Directors' Duty to Creditors and the Debt Contract

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Under the current model of corporate fiduciary law, informational asymmetry between managers and creditors makes the debt contract inadequate to efficiently govern the debtor-creditor relationship. More specifically, as currently devised, the debt contract fails to prevent managerial opportunism, that is, the managers' tendency to increase the investment's risk ex post. Anticipating this contract's failure, creditors ask for higher interest rates. Moreover, because of the scarcity of credible information, they tend to pool firms in general risk categories and price debt on the basis of the average risk increase pursued within each category. As a result, social costs arise and credit capital is inefficiently allocated.

A governance model providing for a permissive regime of directors' duty to creditors and a rule of textualist interpretation of the debt contract are the legal tools I propose to attempt to redress the existing contractual inefficiency. By sanctioning directors with personal liability for increasing the level of risk contractually accepted by creditors, the proposed duty would serve: (i) as a bonding mechanism to induce directors to fulfill the contract and refrain from managerial opportunism; and (ii) to make the debt contract a credible signal on corporate risk. Paired to the duty's existence, the adoption of a textualist interpretative rule, which mandates to consider accepted by creditors any risk they have not contractually excluded or limited, would (i) give both parties the right incentives to write more state-contingent contracts; and (ii) reduce uncertainty in legal relationships by ruling out the possibility of ex post completion of the contract (and of the duty itself) by the third adjudicator. Ultimately, the model I propose aims at achieving a two-fold purpose. On the one hand, it attempts to make the credit market better able to price debt on the basis of firms' specific risks, i.e., to move the market from the existing pooling equilibrium to separating equilibria. On the other, it aims at enabling parties to contract so as to maximize the ex ante value of their exchanges.
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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 the shareholder primacy rule. Thus, a fiduciary duty of directors to creditors has been traditionally denied in American corporate law but for one exception: the insolvent 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 duties 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 also should pursue


2. The decisions on the matter are copious. See, e.g., Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1519 (S.D.N.Y. 1989) (affirming that the rights of corporate debtholders are limited to those arising from the contract governing debtor-creditor relationships); Simons v. Cogan, 549 A.2d 300, 303–04 (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); Harff v. Kerkorian, 324 A.2d 215, 219–20 (Del. Ch. 1974) (dismissing bondholders’ derivative cause of action which alleged breach of directors’ fiduciaries duties on the ground that such duties do not exist).

3. Historically, the insolvency exception finds its origin in the so-called trust fund doctrine, under which directors’ duties shifted to creditors upon the company’s dissolution or the commencement of insolvency proceedings. See, e.g., Wood v. Dummer, 30 F. Cas. 435, 436–37 (C.C.D. Me. 1824) (No. 17,944). Courts, however, gradually started to recognize the mere insolvency of the company as the triggering condition of the duties’ shift. See, e.g., Bovay v. H.M. Bylesby & Co., 38 A.2d 808, 813 (Del. 1944). See infra Part II.A.1.

4. 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. See, e.g., Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 971 n.16 (Del. Ch. 2003), aff’d, 845 A.2d 1040 (Del. 2004).
the interests of other corporate constituencies, in particular that of company creditors.\(^5\)

In this essay, I argue that the problem of directors’ duty to creditors is basically a problem of contractual efficiency. Under the current paradigm of corporate fiduciary law, the debt contract fails to govern the debtor-creditor relationship pursuant to a welfare maximization criterion.\(^6\) This not only increases the cost of corporate borrowing, but also results in an inefficient allocation of credit capital. The main object of this work is thus to explore the legal tools that may help to enhance the debt contract’s efficiency. To this end, I propose adoption of a corporate governance model providing for a permissive regime of directors’ duty to creditors and a textualist interpretation of the debt contract.\(^7\)

My basic claim is that in a corporate governance system dominated by the shareholder primacy rule and in which managers’ compensation is often equity-based, informational asymmetry\(^8\) between managers and creditors makes the debt contract inadequate to prevent managerial opportunism.\(^9\) Being held to the exclusive maximization of share value and often holding themselves an equity interest, managers have weak incentives to disclose their private information to creditors. As a result, it is very difficult for creditors to negotiate contractual provisions that are

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5. See infra Part I.A.

6. 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.

7. The textualist approach to contract interpretation is so termed because it confines the action of the interpreter basically to the sole text of the contract. This approach is also termed “classical” or “Willistonian” as it was dominant in contract interpretation during the late nineteenth and early twentieth centuries and is often associated with the views of Professor Samuel Williston. See *Samuel Williston, A Treatise on the Law of Contracts* § 95, at 349–50 (Walter H.E. Jaeger ed., 3d ed. 1961) (“The court will give [written contract] language its natural and appropriate meaning; and, if the words are unambiguous, will not even admit evidence of what the parties may have thought the meaning to be.”). In contrast to the textualist approach, the contextualist approach to contract interpretation challenges the idea that express terms always represent the best evidence of the parties’ agreements, at least without an examination of the context of that agreement. Arthur Corbin and Karl Llewellyn are among the most distinguished representatives of the contextualist approach. See Arthur L. Corbin, *The Interpretation of Words and the Parol Evidence Rule*, 50 CORNELL L.Q. 161, 161–70 (1965) (observing that written words are intrinsically ambiguous); K. N. Llewellyn, *The Rule of Law in Our Case-Law of Contract*, 47 YALE L.J. 1243, 1243–44 (1938).

8. Informational asymmetry refers to the situation in which one party has more or better information than the other. This creates a power imbalance which may lead to a market breakdown. The term was introduced by George Akerlof in his seminal 1970 work *The Market for "Lemons": Quality, Uncertainty and the Market Mechanism*. See George A. Akerlof, *The Market for "Lemons": Quality, Uncertainty and the Market Mechanism*, 84 Q. J. OF ECON. 488, 489–90 (1970).

9. This is the tendency of managers, acting as shareholders’ fiduciaries, to increase the investment’s level of risk as the company incurs indebtedness (what in finance theory is referred to as asset substitution). See infra Part I.B.2.b. Asset substitution, however, is not the only form of managerial opportunism. The other two are claim dilution and dividend policy. Yet, I maintain that the debt contract is effective in governing the latter two forms of managerial opportunism, but fails to restrain the first one. See *infra id.* For this reason, whereas it is not differently specified, hereinafter, the term managerial opportunism indicates exclusively the managers’ tendency to engage in asset substitution.
effective in restraining managerial opportunism. In fact, under the present fiduciary law paradigm, managers might well be induced to conceal information to borrow at a lower cost and reserve a costless option to invest in riskier projects. Furthermore, even when managers disclose information to creditors, the latter tend to be reluctant to consider it credible, because they expect managers to act in the exclusive interest of shareholders.

The credit agreement's failure to deter managerial opportunism, however, is not a problem of a distributive nature, but rather allocative. Anticipating this failure, creditors charge higher interest rates. In addition, because of the lack of credible 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 pool firms in risk categories and price debt on the basis of the average risk increase pursued within that category. Consequently, problems of cross-subsidization and adverse selection arise, and credit capital is inefficiently allocated.

A default rule of law, imposing on directors a duty not to unilaterally increase the risk accepted by creditors in the debt contract (hereinafter, creditors’ accepted risk or CAR), is the first legal instrument that I propose for attempting to redress the current inefficiency of the debt contract. The basic assumption underlying the existence of the proposed duty 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. Under this view, the duty to creditors, sanctioning directors with personal liability for failing to respect the contract provisions on the CAR, would have two functions. First, it would serve as a bonding mechanism giving directors incentives to stay in the contract and not to exercise options they have not bought. Second, it would make creditors more inclined to rely on the information disclosed by managers. In other terms, the duty would transform the contract into a credible signal on corporate risk. As a result, creditors would become able to price debt on

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10. Cross-subsidization is the phenomenon occurring when one group pays a relatively high price and thus enables another group to pay a relatively low price. Applied to lending relationships, cross-subsidization takes place when good firms are forced by the suspicion of low-quality borrowing to pay higher interest rates than they would if the presence of bad firms was excluded. Adverse selection, instead, refers to a market process in which bad results occur due to information asymmetries between contracting parties so that bad products or customers are more likely to be selected. Applied to lending relationships, this means that bad firms are most likely to receive financing because they are more willing than good firms to bear the average increase of the cost of debt determined by the pooling equilibrium. See infra Part I.B.2.e.

11. A bonding mechanism guarantees one party (i.e., the principal) from the misbehavior of the other (i.e., the agent) by imposing penalties on the latter for shortfall in her performance. Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 308 (1976).

12. In finance theory, a credible signal is one that, in a situation characterized by informational asymmetry, provides accurate information and can distinguish among senders, i.e., among firms characterized by a different corporate risk. The concept of signalling was first studied by Michael Spence, who proposed to consider going to college as a credible signal for an employer who wants to hire an employee skilled in learning.
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the basis of the debt’s contract information and provisions, rather than by pooling firms in general risk categories. Economically, assuming competitive markets, the duty would ultimately induce the credit market to move from a pooling equilibrium to separating equilibria, in which debt is priced on the basis of the firm’s marginal risk.

The second legal tool that I propose to enhance contractual efficiency is a textualist interpretative rule mandating that courts consider creditors to have accepted any risk that they have not contractually excluded or limited. The adoption of such a rule would also have a two-fold purpose. First, it would induce both parties to write more state-contingent debt contracts. Second, it would eliminate the possibility of ex post completion of the contract and, therefore, of the duty (which is therein determined) by the third adjudicator. This, in turn, would reduce uncertainty in legal relationships.

Because creditors' payoffs in pooling and separating equilibria are economically the same, if we relax the competitive market assumption, the duty to creditors by itself might be a weak instrument to change the current mechanism of debt pricing. A textualist interpretative rule would thus be necessary to give also to creditors the right incentives to specify the contract. More specifically, I claim that the adoption of such a rule, together with the duty’s existence, would prompt Nash bargaining.


13. This is a crucial assumption. Perfect competitive markets are those in which “no individual or firm exercises monopoly power . . . and each participant acts as if demand were infinitely elastic at the quoted prices.” Stephen A. Ross, The Determination of Financial Structure: The Incentive-Signalling Approach, 8 Bell J. Econ. 23, 25 (1977).


16. Simply put, a Nash bargaining solution (or equilibrium) corresponds to the solution at which players make equal proportional sacrifices. In other words, it is that in which no single player, by changing her strategy, can obtain higher utility if the other players stick to their parts. In addition, the Nash solution satisfies a number of conditions that are appealing in their own right. Such a solution is, indeed, efficient (Pareto optimal), individually rational and (of course) feasible. See John F. Nash, Jr., Equilibrium Points in N-Person Games, Proc. Nat’l Acad. Sci. USA 36, 48-49 (1950); John Nash, Non-Cooperative Games, 54 Annals Mathematics 286 (1951).
between directors and creditors which would ultimately lead to an optimal level of specification of the debt contract. On the one hand, bearing any unspecified risk, creditors would have incentives to specify the risk they accept. On the other, directors would be induced to disclose more information to avoid general covenants, which would tend to exclude a large set of investment options and, therefore, broaden the area of their liability.

The adoption of a textualist interpretative rule, however, would serve also a second function. It would eliminate the risk of value-decreasing judicial errors in the enforcement of the debt contract. The basic assumption here is that because parties have more and better information on the substantive terms of their exchange, they are in the best position to devise the most efficient allocation of their rights and duties. The contractual determination of the duty to creditors makes no exception to this assumption. In fact, by leading to a re-determination of the duty’s scope by the third adjudicator, any contractual interpretation not conforming to the letter of the parties’ agreement would risk reducing the expected value of the parties’ exchange. Also for this reason, a textualist interpretative regime should be preferred over a contextualist one.\(^\text{17}\)

In Part I of this essay, I first offer a critical assessment of the dominant academic views of directors’ duty to creditors and then illustrate why the debt contract is unable to govern the parties’ relationship pursuant to a welfare maximization criterion. In particular, I explain why the organizational paradigm based on the shareholder primacy rule and managerial equity compensation schemes makes the debt contract inadequate to govern the investment’s underlying risk. I also explain how such inadequacy leads to an inefficient allocation of credit capital. In Part II, I discuss the positive elaboration of the duty to creditors as reproduced in the two most relevant judicial decisions on the matter, namely the *Credit Lyonnais*\(^\text{18}\) and the *Production Resources*\(^\text{19}\) opinions. In 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 *Credit Lyonnais* court is an inefficient test of directors’ liability. I then offer some preliminary comments on the *Production Resources* opinion, focusing, in particular, on the formulation of good faith elaborated by the court.\(^\text{20}\) In Part III, I expound my proposed new model of corporate fiduciary law. First, I describe the functions of the proposed duty to

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\(^{17}\) See Schwartz & Scott, supra note 6, at 572–75 (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) (noting 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).


\(^{20}\) Id. at 786–91.
creditors and clarify why a default rule of law, rather than the private contracting of the parties, is desirable to establish the duty. Second, I illustrate the proposed rule of textualist interpretation of the debt contract. I explain that such a rule would serve two basic purposes. On the one hand, it would prompt Nash bargaining between the parties leading to the optimal specification of debt contracts. On the other, it would also reduce uncertainty in legal relationships by banning subjective interpretations of the debt contract (and of the duty to creditors). Third, I set out the several options that the proposed model would offer to the company's directors for escaping liability. I also discuss why this set of exemptions would not impair the system of incentives provided by the model to induce directors to disclose more and credible information. Fourth, I illustrate how this model should work in practice and offer a basic taxonomy on the contractual determination of the duty to creditors. I then attempt to suggest a conceptualization of the duty based on the good faith fiduciary paradigm as recently elaborated in the Production Resources and the more recent Disney opinion. Fifth, I explain why only creditors that are capital providers should benefit from the proposed duty. Sixth, I make some policy considerations as to the effect of directors' liability insurance over the contractual determination of the duty to creditors and the firm's capital structure.

I. THE CURRENT STATUS OF THE DEBATE ON DIRECTORS' FIDUCIARY DUTIES TO CREDITORS

A. The Rather Different Views of Contractarians and Communitarians

Fiduciary obligation 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. Two dominant views have emerged from the
academic debate: 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. By contrast, communitarians claim that informational and bargaining disparities make non-shareholders unable to achieve self-protection through contract. In turn, they advocate a multifiduciary model where all corporate stakeholders benefit from the attribution of directors' fiduciary duties.

