liability to creditors, directors of distressed corporations should undertake only corporate projects with a positive net present value (NPV).⁶⁴ In the court's opinion, by barring investments that might reduce the overall value of the firm, such a liability rule would "maximize the corporation's long-term wealth creating capacity."⁶⁵ I argue, by contrast, that not only does the NPV test fail to maximize corporate value, but it is an inadequate test of directors' conduct. There are three basic reasons for my claims. First, the NPV test does not consider the effects that a change in the investment's level of risk may have on creditor value. Second, it ignores the option value that is (almost always) embedded in corporate investments. Third, it neglects the fact that creditors do accept a certain investment's risk at signing.

Changes in the risk level of corporate projects might transfer wealth from creditors to shareholders even though these projects have the same net present value.⁶⁶ It is, indeed, apparent that an investment in a high-tech startup yields much different prospects for creditor value than an investment in government bonds although the face value of the two investments is the same. This holds true not just for risk-free investments, but for any change in the risk-level of corporate projects. The NPV test, then, is of no use for choosing among a range of opportunities having all the same gross value, but different volatility. More significantly, the test may result in inefficient corporate decisions. On the one hand, the test may promote, rather than deter, managerial

⁶⁴ Credit Lyonnais, *supra* note 4, at 1156, fn. 55. The court's hypothetical illustrating the NPV test assumes a solvent corporation with a sole asset, an appeal judgment for \$51M, and outstanding bonds for \$12M. The decision's possible outcomes include a 25% chance of affirmance, a 70% chance of a payment of \$4M, and a 5% chance of reversal, resulting in an expected value of litigation of \$15.5M. The company directors, however, also receive two different cash offers to settle, respectively for \$12.5M and \$17.5M. Pursuant to the court's test, directors that consider "the community of interests that the corporation represents", rather than the sole shareholders' interests, would "accept the best settlement offer available providing it is greater than \$15.55 million", that is, any offer increasing the overall firm value.

⁶⁵ *Id.*, at 1157.

⁶⁶ In similar terms, see also Morris, *supra* note 12, at 64-7.

opportunism since it induces directors to pursue projects with a high NPV regardless of their risk profile.⁶⁷ On the other hand, by overlooking the option components of corporate investments, the test may lead to forfeiting valuable business opportunities. As well known to finance theorists, corporate projects can be better evaluated by looking at them as including hidden options (on timing, expansion, closing, flexibility, etc.), and by applying pricing theory to evaluate the implicit value of those options,⁶⁸ than by adopting traditional valuation theories, such as the NPV analysis. Indeed, even investment with a negative NPV may be profitable if evaluated through the real options technique of capital budgeting. ⁶⁹ Similarly, investments with lower NPV may actually be superior if their option components are taken into consideration. ⁷⁰

Finally, the NPV test fails to consider that creditors do accept a certain level of risk when they conclude their contract with the corporation, and that they price capital

⁶⁷ Imagine, for instance, that the possible outcomes of the appeal in the Lyonnais hypothetical include only a 35% chance of affirmance and a 65% chance of reversal. In this case, the litigation alternative would have an expected value of \$17.85M. Thus, pursuant to the NPV test, the company directors should reject both settlement offers and go to court. In so doing, however, the directors would effectively accept a bet having the 65% chance of wasting both shareholders' and creditors' investment. Not exactly what one would expect from a liability rule that, in the words of one eminent commentator, should "minimize the social waste from the perverse incentive to gamble on the doorstep of insolvency." See Coffee, *supra* note 60, at text following fn. 22.

⁶⁸ Option theory (OT), which begins with the development in 1973 of the Black and Scholes model to calculate the value of a stock option, individuates five fundamental determinants to evaluate an option: (i) value of the underlying asset, (ii) time to maturity, (iii) interest rate, (iv) exercise price, and (v) volatility of the underlying assets. See Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. Pol. Econ. 637 (1973). Since the development of the Black and Scholes formula, however, OT has been held relevant to almost any area of finance. For instance, by re-classifying shareholders of a firm that has issued debt as holders of a call option to buy back the firm's assets on the debt maturity, OT permits to illustrate the perverse incentives shareholders may have to increase the value of their option simply by increasing the volatility of the underlying assets. See generally RONAL J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 231-51 (1993). On real options, see also Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 616-39 (2003 ed.). Cf. also George Triantis, Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trust s in Commercial and Charitable Enterprises, 117 HARV. L. REV. 1102, 1103 (2004) (arguing that managerial flexibility, intended as option to switch, can prove very valuable). For an illuminating discussion on the application of OT to a wide range of legal subjects, see IAN AYRES, OPTIONAL LAW-THE STRUCTURE OF LEGAL ENTITLEMENTS (2005).

⁶⁹ AYRES, *supra* note 68, at 3. Consider, for instance, the case of a start-up company that to promote a new product decides to market it below cost. Although the original investment would have a negative NPV, it could still be worth pursuing if one considers the embedded expansion option it contains. By making the new brand known to customers, the company is, in fact, acquiring a call option to make follow-on investments which could be very profitable (as in the case in which the original product is successful or the relevant market suddenly expands) and that could otherwise be definitely lost.

