THE QUALIFIED CASE AGAINST
MANDATORY TERMS IN BONDS

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I. INTRODUCTION

Bonds\(^1\) are among the most important sources of capital for American companies. In 1993, companies sold about $450 billion in investment-grade and junk bonds\(^2\) to the public. In comparison, they issued only $86 billion worth of common stock and about $30 billion worth of preferred stock.\(^3\) The year 1993 was not exceptional. In both 1992 and 1991, companies raised more than three times as much money from the public sale of bonds than from the sale of common and preferred stock combined.\(^4\)

As bonds promise investors fixed interest and principal payments, they may seem to be safe investments. But companies can, and do, take actions that increase the risk of default and cause dramatic losses to their bondholders. For example, the value of RJR Nabisco bonds dropped by $1 billion upon the mere announcement of RJR's proposed leveraged buyout.\(^5\) The RJR buyout was the climax of the take-

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1 The term "bond" is commonly used either as a catchall term for different debt securities (e.g., notes and debentures) or, more narrowly, for a debt instrument secured by collateral (e.g., a mortgage bond). In this Article, I use "bond" in the former sense.


3 Tom Pratt, A Knockout Year for Wall Street, Investment Dealers' Dig., Jan. 10, 1994, at 18. These figures exclude collateralized securities, stock issued by closed-end mutual funds, and privately placed securities. Pratt does not report separately the amount of convertible preferred stock and convertible debt issued in 1993, but extrapolating from 1992 figures, about $8 billion in convertible preferred stock and $7 billion in convertible bonds were issued.

4 See How Sweet It Was!, Investment Dealers' Dig., Jan. 11, 1993, at 14 (stating that companies sold $520 billion in nonconvertible bonds, $14 billion in convertible bonds, $104 billion in common stock, and $49 billion in preferred stock). In terms of market values of outstanding securities, corporate bonds also account for a substantial portion of companies' capital sources. See Board of Governors of the Fed. Reserve Sys., Flow of Funds Accounts: Flows and Outstandings 112, Corporate and Foreign Bonds, line 1, Corporate Equities, line 1 (Mar. 10, 1993) (stating that by end of 1992, $1,883 billion in bonds and $5,127 billion in equities were outstanding).

over wave of the 1980s, in which bondholders of over two hundred companies suffered severe losses.6

Such bondholder losses were not unique to the 1980s. In 1992, Marriott Corporation shocked the bond market by announcing the spin-off of its profitable hotel management business from its ailing real estate operations.7 The planned spin-off inspired several lawsuits by bondholders; and the mere fear of similar actions by other companies caused a staggering $11 billion loss in the corporate bond market.8 In the 1970s, bondholders had suffered losses as a result of debt-for-equity exchange offers and recapitalizations.9 And with the recent surge in the takeover market,10 the stage is set for the next wave of bondholder losses.11

Transactions such as the RJR Nabisco buyout and the Marriott spin-off have attracted the attention of commentators who believe that bondholders receive insufficient protection in their bond contracts. Several commentators have suggested that companies be subjected to variously defined fiduciary duties to bondholders.12 Other

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6 Id. at 933 n.2.
8 See Michael Liebowitz & Michael Brown, Merrill Drops Marriott, But Problems Not Over, Investment Dealers’ Dig., Nov. 23, 1992, at 9 (reporting estimates by Lehman Brothers that the Marriott news caused $11 billion in losses in the corporate bond market); Edwin McDowell, Court Declines to Dismiss Marriott Bondholders’ Suit, N.Y. Times, Apr. 24, 1993, at 39 (reporting that eight bondholder suits had been settled and that one was still pending); see also Michael Liebowitz, Marriott Spin-Off Last Straw to Fed-Up Corporate Bond Mart, Investment Dealers’ Dig., Oct. 12, 1992, at 10 (reporting business fears of more spin-offs and increase in yield spreads from 10 to as many as 50 basis points); Constance Mitchell, Corporates’ New Trait: Volatility, Wall St. J., July 19, 1993, at C1 (reporting decline in bond prices of Pacific Bell after parent Pacific Telesis Group announced plan to spin off its wireless operations).
9 See generally Ronald W. Masulis, The Effects of Capital Structure Change on Security Prices, 8 J. Fin. Econ. 139, 171 (1980).
11 See Johnnie L. Roberts, Credit Agencies Lower Paramount, Viacom Ratings, Wall St. J., June 9, 1994 at B6 (reporting that in wake of Viacom’s leveraged acquisition of Paramount, rating agencies lowered credit rating of both companies).
reform proposals have focused more narrowly on specific bondholder rights. Professors Coffee and Klein and Professor Brudney, for example, advocate rules to prevent companies from “coercing” bondholders to approve amendments to their bond contract. Other commentators have favored enhancing the fiduciary duty of the trustee, who acts as representative of the bondholders for certain purposes, or subjecting the trustee to stricter conflict of interest provisions.

Though these reform proposals touch on a number of different features of corporate bonds, they share one common presumption: that the contractual terms of bonds are inadequate and that judges and legislatures should impose additional protection through “mandatory” terms that cannot be varied contractually. This postulated necessity for mandatory terms is the focus of this Article.

At present, most of the terms of a bond are contractual. The bond terms are contained in the so-called bond indenture and, to a lesser extent, in the bond certificate itself. In addition to certain economic provisions—such as the interest rate the bonds bear and whether the company has the option to redeem its bonds—bonds can include several legal terms, so-called “covenants,” that are designed to protect bondholders. For instance, a bond indenture may restrict a

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16 See, e.g., Brudney, supra note 12, at 1849-52 (attacking notion that bondholders understood or were told about possibility of “coercive” amendments); Coffee & Klein, supra note 13, at 1251-53, 1267-69 (advocating both contractual prohibition of bondholder “coercion” and prohibition by regulatory fiat); McDaniel, Bondholders and Corporate Governance, supra note 12, at 429 (concluding that contractual protection has not worked); Mitchell, supra note 12, at 1181-84 (arguing that since bondholders are completely unrepresented when bond contract is negotiated, extra-contractual duties must be imposed to protect them).
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company's ability to incur additional debt or to pay dividends to shareholders, set conditions for mergers, define when the company is in default and the rights of the bondholders upon a default, provide for subordination of the bonds, or specify how the indenture can be amended.¹⁷

Though most of these terms are purely contractual and discretionary, a few indenture terms are specified by the Trust Indenture Act of 1939¹⁸ and may be varied either not at all or only within limited parameters.¹⁹ The most important of these few mandatory provisions is the rule governing so-called "midstream" changes in the interest rate or maturity, that is, changes after the bonds are issued. The Trust Indenture Act in effect requires the unanimous consent of bondholders for such changes.²⁰ Interestingly, this one mandatory term of importance has been criticized by commentators as inhibiting pre-bankruptcy workouts. These commentators have urged the repeal of the "unanimous consent" requirement.²¹

While commentators concerned with bondholder rights have debated the various reform proposals, others have carried on a separate debate over the general need for mandatory terms with respect to stocks.²² The questions of mandatory terms for stocks and for bonds have some obvious parallels. Both stocks and bonds are publicly is-

¹⁷ See, e.g., American Bar Foundation, Commentaries on Indentures 202-77, 290-311, 368-421, 558-83 (1971) (discussing use of these provisions).
²⁰ More precisely, § 316(b) of the Trust Indenture Act of 1939 provides that the right of any holder to receive interest and principal payments may not be "impaired" without the consent of such holder. 15 U.S.C. § 77ppp(b) (1988). Since unanimous consent can rarely be obtained, companies that want to change interest or maturity terms commonly offer new bonds in exchange for the bonds the terms of which are to be changed. Bondholders who agree to the changes will exchange their bonds for the new bonds; those who do not agree retain their bonds with the original interest and maturity terms.
sued securities sold in impersonal financial markets, and both are sources of investment capital for companies. On the other hand, there are important differences between the economic rights of bondholders and those of stockholders and, as I will show, between the institutional settings of the bond and stock markets.

This Article will connect these separate debates and develop a framework for analyzing the circumstances under which mandatory legal rules should govern the relationship between a company and its bondholders. This framework will then be applied to two of the proposed reforms: the recognition of a fiduciary duty of a company to its bondholders and the prohibition of "coercion" in consent solicitations. Due to the parallels between stocks and bonds, the framework shares certain structural features with the one applied to stocks. But as a result of the economic and institutional differences between stocks and bonds, the analysis of the need for mandatory terms in bonds diverges in important ways from the corresponding analysis for stocks. Thus, even commentators who favor mandatory terms in stocks may oppose them in bonds.