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 its diverse components by means of trust
and mutual interdependence. 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 for the sole purpose of maximizing their profits. From this perspective, the exclusive commitment of directors toward shareholders is viewed as the most efficient way to achieve the profit-maximization goal.

B. 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. 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.

1. The Inefficiency of the Multifiduciary 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 multifiduciary 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 under-


30. 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 of contracts emerged among economists. Among the seminal economic references, see R. 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); Jensen & Meckling, supra note 11.

31. See Hansmann & Kraakman, supra note 1, at 441.

invest. Under such a rule, 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 interests, they are so difficult to administer that they practically become no duties at all. Thus, should directors owe duties to all stakeholders, not only would they be able to exercise unfettered discretion, but they would also be 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.

Third, the multifiduciary model would tend to increase litigation because a larger 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 lawsuits 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

33. Consider, for instance, a corporation with outstanding debt for $500. The company's directors have the opportunity to pursue two different investment projects, Project 1 and Project 2. Project 1 has just one possible outcome where the corporation earns $900. Under this project, the expected value of debt is $500, which is equal to its facial value, and the expected value of equity is $400. Project 2 instead has two possible outcomes: (i) a probability of .8 of yielding $1500; and (ii) a probability of .2 of yielding $300. Thus, Project 2 has a higher NPV ($1,260) than Project 1 ($900). Under Project 2, however, the expected value of debt drops to $460, although the expected value of equity rises from $400 to $800. Under a legal regime that imposes on directors a duty to maximize debt value, Project 1 would be the choice to pursue. This, however, would lead directors to screen out many good investment projects and, therefore, reduce social welfare.

34. This is commonly known as the too many masters argument. Nevertheless, 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. The interests of these different classes of stockholders may conflict as may 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, An Economic Analysis, supra note 25, 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 directorial 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, 1292-96 (1991) (arguing that the increasing complexity of the corporate capital structure might challenge shareholder primacy in the future).


36. Under the current regime, only security holders, among the various nonshareholder constituencies, can pursue legal actions against directors by means of securities class actions in federal courts. Yet, even they cannot sue directors for breach of fiduciary duties.
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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 most likely create uncertainty and, therefore, generate more damage than benefits.

2. The Limits 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.\(^37\) I also claim, however, that under the current model of corporate governance, informational asymmetry between managers and creditors compromise their ability to write debt contracts that regulate the debtor-creditor relationship pursuant to a welfare-maximization criterion.\(^38\) More specifically, the parties' informational asymmetry makes the debt contract inadequate to restrain managerial opportunism, i.e., the managers' tendency to increase the investment's risk once the company has incurred indebtedness.

a. The Managerial Opportunism Problem

From an economic viewpoint, the managerial opportunism problem arises from the intrinsic conflict between shareholders and creditors.\(^39\) 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.\(^40\) The shareholder primacy rule, together with the practice of compensating managers through equity-based compensation schemes, would extend these incentives to managers.\(^41\) Theoretically, managers are more risk averse than the company equity

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\(^37\) Indeed, "[t]he core insight of [the] nexus-of-contracts paradigm is that contract defines each participant's rights, benefits, duties, and obligations in the corporate endeavor." Macey, Fiduciary Duties, supra note 25, at 1267.

\(^38\) See supra note 6.


\(^40\) The problem, however, is not only of distributive nature. In pursuing their interests, shareholders may well be willing to sacrifice the total firm value undertaking value-reducing actions. See Jean Tirole, The Theory of Corporate Finance 84 (2006).

\(^41\) See, e.g., Smith & Warner, supra note 39, at 118 (arguing that managers might behave opportunistically "acting in the stockholders' interest"); Myers, supra note 39, at 149 (referring to "a firm with risky debt outstanding, and which acts in its stockholders' interests"); Tirole, supra note 40, at 84 (stating that "[m]anagers and shareholders often have incentives to take actions that . . . redistribute wealth from lenders to managers
holders because they typically make specific investments in one firm and are, therefore, exposed to a significant risk of reputational capital depreciation for the failure of corporate projects. In addition, like creditors, they do not participate in the upside potential of corporate projects. Yet, I argue that the shareholder primacy rule, by making managers liable to shareholders, gives them incentives to pursue the latter’s interests even at the expenses of those of creditors. In the modern corporation, this tendency would be further incentivized by the widespread use of equity-based compensation plans, which align the interests of managers with those of shareholders.

Creditors, however, anticipating the risk that managers may act in the interest of shareholders to their detriment, specify ex ante contractual provisions to prevent such a risk. In particular, debt contracts are designed to regulate three main sources of conflict: (i) dividend payment—the expropriation of creditor value determined by the pay-out of corporate assets, in the 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. and mainly shareholders.”). But see Stephen M. Bainbridge, Much Ado About Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency, 1 J. Bus. & TECH. L. 335 (2007) (doubting that managers will act in shareholders’ interest and arguing, instead, that at least some of them “will put their own interest ahead of those of either shareholders or creditors.”) Bainbridge, however, seems to overlook that because of equity-based compensation schemes, managers’ own interests tend often to be the same of those of shareholders.

42. But see Larry E. Ribstein & Kelli A. Alces, Directors’ Duties in Failing Firms, 1 J. Bus. & TECH. L. 529 (2007) (arguing that directors’ fixed claims would counterbalance the incentives they may have to pursue shareholders’ interests to the detriment of creditors and, in fact, make directors’ position closer to that of creditors than shareholders).


44. These contractual provisions may have either an affirmative or negative nature. Affirmative covenants “force the borrower to take actions that protect the lender(s) . . .” TIOLE, supra note 40, at 80. Negative covenants, instead, “place restrictions on the borrower’s ability to take decisions that hurt the lender(s)” Id. In addition, a typical debt contract will include default and other remedy conditions governing the parties’ rights and liabilities in case of termination of the debt-financing relationship. See id.

45. More generally, debt contracts usually provide for covenants imposing limitations on further indebtedness, such as covenants against new secured or senior debt, limitations on liens, lease restrictions, etc. Id.

46. 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.
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b. The Debt Contract’s Inadequacy to Restrain Asset Substitution

In my opinion, the debt contract is effective in controlling the first two sources of conflict, i.e., of managerial opportunism, but it fails to curb managers’ tendency to engage in asset substitution. There are two main reasons for this. First, the remedy normally provided for asset substitution by the debt contract, the debtor’s posting of security or grant of guarantees, may be not effective in protecting creditors’ interests. Although security over specific assets might be the best remedy against risk increasing activities carried out by substituting the debtor’s physical assets, it proves virtually useless with risk increasing activities that can be done even though the debtor’s physical assets remain largely the same. Thus, security usually protects creditors in the case the debtor sells machines in category A but buys machines in category B. On the contrary, it might be of little help if the debtor, for instance, decides to enter a new market. In addition, when the security interest is unspecified rather than specific assets, even asset substitution concerning the corporate physical assets might be difficult to deter. Consider, for instance, a floating security over the firm’s inventory. In this case, even if creditors enjoyed a security on the company’s physical assets, they would not be protected against the risk of asset substitution. Directors could still substitute machines category A with machines category B and, by so doing, depreciate the value of creditors’ claims. Finally, security interests on physical assets tend to be a scarce resource. This means that not only might it prove rather expensive (i.e., imply a high opportunity cost) for the debtor to grant a security of this type, but also that there might be situations in which it is not possible for the debtor to post security over specific assets. This would be the case, for instance, in start-up companies, where most of the company value is represented by intangible assets. In fact, in such circumstances,
lenders most of the time lend against cash flows, rather than against assets.\(^2\) This, in turn, increases the risk of asset substitution.

The second reason of the debt contract's failure to govern the asset substitution problem is that, unlike dividend payment and claim dilution, asset substitution cannot be prevented through the imposition of readily verifiable financial parameters.\(^2\) Instead, to bargain for the right investment policy restrictions, creditors need detailed information on the investment's underlying risk.\(^3\) Yet, (i) the informational asymmetry between managers and creditors, paired to (ii) the existing organizational paradigm centered on the shareholder primacy rule (hereinafter, SPR) and managerial equity-based compensation schemes (hereinafter, MECS) make it unlikely that creditors may have such information or can rely on it.\(^5\) Informational asymmetry is the phenomenon that occurs when information is differently observable to parties.\(^5\) 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.\(^5\) In addition, being held to the exclusive maximization of share value,

\(^2\) In business parlance, it is said that lenders may lend against assets or against cash flows to indicate whether lending is or is not backed by assets. In the case of lending against cash flows, thus, the expectation of recovering money is based exclusively on the borrower's ability to generate enough cash. See Tirole, supra note 40, at 80–81. From this perspective, security over unspecified assets, given the high risk of asset substitution, would have characteristics more similar to lending against cash flows than secured lending.

\(^3\) Examples of accounting and financial covenants, which are designed to control, respectively, the problems of dividend payment and claim dilution, include covenants providing that the firm's total debt cannot exceed a fraction of total assets (so-called leverage constraint), or covenants requiring that the firm's net worth exceed at any time some minimum level. Because the breach of accounting and financial covenants requires always an explicit act, such a breach tends to 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 appear prima facie. First, there are "many possible channels for transferring capital to the firm's owners." Myers, supra note 39, at 160 (citing Jensen & Meckling, supra note 11). In addition, as evidenced by the recent wave of corporate scandals, creative accounting and other 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. 301, 326–30 (2004).

\(^4\) Cf. Tirole, supra note 40, at 86 (arguing that "lenders must be well-informed in order to be able to detect a covenant violation and to properly exercise the power they have in that contingency").

\(^5\) 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. From this perspective, a significant distinction between "prospective or value-enhancing information" and "retrospective or value-neutral or speculative information" needs to be drawn. See Tirole, supra note 40, at 334–35. The former is "information that bears on the optimal course of action to be followed by the firm" and "may be structural (investments, spinoffs, diversification, etc.), strategic (product positioning . . . ), or related to personnel (replacement of management . . . )." Id. Retrospective information, conversely, is a mere measurement of past managerial performances, without bearing on future decisions. Id. Prospective information may be collected by debtholders to impose specific covenants forcing or preventing a certain course of action or to trigger a covenant violation. Id. Because retrospective information is much easier to collect than prospective information, however, creditors will tend to have more retrospective than prospective information.

\(^6\) See Akerlof, supra note 8, at 489.

\(^7\) As pointed out by Myers and Majluf:

[T]he managers' information advantage goes beyond having more facts than investors do. Managers also know better what those facts mean for the firm. They have an insider's view of their organization and what it can and cannot do. This organizational knowledge is part of managers' human capital
and often holding themselves an equity interest in the corporation, managers have weak incentives to disclose this information to creditors. In fact, under the current corporate paradigm, they might well be induced to conceal information to borrow at a lower cost and reserve a costless option to invest in riskier projects. Moreover, even when managers disclose information to creditors, the latter would be reluctant to consider it credible because they expect managers to act in the exclusive interest of shareholders.

c. The Geometry of Corporate Debt

More analytically, the discourse on the negative externalities deriving by SPR and MECS needs to be considered in the light of the geometry of corporate debt. From a strict legal viewpoint, when a corporation concludes a debt contract with a lender, the parties enter into a bilateral relation. From an organizational viewpoint, however, a more complicated arrangement comes into existence. Economically, in

\[ \frac{\partial O_{\text{prev}}}{\partial \sigma} > 0. \]

Thus, if managers, invest ex post in a project with a standard deviation \( \sigma > \sigma_n \), they are paying a cheaper option price than that actually due to debtholders because the interest rate they have negotiated does not reflect the effective corporate assets' risk of default. On the OT application as to the debtholder-shareholder conflict, see, among others, Ronald J. Gilson & Bernard S. Black, (Some of) The Essentials of Finance and Investment 231–51 (1993); Sheldon M. Ross, An Elementary Introduction to Mathematical Finance (2d ed. 2003); Margaret M. Blair & Lynn A. Stout, Director Accountability and the Mediating Role of the Corporate Board, 79 Wash U.L.Q. 403, at 411–13 (2001).
fact, two distinct agency relationships\textsuperscript{60} are in play. The first is that between creditors, as principals, and the corporation (i.e., the shareholders), as agent. The second, instead, is that between the corporation (i.e., the shareholders), as principal, and managers, as agents. Thus, economically, managers can be considered as (sub)agents of the corporate creditors.

The following chart illustrates the relationships among creditors, directors, and the corporate debtor:

As shown by the above picture, two different legal instruments govern each relationship. The relationship between creditors and corporation is governed by contract, which means that creditors and the corporate debtor set their respective obligations in it. Instead, the relationship between corporation and managers is governed by fiduciary law. In particular, as to the debtor's obligations, the contract usually specifies rules of corporate governance conduct to which the debtor must comply during the debt-financing relationship, including provisions on the directors' management of the corporation. From a practical viewpoint, though, the contract's fulfillment depends on managers. In their capacity as corporation's agents, they are the parties responsible for corporate investment decisions.\textsuperscript{61} Still, only the corporation, as contracting party, may be held liable for breach of contract if any contractual provision is not fulfilled.\textsuperscript{62} It follows that although managers are (sub)agents of the creditors-principal, they are not liable toward them, but only toward the shareholder-principal.

\textsuperscript{60} In economic terms, agency relationships are those in which "the welfare of one party, termed the 'principal,' depends upon actions taken by another party, termed the 'agent.'" Henry Hansmann & Reinier Kraakman, Agency Problems and Legal Strategies, in The Anatomy of Corporate Law 21 (Kraakman et al. eds., 2004).

\textsuperscript{61} See Tirole, supra note 40, at 239 (arguing that although management would not have formal authority over financing decisions, it would have "substantial real control over such decisions" "precisely because it is superiorly informed").