⁷⁰ *Id*.

accordingly. In fact, anticipating the debt contract's inadequacy to prevent managerial opportunism, creditors also apply an extra premium over the interest rate they ask to cover themselves against the investment's underlying risk.⁷¹ Hence, to hold directors liable for the repayment of creditors' claims, as the Lyonnais court seems to suggest, would be wrong. As long as directors respect the risk accepted by creditors, they should not be held liable, not even in the case of a default on payment. Indeed, creditors are exante compensated for bearing that risk. From a real-option perspective, one could thus say that as long as directors pay for it, they can exercise whatever option is embedded in a corporate investment.

PART III

A NORMATIVE THEORY

The prior parts have individuated three basic problems in the current approach to corporate fiduciary law: (i) the inadequacy of the debt contract to govern the debtor-creditor relationship efficiently; (ii) the social costs that may derive from this inefficiency; and (iii) the incompleteness of the insolvency exception (or the financial distress exception) as a doctrine justifying the need for a directorial duty to creditors. To remedy these problems, I propose the adoptions of two legal instruments: a default duty of directors to creditors and a textualist interpretative regime of the debt contract.

1. Directors' Duty to Creditors

I agree with contractarians that the best way to enhance corporate welfare is to maximize shareholder value.⁷² However, as previously discussed, in a corporate governance system dominated by shareholder primacy, managerial opportunism and informational asymmetry may compromise the parties' ability to write good debt contracts.⁷³ To increase efficiency, I propose the adoption of a default rule of law imposing on directors a duty not to increase unilaterally the risk accepted by creditors in the debt contract (hereinafter, *creditors' accepted risk* or *CAR*).

⁷¹ See supra Part I, Par. 2.2.

⁷² Because of their position as residual claimants, shareholders have indeed the best incentives to make discretionary decisions. See EASTERBROOK & FISCHEL, *supra* note 17, at 67-8.

⁷³ See *supra* Part I, Par. 2.2.

According to the Coase theorem, in a world of symmetric information and zero transaction costs, there would be no need for a default duty of directors to creditors. Regardless of the initial distribution of legal entitlements, parties would be able to remedy privately the negative externalities arising under the current corporate governance system. In the real world, however, the manager-creditor relationship is characterized both by high transaction costs and asymmetric information. Hence, the initial distribution of legal entitlements does matter to enhance efficiency. In this context, a duty of directors to creditors would serve to: (i) deter managerial opportunism; (ii) remedy the current lack of managers' incentives to disclose information;⁷⁴ and (iii) make credible the information disclosed by managers to creditors.

Managers are the parties in the best position to evaluate the hidden options of an investment, including increasing the investment's risk ex-post. However, to avoid expropriation of creditor value, managers (i.e., debtor companies) must pay for the exercise of these options. This requires that they disclose credible information to creditors. Only in this way can creditors adequately price the option(s) to be purchased by managers (i.e., debtors). The proposed duty makes directors personally liable to creditors if they fail to do so and exercise an option for which they have not paid. In particular, the liability threat arising from the existence of the duty would serve to produce three beneficial effects. First, it would discourage managers from undertaking courses of actions that maximize share value by expropriating creditor value. Second, it would give managers incentives to disclose information to creditors and to complete the debt contract, both at bargaining (ex-ante) and after the contract is signed (ex-post). Because under the proposed rule managers must abide by the level of risk specified in the debt contract, if they fail to disclose relevant information to creditors, they risk wasting good business opportunities. To avoid liability, they would be forced to give up all those investment options that have not been negotiated with creditors. Hence, managers would opt for disclosure. Third, the liability threat would serve as a mechanism to signal credible information to creditors. Knowing that directors bear personal losses for the breach of the duty, creditors would deem credible the information disclosed by

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⁷⁴ As it will be hereinafter discussed, directors would be induced to disclose information both as effect of the duty and of the textualist interpretative regime of the debt contract. *See infra* Part III, Par. 3.

directors.⁷⁵

The duty's overall effect would be to enable creditors to screen firms on the basis of their specific risk.⁷⁶ As a result, they would be able to negotiate better investment policy restrictions and could more effectively control the investment's risk.⁷⁷ More importantly, in competitive markets, the larger availability of information on corporate risk would promote a more efficient mechanism of debt pricing. Creditors would tend to move from a pooling equilibrium, in which they price debt on the basis of the average risk increase pursued by firms, to separating equilibria, in which debt pricing is determined by the marginal risk of firms.⁷⁸ Finally, a default duty of directors to creditors would lead to a better allocation of credit capital and, therefore, reduce the social costs discussed above.⁷⁹

Still, one could argue that there would be no need for the law to supplement in this fashion the terms of the debt contract since private negotiation would be sufficient to remedy inefficiency. Creditors could buy out directors' liability and the same efficient outcome would follow. The problem with this view is that creditors would not incur additional transaction costs to prevent a risk (i.e., managerial opportunism) for which they can be ex-ante compensated by increasing the cost of debt. In fact, even the imposition of a default duty to their benefit might not be enough to give creditors incentives to move from one market equilibrium to the other. As a matter of financial theory, the creditors' payoffs in pooling or separating equilibria are the same. ⁸⁰ Thus, to

⁷⁵ This is the reason why, absent the duty, the attempt of good firms' directors to achieve separating equilibria by disclosing information to creditors would not work. Because of the asymmetric information problem, creditors would not be able to recognize that these directors are *good directors*. Neither could creditors rely on a bonding mechanism inducing directors to be good. As a result, they would not deem credible the information disclosed by directors.