The underlying normative objective of the analysis in this Article is efficiency. By efficiency, I mean the maximization of social wealth, which for purposes of this Article principally consists of the net bene-

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23 Given these parallels, it may not be surprising that the proposed reforms for bonds are similar to some of the existing mandatory rights of shareholders. Companies already owe mandatory fiduciary duties to shareholders (though some commentators want to subject that duty to contractual modification). See generally Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians, 65 WASH. L. REV. 1 (1990); Easterbrook & Fischel, supra note 22. And some of the coercive devices used in bondholder consent solicitations would not be permissible in the context of stocks. Compare Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982) (subjecting vote buying in shareholder context to strict scrutiny) with Kass v. Eastern Air Lines, Inc., No. 8700, 1986 WL 13008 (Del. Ch. Nov. 14, 1986) (holding that vote buying in bondholder context is permitted if offer to buy votes is extended equally to all bondholders) and Katz v. Oak Indus. Inc., 508 A.2d 873 (Del. Ch. 1986) (holding that it is permissible to require consent to amendment as condition to participate in exchange offer).

24 This Article does not separately address the issue of mandatory terms in convertible bonds. Much of the evidence presented in Parts II and III relates either to nonconvertible bonds or to corporate bonds at large. Since convertible bonds constitute a small segment of the corporate bond market, see supra note 4, it is possible that the convertible bond market differs substantially from the nonconvertible bond market and that these differences are not reflected in the evidence discussed. To that extent, some of the conclusions of this Article may not apply to convertible bonds. The overall analytical framework, however, would apply to convertible bonds, specifically the following elements, since they relate equally to convertible and nonconvertible bonds: Part II.A.2.a (disclosure and available information); Part II.A.2.c (standardization); Part II.A.2.d (treatment of indentures by courts); Part II.A.2.e (information intermediaries); section II.B (externalities and agency costs); Part III.A.1 (incentives to propose inefficient terms); portions of Part III.A.2 (inadequate information: proclivity of uninformed holders to vote for proposed amendments); Part III.A.3 (coercion); Part III.B (implications for mandatory terms); and Part IV (potential drawbacks of mandatory terms).
fits of a legal rule to shareholders, bondholders, and other creditors. From the perspective of efficiency, it is desirable to provide bondholders with legal rights if that would prevent companies from taking actions that would reduce the aggregate value of a company to its stockholders, bondholders, and other creditors. But legal rights are undesirable if they would prevent companies from acting to increase the company’s aggregate value. This perspective is particularly appropriate in this context, where legal rules affect two classes of securityholders: stockholders and bondholders. Since an investor may invest in either stocks or bonds, and indeed in both, distributional concerns as between stockholders and bondholders are not significant in determining the optimal legal regime.

Part II of this Article examines whether contractual freedom should be limited when bonds are issued and their initial terms are set. It discusses three potential justifications for mandatory terms at the original issuance stage: imperfect information, externalities, and agency costs of equity. Part III considers whether mandatory terms should limit the freedom to amend the terms of a bond after it is issued. Commentators have made strong arguments that such limits on midstream amendments are desirable with respect to stocks even if it is efficient for the initial terms of stocks to be purely contractual. This Part examines to what extent these arguments apply to bonds. Part IV briefly explores potential drawbacks of mandatory terms. In determining whether to impose mandatory terms, one must balance the potential inefficiencies of purely contractual terms with the drawbacks of mandatory terms.

Parts II, III, and IV constitute the general framework for analyzing whether specific mandatory terms are desirable. Part V applies this framework to two reform proposals—a sweeping proposal to recognize a fiduciary duty by companies to bondholders and a narrower proposal to outlaw coercive structures in bondholder consent solicitations. Part VI concludes.

II. MANDATORY TERMS AT ORIGINAL ISSUANCE

When bonds are originally issued, their legal terms may be inefficient for three reasons: imperfect information, externalities, and agency costs of equity. If bondholders possess inadequate information about the existence and scope of certain legal terms, they may misvalue bonds that contain these terms, and companies may include inefficient terms in their bonds. Legal terms of a bond may also result

25 This concept of efficiency is similar to Kaldor-Hicks efficiency. If legal terms are priced, rules that maximize the joint wealth of bondholders and shareholders are also Pareto superior to any other set of rules. See generally Jules L. Coleman, Efficiency, Utility, and Wealth Maximization, 8 Hofstra L. Rev. 509 (1980).
in externalities; that is, they may affect persons other than shareholders and the holders of the bond. A bond may then lack efficient terms that would benefit such third parties (since shareholders and bondholders have no incentive to have the term included), or it may contain inefficient terms that hurt them. Similarly, agency costs of equity may bias the terms of a bond. Managers may omit terms that reduce managerial wealth even if they benefit shareholders and bondholders, or they may include terms that benefit managers but hurt shareholders and bondholders.

Each of these three reasons could justify the imposition of mandatory terms on bonds. In this Part, I first examine the significance of imperfect information, assuming for simplicity that externalities and agency costs of equity do not affect bond terms. Imperfect information is the most important of these reasons, as it may provide a basis for a wide variety of mandatory terms. I then turn to externalities and agency costs of equity as separate bases for mandatory terms.

A. Imperfect Information

It is easy to show how imperfect information could lead to inefficient terms. Assume that XYZ Corporation wants to sell $100 million in bonds to Investor and considers including a covenant in the bond indenture that would restrict XYZ’s ability to pay dividends to its shareholders. Fewer dividends, of course, means more money remains within the corporation and thus available to pay Investor. With the covenant, the bonds would have to carry a 10% interest rate. Without the covenant, it would take a higher interest rate, say 12%, to compensate Investor for the risk that XYZ will pay out too many dividends and consequently be unable to repay its bonds. However, because Investor underestimates this risk, she demands only an 11% interest rate to purchase the bonds without the covenant.

Assume further that restricting XYZ’s ability to pay dividends would be efficient, that is, the combined value of XYZ’s shares and bonds is higher, say $200 million compared to $195 million, if dividends are restricted than if they are not. Covenants such as dividend restrictions can increase aggregate firm value because they prevent companies from taking actions that would reduce aggregate value, but that would nevertheless benefit shareholders because they transfer wealth from bondholders to shareholders. For example, XYZ may pay a high dividend as it approaches insolvency even if it is more efficient to invest the money paid out into XYZ’s continuing operations.26 (Note, however, that covenants can also be inefficient if they

26 See, e.g., Kahan & Klausner, supra note 5, at 938-40 (explaining how companies may act to benefit shareholders but reduce company value); see also Upinder S. Dhillon & Herb Johnson, The Effect of Dividend Changes on Stock and Bond Prices, 49 J. Fin. 281 (1994) (presenting
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prevent companies from taking actions that increase aggregate firm value.\(^{27}\)

If Investor had perfect information and demanded a 12% interest rate to purchase the bonds without the covenant, XYZ would include the covenant. Whether or not the covenant is included, the bonds would be issued at an interest rate that reflects the bonds' default risk; and the $5 million decrease in firm value if the covenant is not included would be borne by XYZ's shareholders. But because Investor "overpays" for bonds without the covenant (by accepting an 11% interest rate), XYZ may omit the covenant. The bonds for which Investor pays $100 million may be worth only, say, $93 million. Even though XYZ's shareholders forego a $5 million value enhancement by omitting the covenant, they gain $7 million by selling "overvalued" bonds to Investor. Thus, of the $7 million loss suffered by Investor, $2 million accrues as a windfall to XYZ's shareholder, and $5 million represents the efficiency loss from the failure to include the covenant.

In the case of publicly issued bonds, of course, a company does not sell bonds to a single investor, but to many bondholders. In that case, what matters is not whether the individual bondholders possess perfect information, but whether the market accurately prices the terms of a bond when it is issued. As long as the market accurately prices the terms of a bond, a company has an incentive to include only efficient terms—even if some individual bondholders are uninformed about them.

To continue the example, XYZ would face correct incentives to include the dividend covenant if it could issue bonds with the covenant at an interest rate 2% lower than the rate for bonds without the covenant. To be sure, there may be some bondholders who will purchase the bonds without even knowing whether the covenant is included and, a fortiori, what value to impute to it. But as long as enough other investors who have the requisite information assure that the market prices the covenant accurately, the existence of other uninformed bondholders will not distort XYZ's incentives.