\textsuperscript{62} Among the few making such a distinction, see Ribstein & Alces, supra note 42.
The outlined geometry of corporate debt makes clearer why the organizational paradigm based on SPR and MECS may induce managers to pursue risky corporate projects, whose risk is ultimately imposed on creditors. Indeed, although managers might risk being held liable to shareholders for not pursuing a potentially successful project, they can never be held liable if the project in question results in a breach of contract, because the relating cost is externalized on the corporation. On the other hand, if the project succeeds, not only will managers please the shareholders, but, in the modern corporation, where managers are often compensated through equity compensation plans, they will also advance their own interests.

As a consequence of the lack of credible information determined by the outlined geometry of corporate debt (i.e., by the organizational paradigm based on SPR and MECS), parties tend to draft sub-optimal covenants, which fail to maximize the ex ante value of their relationship. In particular, they tend to bargain for general, rather than analytical covenants. The former are covenants which limit the firm's investment policy by providing for low state-contingent contractual provisions, such as the obligation not to engage in new lines of business or that limiting the growth of the firm. Although such covenants offer the advantage of being easily verifiable, they also tend to restrict the debtor's investment choice. In fact, general covenants might bear a high opportunity cost. They are, therefore, inefficient.

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. Thus, in a textualist interpretative regime, a no-change-of-business-line covenant obliges the debtor not to undertake any other activity than the one carried out at bargaining, even though the change of activity is not substantial. Under a contextualist interpretative regime, instead, general covenants become generic covenants. Indeed, under such a diverse regime, contractual provisions that are low state-contingent may prove 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, in this regime, the conversion of part of a company's industrial production from automobiles to scooters could be held not to represent a violation of a
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), as in the case of a covenant earmarking the loan for specific purposes. Hence, they deter managerial opportunism at a lower opportunity cost. Nevertheless, being not as easily verifiable as general contractual restrictions, they tend to imply higher monitoring costs. Indeed, creditors need updated information on the investment’s risk and corporate activity to enforce this type of covenants. Such information, however, is both expensive and difficult to gather. Managers have, in fact, even stronger incentives not to disclose private information when its disclosure may trigger a contractual breach.

Similarly, under the current paradigm of corporate fiduciary law, it seems unlikely that managers may opt for renegotiation in order to undertake a project that may violate a contractual covenant. Being held to the maximization of share value, they have weak incentives to disclose information to get the creditors’ permission to do something which is restricted by a specific covenant. On the contrary, especially if the covenant’s breach is not promptly verifiable by creditors, directors may well be induced to take a risky bet and pursue a new project in violation of the contractual provision. If the project succeeds, shareholders will reap all the benefits; if things turn out bad, both directors will not be personally liable and shareholders’ loss will be limited. Hence, directors would tend to renegotiate only when the new project is on the verge of failure. At this juncture, however, it is commonly too late for creditors to rescue their position. Finally, absent a bonding mechanism

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no-change-of-business-line covenant. As a result, generic covenants entail a lower opportunity cost 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.B.2.

66. In finance theory, there is a distinction between active and passive monitoring depending on the kind of information (i.e., prospective or retrospective) required to carried out the monitoring activity. See supra note 55 (citing Tirole supra note 40, at 334–35). Thus, the reference here is to the cost of active monitoring. See also Mitchell Berlin & Jan Loey, Bond Covenants and Delegated Monitoring, 43 J. Fin. 397 (1988) (arguing that lenders might face large costs of acquiring the necessary information to enforce bond covenants).

67. Consider, for instance, an analytical covenant prohibiting the undertaking of a specific activity. Not only it seems difficult that creditors could become aware of the undertaking of such a new activity if directors decide to conceal it, but it seems even more difficult that directors may decide to disclose the relevant information if such a disclosure triggered a default provision.

68. Such tendency of directors would be further incentivized by the fact that, as confirmed by some empirical studies, creditors often prefer not to bring legal action against the company even though they are seasonably informed on the asset substitution carried out by managers. Under the current regime of corporate fiduciary law, the costs and uncertainty of the contract’s enforcement would, indeed, induce creditors to prefer out of court settlements to the judicial enforcement of the contract. For some empirical evidence, see Kevin C.W. Chen & K.C. John Wei, Creditors’ Decisions to Waive Violations of Accounting-Based Debt Covenants, 68 ACCTG. REV. 218, 223–31 (1993). Contra Alan Schwartz, A Theory of Loan Priorities, 18 J. LEGAL STUD. 209, 217 (1989) (quoting a senior lending officer of a large lender to have said that the point of covenants is to prevent the firm from changing plans without the creditors’ permission). Yet, for the difficulties illustrated above, I maintain that covenants would not always be able to ensure the renegotiation of the debt contract’s terms and conditions.
inducing directors to fulfill the contract, even analytical covenants would not be efficient in governing managerial opportunism.

69. See Raghuram Rajan & Andrew Winton, Covenants and Collateral as Incentives to Monitor, 50 J. Fin. 1113, 1134 (1995) (providing evidence that creditors frequently write covenants loosely by using standard boilerplate because restrictive covenants are in practice often inefficient).


71. 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. See Akerlof, supra note 8, at 489. As a result, the expected value of financial claims is calculated on the average risk. See generally Salanie, supra note 12, at 102–06. For an empirical study, see, e.g., Artur Morgado & Julio Pindado, The Underinvestment and Overinvestment Hypotheses: An Analysis Using Panel Data, 9 Eur. Fin. Mgmt. 163, 165–67 (2003). Cf. Ericsson, supra note 70.

72. Consider the following hypothetical. Let’s assume that Firm A is seeking debt on the market. Firm A is a good firm and will respect the promise made to the lender that it will invest in a corporate project whose standard deviation is 100. On the contrary Firm B, which is a bad one, will not keep the promise made to the lender to invest in a project with a standard deviation of 100. It will, instead, enter a project whose standard deviation is 150. Under asymmetric information, lenders (i.e., the capital market) do not know whether they face a Firm A-borrower (i.e., a good firm) or a Firm B-borrower (i.e., a bad firm). In turn, assuming that creditors know that in the market there are as many Firm A-borrowers as Firm B-borrowers, they will charge an interest rate, i, reflecting an average underlying standard deviation of 125 for both firms. Moreover, when creditors do not know even the distribution of the two kind of borrowers, they could well charge an interest rate higher than i, assuming that, in fact, Firm A-borrowers are far fewer in number than Firm B-borrowers.

73. See Tirole, supra note 40, at 252 (discussing asymmetric information and the pooling behavior of bad borrowers).

74. See Ross, supra note 13, at 27 (discussing the failure of good borrowers’ signaling as to their type).
into account the existence of bad firms when pricing debt,\textsuperscript{75} that is, a good firm's pledgeable income is discounted by the presence of bad firms.\textsuperscript{76}

Adverse selection, instead, is the problem that arises because firms pursuing a below-average level of asset substitution might be so penalized by the current mechanism of debt pricing as to drop out of the market\textsuperscript{77} (what finance theorists call market breakdown).\textsuperscript{78} On the contrary, firms pursuing an above-average level of asset substitution would profit from such a mechanism. Being more likely to default on their contractual obligations to creditors, they would be less affected by the rise in interest rates and have all the incentives to stay in the market.\textsuperscript{79} It follows that adverse selection reduces the quality of loans.\textsuperscript{80} Finally, because of the above-described problems, creditors might become unwilling to raise interest rates even if the debtor were willing to pay higher rates for riskier projects.\textsuperscript{81} That is, they might start to offer less aggregate credit,\textsuperscript{82} with the consequence that good firms and good business projects might risk going unfunded.\textsuperscript{83}

\section*{II. THE POSITIVE ANALYSIS}

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

\textsuperscript{75} Cf. Charles B. Cadsby, Murray Frank & Vojislav Maksimovic, Pooling, Separating, and Semiseparating Equilibria in Financial Markets: Some Experimental Evidence, 3 Rev. Fin. Stud. 315, 318 (1990) (claiming that, when managers have better information than potential investors on the value of corporate assets and of corporate projects' likely payoffs, investors will decide "how much to offer for newly issued securities" taking "into account the presence of less valuable firms"). See also Ross, supra note 13 (arguing that when there is uncertainty in the market and one firm cannot be distinguished from the other, any firm has "a \( q \) chance of being a type A firm," which, translated into the good firms/bad firms dichotomy, means that any firm has a chance of being a bad firm).

\textsuperscript{76} In the example discussed supra at note 72, Firm B-borrowers do, in fact, mimic Firm A-borrowers and declare they will also invest in a project whose standard deviation is 100, although they will invest in one with a standard deviation of 150. In turn, rational creditors, anticipating the existence of Firm B-borrowers, charge an interest \( i \) for all firms.

\textsuperscript{77} Thus, in the example discussed supra at note 72, we have just a distributive problem if both firms are funded. In fact, if \( i \) proves too high for the Firm A-borrower, it can well go unfunded. In turn, we have also an allocative problem. On the adverse selection problem determined by the pooling equilibrium, see generally Salaniè, supra note 12, at 11--42; Bolton & Dewatripont, supra note 12, at 15, 31, 47--96 (2004). See also Myers & Majluf, supra note 57, at 196; Cadsby et al., supra note 75; Robert Forsythe, Russel Lundholm & Thomas Rietz, Cheap Talk, Fraud, and Adverse Selection in Financial Markets: Some Experimental Evidence, 12 Rev. Fin. Stud. 481, 486 (1999).

\textsuperscript{78} Literally, the expression market breakdown describes "the fact that potential issuers [in the presence of asymmetric information] may refrain altogether from going to the capital market or, less drastically, limit their recourse to that market." Tirole, supra note 40, at 237.

\textsuperscript{79} Id. at 113.

\textsuperscript{80} Id. at 243.

\textsuperscript{81} Id. at 113. On the credit rationing problem, see also Bolton & Dewatripont, supra note 12, at 57.

\textsuperscript{82} Cf. Ericsson, supra note 70, at 27 (showing that firms could afford to take an additional twenty percent of leverage if the incentives to alter the firm's risk were not present).

\textsuperscript{83} See Cadsby et al., supra note 75, at 318 (stating that, because of cross-subsidization and adverse selection problems, "opportunities to undertake positive net present value projects" are foregone).
ettes, largely known as corporate constituency statutes,\textsuperscript{84} which authorize directors to also consider non-shareholder interests in corporate decision-making.\textsuperscript{85} Most of these statutes, however, did not mandate, but simply permit the consideration of the interests of employees, creditors, local communities, and other corporate constituencies.\textsuperscript{86} As a result of such a discretionary feature, commentators have been widely divided as to the impact of the new legislation on directors’ fiduciary obligations.\textsuperscript{87}

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

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

1. The 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) The directors may consider the national and state economies and other community and societal considerations. (4) The directors may consider the long-term as well as the short-term interests of the corporation and its shareholders. (5) The directors may consider the possibility that the best interests of the corporation and its stockholders may best be served by remaining independent. (6) The directors may consider any other pertinent factor. (7) Officers may also be covered.

American Bar Association (ABA), Committee on Corporate Laws, Other Constituencies Statutes: Potential for Confusion, 45 BUS. LAW. 2253, 2261 (1990).

Among the several states that have adopted corporate constituency statutes, see, ARIZ. REV. STAT. ANN. §10-1202(A) (West 1990); FLA. STAT. ANN. § 607-111(9) (West 1990); GA. CODE ANN. § 14-2-202(b)(5) (2003); IDAHO CODE § 30-1602 (Michie 1990); ILL. COMP. STAT. ANN. 328-85 (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) (LexisNexis 1990); LA. REV. STAT. ANN. § 12-92(G) (West 1991); 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(4) (West 1991); NEB. REV. STAT. § 21-2035(I) (1988); N.J. STAT. ANN. § 14A:6-14(4) (West 1990); N.M. STAT. ANN. § 53-11-35(D) (LexisNexis 1989); N.Y. BUS. CORP. § 717(b) (McKinney 1991); OHIO REV.CODE ANN. § 1701.59(E) (LexisNexis 2003); OR. REV. STAT. § 60.357(5) (2003); PA. CONS. STAT. ANN. §§ 511(d), (e), (g) & 1721(c), (f), (g) (West 1990); R.I. GEN. LAWS § 7-5.2-8 (1990); S.D. CODIFIED LAWS § 47-33-4 (2000); TENN. CODE ANN. § 48-103-204 (2003); WIS. STAT. ANN. § 180.0827 (West 2002); WYO. STAT. ANN. § 17-16-830 (1989).

86. It should be noted, however, that even though the Indiana’s statute does not compel directors to consider non-shareholder interests, its wording is difficult to reconcile 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 weigh each group of interests “as they deem appropriate.” Ind. CODE ANN. § 23-1-35-1 (Lexis-Nexis 1999). 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.” Id.

87. Once again, communitarians and contractarians have supported opposite views. For the former, the statutes have represented 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. See generally, Millon, Redefining Corporate Law, supra note 28; Mitchell, Corporate Constituency Statutes, supra note 28; Hanks, Jr., Non-Shareholder Constituency Statutes: An Idea Whose Time Should Never Have Come, 3 INSIGHTS 20 (1989). Hence, they should be interpreted restrictively. This means that non-shareholder interests should be taken into consideration only when a simultaneous benefit accrues to shareholders. Only in this way, would the risk be avoided that incumbent directors might undertake self-driven decisions adducing uncertain non-shareholder interests. See ABA Committee on Corporate Laws, supra note 85, at 2269, that states:

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In my view, the statutes are part of a broader trend suggesting a need to review the traditional shareholder-centered vision of the corporation. The openness to the case of non-shareholders showed in some circumstances by Delaware courts, should also be regarded 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). In fact, the debate on directors' duties to creditors has been largely shaped by two opinions of the Delaware Court of Chancery: the 1991 Credit Lyonnais opinion and the more recent Production Resources opinion.

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

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. The idea that corporate insolvency shifts directorial duties toward creditors can be traced back to the trust fund doctrine of early American corporate law, which

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 may 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.

Id. See also, e.g., Macey & Miller, supra note 25; DeBow & Lee, supra note 1, at 398–405; James J. Hanks, Jr., Playing with Fire: Nonshareholder Constituency Statutes in the 1990s, 21 STETSON L. REV. 97, 110 (1991); James J. Hanks Jr., Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification, 43 BUS. LAW. 1207, 1227–29 (1988).