⁷⁶ Alternative instruments to induce creditors' screening are the debtor's posting of security or grant of guarantees. Unlike the duty, however, these are limited resources. *Cf.* Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 CORNELL L. REV 1396, 1415-17 (1997) (denying that an inefficient pooling equilibrium would apply as to secured and unsecured borrowers).

 $^{^{77}}$ Even though there would still be *bad firms*, which contract for a certain level of risk and then undertake riskier projects, the threat of a personal liability of directors would reduce their number.

⁷⁸ *Cf.* Schwartz, *supra* note 76, at 1416 (arguing that as long as unsecured borrowers could disclose information to creditors a pooling interest rate would not apply).

⁷⁹ See *supra* Part I, Par. 2.2.

 $^{^{80}}$ For a general but rigorous treatment of the microeconomics of the matter, see MAS-COLELL ET. AL., *supra* note 9, at 462.

achieve a Pareto improvement in the market equilibrium, some other incentives must be provided besides those arising out of the competition among creditors. As I will claim in detail thereinafter, the adoption of a regime of textualist interpretation of the debt contract, paired to the duty's adoption, would provide the right incentives.

2. Contract and Duty: The Bonding Mechanism Function

As a default rule of law, the actual scope and content of the proposed duty to creditors would be determined by the parties' negotiation. Parties themselves would set the boundaries of the duty depending on the level of risk they agree upon in the debt contract. From this perspective, the duty would serve, essentially, as a bonding mechanism giving directors incentives *to stay in the contract*. In this sense, I offer a new contractarian perspective of directors' duty to creditors. As advocated by contractarians, under the fiduciary model I propose, directors' obligations to creditors are determined by contract. The existence of a default duty, however, would remedy the debt contract's inefficiency that the contractarian analysis neglects to consider. On the one hand, this fiduciary paradigm would deter managerial opportunism and give directors incentives to disclose information. On the other, since the violation of the contractual provisions establishing the duty would constitute a breach of the duty itself, it would induce managers to fulfill the contract. This would reduce monitoring costs. Being able to rely on the incentives provided by the duty, creditors would need to spend less to verify directors' performance. Also for this reason, the cost of credit capital would decrease.

Hence, my proposal would make the parties able to devise the best allocation between risk, policy restrictions, and cost of capital. Accordingly, contracting parties would determine privately what scope the duty should have to maximize the value of their exchange. For instance, they could provide for a different scope of the duty depending on the financial conditions of the company. Until the company is a going concern, directors would be free to pursue any kind of investment they may like. If the

⁸¹ By imposing on directors to bear personal losses for the breach of the contractual provisions on creditors' accepted risk, the duty would guarantee creditors from directors' misbehavior. On the incentive function of bonding mechanisms, see Jensen & Meckling, *supra* note 22, at 308.

⁸² Provided that a default on payment occurs as a result of the breach of the duty; see infra Part III, Par. 3.

company started to experience financial distress, directors would then be held to the respect of some financial parameters. With the same logic, contracting parties could agree that directors are free to pursue risky projects even when the corporation is "in the vicinity of insolvency". The question would simply be how much the creditor(s) would ask to sell this kind of option (i.e., to bear the higher risk that this option would imply). More generally, three basic scenarios could be individuated as to the contractual determination of the duty to creditors:

- (i) on a (purely) theoretical level, the debt contract could be silent as to the risk accepted by creditors, meaning that it might contain no protective or restrictive covenants. In this case, directors would be free to pursue any project they may like. Indeed, under a regime of textualist interpretation of the debt contract (which will be hereinafter discussed in details), creditors would be presumed to have accepted any kind of risk in such theoretical circumstances;
- (ii) the debt contract could specify the level of risk accepted by creditors and, therefore, set the limits of the duty. In this case, the law would supplement the obligations undertaken by the company, as subscriber of the debt contract, with a side obligation of directors. Thus, in a way, directors could be regarded as guarantors of the company's obligations as to creditors' accepted risk;
- (iii) the debt contract could specify the level of risk accepted by creditors, but at the same time establish an exculpatory clause for directors' liability to creditors. In this case, as in the first, directors could never be held liable for breach of the duty. Here, however, the company would still be liable to creditors for breach of the contract; while in the first case, both the directors and the company would be exempted from liability.