The remainder of this section examines the operation of the bond market to determine whether the legal terms of bonds are accurately priced. The first subsection analyzes the empirical evidence on

\[^{27}\) For example, a dividend restriction that is too tight may induce companies to make investments in inefficient projects instead of distributing dividends to its shareholders. See Avner Kalay, *Stockholder-Bondholder Conflict and Dividend Constraints*, 10 J. FIN. ECON. 211, 226-27 (1982).
whether the terms of bonds are priced. This evidence, however, is necessarily inconclusive. Only a few studies have considered whether the terms of bonds are priced, and those studies can show at most that terms are priced, not whether they are accurately priced. The second subsection therefore examines the institutional setting in which bonds are issued to determine whether that setting is likely to promote accurate pricing.

1. The Pricing of Bonds.—A company might not incorporate efficient legal terms in its bonds if such terms would not be accurately priced when the bonds are issued. The degree to which the market price of an asset reflects information about the value of the asset is referred to as the "efficiency" of the market. For example, a market in which the prices of securities accurately reflect all publicly available information is called "semi-strong form efficient," while a market where prices reflect both public and nonpublic information is "strong form efficient."28 (To avoid confusion between this concept of informational efficiency and economic efficiency, which I use as the normative objective of my analysis, I will refer to the former as "informational efficiency" and to the latter as "efficiency."

Many studies have examined the informational efficiency of the U.S. stock market. Most have concluded that the stock market is informationally efficient in the semi-strong form, though not necessarily in the strong form.29 Some recent studies, however, have pointed to specific pricing patterns that seem, at least at first blush, inconsistent with semi-strong informational efficiency.30 Commentators summarizing the collective evidence have arrived at different conclusions as to the overall informational efficiency of the stock market.31

29 For an overview of these studies, see, e.g., Thomas E. Copeland & J. Fred Weston, Financial Theory and Corporate Policy, 361-93 (3d ed. 1988).
30 See, e.g., Marcel Kahan, Securities Laws and the Social Costs of "Inaccurate" Stock Prices, 41 DuKE L.J. 977, 998 (1992) (summarizing studies finding anomalous price patterns and potential explanations for such patterns that are consistent with informational efficiency).
31 Compare, e.g., Copeland & Weston, supra note 29, at 392 (concluding that most evidence suggests that market is at least semi-strong form efficient); Easterbrook & Fischel, supra note 22, at 1431 ("[A] great deal of data . . . supports the proposition that prices quickly and accurately reflect public information about firms.") and Michael C. Jensen, Some Anomalous Evidence Regarding Market Efficiency, 6 J. Fin. Econ. 95 (1978) ("[T]here is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis.") with Thomas L. Hazen, The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law, 70 N.C. L. Rev. 138, 153-57 (1991) (finding it difficult to attribute market movements solely to rational economic behavior); Donald C. Langevoort, Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited, 140 U. Pa. L. Rev. 851, 872 (1992) (stating that an "objective observer," when presented with conflicting evidence on informational efficiency of stock market, would be "something of an agnostic") and William K.S. Wang, Some Arguments That the Stock
But, while the degree of informational efficiency of stock markets may be an enlightening analogy, it is the informational efficiency of the bond market that matters for our inquiry. In particular, what matters is the even narrower issue of whether the bond market is informationally efficient in pricing legal terms when a bond is issued, rather than whether the bond market is generally semi-strong or strong form efficient.\(^3\) As long as the legal terms are accurately priced when a bond is issued, other forms of mispricing will not distort the company's incentives to include wealth-maximizing legal terms.\(^3\)

The following discussion thus focuses on the pricing of legal terms and on the pricing of bonds when they are issued. However, since only few studies are directly on point, I also briefly discuss studies of the informational efficiency of the bond market in other contexts.

\(a. \) The pricing of legal terms.—Only few studies have investigated whether the legal terms of a bond are priced.\(^3\)\(^4\) Probably the most relevant of these studies is Leland Crabbe's examination of "super poison put" covenants in bonds issued from November 1988 to December 1989.\(^5\) These covenants protect bondholders if the credit rating of the bonds is downgraded after their company is acquired by a third party, pays a substantial dividend, or engages in a major share repurchase.\(^6\) (The credit rating reflects the likelihood of default, a downgrade thus signifying an increase in that likelihood.) Crabbe finds that, at the time of issuance, super poison put covenants were priced at an average of 24 basis points, that is, a company could reduce the interest payable on its bonds by 0.24% if it included such a covenant. By December 1989, when the takeover market was still in full swing, super poison put covenants were priced at 32 basis points in the secondary market. And even by June 1990, when takeover activity

\(^{32}\) Cf. Kahan, supra note 30, at 987-1005 (arguing that different aspects of informational efficiency matter for different purposes).

\(^{33}\) Cf. id. at 1038-39 (arguing that a company faces optimal incentives to include efficient charter terms if charter terms are accurately priced when stock is publicly issued).

\(^{34}\) There is also some anecdotal evidence indicating that legal terms are priced. See Tom Pratt, Debt Issues Are Back, But Are the Investors?, INVESTMENT DEALERS' DIG., June 24, 1991, at 17 (stating that low yield on J.C. Penney bonds is due to tight debt-to-capital restriction); Christian Stetkiewicz, Junk Buyers Slake Thirst with Dr. Pepper Offerings, INVESTMENT DEALERS' DIG., Aug. 26, 1991, at 16 (reporting opinion of analysts that low coupon on Dr. Pepper bond reflects strong covenant protection); Junk Investors Hold the Line on Covenants, BONDWEEK, Oct. 5, 1992, at 4 (reporting statements of fund managers who say they are unwilling to give up covenants in junk bonds for higher coupons).


\(^{36}\) For a detailed description and analysis of these covenants, see Kahan & Klausner, supra note 5, at 955-58.
had substantially declined, super poison put covenants carried a price of about 15 basis points.\textsuperscript{37}

Also of substantial interest is Brauer’s case study of two bonds issued by Sunshine Mining Company.\textsuperscript{38} The two bonds contained practically identical terms with one important difference: one issue prohibited the payment of dividends in silver to shareholders, while the other did not restrict such dividends.\textsuperscript{39} Brauer found that the market value of the bond without the restriction was about 2.3\% lower than the market value of the bond that contained the restriction.\textsuperscript{40}

Finally, Roberts and Viscione studied the impact of seniority and security covenants.\textsuperscript{41} Seniority and security provisions are among the most important legal terms, because they determine the order in which creditors are paid—secured creditors ahead of unsecured ones, and senior creditors ahead of subordinated ones—if a company has insufficient assets to pay all creditors in full. Roberts and Viscione found that these covenants are priced. Bonds with seniority and security covenants carry a yield that, depending on the industry, is between 0.28\% and 0.45\% lower than the yield of comparable bonds without these covenants.\textsuperscript{42}

\textit{b. Bond pricing at original issuance.—}Several studies have compared the pricing of newly issued bonds with the pricing of outstanding bonds in the secondary market.\textsuperscript{43} These studies have been motivated, at least to some extent, by studies that have found significant underpricing of stocks in initial public offerings.\textsuperscript{44} Based on the latter studies, some commentators have concluded that the initial public offering market for stocks is not informationally efficient.\textsuperscript{45}

\begin{itemize}
\item \textsuperscript{37} Crabbe, supra note 35, at 701-04.
\item \textsuperscript{38} Greggory A. Brauer, Evidence of the Market Value of Me-First Rules, FIN. MGMT., Spring 1983, at 11.
\item \textsuperscript{39} Id. at 12. The only other differences between the bond issues was an eight-month difference in their terms to maturity and a difference in their coupon payment dates. Brauer's study adjusted for these differences in determining the impact of the dividend restriction. Id.
\item \textsuperscript{40} See id.
\item \textsuperscript{42} Id. at 1601.
\item \textsuperscript{45} See Louis Lowenstein, Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson, 89 COLUM. L. REV. 979, 990-95 (1989) (describing IPO market as one of the least perfect and as substantially inferior to secondary market); Lynn A. Stout, The Unimpor-
The findings of the studies on newly issued bonds differ from those on newly issued stocks in two major respects. First, although several studies have found that newly issued bonds are underpriced relative to outstanding bonds, the degree of underpricing is small, both in absolute terms and in comparison to the degree of underpricing of stocks. The most recent of these studies actually finds no evidence of underpricing.

Second, the studies generally attribute the differential between newly issued and outstanding bonds to an overpricing of the outstanding bonds. This sharply contrasts with the studies of stocks, where the differential is attributed to the underpricing of newly issued stocks. Thus, while the bond studies indicate the existence of informational inefficiencies in the market for outstanding bonds, they are consistent with the accurate pricing of bonds at original issuance.

c. Other studies on bond market efficiency.—A number of other studies have considered the informational efficiency of the bond market in other contexts. Many of these studies are consistent with a high degree of informational efficiency, although some point to instances of mispricing. As explained before, however, these studies are less relevant in assessing the need for mandatory terms than the studies on the pricing of legal terms and on the pricing at original issuance.