88. In similar terms, but advocating a communitarian-oriented reading of this trend, see Mitchell, Corporate Constituency Statutes, supra note 28, 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.

89. See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (dismissing a shareholder derivative action against the company directors, stating that the adoption of anti-takeover 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 Commc’ns, Inc. v. Time, Inc., 571 A.2d 1140, 1144 n.4, 1150 (Del. 1989) (upholding the decision of Time’s directors to prefer uncertain long-term strategies over short-term shareholders’ gains on 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, 1341–42 (Del. 1987) (affirming the right of directors to refuse a hostile bid on the ground of the consideration of broad corporate interests); TW Services, Inc. v. SWT Acquisition Corp., 1989 Fed. Sec. L. Rep. (CCH) ¶ 94334, 1989 WL 20290 (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 ‘multi-constituency interests’” as opposed to the “shareholder short term interests’ or ‘current share value interests’”).

90. On the trust fund doctrine, see, e.g., Joseph Jude 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 Shifts Directors' Burden from Shareholders to Creditors, 19 DEL. J. CORP. L. 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. 1, 76–91 (1995). Among the very earliest comments on the
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established that the corporate assets of a company facing dissolution were to be held in trust for the benefit of its creditors. 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.

In 1991, however, a decision of the Delaware Court of Chancery, Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 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.” And in the court’s opinion the concept of corporate enterprise encompassed “the community of interest[s] that sustained the corporation,” including creditors’ interests. Then, in a now-famous footnote, Chancellor Allen, the decision’s extensor, explained why under such circumstances creditors should benefit from the attribution of directors’ fiduciary duty: “[t]he possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors.”

By hinting at the managerial opportunism problem, the elaboration of directors’ duty to creditors formulated in the Credit Lyonnais decision has represented a step
forward compared to the traditional insolvency exception approach.97 What the Credit Lyonnais court overlooked, however, is that a corporation does not need to be in financial distress (i.e., in the vicinity of insolvency) for the managerial opportunism risk to arise. As discussed above,98 it is sufficient that a firm has outstanding debt in order that its managers might have incentives to behave opportunistically. Financial distress would merely increase such incentives,99 inducing managers "to gamble for resurrection."100 Therefore, unlike most commentators, I argue that the problem with the Credit Lyonnais opinion does not lie in the uncertainty of the


98. See supra Part I.B.2.a.

99. See, e.g., David A. Skeel, Jr., Corporate Anatomy Lessons, 113 YALE L.J. 1519, 1553–54 (2004) (book review); Barry E. 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 92, 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 97, at 48–63. According to Barondes, covenants directly restricting the firm's investment policy, in concurrence with financial covenants that indirectly do so, would deter excessive risk-taking by financially-distressed firms. For a discussion of the problems affecting investment policy restrictions, see supra Parts I.B.2.b, I.B.2.d. As to the role played by financial covenants, instead, Barondes seems to neglect that the threat of accelerating the loan risks proving more harmful, than beneficial for creditors. Indeed, its exercise may lead to a paralysis of the production of cash flow, which could nullify creditors' expectation of repayment. Managers know this. Thus, it seems difficult that the creditors' threat of accelerating the loan may deter managers from overinvesting. For these reasons, it is unlikely that "creditors of firms that are nearly insolvent . . . may have an incentive to cause the covenants to be triggered." Barondes, supra note 97, at 52. This would be also confirmed by the empirical studies cited supra at note 68. As a matter of fact, creditors would cover the risk of a downfall in the interest rate applied to the debtor's loan 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 what was the average level of asset substitution undertaken by this forty-six percent. Barondes, supra note 97, at 60. As previously discussed, creditors would not be able to distinguish between good and bad firms, but would price debt by pooling firms together and calculating the average risk. Thus, that forty-six percent (which, anyway does not seem a low number) could well have determined an increase in the cost of debt for all firms.

vicinity of insolvency standard,101 but rather in that this opinion still conceives of the duty to creditors as shifting upon a determined condition (or its vicinity). If the duty's existence is justified by the managerial opportunism risk, as the Credit Lyonnais court seems to suggest, creditors should be entitled to it beginning with the signing of the credit agreement because directors' incentives to behave opportunistically start at that moment.

2. The Inadequacy of the NPV Test

The major flaw of the Credit Lyonnais decision, 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).102 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." 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 certain investment 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.104 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

101. Most of the criticisms moved against the Credit 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 (arguing that "Credit Lyonnais moved beyond the event/condition paradigm to an unmapped (perhaps unmappable) coordinate . . ."); Conaway Stilson, supra note 90, 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 92, at 671–72 (claiming that the vicinity of insolvency standard is too difficult to define and evaluate); Barnett, supra note 92, at 465 (defining the vicinity of insolvency standard as a "fuzzy concept[ ]"); Rao et al., supra note 97, at 62–64 (talking of the vicinity of insolvency standard as a phrase without any clear significance).

102. Credit Lyonnais, supra note 18, at 1156, n.55. The court's hypothetical illustrating the NPV test assumes a solvent corporation with a sole asset, an appeal judgment for $51 million, and outstanding bonds for $12 million. The decision's possible outcomes include a twenty-five percent chance of affirmance, a seventy percent chance of a payment of $4 million, and a five percent chance of reversal, resulting in an expected value of litigation of $15.5 million. In the hypothetical, however, the company directors also receive two different cash offers to settle, respectively for $12.5 million and $17.5 million. 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. Id.

103. Id. at 1157.

104. See also Morris, supra note 97, at 65–68.
NPV test, then, does little to help directors to choose among a range of investment opportunities having all the same gross value, but different volatility. In other words, in such circumstances, the test is of poor guidance to identify ex ante the corporate strategy that maximizes the firm's value.

Furthermore, the test may result in inefficient corporate decisions. On the one hand, the test may promote, rather than deter, managerial opportunism because it induces directors to pursue projects with a high NPV regardless of their risk profile. 105 On the other hand, by overlooking the option components of corporate investments, 106 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 107 (on timing, expansion, closing, flexibility, etc.), and by applying pricing theory to evaluate the implicit value of those options, 108 rather than by adopting traditional valuation theories, such as the NPV test.

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105. Imagine, for instance, that the possible outcomes of the appeal in the Credit Lyonnais hypothetical include only a thirty-five percent chance of affirmance and a sixty-five percent chance of reversal. Under such a different hypothesis, the litigation alternative would have an expected value of $17.85 million. 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 sixty-five percent 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." Coffee, supra note 97, at text following n.22.

106. 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, 640 (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 supra note 58. On OT, see generally Gilson & Black, supra note 56, at 231–51. 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).

107. In business parlance, such hidden options are known as real options. More specifically, a real option is defined as the right, but not the obligation to acquire the present value of the expected cash flows by making an investment when the opportunity is available. See generally Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 616–39 (7th ed. 2003); Lenos Trigeorgis, Real Options: Managerial Flexibility and Strategy in Resource Allocation (1996).

108. A real option valuing the ability to wait and resolve uncertainty is called a timing option; an option to learn about an uncertain quantity or technology is called a learning option; an option to abandon the project if unsuccessful is called an exit or abandonment option; an option to invest now and make follow-up investments if the original project is successful is called a growth or expansion option; etc. See generally Brealey & Myers, supra note 107, at 616–39.

109. Real options can thus be considered a loan on the opportunity to make further investment. In OT terms, because the option's exercise price is the cost of the investment in the specific project, the option value increases when the expected cash flows are higher than that of the original investment. Thus, the higher the uncertainty of the potential cash flows, the higher the value of the option. See Keith J. Leslie & Max P. Michaels, The Real Power of Real Options, 3 McKinsey Q. 413 (1997); Avinash K. Dixit & Robert S. Pindyck, Investment Under Uncertainty (1994).
analysis. Indeed, even investment with a negative NPV may be profitable if evaluated through the real options technique of capital budgeting. Similarly, investments with lower NPV may actually be superior if their option components are taken into consideration.

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 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. Hence, to hold directors liable for the repayment of creditors' claims, as the Credit Lyonnais court seems to suggest, is 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 ex ante 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.

B. Production Resources Group L.L.C. v. NCT Group, Inc.

In November 2004, the Delaware Court of Chancery issued a new, crucial opinion on directors' duties to creditors:


111. Consider, for instance, the case of a small company having the option to invest in a new technology. The new technology has a fifty percent probability of working well and generating revenues for $16 million, and a fifty percent probability of not working and generating losses of $18 million. The cost of waiting to make this investment (i.e., the timing option's cost) is equivalent to $3 million (equal to the cost of decrease sales as a result of not having the greatest product features for lack of adequate equipment). Pursuant to the NPV technique of capital budgeting, the project should not be undertaken. Indeed it would have a negative NPV. (The NPV of investing today is equal to: \((16M)(.5)-(18M)(.5) = -1M\). Yet, it could still be worth pursuing it if one considers the embedded timing option it contains. If one waits and sees until the risk the new equipment might not work is eliminated, the project's value becomes: \((16M)(.5)-(0)(.5)-3M = 5M\).) Thus, by ignoring management's ability to wait until the risk that the equipment might not work is eliminated, the NPV analysis may lead the management to forfeit a valuable investment opportunity.

112. See supra Part I.B.2.e.

113. For other decisions on directors' duties to creditors following the Credit Lyonnais opinion, see Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 790 (1992) (holding that "fiduciary duties to creditors arise when one is able to establish the fact of insolvency"); Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (In re Buckhead Am. Corp.), 178 B.R. 956, 968 (D. Del. 1994) (denying motion to

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Although much of what the court said on the matter is in dicta, such a decision represents the most influential pronouncement on managerial duties to creditors since that of Chancellor Allen. The opinion makes four central points as to creditors' fiduciary duty claims against directors:

(i) Absent bad faith or self-dealing, both creditors of solvent corporations and of corporations in the vicinity of insolvency have no standing to bring fiduciary duty claims against directors. According to Vice Chancellor Strine, the decision's ex-tensor, creditors would have other legal tools at their disposal to protect their interests, namely the contract and specific bodies of law (i.e., fraudulent conveyance law and federal bankruptcy law). Thus, “[s]o long as the directors honor the legal obligations they owe to the company's creditors in good faith, as fiduciaries they may pursue the course of action that they believe is best for the firm and its stockholders.”

(ii) The Credit Lyonnais opinion did not intend to create a new set of fiduciary duties to the benefit of creditors of financially distressed companies. Instead, it gave directors of such companies a shield against shareholders' claims which alleged that

115. 863 A.2d 772 (Del. Ch. 2004). The factual background of the decision involved a claim brought against the directors of the NCT Group (NCT) by one of its creditors, Production Resources Group (PRG). Charges brought against the directors included the failure to comply with a judgment condemning NCT to pay PRG and the attempt to avoid payment in several ways (including the issuance of more shares than were authorized, the grant of inappropriate liens, and other benefits in favor of directors themselves, etc.). For a much more detailed articulation of the facts of the case, see Pamela L.J. Huff & Russel C. Silberglied, From Production Resources to People Department Stores: A Similar Response by Delaware and Canadian Courts on the Fiduciary Duties of Directors to Creditors of Insolvent Companies, 1 J. Bus. & Tech. L. 455 (2007). Substantially reproducing the content of Production Resources, see also Ribstein & Alces, supra note 42. Among other articles discussing the decision, see, e.g., Bainbridge, supra note 41, at 347–48; Frederick Tung, Gap Filling in the Zone of Insolvency, 1 J. Bus. & Tech. L. 607 (2007); Frank Partnoy, Financial Innovation and Corporate Law, available at http://www.uiowa.edu/~law/jcl/Financial%20Innovation%20and%20Corporate%20Law.pdf (last visited Jan. 3, 2006) (paper presented at the University of Iowa College of Law 2005 Symposium in honor of Professor Bob Clark).


117. Id. at 787.

118. Id. Later in the decision, the Chancellor specifies that, given the protection granted by the contract and these specific bodies of law:

[W]hen creditors are unable to prove that a corporation or its directors breached any of the specific legal duties owed to them, one would think that the conceptual room for concluding that the creditors were somehow, nevertheless, injured by inequitable conduct would be extremely small, if extant. Having complied with all legal obligations owed to the firm's creditors, the board would, in that scenario, ordinarily be free to take economic risk for the benefit of the firm's equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm's value.

Id. at 790.
they acted too conservatively in managing the company's affairs. Indeed, the business judgment rule protects directors who undertake less risky corporate strategies in the belief that riskier ones might compromise the company's ability to meet its legal obligations to the corporate creditors. This, however, does not mean that directors' duties shift to creditors. Directors of corporations in the vicinity of insolvency do not have an obligation to pursue less risky corporate strategies. On the contrary, they remain free to exercise their business judgment to select the course of action they deem to be in the best interest of the corporation (i.e., which maximizes the corporate value).

(iii) Corporate insolvency neither changes the object of directors' fiduciary duties, which continues to be the corporation itself, nor its content, which remains the obligation to maximize the firm's value. Insolvency simply transfers the right to pursue derivative claims against directors for fiduciary improper conduct from shareholders to creditors, the new residual claimants of the firm.

(iv) Being that the fiduciary claims of creditors of insolvent corporations derivative in nature, directors of such corporations can be protected from personal liability for creditors' claims under charter exculpation provisions adopted pursuant to section 102(b)(7) of the Delaware General Corporation Law. Policy reasons would also induce one to interpret section 102(b)(7) in this sense. Otherwise, the primary purpose of the section, "to encourage directors to undertake risky, but potentially value maximizing, business strategies," would be largely frustrated. Indeed, it is when a corporation becomes insolvent that the risk of judicial hindsight bias about directors' business decisions is more likely. Therefore, it is in that moment that the protection granted by exculpatory provisions becomes most needed.

1. Some Preliminary Comments

Although the actual impact of the Production Resources opinion on directors' duties to creditors will depend on whether other members of the Delaware Court of Chancery and other judges will follow its ruling, some preliminary comments can be drafted.