Under this view, the insolvency exception would no longer apply. The duty to creditors would not shift upon corporate insolvency or financial distress, but be determined by the parties at the conclusion of the debt contract. Indeed, not only do I claim that the insolvency exception is an incomplete doctrine of the duty to creditors, but also a misleading one. It is incomplete because, as previously discussed, ⁸³ it neglects that directors' incentives to behave opportunistically arise in the same moment in which the company incurs indebtedness. It is misleading because it implies that directors owe the

⁸³ See *supra* Part II, Par. 2.2.

same duties to shareholders and creditors. This creates uncertainty and exacerbates the intrinsic conflict between these two classes of stakeholders.⁸⁴ Hence, this proposal does not impose on directors any obligation to maximize creditor value,⁸⁵ but the different one of respecting the investment's risk agreed upon in the debt contract by the parties' themselves.

3. The Enforcement of the Duty to Creditors and the Need for a Textualist Interpretative Regime of the Debt Contract

Because the contract itself determines the actual scope and content of the duty, establishing whether directors are liable to creditors becomes essentially a matter of contractual interpretation. More specifically, the enforcement mechanism of the duty entails two different interpretative steps. The first is to determine the risk agreed upon by the parties. The second is to understand whether directors have increased that level of risk ex-post (i.e., after the signing of the credit agreement).

As to the first step, it must be initially observed that creditors always accept the investment's systematic risk, which they automatically discount at the conclusion of the debt contract. Thus, directors do not owe creditors a duty as to this type of risk. To say otherwise, would mean requiring directors to guarantee the repayment of creditors' claims, which is not the purpose of the duty. Thus, creditors who finance a car manufacturing company always accept (and discount) the risk of failure determined by a car industry crisis. Consequently, they could never sue directors for the company's default due to such circumstances. Similarly, creditors accept the specific risk of failure; for instance, the risk that the car manufacturing company may default on payment because of the poor sales of a new line of cars. However, unlike the case of the systematic risk, creditors may limit the investment's specific risk by contract. For

⁸⁴ See *supra* Part I, Par. 2.1.

⁸⁵ As previously discussed, this would lead to a policy of underinvestment which would ultimately compromise the maximization of corporate welfare. *Id.*

⁸⁶ See *supra* the discussion at text following note 71.

⁸⁷ As long established under the CAPM theory, devised by Stanford Professor William Sharpe and Harvard Professor John Lintner, an alternative way in which creditors may limit the specific risk they bear is through the diversification of their investments. *See* John Lintner, *The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budget*, 47 REV. ECON. & STAT. 13 (1965);

instance, the creditors of the car-manufacturing company could negotiate an investment policy restriction against the undertaking of new lines of business. By so doing, they would rule out the risk that the directors may decide to reconvert the company's production into aircraft manufacturing and fail to repay the debt because of this undertaking.

To individuate the specific risk accepted by creditors, I suggest that the contract should be interpreted literally. This means, in the first place, that creditors should be deemed to have accepted (and discounted) any kind of (specific) risk that they have not expressly excluded or contractually limited. In this way, both parties would have an incentive to bargain for the best allocation of risk. Indeed, a textualist interpretative regime would prompt a Nash bargaining between directors and creditors ultimately leading to optimality. Because under such a regime creditors would bear the unspecified risk, they would have incentives to specify the risk they accept. Directors, on the contrary, would seem induced to conceal information and specify less. In this way, they could indeed limit their liability and reserve investment options. At a closer look, however, directors would also be incentivized to specify the contract. 88

Imagine this negotiating sequence. At the parties' kick-off meeting, the managers illustrate a business plan that is rather generic. Being aware that they are presumed to accept any risk that is not limited by contract, creditors would seek to impose restrictions on the firm's investment policy. However, lacking information on the actual risk of the investment, they would draft general covenants, which are low state-contingents on the external state (i.e., the corporate activity). This would result in the exclusion of a large set of investment opportunities and, therefore, broaden directors' liability. Hence, at the drafting session, rational managers would ask for some modifications of the general

William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk*, 19 J. FIN. 425 (1964). The incentive scheme provided by the CAPM model, however, does not promote contractual efficiency. Under such a theory, creditors have indeed no incentives to expend resources to write better contracts, since they can diversify their risk away simply by investing in different classes of capital assets.

⁸⁸ Besides the incentives arising out of the imposition of the duty to creditors and the textualist interpretative regime, directors would be induced to disclose information to avoid the imposition of excessively high interest rates. Where creditors were completely uninformed as to the risk affecting the debtor company, they would presumably charge an interest rate so high that good firms directors could decide to make different capital structure choices. On the contrary, bad firms would still borrow. As a result, an adverse selection problem would take place.

covenants. In order to obtain such modifications, however, they would be forced to disclose credible information to creditors. Because of this interaction, parties would write contracts as state-contingent as possible. The availability of information on the investment's risk would have parties to negotiate for detailed contractual provisions, which would be effective in preventing managerial opportunism without imposing excessive restrictions on the firm's investment policy. This would maximize the utility of both parties. Debtors would benefit from a reduction of both the interest rate applied to debt⁸⁹ and opportunity costs. Creditors would be ex-ante compensated for the exercise of the investment's hidden options that managers intend to exercise. Finally, the specification of the contract would induce creditors to price debt on the basis of such specification rather than through a pooling mechanism. In this way, some efficiency could be reached.