Several studies have found evidence that many factors other than legal terms are priced. In particular, bond prices have been shown to

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See Ederington, supra note 43, at 1540 (finding underpricing); Lindvall, supra note 43 at 1063-64 (finding underpricing with yield spread of 45.3 or 18.1 basis points, depending on price data used); Weinstein, supra note 43, at 1354 (finding that underpricing of bonds is much smaller than underpricing of stocks).

See Fung & Rudd, supra note 43, at 642.

See Ederington, supra note 43, at 1539 (finding that yields on outstanding bonds lag behind yields on new issues); Lindvall, supra note 43, at 1065 (suggesting that low trading activity and profit maximizing behavior of dealers result in mispricing of outstanding bonds); Weinstein, supra note 43, at 1343 (stating that underpricing is typically attributed to "thin" market for outstanding bonds).

See supra note 44.

Other anecdotal evidence also indicates that the lack of liquidity and of adequate information causes inefficiencies in the secondary bond market. See, e.g., Coffee & Klein, supra note 13, at 1218-20 (noting that secondary market is illiquid, discrepancies exist in bid prices quoted by different brokers, companies disclose little information, and analysts play lesser role than in stock market). These asserted reasons for the informational inefficiency in the secondary markets are not present in the primary market, where a high degree of liquidity and information is present.

See supra text accompanying notes 32-33.
reflect the likelihood of default, the presence of sinking funds (obligations by the company to retire a certain percentage of a bond issue before maturity), call provisions (rights of the company to repurchase bonds at a predetermined price), call deferment protection (prohibitions on calling a bond for the first couple of years after it is issued), and maintenance and replacement funds (obligations to use excess cash to retire bonds before their maturity).

On the other hand, one study did not find statistically significant evidence that so-called “funnel sinking funds” are priced. Funnel sinking funds are (rather exotic) provisions found in some utility bonds that require a company to retire a certain percentage of its aggregate debt obligations before maturity (rather than, as in regular sinking funds, a certain percentage of the bond issue at hand).

Other studies have examined the impact of changes in a bond’s credit rating on its value. A rating upgrade, signifying a lower likelihood of default, should be associated with an increase in bond prices, and a downgrade with a price decrease. The credit rating agencies base their ratings on financial and other information about the company that is, to a large degree, publicly available. In an informationally efficient market, it is the underlying information, not the rating itself, that causes bond prices to change. Thus, bond prices should “anticipate” rating changes: they should decline before the rating is lowered, and increase before the rating is raised.

The studies point to a difference among bond market segments in their response to credit rating changes. Changes in the credit rating of industrial bonds (for our purposes, the most important market segment) are anticipated: bond prices change in the predicted direction prior to the rating change, consistent with a high degree of informa-

52 See, e.g., Edward I. Altman & Scott A. Nammacher, The Default Rate Experience on High-Yield Corporate Debt, FIN. ANALYSTS J., July-Aug. 1985, at 25 (finding that the default risk on low rated debt is priced ex ante, but overpriced ex post); Calvin M. Boardman & Richard W. McEnally, Factors Affecting Seasoned Corporate Bond Prices, 16 J. FIN. & QUANTITATIVE ANALYSIS 207 (1981); Jerome S. Fons, The Default Premium and Corporate Bond Experience, 42 J. FIN. 81 (1981) (finding that higher yields, on average, compensate holders of low-grade bonds for higher default risk); Martin S. Fridson, Initial Pricing as a Predictor of Subsequent Performance of High-Yield Bonds, FIN. ANALYSTS J., July-Aug. 1990, at 61 (finding that the default risk on low rated debt is priced ex ante, but underpriced ex post). The different results in the Altman-Nammacher and the Fridson studies on the ex post adequacy of the price for the default risk is presumably attributable to the different dates of their studies.


55 Pye, supra note 54.

56 Gene Laber, Bond Covenants and Managerial Flexibility: Two Cases of Special Redemption Provisions, FIN. MGMT., Spring 1990, at 82, 83-84.

57 See id. at 88 (finding that effect on yield is not statistically significant).
tional efficiency. Furthermore, and also consistent with informational efficiency, older ratings that have not been updated seem to be a less reliable predictor of bond prices than more recent or updated ratings. The prices of municipal and utility bonds, however, change only after the credit rating is changed.

The most recent of these studies again presents ambiguous results. For example, bond prices generally do not decline when a bond is added to Standard & Poor's Credit Watch list for possible downgrade (the precursor to an actual downgrade), but the prices of bonds decline if this addition is classified as unexpected.

d. Concluding remarks.—On the whole, studies of informational efficiency in the bond market establish that at least some legal terms are priced. Moreover, there is no evidence pointing to particular informational inefficiencies in the market for newly issued bonds. To the contrary, the primary market for newly issued bonds is more informationally efficient than the secondary bond market.

The studies, however, do not establish that all legal terms are accurately priced. The few studies that have examined the pricing of legal terms contain features that may make it inappropriate to generalize their results. Crabbe examined event-risk covenants during the height of the takeover boom and its immediate aftermath, when investors arguably paid special attention to these covenants. Brauer's study is very narrow, dealing with only one covenant in just two bond issues. And Roberts and Viscione's study concerned two of the most important covenants. Moreover, though most studies support the notion that the bond market is informationally efficient, there is some evi-

58 Paul Grier & Steven Katz, The Differential Effects of Bond Rating Changes Among Industrial and Public Utility Bonds by Maturity, 49 J. Bus. 226 (1976) (finding that rating reclassifications of industrial bonds are anticipated); Mark I. Weinstein, The Effect of a Rating Change Announcement on Bond Price, 5 J. Fin. Econ. 329 (1977) (finding no evidence that the announcement of a rating change affects prices of corporate bonds, and some evidence of price change 18 to 7 months before the rating change is announced).


60 Grier & Katz, supra note 58, at 235-38 (finding no significant anticipation of rating changes in utility bonds); Robert W. Ingram et al., The Informational Content of Municipal Bond Rating Changes: A Note, 38 J. Fin. 997 (1983) (finding that rating changes of municipal bonds have an effect on bond prices and attributing the effect to the small amount of publicly available information on municipal issuers); Steven Katz, The Price Adjustment Process of Bonds to Rating Reclassifications: A Test of Bond Market Efficiency, 29 J. Fin. 551 (1974) (finding no price changes prior to rating change of utility bonds and that the price adjustment takes 6 to 10 weeks).

61 John R.M. Hand et al., The Effect of Bond Rating Agency Announcements on Bond and Stock Prices, 47 J. Fin. 733, 741-44 (1992). Other findings in the study include that, when bonds are actually downgraded, prices in the full sample decline, but prices in a sample of bonds uncontaminated by other information do not decline. On the other hand, if bonds are upgraded, prices in both samples increase. Id. at 744-48.
dence of inefficiencies in the pricing of factors other than legal terms. Finally, by their nature, the studies show only whether legal terms are priced, not whether they are accurately priced. Thus, although the evidence on pricing is inconsistent with a high degree of informational inefficiency in pricing legal terms, it does not rule out the possibility that legal terms are not accurately priced, or even that some terms are not priced at all.

2. The Institutional Setting.—Since the evidence on the pricing of legal terms does not resolve whether all legal terms are accurately priced, it is important to analyze the institutional setting in which bonds are issued and priced for factors that generally contribute to a well-working market. I start this analysis with an examination of the amount of information on the legal terms of bonds that is available to investors when bonds are issued. The more information available, and the more easily that information is accessible, the more likely it is that the legal terms of a bond are priced. I argue that information on legal terms is readily available, though the complexity of legal terms may make it difficult to assess.