Endorsing a contractarian view of corporate law, I basically share Chancellor Strine's vision of directors' duties to creditors and agree that the essential legal instrument to protect creditors' interests is the debt contract. Nevertheless, I also

119. Id. at 788.
120. Pursuant to § 102(b)(7), under Delaware law, a corporation may include in its certificate of incorporation a provision exculpating directors from personal liability "to the corporation or its stockholders" for monetary damages for breach of the fiduciary duty of care. In contrast to some previous decisions, in Production Resources, the court stated that § 102(b)(7) protects directors even against suits brought by creditors. According to the court, because creditors' claims are derivative in nature, the corporation is the one actually bringing suit against directors. Therefore, the literal wording of § 102(b)(7) is respected and the section can be applied to exculpate directors.

claim that the debt contract, as currently devised, is an imperfect instrument to regulate the debtor-creditor relationship. In particular, I challenge the Chancellor's idea that creditors' contractual protection is complete and that using the law of fiduciary duty in this context would lead "to fill gaps that do not exist." Although "[c]reditors are . . . protected by strong covenants," I have previously discussed why such covenants are often inefficient in governing managerial opportunism. Similarly, I have also showed that, at least in relation to risk-increasing activities carried out without substituting the debtor's physical assets, the posting of liens or other security is of limited use. Furthermore, the alleged protection granted to creditors by the implied covenant of good faith and fair dealing risks proving more harmful than beneficial. The uncertainty surrounding the scope and content of the good faith obligation may lead to judicial activism in contract interpretation, which may prove detrimental when parties are sophisticated ones, as it happens in the debtor-creditor relationship.

Indeed, although I share the traditional law and economics view of the good faith obligation as the rule of law prohibiting each contracting party from taking advantage of the contract's incompleteness to expropriate her counterparty's expected contractual benefits, I challenge the law and economics argument supporting the efficiency of good faith. For law and economics scholars, good faith reduces contractual specification cost by supplementing the parties' agreement with a general term that prevents opportunistic behavior. This view, however, overlooks the higher risk of judicial error that parties face when courts interpret their agreement pursuant to the obligation of good faith (i.e., under a good-faith interpretative regime). Under such a regime, the court is not obliged to abide by the express

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122. Id. at 790.
123. Id.
124. See supra Part I.B.2.d.
125. See supra Part I.B.2.b.
126. Parties may have either an unsophisticated or sophisticated nature. Sophisticated parties include corporate entities and other business forms (such as limited partnerships, for instance) which operate in commercial context and are "expected to understand how to make business contracts . . ." Schwartz & Scott, Contract Theory, supra note 6, at 545. This means that they are repeat players in the industry in which they operate, regularly conclude contracts of one or more particular commercial types, and know well the economic substance of their exchanges. In addition, sophisticated parties enjoy economic, informational, and, most of the time, organizational resources. In turn, they are able to assess their risk adequately and write contracts that contain such a risk. Unsophisticated parties are defined residually as those that are not sophisticated. Hence, these parties will normally tend to be individuals or other commercially unsophisticated entities that conclude sporadic and heterogeneous transactions, mostly in the context of simple transactional environments (such as one-time sales of relatively low-value, common, goods). In addition, unsophisticated parties have limited economic and informational resources. As a result, they might both have a scarce understanding of the economics of their exchanges and not be able to assess their risk adequately. Moreover, their bounded rationality may well lead to cognitive errors and to inefficient allocations of entitlements. On the dichotomy between sophisticated-unsophisticated parties, see, e.g., Benjamin E. Heremalin & Michael L. Katz, Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach, 9 J. L. Econ. & Org. 230, 248 (1993); J.H. Verkerke, Legal Ignorance and Information Forcing Rules, American Law & Economics Association, Annual Meeting, Paper 22 (2004).
terms of the contract, but can determine in its own discretion what good faith means in relation to both specified and unspecified contingencies. This means that the court might make errors even if the parties' entitlements are clearly specified by express provisions. Thus the inclusion of the good faith obligation in the parties' agreement would prove efficient only when the specification cost that it permits the parties to save exceeds the expected cost they bear due to the higher likelihood of judicial error. Put differently, the obligation of good faith would imply a trade-off between specification cost saving and expected cost deriving from judicial error (the "good faith trade-off"). I then claim that, in the case of unsophisticated parties, the good-faith trade-off would almost always be positive because these parties' contracts will tend to be "necessarily incomplete" due to bounded rationality, limited economic resources, and informational deficit. On the contrary, in the case of sophisticated parties, the good-faith trade-off would tend to be negative given the complexity of the underlying agreement and the consequently higher probability of judicial error.

Finally, even admitting that debt contracts are complete, the Production Resources perspective seems to overlook that the contract does not bind directors but only the corporation. Thus, even admitting that a duty of directors to creditors is not needed to fill in gaps in the contract; such a duty would still be desirable to give directors the right incentives to fulfill the contract.

As to the test of directors' conduct devised by Production Resources, i.e., the good faith fulfillment of all legal obligations owed to creditors, I wonder whether, pursuant to such a test, directors who increase the investment's risk ex post should be held liable to creditors. Indeed, Production Resources seems to emphasize two different dimensions of good faith. First, there would be a horizontal dimension, concerning the relationship between corporation and creditors, in which good faith is conceived of as contractual gap filler. From this perspective, the decision would promote the adoption of a contextualist interpretative regime of the debt contract. As just seen, I take issue with such a view and claim that the adoption of this regime would produce uncertainty in legal relationships. For this reason, to increase efficiency, a textualist interpretative regime should, instead, be adopted.127

Nevertheless, there would be also a vertical dimension, concerning the relationship between corporation and managers, in which good faith qualifies as a managerial duty.128 In this sense, pursuant to Production Resources, the good faith fulfillment of directors' legal obligations, including those arising from the debt con-

127. See infra Part III.B.
128. The Delaware case law is far from clear with respect to whether there is a separate fiduciary duty of good faith. The answer, however, seems most likely negative. Cf. Nagy v. Bistricer, 770 A.2d 43, 48 n.2 (Del.Ch. 2000) (arguing that the duty of good faith is an independent concept, whose "utility may rest in its constant reminder ... that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes"). Still, it seems undoubted that good faith in the corporate realm assumes a different connotation than good faith in the contractual context.
tract, would exempt directors from liability. Therefore, I wonder whether the directors' intentional breach of the parties' agreement as to the investment's underlying risk can be considered a breach of the vertical dimension of good faith. In accordance with a more recent decision of the Delaware Chancery Court, In re Walt Disney Company Derivative Litigation [hereinafter, Disney], the answer would seem affirmative. Indeed, in Disney, the court explained: "[a] failure to act in good faith may be shown, for instance, where the fiduciary . . . intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." Under this view, the debt contract's provisions on the directors' management of the corporation might well be deemed to constitute a known duty of directors. Hence, an intentional breach of such contractual provisions would represent a breach of the vertical dimension of good faith.

Finally, I argue that the broad application of the business judgment rule (BJR) restated by the Production Resources opinion, together with the contextualist interpretative regime advocated therein, risks stressing the problem of managerial opportunism. Contrary to other commentators, I maintain that if the BJR was extended also to creditors' claims, managers could justify virtually any action they undertake on the basis of their business judgment, regardless of what was established by the debt contract. Thus, they would become even more likely to undertake asset substitution corporate projects. Ultimately, then, the extension of the BJR to creditors' claims would jeopardize, rather than secure, the maximization of the firm's value.

III. A NORMATIVE THEORY

I have previously individuated four 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; (iii) the incompleteness of the insolvency exception (or the financial distress exception) as a doctrine justifying the need for a directorial duty to creditors; and (iv) the uncertainty created by a contextualist interpretation of the debt contract.

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129. See text reported supra at note 118.
131. Id. at 36 (emphasis added).
132. This interpretation of the dicta in In re Disney seems also consistent with Chancellor Strine's statement at n.52: "I assume that, at all times directors have an obligation to consider the legal duties of the firm and to avoid consciously placing the firm in a position when it will be unable to discharge those duties." Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 788 n.52 (Del. Ch. 2004).
133. The BJR consists of the "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
134. See Ribstein & Alces, supra note 42, at 529 (arguing that the business judgment rule give directors discretion "not only to decide what actions to take, but in whose interests to act"); Bainbridge, supra note 41 (claiming that the "zone of insolvency doctrine" of directors' duties to creditors is "much ado about very little" because the business judgment rule would protect directors from creditors' claims in most of these cases).
DIRECTORS' DUTY TO CREDITORS AND THE DEBT CONTRACT

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.

A. Debt Contract and Duty to Creditors

The first legal tool that I propose to enhance the debt contract’s efficiency is a default rule of law imposing on directors a duty not to increase unilaterally creditors’ accepted risk (CAR). As a default rule of law, the actual scope and content of the duty would be determined by the parties’ negotiation as reflected in the debt contract. Parties themselves would set the duty’s boundaries depending on the level of risk they agree upon in the debt contract. In this sense, I offer a new contractarian perspective of directors’ duty to creditors. As advocated by contractarians, under the model I suggest, directors’ obligations to creditors are determined by contract. The existence of a default duty, however, attempts to remedy the debt contract’s inefficiency that the contractarian analysis neglects to consider; namely, the contract’s inadequacy to govern the managerial opportunism problem and to serve as a credible signal on corporate risk.

1. The Functions Served by the Duty to Creditors

The basic working assumption underlying the existence of the proposed duty to creditors is that managers are the parties in the best position to evaluate the hidden options of an investment, including the option to increase the investment’s risk ex post. Nevertheless, 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). Under this view, the duty, imposing on directors an obligation not to increase the CAR ex post, would make them personally liable to creditors for failing to disclose relevant information and exercise options that they have not bought. This would serve two distinct, but closely related functions. First, making directors liable also to creditors, the duty would realign the asymmetry intrinsic to the geometry of corporate debt. Second, it would remedy the negative externalities arising out of SPR and MECS and, therefore, make the debt contract a credible signal on corporate risk.

Being the duty determined by contract, any violation of the contractual provisions on the CAR would also constitute a breach of the duty. Therefore, the duty would induce managers to fulfill the contract. Indeed, the imposition of personal losses for the duty’s breach would discourage managers from undertaking courses

135. For a practical example of what this would entail, see infra Part III.D.
136. See Part II.A.2 for a discussion on the option theory analysis of corporate projects.
137. Provided that, as it will be discussed in more details thereinafter, the breach of the CAR provisions also results in a default on payment. See infra Part III.C.

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of actions that maximize share value by expropriating creditor value. In other terms, the duty would deter managerial opportunism by serving as a bonding mechanism giving directors incentives to stay in the contract. 138 This, in turn, would lead to a reduction of monitoring costs. Being able to rely on the incentives provided by the duty, creditors would need to spend less to verify the debtor’s (i.e., the directors’) compliance with the credit agreement’s provisions. In addition, being that monitoring costs are translated on the debtor through an increase of the interest rate, their reduction would also lead to a decrease of the cost of capital.

The second function served by the duty would be to transform the debt contract into a credible signal on corporate risk, 139 thereby enabling the credit market to screen firms on the basis of their marginal risk. 140 First, the bonding mechanism provided by the duty would make the investment policy restrictions creditors negotiate more effective in governing the investment’s underlying risk. In other terms, the duty would make the debt contract a more adequate instrument to deter managerial opportunism. 141 Second, the liability threat determined by the duty would induce creditors to deem credible the information disclosed by managers. Knowing that directors bear personal losses for the duty’s breach, creditors would indeed be more likely to rely on such information. As a result, the credit market would become better able to price the investment’s underlying risk. This means that it could

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138. The incentive function served by the duty to creditors would be consistent with a basic theoretical result in the economics of agency: Holmstrom’s finding that making agents accountable for events over which they have no control does not solve the moral hazard problem. By making managers accountable over an event that they control, i.e., the contract’s fulfillment, the duty’s existence would instead remedy the managerial opportunism problem. Bengt Holmstrom, Moral Hazard and Observability, 10 Bell J. Econ. 74, 89–90 (1979).

139. This is consistent with Ross’s discussion on the incentive-signaling model. For Ross, if there is uncertainty in the market and one firm cannot be distinguished from the other, returns for each firm become conditional on exogenous information. Therefore, absent a credible signal, all firms will be considered of the same value (instead of being attributed a value corresponding to the firm’s discounted cash flows as it happens in conditions of certainty). To stick with the good firm/bad firm distinction I have previously proposed, this means that all firms will be considered as potential bad firms. Ross argues that “[o]ne way to break out of the constraint that binds the value of . . . firms is to assume a significant role for the manager.” Ross, supra note 13, at 27. For him, managerial accountability would be “a means of validating financial signals” which would otherwise be useless to differentiate one firm from the other due to moral hazard and adverse selection problems. Id. Similarly, a duty imposing a personal liability of directors to creditors is a means to transform the debt contract in a credible signal to distinguish good firms from bad firms. Cf. also Lars A. Stole, The Economics of Liquidated Damage Clauses in Contractual Environments with Private Information, 8 J. L. Econ. & Org., 582, 584 (1992) (arguing that, when parties have asymmetric information, liquidated damage clauses may be used to communicate valuable information and move from a pooling to a separating equilibrium); Robert Forsythe, Russell Lundholm & Thomas Rietz, Cheap Talk, Fraud, and Adverse Selection in Financial Markets: Some Experimental Evidence, 12 Rev. Fin. Stud. 481, 486 (1999) (arguing that an antifraud rule, punishing sellers who make false statements as to the quality of their products, constitutes a way to give the “seller a means to credibly communicate its quality”).

140. As to the limits of the debtor’s posting of security or grant of guarantees as alternative instruments to induce creditors’ screening, see supra Part I.B.2.b. Cf. also 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).

141. The duty would make the debt contract adequate to govern the risk of the projects that the corporation will undertake. See supra Part I.B.2.d.
price debt on the basis of the debt contract's information and provisions rather than through a pooling mechanism. Indeed, by offering to creditors a liability rule that does not appeal to bad firms, good firms' directors would allow the credit market to break. Thus, assuming competitive markets, the credit market could move from a pooling equilibrium, in which debt is priced on the basis of the average risk increase, to separating equilibria, in which debt's price is determined on the basis of firms' specific risk.

2. Why a Default Rule of Law Imposing a Directors' Duty to Creditors Would Be Desirable

Before discussing the second legal tool I propose, a crucial question needs to be addressed. Why is a default rule of law necessary to remedy the described inefficiency of the debt's contract? If the scheme I advocate is truly efficient, why would parties not establish a liability of directors through private contracting under existing law?