A regime of textualist interpretation would also mandate to read restrictively the contractual provisions that specify creditors' accepted risk (i.e., the CAR provisions). As pointed out by Professor Schwartz together with Professor Scott, 90 contractual clauses should be interpreted on a narrow evidentiary base, which essentially includes solely the contract itself. 91 Moreover, it should be assumed that these clauses are written in the *majority talk*, i.e., in the "language that people typically use when communicating with each other." 92 The reason explaining why contractual terms should be read restrictively is that contracting parties have more and better information on the substantive terms of their exchange than any other party. 93 Hence, they are in the best position to assess the relative

⁸⁹ Even assuming that the described mechanism should not lead to a reduction of the interest rate, it would still promote efficiency. The reduction of opportunity costs determined by the negotiation of more state-contingent covenants would, indeed, produce this result.

⁹⁰ See Schwartz & Scott, supra note 5.

⁹¹ *Id.*, at 572. More specifically, Schwartz and Scott individuate the evidentiary base to be allowed in a strict textualist approach in: (i) the contract, (ii) an English language dictionary, and (iii) the interpreter's experience and understanding of the world.

⁹² *Id.*, at 570.

⁹³ Not only some of the parties' information would not be observable by the third adjudicator, but, even when observable, it would not be verifiable. This means that the third adjudicator could observe the information, but could not verify its existence at reasonable costs and with reasonable accuracy. As a result, the adjudicator would be unable to enforce parties' obligations on the basis of such information. *See* Eggleston et al., *supra* note 10, *at* 119-20 (considering the case of a long-term contract for the delivery of some perishable goods, in which the parties agree that the goods to be delivered must be of some standard

costs and benefits of their relationship and allocate contractual rights so to maximize the value of their exchange.⁹⁴ From this perspective, any contractual interpretation not conforming to the letter of the contract would risk altering the distribution of rights agreed upon by the parties and, in turn, reducing the expected value of their exchange.⁹⁵ In particular, in the case of the managers-creditors relationship, broadening the evidentiary base of contractual interpretation would lead to a managerial policy of underinvestment. If the CAR could be determined on the basis of the courts' subjective interpretation of the parties' intentions, rather than the letter of the contract, managers would be so concerned over the possibility of a judicial error that they would avoid taking risk altogether. Because corporations need to take risks to prosper, this would jeopardize the maximization of corporate welfare. In addition, parties could exploit the risks implied by the third adjudicator's ex-post completion of the debt contract and engage in strategic behaviors. 96

In this context, the second interpretative step of the duty's enforcement, understanding whether directors have increased creditors' accepted risk ex-post, requires essentially an analysis of the CAR provisions. Because creditors accept any risk they do not contractually exclude or limit, directors can be held liable to creditors only if they violate one of these clauses. In this sense, the breach of a CAR provision is a necessary condition for the enforcement of the duty to creditors. However, it is not also a sufficient condition. To be able to claim directors' liability, creditors must also be damaged by the conduct of directors. For instance, suppose that a restrictive covenant prohibits firm A from investing in project x, which creditors consider too risky. Regardless of the covenant's provision, the company's directors decide to invest in the project. Project x, however, performs well and the company is able to meet its payment obligations. In such

quality. At a certain point the buyer refuses the goods, claiming that their quality is substandard. By the time the court settles the dispute, the court will most likely be unable to verify the quality of the goods because of their perishable nature. And, even if the goods had not yet perished, a court might not be able to distinguish a good of standard quality from one of substandard quality due to lack of specific expertise.)

⁹⁴ See supra note 13. See also, in similar terms, Robert E. Scott, The Case for Formalism in Relational Contract, 94 Nw. U. L. REV. 847, 864-65 (2000).

⁹⁵ In these terms, see, e.g., Schwartz, supra note 13, at 271; Schwartz & Scott, supra note 5, at 549.

⁹⁶ Indeed, under the current regime, the uncertainty surrounding legal procedures would induce creditors to prefer out of court settlements. See supra note 39. As a consequence, borrowers might attempt to profit from this tendency of creditors to seek more favourable contract's terms.

a case, although the company would be liable to creditors for breach of the contract, directors would not.

Under this view, it would be necessary to draw a distinction between two different kinds of contractual clauses. On one side, there are the CAR provisions, which fix the risk accepted by creditors. On the other, there are provisions setting the terms of repayment of debt. The violation of just one type of contractual provisions does not entail the breach of the duty to creditors. Directors cannot be held liable when the default on payment is not due to the violation of the CAR. In the same way, directors would not be liable when the violation of the CAR is not followed by a default on payment. Only when a payment obligation is violated following the breach of a CAR provision, would directors be liable to creditors. Indeed, even if creditor value could be depreciated before the actual default on payment, giving creditors the right to enforce the duty prior to the occurrence of such an event would create uncertainty. ⁹⁷ Creditors, however, could always trigger the contract for breach of the CAR provision and seek compensation from the corporation.