I then discuss four institutional factors that bear on the ability of investors to assess complex legal terms. First, bondholders themselves may possess enough sophistication and incentives to assess even complex legal terms. Second, the standardization of legal terms affects the ease with which they are evaluated. Third, the approach courts have taken with respect to legal terms in bond indentures bears on investors’ ability to assess complex terms. And fourth, information intermediaries may serve a certification function with respect to legal terms. I conclude this section by examining the empirical evidence on incidence and effectiveness of covenants, which indicates that investors actually possess information about the legal terms of bonds.

a. Disclosure and the available information.—The information available to investors in newly issued bonds consists of the information contained in the prospectus or the preliminary prospectus, the other information that must be filed with the SEC, and other publicly available information such as newspaper reports and press releases. Of these, the information in the prospectuses is most easily and widely available, since the Securities Act of 1933\(^62\) requires the company to deliver these documents to potential investors before they purchase securities.\(^63\)

Both the prospectus and the preliminary prospectus\(^{64}\) for a bond must outline the principal legal terms of a bond. In particular, they must provide information about any lien securing the bonds,\(^{65}\) any provisions related to subordination,\(^{66}\) any restrictions on the amount of dividends the company may pay or the amount of additional debt the company may incur, the conditions under which the bonds are deemed to be in default,\(^{67}\) and the requirements for amending the indenture.\(^{68}\) If a prospectus is lengthy or complex, it must also contain a summary of these provisions.\(^{69}\)

Companies may of course describe the legal terms of a bond more extensively than the Securities Act requires. Thus, though not mandated by the Act, prospectuses usually describe all covenants that are not trivial. Furthermore, these descriptions are highly detailed. In fact, for practical purposes, they generally restate the relevant language of the indenture, rather than merely outlining them as the Act requires.\(^{70}\)

That companies go to great length in describing these legal terms should not be surprising. It is very much in the interest of a company to highlight the existence of any additional rights conferred on the bondholders since this may lower the interest rate at which the bonds can be issued. Thus, if a prospectus does not describe any duties of the company beyond the duty to pay principal and interest, any investor could fairly—and correctly—conclude that the indenture confers no additional rights on the bondholders. And it is crucial to describe any rights accurately since any imprecisions may give rise to charges of securities fraud.

Information about the existence of special legal rights is then both easily available and accessible. Whenever a bond contract confers such rights, the prospectus describes them in its main part and sometimes highlights them in the prospectus summary. It thus suffices to look at the headings in the prospectus summary or in the section describing the bonds in order to determine whether, say, the indenture limits the company's ability to pay dividends or to incur additional debt. The ease with which such information can be obtained

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\(^{64}\) The main difference between the preliminary prospectus and the prospectus is that the preliminary prospectus may omit certain terms related to the offering price. See SEC Rule 430(a), 17 C.F.R. § 230.430(a) (1993).


\(^{66}\) Id. § 229.202(b)(3).

\(^{67}\) Id. § 229.202(b)(5), (6).

\(^{68}\) Id. § 229.202(b)(7).

\(^{69}\) Id. § 503(a).

\(^{70}\) See, e.g., CIRCUS CIRCUS ENTERPRISES, INC., PROSPECTUS, May 30, 1990, at 8-10 (describing super poison put provision in detail); id. at 11-12 (describing covenant limiting liens in detail).
makes it unlikely that investors fail to take account of the existence of such legal terms in pricing a newly issued bond.

Information about the particular content of special legal rights is also easily available. As explained, prospectuses generally restate the relevant indenture provisions word-for-word. Thus, it is generally not necessary for an investor to examine the actual indenture. In any case, the indenture must be filed as an exhibit to the registration statement for the bonds and would thus also be available for review.  

Despite the ease of availability, however, the particular content of a legal term is often inaccessible for an investor without sophistication in this matter. This lack of accessibility results from the fact that bond covenants tend to be highly complex. The legal formulation, for instance, of the conceptually simple dividend covenant, which limits dividends and share repurchases to a percentage of net income, can take several pages of finely printed text.  

Thus, any investor could easily determine whether an indenture restricts the company’s ability to pay dividends. And an investor could with little effort find out, say, that the cumulative amount of “dividends” is limited to $50 million plus 50% of the company’s net income. Many unsophisticated investors, however, would have difficulty in ascertaining whether “dividends” include, say, dividends payable in common stock, dividends payable in redeemable preferred stock, or dividends payable in warrants to purchase common stock. 

The relative difficulty of ascertaining the particular content of a legal term suggests the possibility that companies will intentionally puncture such terms with loopholes. For example, the several pages

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72 See, e.g., SUPERMARKETS GENERAL HOLDINGS CORP., PROSPECTUS, May 21, 1992, at 52-55 (containing three-page description of “restricted payments” covenant).
73 See, e.g., id. at 6 (stating in the summary that the indenture contains a “restricted payments” covenant—the term of art for restrictions on dividends and share repurchases). The prospectus further reports that “Restricted Payments” are limited to 50% of net income earned after May 3, 1992, plus certain proceeds from the issuance of equity rights. Id. at 52-53. “Restricted Payments” generally include any dividend, but do not include dividends payable in shares of capital stock or in options to purchase capital stock, except that “Restricted Payments” do include stock dividends if the stock is “Redeemable Capital Stock,” which is separately defined to include stock redeemable at the option of the holder prior to the maturity of the notes. Id. at 52-53, 73. Although this provision may sound arcane, it should be noted that its treatment of stock dividends, options, and redeemable stock is rather standard. See infra text accompanying note 88.
74 The notion that covenants can be easily evaded has some currency. See, e.g., Christopher Farrell et al., Bondholders Are Mad as Hell—And No Wonder, Bus. Wk., Dec. 5, 1988, at 29 [hereinafter Farrell et al., No Wonder] (reporting that bond analyst stated that good law firm could find a way out of a restrictive covenant in three weeks); Christopher Farrell et al., Bondholders are Mad as Hell—And They’re Not Going to Take It Anymore, Bus. Wk., Feb. 6, 1989, at 82 (noting that good lawyer and determined management can almost always get around a covenant). The empirical studies discussed infra text accompanying notes 124-25 demonstrate, however, that covenants offer effective protection to bondholders. It is also not true that companies
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describing a dividend restriction could contain an obscure provision exempting dividends payable on January 12 of any year—thus rendering the restriction useless. The company might hope that investors, aware of the existence of the dividend covenant but not of its specific content, will fail to take account of this loophole in pricing the covenant—thus enabling the company to issue bonds at a lower interest rate without offering real protection to bondholders.

There are, however, several forces that constrain companies from taking such actions. Many investors are sophisticated enough, and have the incentives, to assess the content of legal terms independently. Standardization facilitates the evaluation of the content of legal terms. Judicial interpretation of the securities laws and contract law makes it difficult for companies to exploit hidden loopholes in indentures. And finally, information intermediaries provide some help in assuring that covenants are effective.

b. The identity of bond purchasers.—The available evidence indicates that the market for corporate bonds is heavily dominated by institutional investors, and that individual investors play only a small role. The best evidence on holdings of corporate bonds comes from the Flow of Funds Accounts prepared by the Federal Reserve Board. According to the Fed, the amount of corporate bonds outstanding at the end of 1992 was $1,883 billion. The amount of these bonds held by households was $131 billion, or 7%. By contrast, insurance companies held 62% and banks, savings and loan associations, and mutual funds held another 15% of the outstanding bonds. The data for 1991 and 1990 are similar: households held 9%, insurance companies 61% to 62%, and the other financial institutions 14% of the outstanding bonds.

can easily devise novel types of transactions that expropriate bondholder wealth in unanticipated ways and are thus difficult to address by covenants. The Marriott spin-off is a case on point. While spin-offs of subsidiaries to shareholders were relatively uncommon (though hardly novel), technically a spin-off is just a payment of a large dividend (consisting of stock of the spun-off subsidiary) and thus a classic type of wealth-shifting transaction.

If companies were to engage in such behavior systematically, investors would eventually catch on and stop attributing any value to legal terms (whether effective or not), since they would assume that these terms contain so many loopholes that they are de facto ineffective. Thus, over time, ineffective covenants would drive out effective ones. See generally George Akerlof, The Market for Lemons: Quality Uncertainty and the Market Mechanism, 84 Q.J. Econ. 488 (1970) (arguing that uncertainty over quality may drive higher-quality goods out of the market).