A first answer to such question is that parties, under the current model of corporate fiduciary duties, could not bargain for a liability rule of directors to creditors as the one I propose. According to the dominant opinion of both legal scholars and justices, corporate law would provide for a mandatory fiduciary model. Under such a model, directors owe their duties to the exclusive benefit of shareholders when the company is solvent and to creditors when the company becomes insolvent. Thus, parties would have very limited room to contract around the legal arrangement of their rights and duties.

The above consideration, however, does not represent the major reason for imposing a default rule of law creating a directors' duty to creditors. In fact, I share the idea of those who, contrary to the popular wisdom, claim that the corporate

142. Good firms' directors would offer their personal liability to creditors in the sense that they decide to not opt out of the default liability rule. See infra Part III.A.2.
143. See Tirole, supra note 40, at 238 (arguing that the "informed side of a market is likely to introduce or accept distortions in contracting so as to signal attributes that are attractive to uninformed side of the market . . . . [A] good borrower will try to demonstrate attractive prospects to the investors by introducing distortions that are costly to her, but that would be even costlier to a bad borrower."). See also Spence, supra note 15, passim; Michael Rothschild & Joseph Stiglitz, Equilibrium in Competitive Insurance Markets: An Essay in the Economics of Imperfect Information, 90 Q. J. Econ. 629 (1976); Charles Wilson, A Model of Insurance Markets with Incomplete Information, 16 J. Econ. Theory 167 (1977).
144. Cf. Schwartz, supra note 140, at 1416 (arguing that as long as unsecured borrowers could disclose information to creditors a pooling interest rate would not apply).
145. I wish to give special thanks to Professor Henry Hansmann for the insights provided on this part of the essay and the year-long discussion we have had on the matter.
146. See supra notes 1–2 and accompanying text.
147. Id.
148. The only exception is represented by the possibility of contracting exculpatory clauses for the managers' duty of care. See also supra note 120 and accompanying text.
fiduciary model has a permissive, rather than a mandatory nature.\textsuperscript{149} Under this view, fiduciary duties could be modified by contract. In particular, parties would be "free to make deals that carve into the fiduciary rights of shareholders,"\textsuperscript{150} i.e., they could modify the shareholder primacy rule. Nevertheless, I argue that a default rule of law imposing a duty to creditors would still be desirable. There are several reasons for this. First, both creditors and directors would have no incentives to bargain privately for the personal liability of directors. Second, the existence of such a default rule would reduce the transaction costs parties bear to achieve the efficient outcome. Third, a model in which parties may opt out of the duty would induce directors to disclose more information than a model in which parties must negotiate for it.

My first claim as to the desirability of a default duty to creditors concerns the position of creditors and directors. Indeed, one could argue that there is no need for the law to supplement the terms of the debt contract in the fashion I propose. Creditors could buy out directors' liability, and the same efficient outcome would follow. On the contrary, I argue that creditors would not incur additional transaction costs to bargain privately for a directors' duty to their benefit. As previously discussed, anticipating the inefficiency of the debt contract in governing the managerial opportunism risk, creditors price debt on the basis of the average risk.\textsuperscript{151} As a matter of financial theory, creditors' payoffs are the same under a pooling or separating equilibrium.\textsuperscript{152} Thus, they have no incentives to bargain for a rule which would induce the credit market to price debt on the basis of firms' specific risk.\textsuperscript{153}

Once again, however, the above argument is not decisive. Although creditors would not have incentives to bargain privately for the duty I propose, one could always argue that, if there are prospective efficiency gains, directors themselves could negotiate their personal liability with creditors. Although they are formally third parties to the credit agreement between corporation and creditors,\textsuperscript{154} directors could intervene in such agreement as guarantors of the CAR provisions. Yet, it seems unlikely that directors would act in this way. To begin with, a collective negotiation by the board seems very difficult; most likely directors would negotiate individually, with a serious risk of board's disruption.\textsuperscript{155} In addition, because directors would not benefit directly from the efficiency gains, the existence of the duty

\textsuperscript{149} See, e.g., Easterbrook & Fischel, supra note 25; Macey, An Economic Analysis, supra note 25; Macey, Fiduciary Duties, supra note 25.

\textsuperscript{150} Macey, Fiduciary Duties, supra note 25, at 1281.

\textsuperscript{151} See supra Part I.B.2.e.

\textsuperscript{152} For a general but rigorous treatment of the microeconomics of the matter, see Mas-Colell et al., supra note 15, at 462.

\textsuperscript{153} See Cadsby et al., supra note 75 (empirically proving that, in financial markets, the pooling equilibrium is dominating when theory permits both pooling and separating equilibria).

\textsuperscript{154} See supra Part I.B.2.c.

\textsuperscript{155} Indeed, in the case of individual negotiation of directors' liability to creditors, there would be the risk that only the more reckless directors would agree to become guarantors of the CAR provisions.
would produce, they would have no incentives to incur additional liability unless they were compensated by the shareholders.\textsuperscript{156}

From this perspective, then, the ultimate question is whether shareholders would bargain for the duty. Assuming a competitive credit market, good firms' shareholders could be incentivized to bargain for the duty to induce the market to break. I claim, however, that the transaction costs shareholders would incur to bargain privately for the duty would risk overcoming the efficiency gains arising from its existence. According to the Coase theorem,\textsuperscript{157} in a world of symmetric information and zero transaction costs, there would be no need for a default rule imposing a duty of directors to creditors. Regardless of the initial distribution of legal entitlements, parties would be able to remedy privately negative externalities arising under the current corporate governance system. In the real world, however, the debtor-creditor relationship is characterized both by high transaction costs and asymmetric information.\textsuperscript{158} Hence, the initial distribution of legal entitlements does matter to enhance efficiency. From this perspective, I argue that it would be cheaper for the shareholders to opt out of a duty to creditors than to bargain for it.

Because of the described geometry of corporate debt, to opt in the duty, shareholders should engage in a complex and expensive negotiation with both creditors and managers. They should negotiate the scope of the duty, i.e., the single CAR provisions, with creditors and then have managers to accept liability for any of these provisions and negotiate with the managers the extra compensation required to cover the liability risk. This would increase transaction costs. In addition, whereas opting out of the duty might be easily done through a single sentence, specifying it by contract could only be done through a complex and detailed set of contractual specifications, which could be assessed only at a great cost. Hence, a default rule should be imposed because it would actually be cheaper to bargain around it than it would be to bargain for it.\textsuperscript{159}

One last reason would justify the imposition of a default rule of law establishing a duty to creditors. Under the model I suggest, as it will be discussed in detail

\textsuperscript{156} In the case managers hold an equity stake, the discussion is substituted by the following paragraph on the shareholders' position.

\textsuperscript{157} The Coase theorem relates to the economic efficiency of the initial allocation of property rights. See R. H. Coase, \textit{The Problem of Social Cost}, 3 J. \textsc{Law} \& \textsc{Econ.} 1 (1960). In essence, the theorem states that in the absence of transaction costs, all initial allocations of property are equally efficient, because interested parties will bargain privately to correct any externality. See \textit{id}. As a corollary, the theorem also implies that in the presence of transaction costs, inefficiency may be minimized by allocating property initially to the party assigning it the greatest utility. See \textit{id}.

\textsuperscript{158} See supra Part I.B.2.b.

\textsuperscript{159} Cf. David Charny, \textit{Hypothetical Bargains: The Normative Structure of Contract Interpretation}, 89 \textsc{Mich. L. Rev.} 1815, 1842–43 (1991). Charny argues that, in establishing the best default, one should consider the costs that would be incurred from each possible contractual specification of the term (i.e., the costs incurred to opt in the term) and choose the term that minimizes the net costs of transacting. \textit{See id}. From this perspective, it would be right to “choose a term that would actually be desired in relatively few transactions if it is much cheaper to bargain around that term than it would be for the few parties who want that term to bargain for it (or to submit to the terms that others want or to not transact).” \textit{Id}. at 1842.
thereinafter, directors would reveal information to creditors both when they accept the liability regime, through the specification of the duty’s scope and content, and when they decide to opt out of such a regime. Indeed, opting out of the duty would have an intrinsic informational meaning, which creditors would consider in pricing debt. On the contrary, in a regime in which parties must bargain privately for the duty, directors would reveal information only if they opted in the duty. If they decided not to bargain privately for it, no additional information would be revealed. The result would be that the current inefficiency of the debt contract would not be solved and that there would not be credible signals on corporate risk.

B. The Need for a Textualist Interpretative Rule

The second legal instrument I propose to redress the current inefficiency of debt contracts is a textualist interpretative rule mandating to consider accepted by creditors any risk that they have not contractually excluded or limited. The adoption of such a rule would have a two-fold purpose. First, it would serve to induce both parties to specify the contract. Second, it would eliminate the possibility of ex post completion of the debt contract (and of the duty) by the third adjudicator, thereby reducing uncertainty in legal relationships.

1. Textualist Interpretation and Contract Specification

I have claimed above that, assuming competitive markets, the existence of a managerial duty to creditors would make the debt contract a credible signal as to corporate risk. This, in turn, would induce the credit market to move from a pooling equilibrium to separating equilibria. From this perspective, the first reason justifying the imposition of a textualist interpretative rule would be to give parties additional incentives, besides those arising from the duty, to write more state-contingent contracts. Indeed, because creditors’ payoffs in pooling or separating equilibria are the same, if we relax the competitive market assumption, the duty to creditors, by itself, might be a weak instrument to change the current mechanism of debt pricing. Thus, a textualist interpretative rule would serve to give also to creditors the right incentives to specify the contract.

Before illustrating in detail the proposed interpretative rule, some preliminary considerations as to the risk accepted by creditors needs to be drawn. First, it must be observed that creditors always accept the investment’s systematic risk, which they automatically discount at the conclusion of the debt contract. Hence, directors never 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

160. See infra Part III.C.
161. See infra Part III.C.
162. See supra Part III.A.2.
163. The systematic risk is the risk inherent to the entire market (or entire market segment). It is also known as un-diversifiable risk or market risk.

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purpose of the proposed duty. Thus, creditors who finance a car manufacturing company always accept (and discount) the risk of failure determined by a car industry crisis. This means that creditors cannot 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. Unlike the case of the systematic risk, however, creditors can adjust the investment’s specific risk by contract. For 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. Thus, when I say that parties themselves would set the scope and content of the duty to creditors by negotiating a certain investment’s risk, I always refer to the investment’s specific risk.

Having clarified this, my basic claim is that a textualist interpretative rule, together with the duty’s existence, would prompt Nash bargaining between directors and creditors ultimately leading to an optimal level of specification of the debt contract. Although the incomplete contract approach to contract theory correctly teaches that specification is expensive, I have previously explained that also writing low state-contingent contracts (that is contracts including mostly general covenants) may prove very expensive. When contracts are drafted in this way, not only do parties bear an high opportunity cost, but also an increased cost of debt because creditors anticipate that such contracts are less likely to constrain managerial opportunism.

The Nash bargaining between the parties would work approximately in this way. Because the textualist interpretative rule would mandate to consider that creditors accepted any specific risk that they have not ruled out (or otherwise limited), it would give creditors incentives to specify the contract. In fact, as to creditors, the proposed interpretative rule would work as a penalty default, that is, as a rule “designed to give at least one party to the contract an incentive to contract around the

164. 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 Budgets, 47 REV. ECON. & STAT. 13 (1965); William F. Sharpe, Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk, 19 J. FIN. 425, 426 (1964). The incentive scheme provided by the CAPM model, however, would not promote contractual efficiency. Under such a theory, creditors have indeed no incentives to expend resources to write better contracts, because they can diversify their risk away simply by investing in different classes of capital assets.

165. See Nash, Equilibrium Points, supra note 16; Nash, Non-Cooperative Games, supra note 16.

166. By optimal level of specification, I intend that level in which the marginal cost of specifying an additional contractual provision equals the marginal cost parties might bear if they do not specify such a provision.

167. In accordance with the incomplete contract approach, contract writing costs are positive and may be too high to permit the parties to contract on all foreseeable contingencies. See Schwartz, supra note 14.

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default [ ] and therefore to choose affirmatively the contract provision they prefer.”169 Yet, as to directors, the proposed interpretative rule might seem to induce the former to conceal, rather than disclose information. By so acting, directors would maintain that creditors accept even the risk inherent to the undisclosed information. Indeed, not being aware of such a risk, creditors could not rule it out. This, in turn, not only would limit the area of directors’ liability, but also reserve them further investment options at no additional cost. On the contrary, I argue that the rule would give incentives to specify the contract also to directors. To understand why, consider this negotiating sequence.

Stage 1: At the parties’ kick-off meeting, the managers, seeking to reserve additional investment options, illustrate a rather generic business plan to creditors. Being aware that they are presumed to accept any risk that is not limited by contract, creditors will then seek to impose restrictions on the firm’s investment policy. Lacking credible information on the actual risk of the investment, however, they will demand general covenants. Being low state-contingent on the external state (i.e., the corporate activity), in a textualist interpretative regime,170 such covenants ban a large set of investment opportunities. Hence, under the proposed model, the ultimate result of the information-hiding behavior adopted by managers would be to broaden rather than restrict the area of their personal liability to creditors.

Stage 2: At the next meeting, rational managers will then attempt to narrow their liability’s risk. They will thus ask for some modifications of the general covenants demanded by creditors. In order to obtain such modifications, however, they will be forced to disclose credible information to creditors. As a result of this interaction, the contract the parties would finally write would be as state-contingent as possible.171 The availability of credible information on the investment’s risk would have them to negotiate for detailed contractual provisions, which would be effective in preventing managerial opportunism without imposing excessive restrictions on the firm’s investment policy. The described negotiation scheme should, in fact, induce parties to write contracts as state-contingent as to minimize the aggregate cost of (i) the interest rate applied to corporate debt;172 (ii) the firm’s opportunity cost; and (iii) the expected directors’ liability cost.173

170. See supra note 65.
171. Cf. Smith & Warner, supra note 39, at 129–146 (arguing that, for each firm, would exist a unique optimal set of protective covenants that maximize the value of the firm).
172. 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 be forced to make different choices as to the corporate capital structure.
173. From this perspective, the proposed model also takes into account the complete contract approach to contract theory. In contrast to the incomplete contract approach, the latter teaches that parties can write highly state-contingent contracts, but some contingencies could not be verified by the third adjudicator. (For a brief
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The proposed model would, thus, maximize the utility of both parties. Debtors would benefit from a reduction of both the interest rate applied to debt and the opportunity cost, because creditors would become better able to price the investment’s underlying risk. Creditors, on the other hand, would be \textit{ex ante} compensated for the investment’s hidden options that managers intend to exercise, because they would have sufficient information at their disposal to price such hidden options and adjust the cost of debt accordingly.