4. Exemption from Liability

Under the proposed model, directors would have several options to negotiate an exemption from liability. First, as anticipated above, they could negotiate exculpatory clauses from liability. This does not mean that directors could undertake any kind of project they choose. The debt contract could still impose limits on the management of the firm's investment policy. However, directors would not be personally liable to creditors for the breach of such investment policy restrictions. Second, should they want to reserve further options to increase the level of risk agreed upon in the debt contract, ⁹⁸ directors would have two alternatives at their disposal. They could bargain for a contractual right

⁹⁷ To establish ex-ante (i.e., before a default on payment) whether the depreciation of creditors' claims has been determined by the breach of the duty (i.e., of the CAR provision) or other macro-economic variable would, indeed, be very difficult.

⁹⁸ Practically, managers would reserve an option to negotiate for future options. Under this view, the debt contract would serve to provide for general criteria regulating the future negotiation of the parties. In *optional language*, the parties would fix criteria establishing how future options should be priced.

either to renegotiate the credit agreement's terms or to exit the relationship through a debt refinancing.⁹⁹

This set of options to avoid liability would not impair the system of incentives provided by the proposed duty as to the disclosure of information. Indeed, in seeking exculpatory clauses, managers would disclose information. Above all, opting out of the duty would have an intrinsic informational meaning. Creditors would evaluate and price the project's risk also on the basis of the directors' request for an exculpatory clause. Similarly, in order to renegotiate contractual terms for engaging in riskier corporate strategies, directors would be forced to reveal further information. This set of liability exemptions would also avoid the risk that the duty might result in an over-conservative managerial investment policy. The exemptions from the rule would serve as additional contractual instruments the parties would have at their disposal for devising the best allocation between investment's risk and cost of capital.

From this perspective, directors' discretion in the firm's management would increase, while uncertainty in legal relationships would be reduced. Unlike in the current corporate fiduciary law model, directors of financially distressed firms should no longer be concerned as to the actual beneficiaries of their fiduciary duties or the undertaking of excessively risky corporate projects. Regardless of the financial conditions of the corporation, directors would be free to pursue whatever strategy they might deem beneficial, as long as they (i) respect the CAR; or (ii) bargain for exculpatory clauses from liability; or (iii) engage in re-negotiation of the agreement's terms (or buy-out such

⁹⁹ In other terms, the parties could provide for buy-out agreements giving the debtor the right to exit the relationship with the creditors by refinancing the project.

¹⁰⁰ In the case of the negotiation of exculpatory clauses, creditors would face a risk that directors could disclose false information. Even in the absence of personal liability, however, the risk of reputational capital depreciation would discourage directors to act in this way. In addition, creditors could bargain for a bonding mechanism designed to ensure the truthfulness of directors' information.

¹⁰¹ From this perspective, the duty would also reduce the risk of strategic behaviors of the parties during renegotiation. Absent the bonding mechanism offered by the duty, instead, creditors would not be able to renegotiate intelligently since they could not adequately estimate the value of the riskier project(s) that managers want to undertake. *See* Myers, *supra* note 28, at 158.

a right). As a result, the duty would exclude that the fear of liability's exposure might impair managers' decision-making when their resolute action would be most needed. ¹⁰²

5. The Distinction between Capital Providers and Other Fixed Claimants

Although the discussion on the proposed duty has so far referred generally to corporate creditors, not all the firm's fixed claimants would actually need being attributed such a duty. Essentially, by corporate creditors, I mean the firm's capital providers. In their case, the attribution of the duty would be justified by the need for modifying the current distribution of legal entitlements to enable parties to write better contracts. Instead, in the case of other fixed claimants, the law would already attribute express rights to solve the potential inefficiency arising from the creditors' relationship with the corporation. Labor law, for instance, is the legal instrument designed to solve the inefficiency of the employment contract.

In addition, other fixed claimants' contractual relationship with the corporation would be characterized by a lower *transactional insecurity*. ¹⁰⁴ The expression describes the situation that may arise when the parties' performances take place sequentially. When one party performs before the other, she may risk that the counterparty may deny her the benefit bargained for in return. In lender-borrower relationships, this risk is elevated since the lender carries out in full her side of the exchange before the debtor. In contrast, in the case of other fixed claimants, for instance trade creditors, this risk is limited by the fact

¹⁰² This was one of the main critiques raised against the vicinity of insolvency standard proposed in the Credit Lyonnais decision. See, among others, Rao, *supra* note 12, at 58, 66 (adducing empirical evidence to confirm that, under the vague Credit Lyonnais regime, directors of financially troubled companies would prefer to terminate their office rather than face the liability's exposure. Thus, nearly-insolvent companies would risk "go[ing] bare" in the moment in which they need the resolute action of their managers most. In addition, the prospect of such "poorly defined, potentially large liability" would "chill directors' exercise of their business judgment when confronted with difficult choices." Indeed, directors may "feel constrained to make overly-conservative decisions when they are unsure whether their corporation is in the 'vicinity of insolvency."). In similar terms, see McDonnell, *supra* note 53, at 180 (arguing that "[d]irectors ..., fearing the imposition of personal liability, may be hesitant to accept or remain in their positions.) *See also* authors quoted *supra* at note 12.