75 See Board of Governors of the Fed. Reserve Sys., supra note 4, at 112, Corporate and Foreign Bonds, lines 1, 9-21. The remainder is held by brokers and dealers and by foreigners. The 62% holding by insurance companies is subdivided into holdings by life insurance companies (34%), private pension funds (12%), state and local government retirement funds (10%), and other insurance companies (5%). See also Andrew L. Bab, Note, Debt Tender Offer Techniques and the Problem of Coercion, 91 Colum. L. Rev. 846, 882 (1991) (reporting that individuals own not more than 5-10% of junk bonds).
The Flow of Funds data include both publicly issued and privately placed bonds. Privately placed bonds are rarely sold to individual investors and contain different legal terms than publicly issued bonds. But even when privately placed bonds are eliminated from the data, the picture changes little. An estimated $260 to $418 billion in privately placed bonds were outstanding in 1990.\footnote{See Mark Carey et al., The Private Placement Market: Intermediation, Life Insurance Companies and a Credit Crunch (unpublished manuscript, on file with the Northwestern University Law Review).} Even assuming that all of these bonds were held by institutional investors and none by individuals, households would hold only 11% to 13%, and institutions 66% to 70%, of the publicly issued bonds outstanding in 1990. By comparison, households held at least 52% of the outstanding corporate equities.\footnote{See Board of Governors of the Fed. Reserve Sys., supra note 4, at 44, Corporate Equities, lines 5 and 6, 1990 data. Even by 1992, household ownership of corporate equities was still at least 49%. \textit{Id.} at 1992 data. These Flow of Funds data underestimate household ownership of publicly issued equities as the data include privately placed equity securities. The data do not include ownership of mutual fund shares.}

In addition, the ownership of bonds of any particular issue tends to be highly concentrated, that is, a relatively small number of investors generally owns a high fraction of the bonds of a single issue. While no systematic data on overall ownership concentration of bonds is available,\footnote{Data on record ownership of bonds are unreliable since most beneficial holders do not register their bonds in their own name.} data exist for holdings by life insurance companies (arranged by bond issue) and for holdings by mutual funds (arranged by fund).

Even a casual look at these data is telling. Take, for example, the eleven different bonds issued by Marriott before it announced its spinoff. The life insurance group with the largest holding for each of these bonds held, on average, 14.3% of the outstanding principal amount. And the five largest insurance groups held, on average, 36.1% of the outstanding amount.\footnote{See Best's Market Guide Corporate Bonds (1992). For purposes of calculating these figures, I disregarded two Marriott bond issues for which fewer than five insurance groups were listed as holders. For one of these issues, three groups held 9.5% of the outstanding amount; for the other, one group held 100%.
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Moreover, the individual investors who do hold corporate bonds are likely to be among the most sophisticated ones. According to 1988 census data, 21.8% of households owned stock or mutual fund shares, but only 2.8% held corporate or municipal bonds. See Bureau of the Census, U.S. Dept of Commerce, Household Wealth and Asset Ownership: 1988, at 2, (Current Population Reports, Series P-70, No. 22, 1990). Federal data show that, at that time, households held more than four times as many stocks than mutual fund shares and more than three times as many municipal bonds than corporate bonds. Thus, while stock ownership among individual investors is widespread, only a minuscule percentage of individuals—presumably many fewer than 2.8%—invests in corporate bonds. These individuals are likely to be among the most financially astute investors.
degree of ownership concentration, since they fail to account for large holdings by investors other than life insurance companies.

Data for mutual funds look similar. The Investment Grade Corporate Portfolio of the Vanguard Fixed Income Fund, for example, holds 55 issues of industrial bonds with a $965 million market value. Based on 48 of these issues on which data were available, the average holding constituted 7.8% of an issue's outstanding principal amount. For over 70% of the holdings, the portfolio owned at least 5% of the outstanding amount; and for 35% of the holdings, it owned 10% or more of the outstanding amount. These data again underestimate Vanguard's overall ownership since other Vanguard portfolios hold bonds of the same issues as the Investment Grade Corporate Portfolio.

The data on mutual funds suggest that ownership concentration is indeed significantly higher than evidenced merely by the data on life insurance company holdings reported above. For example, the High Yield Corporate Portfolio of the Vanguard Fixed Income Securities Fund holds $12 million of Marriott's 10.25% Notes. Only one insurance group holds more bonds of that issue. If the holding of the Vanguard portfolio are added to the holdings of the five largest insurance companies, their ownership stake in that issue increases from 37% to 47% of the outstanding principal amount.

The type of investors that holds bonds and the concentration of ownership are highly relevant. The more sophisticated the investors are, the more likely it is that the legal terms of a bond are accurately priced. Moreover, as institutional investors tend to purchase many


82 For example, the High Yield Corporate Portfolio of the Vanguard Fixed Income Securities Fund holds an additional $60 million of Auburn Hills bonds due 2020 and $25 million United Air Lines bonds due 2021, raising Vanguard's ownership shares of these issues from, respectively, 2% and 3% to 7% and 12% of the outstanding principal amount. See Vanguard Fixed Income Securities Fund, supra note 81.

83 Id.

84 A study by Bruce Tuckman and myself on bondholder consent solicitations also suggests a high level of ownership concentration. See Marcel Kahan & Bruce Tuckman, Do Bondholders Lose from Junk Bond Covenant Changes?, 66 J. Bus. 499 (1993). In over 20% of the solicitations in our sample (12 of 54) the press reported that bondholders formed groups in response to the solicitations, and these groups were highly effective in bargaining on behalf of bondholders. In 11 of the 12 cases, the solicitation failed or was modified, and no data were available for the remaining case. Id. at 512. The actual number of bondholder group formation may even be higher since the press may have failed to report on some of them. The frequency with which bondholders get together and their consistent success indicates that it is relatively easy to form groups that hold a large fraction of the bonds, i.e., the level of ownership concentration is high. Indeed, the concentration is probably even greater than indicated in our study, since we excluded instances where the formation of groups preceded the consent solicitation.
different bond issues, they will have great experience in analyzing covenants. And if an investor purchases a significant fraction of a bond issue, that investor has a strong incentive to analyze the features of that bond carefully.

These considerations are particularly significant in light of the earlier discussion about the information available to investors. Even though information about the content of covenants is readily available, it is not accessible to unsophisticated investors. Thus, if unaided and unsophisticated investors dominated the bond market, market prices might easily fail to account fully for the content of covenants. But since financial institutions—the most sophisticated of investors—dominate the bond market, the concern that the content of covenants might escape scrutiny is significantly alleviated.

c. **The standardization of legal terms.**—Another factor that facilitates the evaluation of complex legal terms in bonds is their high degree of standardization—both as to category and in content. Bond indentures generally contain only a limited variety of categories of substantive terms. These include, for example, debt limitations, dividend limitations, restrictions on mergers and asset sales, restrictions on liens and sale/leasebacks, and restrictions on transactions with affiliates. That is not to say that most indentures contain most of these covenants; they do not. Rather, it means that only few indentures contain uncommon types of legal terms. Thus, a bond analyst effectively needs to be conversant with only few covenant categories.

Within a given category, covenants often provide for identical substantive details across different bond issues. Most modern dividend restrictions, for example, do not apply to dividends paid in shares of capital stock of the company generally, though they do apply

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85 See supra part II.A.2.a.

86 Not every lengthy or convoluted covenant is substantively complex. Many covenants are made lengthy by what nonlawyers would consider excess verbiage. Thus, for example, dividend covenants not only restrict stock "repurchases," but also enumerate a variety of other ways to obtain stock, to wit, redemptions, retirements, and acquisitions. See, e.g., Supermarkets General Holdings Corp., supra note 72, at 53. Unsurprisingly, even such verbiage is generally standardized.

87 With the exception of merger and asset sale restrictions, all these terms are generally found in the "covenant" article in the indenture, which may also contain provisions relating to the maintenance of properties, corporate existence, and office; the payment of taxes and compliance with other laws; the furnishing of information; the maintenance of net worth; investment restrictions; asset dispositions; a change of control; payment restrictions affecting subsidiaries; and restrictions on subsidiary debt. Other articles of the indenture also contain important legal terms. For instance, the article on "supplemental indentures" contains the provisions for amending indentures, the article on "default" defines default and provides for available remedies, and, in case of subordinated bonds, the article on "subordination" defines the extent of subordination and the relative rights of the holders of the subordinated bonds. All of these terms are likely to be standardized with respect to both category and content.
to dividends paid in shares of stock that are convertible or exchangeable prior to the maturity of the bonds. Although such a specific provision is substantively complex, the repeated appearance of identical provisions greatly facilitates their valuation. Thus, when an analyst reads a dividend covenant containing such a provision (verbalized, of course, in legalese), she will know that it is standard, be familiar with its meaning, and understand how much it adds or detracts from the value of the covenant.

Standardization is especially helpful for insurance companies, mutual funds, and other financial institutions that regularly purchase bonds. These institutional investors, which dominate the bond market, gain the most from being able to spread the costs of analyzing the significance of a standard covenant over all of their bond issues that contain that covenant. Standardization in category and content thus greatly lowers the difficulty of evaluating many complex covenants.

But standardization also has its drawbacks: it is of no help in evaluating novel categories or novel provisions within a common category. This suggests that novel terms may be less accurately priced than standard terms. Indeed, since it is much easier to evaluate standardized terms, standardization may actually impede the development of novel ones. As a result, indentures would continue to use the familiar standard legal terms even if a novel term is more efficient.