2. Textualist Interpretation and Enforcement of the Duty to Creditors

A regime of textualist interpretation would also mandate to read restrictively the contractual provisions that specify creditors' accepted risk (i.e., the CAR provisions). This means that, as pointed out by Professor Schwartz together with Professor Scott, contractual clauses should be interpreted on a narrow evidentiary base, which essentially includes solely the contract itself.\footnote{174} Moreover, it should also 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."\footnote{175}

Contractual terms should be read restrictively because contracting parties have more and better information on the substantive terms of their exchange than any other party.\footnote{176} For this reason, they are in the best position to assess the relative costs and benefits of their relationship and allocate contractual rights so to maximize the value of their exchange.\footnote{177} It follows that any contractual interpretation not conforming to the letter of the contract would risk altering the distribution of

discussion on the meaning of unverifiable information, see \textit{infra} note 176). To solve this problem, under the proposed model, parties could play with the cost individuated in the text. In particular, to avoid the opportunity cost implied by less contingent covenants, which would be the natural response to unverifiable information, the debtor could well offer to pay a higher interest rate. From this perspective, extra spread on the interest portion and contractual rights, in the case of non verifiable information, could be regarded as substitute goods for the creditors.

174. Schwartz & Scott, \textit{supra} note 6, 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. \textit{See id.}

175. \textit{Id.} at 570.

176. 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., \textit{supra} note 14, at 119–20. (Eggleston et al. considers 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 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.) On the utility of the proposed model to solve the problem of unverifiable information, see \textit{supra} note 173.

rights agreed upon by the parties and, in turn, reducing the expected value of their exchange. 178

Indeed, if the CAR could be determined on the basis of the courts’ subjective interpretation of the parties’ intentions, courts themselves, rather than parties, would (re)determine the duty’s scope and content. This would lead to a managerial policy of underinvestment. In fact, managers would be so concerned over the possibility of a judicial error in the duty’s determination that they would avoid taking risk altogether. And because corporations need to take risks to prosper, this would jeopardize the maximization of corporate welfare. 179

Under a textualist interpretative regime, 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 would be a necessary condition for the enforcement of the duty to creditors. It would not also be a sufficient condition, however. To be able to claim directors’ liability, creditors should 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 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 the one side, there would be the CAR provisions, fixing the risk accepted by creditors; on the other, the provisions setting the terms of repayment of debt. The violation of just one type of contractual provision would not entail the breach of the duty to creditors. Directors could not 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 if a payment obligation was 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. To establish *ex ante* (i.e., before a payment default) whether the depreciation of creditors’ claims was determined by the breach of the duty (i.e., of the CAR provisions), rather than by some macro-economic variable,


179. 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. Because, under the current regime, the uncertainty surrounding legal procedures would induce creditors to prefer out of court settlements, borrowers might attempt to profit from this tendency to seek to extort more favorable contract terms. See Chen & Wei, *supra* note 68, at 223–31.
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would, in fact, be very difficult. Yet, in such an event, creditors could still trigger the contract for breach of the CAR provision and seek compensation from the corporation.

C. Exemption from Liability

Under the proposed model, directors would have several options to negotiate an exemption from liability. First, they could negotiate exculpatory clauses from liability. This does not mean that directors could undertake any kind of project they might like. The debt contract could (and, most likely, will) still impose limits on the management of the firm’s investment policy. The negotiation of exculpatory clauses would simply imply that directors could not be held liable to creditors in the case where an investment decision resulted in the breach of a contractual covenant on the CAR (and, contextually, in a default on payment). In addition, under the proposed model, should directors want to reserve further options to increase the level of risk agreed upon in the debt contract, they would have two alternatives at their disposal. They could bargain for a contractual right either to renegotiate the credit agreement’s terms or to exit the relationship by refinancing the outstanding debt.

This set of options to avoid liability would not impair the system of incentives provided by the proposed model as to the disclosure of information. To begin with, in seeking exculpatory clauses, managers would still disclose information. As anticipated, opting out of the duty would have an intrinsic informational meaning. Indeed, as managers opting in the duty would allow the market to break by offering contractual terms that do not appeal to bad firms, managers opting out of it would allow the market to break by refusing to offer creditors such contractual terms. In turn, 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 projects, directors would be also forced to reveal information. From this perspective, the disclosure policy implied by the renegotiation of the contract’s terms would work as a typical dissipative signal conveying (additional) information on the quality of the firm’s claims and

180. When managers bargain a contractual right to renegotiation, they practically reserve an option to negotiate for future options. More simply, the parties agree they will agree. From this perspective, the debt contract’s function becomes that of providing general criteria regulating the future negotiation of the parties. In optional language, the contract fixes the criteria establishing how future options should be priced.

181. See supra Part III.A.2.

182. See supra note 143.

183. 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 because of the problems discussed in Part I.B.2.d. and because they could not adequately estimate the value of the riskier project(s) that managers want to undertake. On this latter problem, see Myers, supra note 39, at 158.
management.\footnote{See Tirole, supra note 40, at 249 (stating the adverse selection problems arising out of asymmetry of information can be reduced "through disclosure to investors of information about the firm's prospects").} In particular, although soft information might be easy to manipulate, the dissipative signal function served by the disclosure policy mechanism just described should also work for this kind of information. By making managers directly liable to creditors, the duty should lead creditors to deem disclosed information credible even when such information is not directly verifiable, i.e., it is soft.\footnote{Id. at 249–50. See also sources cited supra note 39.}

The proposed model of exemption from liability would also not jeopardize the firm’s interest in secrecy. Consider, for instance, the interests of a mining company wanting to explore international opportunities. Further assume that the company’s management also wants to buy a mine in a risky place, which itself is a high variance investment. The managers, however, do not want to disclose this latter piece of information, because it could tip off other bidders. In such a circumstance, managers will thus face a trade-off between the value of keeping this information secret and the reduced cost of debt following the disclosure of such information. As explained above, if managers decide not to disclose accurate information, creditors might react in two ways. They might ask for more general covenants, which translate in a higher opportunity cost, or they might negotiate a higher interest rate to be covered against the risk they believe managers have not disclosed. Then, it will be up to managers, who are in the best position to take such a decision, to evaluate whether it is more convenient to opt for disclosure or bear a higher cost of debt.

D. The Mechanics of the Duty and its Possible Conceptualization

The ultimate purpose of the proposed model is to try to make contracting parties able to devise the best allocation between investment’s risk and policy restrictions (i.e., opportunity and monitoring costs) so as to maximize the \textit{ex ante} value of their exchange. To this end, contracting parties would determine privately what scope the duty should have. For instance, they could provide for a different scope of the duty depending on the financial conditions of the company. They could establish that, until the company is a going concern, directors could pursue any kind of investment they like. When the company starts to experience financial distress, instead, directors could be held to the respect of some predetermined financial parameters.\footnote{The idea here is that, as long as the company is a going concern with very liquid financial resources, creditors could even agree in the contract for the absurd; for example, creditors could agree that managers are free to gamble the company’s money at the casino. Yet, once the company starts experiencing financial distress, the same managers could no longer make an investment choice of this kind but would be held to the respect of some predetermined financial parameters.} With the same logic, contracting parties could agree that directors could pursue risky projects even when the corporation is in the vicinity of insolvency. The question would simply be how much creditors would ask to sell this kind of option (i.e., to bear the higher risk that this option implies). Under this view, the set of liability exemptions described above would serve as additional con-
tractual instruments the parties would have at their disposal to devise the best allocation of their interests.

It follows that 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 a right). As a result, directors’ discretion in the firm’s management would increase. In addition, the proposed model would also exclude that the fear of liability’s exposure might impair managers’ decision-making when their resolute action is most needed.187

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 that it risks being misleading. It is incomplete because, as previously discussed,188 it neglects that directors’ incentives to behave opportunistically arise in the same moment in which the company incurs indebtedness. It risks being misleading because it implies that directors owe the same duties to shareholders and creditors. This creates uncertainty and exacerbates the intrinsic conflict between these two classes of stakeholders. In fact, this proposal does not impose on directors any obligation to maximize creditor value,189 but the different one of respecting the investment’s risk agreed upon in the debt contract by the parties themselves.

1. A Basic Taxonomy

Three basic scenarios could be individuated as to the contractual determination of the duty to creditors:

187. This was one of the main critiques raised against the vicinity of insolvency standard proposed in the Credit Lyonnais decision. See, e.g., Rao et al., supra note 97 (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). For this reason, nearly-insolvent companies would risk going “bare” in the moment in which they need the resolute action of their managers most. In addition, even when directors decide to stay, “[t]he prospect of such [a] poorly defined, potentially large liability could chill directors’ exercise of their business judgment when confronted with difficult choices.” Id. at 66. As a result, directors “may feel constrained to make overly-conservative decisions when they are unsure whether their corporation is in the ‘vicinity of insolvency.’” Id. In similar terms, see McDonnell et al., supra note 90, at 180 (arguing that “[d]irectors . . . , fearing the imposition of personal liability, may be hesitant to accept or remain in their positions”).

188. See supra Part II.A.1.

189. As previously discussed, this would lead to a policy of underinvestment which would ultimately compromise the maximization of corporate welfare. See supra Part I.B.1.
(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 positive or negative covenants. In this case, directors would be free to pursue any project they may like. Under the proposed regime of textualist interpretation of the debt contract, creditors would be presumed to have accepted any kind of risk. The interest rate applied to the debt, in turn, will reflect such an arrangement of the parties’ relationship. In accordance with this proposal, in fact, the market should have enough information to price this kind of specific risk and demand an adequate compensation;

(ii) the debt contract could specify the level of risk accepted by creditors and, therefore, set the scope of the duty. In this case, the duty would have the effect to supplement the obligations undertaken by the company, as subscriber of the debt contract, with a side obligation of directors. More analytically, the duty, making directors liable also to creditors and serving as a bonding mechanism to fulfill the contract, would solve the above-described asymmetry intrinsic to the geometry of corporate debt. Because under the proposed model, directors would be liable to creditors for breach of the CAR provisions, they would no longer be incentivized to undertake corporate projects that pursue the shareholders’ interests in violation of the letter of the contract, because they would personally bear the cost of such a contractual breach;

(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 the duty’s breach. In the first case, however, both the directors and the company would be exempted from liability; here, instead, the company would still be liable to creditors for breach of contract. In other terms, by opting for this kind of contractual arrangement, parties would go back to the current regime, but to do this they should disclose additional information.

2. A Possible Conceptualization of the Duty

Although attempting to re-conceptualize the proposed duty to creditors is a task which will require much more investigation than that carried out so far, I will try to outline some preliminary ideas on the matter. My basic claim is that, pursuant to the interpretation of the fiduciary duty of good faith recently advanced by the Production Resources and the Disney decisions, the proposed duty could be subsumed under such a fiduciary paradigm. In accordance with the Production Resources opinion, the duty could well be read as sanctioning the lack of (vertical) good faith in the fulfillment of directors’ obligations which arise from the debt contract. Similarly, consistently with Disney, one could say that the proposed duty sanctions directors’ intentional failure to fulfill their known duties deriving from the debt contract.

190. See supra Part II.B.1.
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From this perspective, creditors should be considered indirect beneficiaries of the duty, which would run to the corporation. This would also be consistent with the court’s decision in Production Resources, which has advocated a return to the traditional corporate law view of the corporate entity as the ultimate beneficiary of directors’ fiduciary duties\(^\text{91}\) (and, consequently, also claimed the derivative nature of creditors’ rights). Although not all commentators share this view,\(^\text{92}\) most have welcomed this formulation of the duties.\(^\text{93}\) Nevertheless, unlike in Production Resources, where the creditors’ right to bring action against directors is determined by corporate insolvency, under the model I envisage, the violation of the CAR provisions would trigger creditors’ rights. This would solve the problem of the co-existence between managerial duties to creditors and shareholders. Directors’ decision-making would not be complicated by the fact that they owe duties both to creditors and shareholders, because, in the proposed textualist interpretative regime, their duty to the former would be limited to what was established by the debt contract.

E. 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 of modifying the current distribution of legal entitlements so to enable parties to write better contracts. In the case of other fixed claimants, instead, the law would already attribute express rights to solve the potential inefficiency arising from the creditors’ relationship with the corporation.\(^\text{94}\) Labor law, for instance, is the legal instrument designed to solve the inefficiency of the employment contract. Thus, minimum wage, safety, plant-closing, unemployment compensation, and other labor laws\(^\text{95}\) provide substantial protection to the interests of employees and, more generally, ensure that they can write good contracts.

In addition, other fixed claimants’ contractual relationship with the corporation is characterized by a lower “transactional insecurity” than the creditor-debtor relationship.\(^\text{96}\) The latter expression describes the situation that may arise when the

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191. See *supra* note 25. The view identifying the corporation as ultimate beneficiary of directors’ duty used to be very popular at least until the rise of the contractarian theory of the firm, which, instead, identifies shareholders as the exclusive beneficiary of the duties.

192. See Bainbridge, *Much Ado*, *supra* note 41 (arguing that the approach characterizing the duty of directors as running to the corporate entity rather than any individual constituency is “incoherent in practice and unsupported in theory”).


194. 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.B.1.

195. For instance, employees enjoy a priority right over other creditors’ claims in case of bankruptcy.

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 because the lender carries out in full its side of the exchange before the debtor. In contrast, in the case of other fixed claimants, like trade creditors, this risk is limited by the fact that they usually provide their service/goods on a short-term basis. If the debtor defaults on payment, the creditor can simply stop providing the services or good and, assuming competitive markets, take their business elsewhere. The credit interest of employees is even on a shorter basis than that of trade creditors. Thus, always assuming competitive markets, the transactional insecurity risk faced by employees is very limited.