¹⁰³ I do not share the view that remedial redundancy would, in fact, not be a problem. See Lipson, *supra* note 1, at 1256. I argue instead that the overlapping of different causes of action would create uncertainty and, therefore, compromise efficiency. *See also supra* Part I, Par. 2.2.

¹⁰⁴ The expression transactional insecurity is borrowed by Professor Kronman. *See* Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 5, 6 (1985).

that they usually provide their service/goods on a short-term basis. ¹⁰⁵ If the debtor defaults on payment, they can simply stop providing the services or good and take their business elsewhere. ¹⁰⁶

A further line, then, should be drawn among the same capital providers. Because of both economic and organizational advantages, banks would be more able than bondholders to write good debt contracts. Thus, at the margin, bondholders would benefit more from the attribution of the proposed duty than would banks. The problem of the shortage of available information, which represents the main cause of contractual inefficiency, would be more pressing in the case of bondholders. Indeed, they would not have the same ability as do banks to obtain and process information. Banks are often specialized in providing funds to companies in specific industries, which gives them a qualified knowledge of the trends and developments in the debtor's business. As a result, not only do banks tend to have more information than bondholders, but also to be in a better position to assess the firm-specific and industry-specific risk. Furthermore, to obtain information, banks could use economic and political means that bondholders would not have at their disposal.¹⁰⁷

Still, it could be argued that the information released in the bond prospectus and that provided by rating agencies would be sufficient to ensure a "fairly high level of disclosure." This analysis, however, overstates both the quality of the information

¹⁰⁵ In fact, trade creditors bear a risk of insolvency limited to the payment of the last supply provided to the firm. And they bear this risk independently from the undertaking by the management of asset substitution investments. The company managers could simply wake up one day and decide they prefer the goods or services supplied by another trade creditor. Under this view, the distinction between less and more sophisticated trade creditors would matter to a limited extent. *See* Lipson, *supra* note 1, at 1248-49. In both cases, the short term of credit would limit the damage suffered by the creditors.

¹⁰⁶ The position of trade creditors, however, should be regarded differently when their relationship with the corporation has an idiosyncratic nature. By idiosyncratic relationships, I mean those where one of the parties makes investments that have limited redeployability to alternative uses (i.e., specific investments) and is, therefore, subject to a significant risk of opportunistic behavior by the counterparty. In the case of trade creditors, they may well specialize in providing services/goods that are exclusively tailored to a particular corporation. Under these circumstances, then, their position would be assimilable to that of the firm's capital providers. Imagine, for instance, that a company has a sole supplier and also holds the sole right to its services. The supplier's investment is firm-specific, since its services are not recoverable once committed to the company. In such a case, the same reasons discussed above to justify the exclusion of the duty to trade creditors would impose to grant it.

¹⁰⁷ See Lipson, supra note 1, at 1249-50.

¹⁰⁸ Lipson, *supra* note 1, at 1250.

released to bondholders and the latter's ability to process it. Not only information contained in the bond prospectus is often not so material, ¹⁰⁹ but information provided by rating agencies tends to be assembled by putting firms in risk categories and calculating the average risk of that category. ¹¹⁰ Thus, in a way, rating agencies are responsible for the current pooling equilibrium between bad and good firms. Finally, the dispersive nature of the organizational structure of bondholders raises coordination problems which may impair their ability to process information and write good debt contracts.

6. Some Policy Considerations

An aspect of this proposal which might raise some difficulties is that of directors' liability insurance. It is indeed presumable that directors will seek some form of coverage against their potential liability to creditors, either requiring extra compensation or company-funded insurance. In this way, the ultimate cost of directors' liability would be borne by the company's shareholders. It could thus be argued that the liability threat would no longer serve to induce directors to disclose information since they would not have to pay for creditors' damages out of their own pockets.

I claim, instead, that directors' liability insurance would alter the incentive effects arising out of the duty to creditors only to a limited extent and not necessarily for the worst. Although they would not bear personal losses for the breach of the duty, directors

¹⁰⁹ See Mitchell, Corporate Bondholders, supra note 20, at 1181 (claiming that "the prospectus more restates than explains relevant bond terms and is always qualified by reference to the indenture.") Professor Mitchell also quote BREALEY & MYERS, supra note 68, for whom bond prospectuses, "like most legal documents, . . . review only the conditions and safeguards that exist and do nothing to draw your attention to any omission or unusual features."