**d. The treatment of indentures by courts.**—The approach courts have taken to indentures further aids investors in their analysis of covenants. Courts have persistently refused to read new rights into indentures that did not contain relevant covenants. But they have

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88 See, e.g., Supermarkets General Holdings Corp., supra note 72, at 52, 73. The rationale for this provision is presumably that stock dividends do not result in an outflow of assets, and thus do not hurt creditors. If such stock is convertible or exchangeable, however, the company may be forced to pay out assets in such conversion or exchange prior to the maturity of the bonds, and bondholders may thus be hurt.

89 See, e.g., Kahan & Klausner, supra note 5, at 973 (arguing that inaccurate pricing of novel terms may have impeded development of change of control covenant); see generally Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. Rev. 549, 615 (1984). As I will argue below, there are also other reasons to believe that there is too little innovation in bond covenants. This market failure, however, does not justify mandatory terms. See infra text accompanying notes 138-40.

used both contract law and the securities laws to fill loopholes that would have resulted from a strictly literal interpretation of those covenants contained in an indenture.

Noteworthy examples of this approach are the decisions in Alleco, Inc. v. IBJ Schroeder Bank & Trust Co., Sharon Steel Corp. v. Chase Manhattan Bank, N.A., and McMahan & Co. v. Wherehouse Entertainment, Inc. In 1985, Alleco had issued bonds that contained a standard dividend covenant limiting the amount of dividends the company could pay and the amount the company and its subsidiaries could spend in acquiring Alleco stock. Three years later, Alleco was to be acquired by LP Acquisitions in a typical leveraged buy-out: LP Acquisitions took on a $65 million “bridge loan” used these funds to purchase most Alleco shares in a tender offer, exchanged the remaining shares of Alleco for cash in a freeze-out merger, and had Alleco (now merged with LP Acquisition) repay the bridge loan.

From the perspective of Alleco’s bondholders, the net result of these transactions was the same as if Alleco itself had spent $65 million to acquire its stock. Literally, however, Alleco did not itself acquire its stock, but merged with another company that did. Nevertheless, the district court found that accepting such a literalist argument would mean that the dividend covenant “provide[d] little or no protection” to the bondholders. Since “LP’s tender was in effect a [tender by Alleco],” the court held that Alleco violated the dividend restriction in its indenture.

The Second Circuit took a similar approach in Sharon Steel. UV Industries, a company that had issued bonds under several indentures, had adopted a plan of liquidation and sold its three operating units over a one-year period to three different companies. In the last of these transactions, UV sold its metal operations and all its other assets (mostly cash) to Sharon Steel in exchange for $107 million in cash and Sharon Steel’s assumption of UV’s liabilities. Sharon Steel and UV

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92 691 F.2d 1039 (2d Cir. 1982), cert. denied, 460 U.S. 1012 (1983).
94 A loan that is to be paid off shortly in a later stage of the transaction.
95 Arguably, the term “acquisition” in the dividend covenant includes an acquisition by merger, and the transaction falls within the literal scope of the dividend covenant. The court’s opinion, however, does not rest on this argument.
96 Alleco, 745 F. Supp. at 1474 (emphasis added).
argued that this sale released UV from its obligations under the indentures pursuant to a clause that provided for such a release upon the sale of “all or substantially all” of UV's assets.\textsuperscript{97}

The court rejected this “literalist approach.”\textsuperscript{98} Instead, it interpreted the indenture in light of its underlying purposes: assuring bondholders of a degree of continuity of assets and giving companies the ability to sell their assets and enter into a new line of business free of public debt. Where a company sells off its assets in a piecemeal liquidation, the asset base prior to the commencement of the liquidation determines whether “all or substantially all” assets have been sold. Thus, a company is released only if a single purchaser acquires substantially all of its preliquidation assets. Because the operating assets sold to Sharon Steel constituted only 41\% of UV’s preliquidation assets, the court held that the sale did not release UV from its obligations under the indentures.\textsuperscript{99}

The third case, \textit{McMahan}, dealt with a poison put covenant in bonds issued by Wherehouse Entertainment that granted bondholders the right to resell (“put”) the bonds to the company if it merged with another company.\textsuperscript{100} The put right, however, was not available if the merger was approved by Wherehouse’s “Independent Directors.” Eighteen months after the bonds were issued, the Independent Directors approved a merger of Wherehouse and WEI Holdings.\textsuperscript{101}

In the bond prospectus, the poison put covenant was described using terms of entitlement, such as “holder’s right to tender” or “[an] option to require the company to redeem” the bonds. The bondholders claimed that this description was misleading. The district court dismissed this claim on summary judgment, finding that the description in the prospectus was literally accurate and holding that Wherehouse was not obligated to alert the bondholders that the covenant may have little value.\textsuperscript{102} The Second Circuit reversed. It found that a jury could have reasonably concluded that the covenant in fact offered only illusory protection and that the language of entitlement used to describe the covenant created a misleading impression that the option to tender was a valuable right. By creating such a misleading impression, the company would have violated various provisions of the securities laws—despite the fact that the description of the covenant was literally accurate.\textsuperscript{103}

\textsuperscript{97} Sharon Steel, 691 F.2d at 1042-47.
\textsuperscript{98} Id. at 1049. The Court noted that a literalist approach would be self-defeating since, even after the sale to Sharon Steel, UV would not have sold all of its assets as it would have received new assets from Sharon Steel.
\textsuperscript{99} Id. at 1049-51.
\textsuperscript{100} McMahan, 900 F.2d at 577-78.
\textsuperscript{101} Id.
\textsuperscript{102} Id. at 578-79.
\textsuperscript{103} Id. at 578-82.
These cases indicate that courts impose a substantial burden on companies that want to slip through loopholes. As in Alleco and Sharon Steel, courts may close implicit loopholes and prohibit companies from taking certain actions even if they do not violate a literalist reading of an indenture provision. And even if an indenture provision expressly limits a right, as in McMahan, courts may still afford protection to bondholders if they have not been sufficiently alerted to the explicit loophole.\(^{104}\)

e. The information intermediaries.—Even if investors did not themselves possess information about the legal terms of a bond, the terms may be priced if information intermediaries vouch for their existence and effectiveness. Two information intermediaries may serve this function for bonds: underwriters and bond rating agencies.\(^{105}\)

Underwriters assist a company in marketing bonds to the ultimate investors.\(^{106}\) Generally, several investment banks act as joint un-

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\(^{104}\) See also Van Gemert v. Boeing Co., 520 F.2d 1373 (2d Cir.), cert. denied, 423 U.S. 947 (1975) (holding that notice provision in indenture, which failed to provide for reasonable notice to bondholders of redemption, was invalid where bondholders were not advised of provision in the bond certificate and the prospectus); Coronet Ins. Co. v. GACC Holding Co., No. 90 C 07189, 1991 U.S. Dist. LEXIS 12120 (N.D. Ill. Aug. 27, 1991) (implying third-party beneficiary rights of bondholders against company's reset advisor, which rights cannot unilaterally be waived by company in its contract with reset advisor); cf. Bratton, supra note 12 (favoring broad reading of contractual implied duty of good faith and fair dealing). Of course, in other cases, courts have interpreted indenture provisions more literally, especially where the indenture confers only explicitly limited rights on the bondholders. See, e.g., Broad v. Rockwell Int'l Corp., 642 F.2d 929 (5th Cir.), cert. denied, 454 U.S. 965 (1981) (holding that clause entitling holders of convertible debentures to convert, upon a merger, into such consideration as they would have received had they converted prior to the merger does not entitle holders to convert their debentures into stock of surviving company if stockholders of issuing company received cash in the merger); Morgan Stanley & Co. v. Archer Daniels Midland Co., 570 F. Supp. 1529 (S.D.N.Y. 1983) (holding that clause prohibiting redemption of bonds from proceeds of debt issued at lower interest rate does not prohibit redemption where source of funds was sale of equity, even if company had also lower interest rate debt outstanding); Shenandoah Life Ins. Co. v. Valero Energy Corp., No. CIV. A. 9032, 1988 WL 63491 (Del. Ch. June 21, 1988) (holding that clause prohibiting redemption of bonds from proceeds of debt issued at lower interest rate does not prohibit redemption where source of funds was sale of equity interest in subsidiaries, even if such sale was part of integrated transaction in which lower interest rate debt was also issued).