Finally, following the reasoning illustrated in the context of the discussion on the geometry of corporate debt, creditors who are not capital providers would not qualify as principal of the corporation. On the contrary, some of them (employees, for instance) would instead be corporate agents. Under this view, the reasons above-listed to justify the existence of the duty in favor of creditors that are capital providers would not apply to other fixed claimants.

1. The Distinction between Bondholders and Other Capital Providers

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. In fact, the informational asymmetry problem would be more pressing in the case of bondholders. This means that, at the margin, bondholders would benefit more from the attribution of the proposed duty than would banks.

197. 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. In both cases, the short term of credit would limit the damage suffered by the creditors. Contra Lipson, supra note 1, at 1248–49.

198. 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 fact, trade creditors may well specialize in providing services/goods that are 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 because 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.

199. See supra Part I.B.2.c.

200. It should be noted that when I refer to bondholders I refer, basically, to the holders of privately placed debt. Indeed, because the default risk of public bonds is usually quite limited, there is commonly little asymmetry of information among markets participants about the value of public bonds. Thus, unlike in the case of...
The basic difference between banks and bondholders is that the latter do 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. Indeed, banks commonly enjoy a permanent organizational structure, which routinely perform credit analysis of potential borrowers to assess the underlying risk of the investment. In contrast, the dispersive nature of the organizational structure of bondholders raises coordination problems which may impair their ability to process information and, therefore, to write good debt contracts. As a result, not only do banks tend to have more information than bondholders, but they also tend to be in a better position to assess the firm-specific and industry-specific risk. Finally, to obtain information, banks can use economic and political means that bondholders would not have at their disposal.

Still, it could be argued that the information released in the bond prospectus and that provided by rating agencies are sufficient to ensure "a fairly high level of disclosure." This analysis, however, overstates the quality of the information released to bondholders. Not only does information contained in the bond prospectus tend to be not so material, but it is also doubtful whether information provided by rating agencies is valuable at all to measure the corporate risk. Contrary to the dominant opinion that "credit rating agencies enhance the capital markets infrastructure by distilling a great deal of information . . .," I share Professor Partnoy's view that "credit ratings are of scant informational value." Several ele-

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201. See Triantis, supra note 51, at 309-11 (discussing the importance of banks as financial intermediaries that yield significant information about firms' activities and financial condition).

202. The elements considered in the credit analysis performed by banks are commonly referred to as the "five Cs of credit": (i) character of management; (ii) capacity (capability) of management (or the entrepreneur in closely held corporation); (iii) capital (i.e., capital structure, cash flows statements, liquidity, etc.); (iv) collateral (i.e., the market and liquidation value of the corporate assets); and (v) coverage (i.e., the existence of insurance against the death or disability of a key person). See Tirole, supra note 40, at 82.

203. See Lipson, supra note 1, at 1249-50. See also Triantis, who notes that banks often have representatives on the boards of their debtors, which does not happen in the case of bondholders. Triantis, supra note 51, at 314.

204. Lipson, supra note 1, at 1250.

205. See Mitchell, Corporate Bondholders, supra note 28, at 1181 n.55 (claiming that "the prospectus more restates than explains relevant bond terms and is always qualified by reference to the indenture"). Professor Mitchell also quotes Brealey & Myers, supra note 107, 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." Id. at 1181 n.52.

206. Susan M. Phillips & Alan N. Rechtschaffen, International Banking Activities: The Role of the Federal Reserve Bank in Domestic Capital Markets, 21 FORDHAM INT'L L.J. 1754, 1762-63 (1998). See also George G. Triantis & Ronald J. Daniels, The Role of Debt in Interactive Corporate Governance, 83 CAL. L. REV. 1073, 1110 (1995) (arguing that "information intermediaries, such as securities analysts or credit rating agencies, facilitate such conventions by decoding ambiguous signals").

ments would sustain this view. In recent years, there have been multiple defaults not anticipated by rating agencies. It seems thus fair to infer that rating agencies are poorly equipped to predict the corporate risk. This would be even truer in the case of highly-risky investments (i.e., sub-investment-grade issues), as confirmed by the fact that investors in lower-quality issues tend to rely on other sources of information. Empirical evidence and numerous academic studies also confirm that rating agencies lag the market and that the market anticipates rating changes.

From this perspective, the traditional view of credit ratings as screening mechanisms for information unavailable publicly appears difficultly assertable. Quite on the contrary, credit ratings would be determined on the basis of standard economic indexes, such as the debt-to-equity ratio, liquidity of the existing assets, dividend policy, etc. Indeed, even though the process used to generate ratings includes meetings with the issuer’s representatives, agencies would not be able to extract from them private information that can prove disadvantageous for the issuer if released to the public. In addition, even admitting that agencies could obtain all relevant information, there would still be a credibility problem. Because representa-

Partnoy has written extensively on the role of credit rating agencies, arguing that the continuing prosperity of the agencies is best explained by the regulatory dependence on credit ratings rather than by the alleged informational value of the ratings. See, e.g., Frank Partnoy, The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies, 77 Wash. U. L. Q. 619 (1999) [hereinafter Partnoy, Two Thumbs Down for the Credit Rating Agencies].

208. Unfortunately, the case of Enron is only the last of a series of unanticipated defaults, involving both private and public entities. See Partnoy, Two Thumbs Down for the Credit Rating Agencies, supra note 207, at 621 n.8.

209. Id. at 621 n.9 (arguing that the collapse, at the end of the nineties, of Long-Term Capital Management, the Connecticut hedge-fund that reported losses of $4 billion, “prodded” the major credit rating agencies to review the credit quality of most U.S. and European banks, and to downgrade one of the banks, Bankers Trust).


211. See Partnoy, Two Thumbs Down for The Credit Rating Agencies, supra note 207, at 647 n.132 (citing, among others, George Pinches & J. Clay Singleton, The Adjustment of Stock Prices to Bond Rating Changes, 33 J. Fin. 29, 39 (1978), who carried out a survey on 207 corporate bond rating changes from 1950 to 1972 and found that most changes merely reflected information already incorporated in stock market). See also James C. van Horne, Financial Market Rates and Flows 191 (3d ed. 1990); Richard Cantor & Frank Packer, Determinants and Impacts of Sovereign Credit Ratings, Fed. Reserve Bank of N.Y. Econ. Pol’y Rev., Oct. 1996, at 45–46; Galen Hite & Arthur Warga, The Effect of Bond-Rating Changes on Bond Price Performance, Fin. Analysts J. May/June 1997, at 35. Partnoy argues that credit spreads (i.e., the difference between the yield on a particular bond and the yield on a risk-free bond with comparable characteristics and maturity) are more accurate than credit ratings and denies that credit ratings include additional information not already reflected in credit spreads. In fact, for Partnoy, credit spread would reflect all available information in the market, including the rating. From this perspective, he proposes to substitute the current credit rating-based regulation with credit spread-based regulation. See Partnoy, Two Thumbs Down for The Credit Rating Agencies, supra note 207 at 655–62, 704–5. Because credit ratings influence market prices, however, Partnoy’s solution risks suffering indirectly from the same problems he aims to overcome.


tives of higher quality issuers do not have credible signals at their disposal to convey their corporate risk,\textsuperscript{214} analysts would be unable to distinguish them from inferior quality issuers. The result is that single rating categories will tend to be determined on the basis of the average risk rather than the specific risk characterizing firms. Put differently, the single rating category will normally include firms characterized by different risk profiles. Thus, rather than serving as credible signals of firms' credit quality and corporate risk,\textsuperscript{215} credit ratings would to some extent contribute to the current pooling equilibrium between bad and good firms.

\textbf{F. Some Policy Considerations}

An aspect of this proposal which might raise some difficulties is that of directors' liability insurance. Indeed, one could argue that directors will most likely seek some form of coverage against their potential liability to creditors, either requiring extra compensation or company-funded insurance.\textsuperscript{216} In this way, the ultimate cost of directors' liability would be borne by the company's shareholders. Hence, the liability threat would no longer serve to redress the inefficiency intrinsic to the geometry of corporate debt, because once again directors would not have to pay for creditors' damages out of their own pockets. Although further analysis is required on the issue, hereinafter I draft some preliminary considerations.

In the first place, I wonder whether such an interest would be insurable. An insurable interest is, in general, a loss that is not intentionally caused by the insured. Yet, under the textualist interpretative rule that I propose, the duty's breach could only be triggered by a violation of the debt contract provisions on the CAR and, as such, be intentionally caused by the directors. Therefore, because only a policy with an insurable interest at its basis can be purchased and is enforceable, I wonder how can managers be insured against a risk they have the exclusive power to trigger.\textsuperscript{217}

Still, should such an interest be insurable, 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 duty's breach, directors would still be subject to a significant reputational threat as a result of the proposed liability rule. Indeed, I do not conceive of directors' liability insurance

\textsuperscript{214} This seems especially true as to the risk underlying future corporate projects. See \textit{supra} note 55 on the distinction between prospective and retrospective information.

\textsuperscript{215} See Partnoy, \textit{Two Thumbs Down for The Credit Rating Agencies}, \textit{supra} note 207, at 631.

\textsuperscript{216} 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 purchased directly by the company would presumably decrease, because of the higher bargaining power of the firm. See Vanessa Finch, \textit{Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance}, 57 Mod. L. Rev. 880 (1994); Reinier H. Kraakman, \textit{Corporate Liability Strategies and the Costs of Legal Controls}, 93 Yale L. J. 857 (1984).

\textsuperscript{217} Independent directors would represent an exception. Indeed, because directors' liability to creditors would be of a collegiate nature, the former should always be insurable against such a risk.
liability as a compensatory means, even though in closely held corporations it could serve also this function. Instead, the duty's ultimate purposes are to provide a bonding mechanism inducing directors to fulfill the contract and to serve as a means incentivizing the disclosure of private information. Should directors have liability insurance, these basic functions would still be served by the risk of reputational capital depreciation to which directors would be subject for breach of the duty. Under this view, the reputational capital would most likely be the most important variable insurance companies would consider in pricing directors' insurance.\footnote{This means that insurance companies would also monitor directors. In turn, the risk of reputational capital depreciation following the duty's breach would increase.}

More interesting, however, is understanding the impact of the possible liability insurance on the choice of the corporate fiduciary model and capital structure. Indeed, in devising the best capital structure, managers would take into consideration the tradeoff between the reduced cost of debt determined by the existence of the duty and the increased cost of equity determined by the liability insurance and shape their contractual relationships with creditors accordingly. If the increase in the cost of equity outweighed the reduction of the cost of debt, 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 (i.e., shareholders) 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.\footnote{This seems consistent with Smith and Warner's conclusion that "there is an optimal form of the debt contract, but an optimal amount of debt as well." Smith & Warner, supra note 39, at 154.}

From this perspective, innovative finance could play an important role in devising hybrid financial instruments that would better reflect not only the risk of the underlying assets, but also the parties' distribution of entitlements and liabilities.\footnote{The problem of the firm's capital structure has been investigated by Oliver Williamson. In his 1988 essay on Corporate Finance and Corporate Governance, he points out how assets with high specificity (and high variance) should be financed through equity; whereas assets with low specificity (and low variance) through debt. Economically, this would be explained by the fact that even though debt has a lower cost of capital (being, inter alia, deductible for tax purposes) than equity, it has a higher marginal cost. From this consideration, Williamson moves, then, to propose the development of financial instruments gathering the characteristic of both debt and equity instruments. Under this view, the discourse on the cost of directors' liability versus that of insurance should also be evaluated in devising financial instruments which reflect the best allocation of debt and equity. Cf. Oliver Williamson, Corporate Finance and Corporate Governance, 43 J. Fin. 567 (1988).}

IV. CONCLUSION

Creditors' rights should be governed by contract. Under the current model of corporate fiduciary law, however, informational asymmetry makes the parties unable to write debt contracts that govern the managerial opportunism problem effi-
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ciently, i.e., pursuant to a welfare-maximization criterion. This, in turn, leads to the inefficient allocation of credit capital and to cross-subsidization and adverse selection problems.

To redress the present inefficiency, I suggest the adoption of two legal institutions. First, I propose a default rule of law imposing on directors a duty not to increase unilaterally the risk accepted by creditors in the debt contract. Second, I propose a rule of textualist interpretation of the debt contract, mandating to consider accepted by creditors any risk they have not contractually limited or excluded. Such institutions would serve two basic functions: (i) to enable parties to write more state-contingent contracts; and (ii) to make the debt contract a credible signal on corporate risk.

By charging directors with personal liability for the ex post increase of the investment’s risk negotiated in the contract, the duty would bond managers to stay in the contract and prevent them from exercising investment options for which they have not paid. Moreover, making information disclosed by managers credible, the duty would enable creditors to price debt on the basis of the contract’s provisions rather than by pooling firms in general risk categories. Paired to the duty’s existence, a rule of textualist interpretation would then prompt Nash bargaining between the parties leading to an optimal level of specification of the debt contract. As to creditors, such a rule would work as a penalty default inducing them to specify to a greater extent in the contract. As to directors, instead, it would have them to disclose more information so as to avoid the drafting of general covenants that, being poorly state-contingent, would extend the area of their liability to creditors.

Finally, the proposed model should enable the credit market to move from the existing pooling equilibrium, in which debt is priced on the basis of the average risk increase pursued by firms in a given risk category, to separating equilibria, in which debt is priced on the basis of the firm’s specific risk. In addition, because parties could determine what scope the duty should have by contract, the model would enable them to bargain for the most cost effective trade-off between an investment’s level of risk and opportunity and monitoring costs. Hence, the proposed model would allow parties to write debt contracts that maximize the ex ante value of their exchange. From this perspective, any contractual interpretation not conforming to the letter of the parties’ agreement would risk reducing the expected value of their exchange by leading to a re-determination of the duty’s scope, and therefore of the parties’ distribution of rights, by the third adjudicator. Also for this reason, I argue that a textualist interpretative regime should be preferred over a contextualist one.