Rating agencies classify risk categories on the basis of macroeconomic indexes, such as the debt-to-equity ratio, liquidity of the existing assets, dividend policy, etc. Normally, they do not offer more sophisticated information on the firm than the Wall Street Journal does. Credit markets, however, tend to price debt instruments consistently with the rating agencies' assessments.

¹¹¹ Company-funded liability insurance seems more likely. Indeed, the increase in the salary compensation that directors would demand if required to pay for the insurance cost would probably be unbearable. Moreover, the cost of insurance whether purchased directly by the company would presumably decrease, because of the higher bargaining power of the firm. In these terms, see Vanessa Finch, *Personal Accountability and Corporate Control: The Role of Directors and Officers' Liability Insurance*, 57 MODERN LAW REVIEW 881 (1994); Rainier Kraakman, *Corporate Liability Strategies and the Cost of Legal Control*, 93 YALE L. J. 857 (1984).

would still be subject to a significant reputational threat as a result of the liability rule. ¹¹² Indeed, I do not conceive of directors' liability as a compensatory means, even though in closely held corporations it could serve also this function. The duty to creditors is, instead, the legal tool inducing directors to disclose credible information to creditors. When directors are covered against liability, this basic function of the duty would be ensured by the reputational capital depreciation that would follow its breach. In addition, the risk-spreading effect of liability insurance would limit shareholders' preference for asset substitution investments. Their expected gains out of these investments would be reduced by the expected costs of directors' liability. Finally, liability insurance might have the positive effect of shifting part of creditors' monitoring costs to insurance companies. Insurance policies' terms might, in fact, be expected to provide for the monitoring of directors' conduct in a number of ways. Investigations of firms' financial conditions and past records, requests of periodical information, and recurrent assessments of insurance premiums are just a few examples.

More interesting is to understand the impact of the liability insurance on the choice of the corporate fiduciary model and capital structure. Depending on the effect of the liability rule on the cost of equity, directors would indeed shape their contractual relationships with creditors differently. If the increase in the cost of equity due to the liability insurance outweighed the reduction of the cost of debt determined by the liability rule, it is probable that directors would bargain for exculpatory clauses. On the contrary, if the reduction of the cost of debt more than compensated for the increase in the cost of equity, directors would find it profitable to maintain the liability rule. Simultaneously, the cost of liability/insurance would influence directors' decisions as to the firm's optimal capital structure. Indeed, the contractual arrangement achieved by the parties on directors' liability to creditors might change the proportion of debt and equity capital that maximizes firm value. The perspective, innovative finance could play an important role in devising hybrid financial instruments that would better reflect not only

Even in the absence of personal losses, directors engaging in asset substitution would be penalised by bad reputation once they return to the market to borrow again. The company would have to pay a higher interest rate to obtain credit and, in turn, directors' compensation would decrease.

¹¹³ This seems consistent with Smith and Warner's conclusion that "there is an optimal form for the debt contract, but an optimal amount of debt as well." Smith & Warner, *supra* note 11, at 154.

the risk of the underlying assets, but also the parties' distribution of entitlements and liabilities.

CONCLUSIONS

Creditors' rights should be governed by contract. Under the current model of corporate fiduciary law, however, managerial opportunism and informational asymmetry make the parties unable to write optimal debt contracts. This, in turn, leads to the inefficient allocation of credit capital.

To remedy the present inefficiency, I propose the adoption of two legal institutions: a default duty of directors not to increase unilaterally the risk contractually accepted by creditors and a regime of textualist interpretation of the debt contract. Such institutions would serve two basic functions: (i) discouraging managerial opportunism; and (ii) inducing managers to disclose credible information to creditors. As a result, a Pareto improvement in the credit market equilibrium could be reached.

By charging directors with personal liability for the ex-post increase of the investment's risk, the duty would bond managers to stay in the contract and prevent them from exercising investment options without compensating creditors. In addition, the double-system of incentives provided by the duty and the textualist interpretative regime of the debt contract would, respectively, induce directors to disclose credible information and creditors to specify the risk they accept. This would lead parties to write more state-contingent contracts and enable creditors to better evaluate the risk underlying corporate projects. Indeed, creditors could rely both on the disclosure of credible information and on directors' incentives to fulfill the contract arising out of the duty's existence. As a consequence of the more accurate evaluation of corporate risk, it would become possible to screen firms depending on their specific risk. Hence, the credit market would move from a pooling equilibrium, in which debt price is determined by the average risk increase pursued by firms, to separating equilibria. In this way, some efficiency would be reached.

This legal framework would also reduce monitoring and opportunity costs. The first would diminish because the duty serves as a bonding mechanism inducing directors to fulfill contractual obligations. Opportunity costs, instead, would be reduced by the

parties' ability to specify optimal investment policy restrictions, which would control the investment's risk without inefficiently constraining managerial discretion. Finally, the adoption of a textualist interpretative regime would also curb uncertainty and avoid the possible reduction of the expected value of the parties' relationship due to the ex-post completion of the contract by the third adjudicator.