\(^{105}\) See Gilson & Kraakman, supra note 89, at 605, 613-21 (discussing role of bond rating agencies and investment bankers as information intermediaries). Note that the indenture trustee, which acts as legal representative of the bondholders once the bonds are issued, is neither an information intermediary nor much of an agent for the bondholders in setting the terms of the bond. The trustee is selected by the company. Its role prior to the issuance of the bonds is largely confined to reviewing the indenture provisions relating to the rights and duties of the trustee and matters such as ascertaining that the indenture conforms to the prospectus. See, e.g., JAMES E. SPIOTTO, DEFAULTED SECURITIES V-1 to V-19 (1990).

\(^{106}\) In a "best efforts" underwriting, the underwriter acts like a sales agent, rounding up investors interested in purchasing the bonds. In the more common "firm commitment" underwriting, it acts as intermediate purchaser, buying the bonds from the company at an agreed-upon price.
derwriters, with one bank as lead underwriter. It is the lead underwriter and its lawyers that negotiate the legal terms of a bond with the company.

The investment bank acting as lead underwriter has a reputational interest with regard to the investor community. If bonds underwritten by, say, Goldman, Sachs always defaulted, investors would stop buying bonds that Goldman, Sachs underwrites. It is therefore in the interest of Goldman, Sachs to ensure that the bonds it underwrites are not "lemons," that is, of lesser quality than meets the eye. Empirical studies of stock offerings suggest that underwriters indeed serve such a certification function for the quality of their offerings.\(^{107}\)

It is plausible that underwriters serve a similar certification function with respect to the effectiveness of bond covenants. If a bond covenant purports to offer protection to bondholders, the underwriter has a reputational interest to ensure that loopholes do not render this purported protection ineffective. After all, the underwriter and its lawyers approved the precise legal wording of the covenant. Thus underwriters have an incentive to make sure that legal terms are not gaping with unusual loopholes.\(^{108}\)

To be sure, underwriters also have an interest with regard to the issuing companies, which select and pay them.\(^{109}\) The companies that issue bonds may, of course, pressure the underwriter to acquiesce in loopholed legal terms. Such pressure countervails the reputational interest of underwriters with regard to investors and might well induce underwriters not to insist on unusually strong covenants. But the reputational interest is likely to dominate with respect to hidden loopholes.\(^{110}\) After all, a company picks an underwriter because of its ca-

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\(^{108}\) On the other hand, if the indenture contains no special covenant protection—a fact that investors can easily ascertain—the underwriter has less of its reputation at stake since investors do not expect any special protection.

\(^{109}\) See Mitchell, supra note 12, at 1183 (arguing that underwriters want to please management); Tauke, supra note 12, at 24 (stating that underwriter might not diligently bargain for protective covenants in order not to alienate issuer).

\(^{110}\) Cf. Lucian A. Bebchuk, Freedom of Contract and the Corporation: An Essay on the Mandatory Role of Corporate Law 58 (Harvard Program in Law and Economics Discussion Paper No. 46, 1988) (arguing that reputational interest of investment bankers is more...
pacity to place bonds with investors. Once an underwriter loses that capacity, it loses its attractiveness to issuers—even to those most eager for loopholes.

Another group of information intermediaries are the rating agencies, most importantly Moody's Investors Service and Standard & Poor's (S&P). Bond ratings assess the credit quality of a bond issue. Higher ratings signify a lower credit risk and are associated with lower interest rates. The rating of a bond is widely circulated before the bond is sold to investors. Thus, if bond ratings were to reflect the quality of a bond's covenant protection (in addition to the company's business prospects), that protection might be priced regardless of the investors' knowledge of the actual legal terms.

Bond covenants, however, are only a minor factor in the bond rating. As the bond rating is designed to assess the credit quality of a bond issue, it depends primarily on the economic prospect of the company, for example, its expected earnings, its cash flow, its leverage, or its asset base. The only legal term that significantly affects the bond rating is the seniority status of the bond, that is, whether the bond is secured and whether it is subordinated to other debt. Other legal terms, such as whether the bond indenture limits the amount of debt the company may incur or the dividends it may pay, exert only negligible influence.

likely to assure that charter provisions are not unconventional or shady than that charter provisions are generally optimal).

111 While five agencies supply bond ratings, the ratings by Moody's and S&P are most widely used. The other three agencies are Duff and Phelps; McCarthy, Crisanti & Maffei; and Fitch Investors Service. See Wilson & Fabozzi, supra note 2, at 23-24 (1990).


113 See Regulation S-K, Item 10(c), 17 C.F.R. § 229.10(c) (1993) (stating that issuers may disclose bond rating in registration statement and tombstone advertisements).


116 In principle, Moody's takes meaningful covenant protection into account in rating bonds. See Wilson & Fabozzi, supra note 2, at 25-27. There is anecdotal evidence that covenants have indeed affected some of Moody's ratings. See Christopher Farrell et al., No Wonder, supra note 74, at 29 (reporting that Moody's raised the rating of Harris Corp.'s debentures from A3 to A2 because of its poison-put provision). It is, however, clear that covenants are only a minor factor in Moody's ratings. See Hawkins et al., supra note 114, at 73-75 (reporting that in determining rating, indenture provisions are "far less important" than financial factors). The story is somewhat different for S&P. In July 1989, S&P introduced a separate "event-risk" rating (as a supplement to its general credit rating) designed to rate covenant protection. See S&P Introduces Event Risk Ranking Service, PR Newswire, July 21, 1989. These "event-risk" ratings provide important information to investors and may have led to an improvement in the pricing of rated covenants. See Kahan & Klausner, supra note 5, at 952-60, 977-78. However, only relatively few bonds have been rated for "event-risk," and most of these bonds con-
Thus, there are reasons to believe that underwriters, concerned with their reputation among investors, assure that those covenants which are offered are not ridden with loopholes. Rating agencies, on the other hand, do not seem to play a significant role. Although they act as information intermediaries with respect to a company's financial state and its business prospects, they do not, for the most part, evaluate bonds for the effectiveness of their covenants.

f. Incidence and effectiveness of covenants.—Finally, it is important to consider empirical evidence on two additional aspects of bond covenants: their incidence and their effectiveness. By incidence, I mean the relationship between firms that issue bonds with stronger covenants and those that issue bonds with weaker covenants. In an informationally efficient market, one would expect covenants in the bonds of firms that have the most to gain by including them; that is, in firms that would be most likely to engage in inefficient actions if their bonds contained no covenants.

Empirical studies indicate that this is indeed the case. Studies have shown that stricter covenants are more frequent in bonds of highly-leveraged firms. Moreover, bonds of firms with a prior record of nonexpropriation contain fewer covenants. Highly-leveraged firms, of course, have the greatest incentive to engage in inefficient actions to expropriate wealth and would thus benefit most from offering covenant protection. And firms that have resisted the temptation to expropriate wealth in the past are presumably less likely to engage in expropriation in the future. Another study found that sinking funds are used to alleviate conflicts between bondholders and stockholders. These studies are consistent with an informationally efficient market for bonds.

Another aspect of the incidence of bond covenants relates to the differences between covenants in publicly issued bonds and in privately placed ones. Privately placed bonds, which are sold to a small number of institutional investors, contain more and stricter covenants.


118 Malitz, supra note 117. Malitz also finds that bonds of smaller firms contain stricter covenants and attributes this finding to efforts to reduce asymmetric information. Id.

than publicly issued bonds.\textsuperscript{120} This finding lends support to those commentators who argue that holders of public bonds receive too little protection:\textsuperscript{121} after all, holders of privately placed bonds, who directly negotiate the covenant package with the company, bargain for more covenants.

On the other hand, there are a number of other reasons why one would expect more covenants in privately placed bonds than in publicly issued ones. For one, it is much easier to renegotiate covenants in privately placed bonds since these bonds have fewer holders whose consent to an amendment needs to be obtained and since these holders tend to have greater familiarity with the company’s affairs. Moreover, holders of privately placed bonds have reputational incentives to consent to minor amendments without a quid pro quo, and often do so; in contrast, holders of public bonds generally have to be paid some consideration to obtain their consent.\textsuperscript{122} Finally, the smaller number of holders of privately placed bonds facilitates monitoring the company’s compliance with the covenants. All of these factors suggest that companies may legitimately include more covenants—with a greater likelihood of having to seek amendments and higher monitoring costs—in privately placed bonds than in publicly issued ones.\textsuperscript{123}

Thus, the greater level of covenant protection in privately placed bonds is not inconsistent with an efficient market for publicly issued bonds.

Finally, legal terms have in fact not generally declined to a loophole-ridden status at which they are nearly worthless. If covenants were easily evaded, they would not benefit bondholders, and companies would care little whether or not a covenant was included in the indenture. But empirical studies have found that bonds with protective covenants gain in exchange offers and leveraged buyouts, while bonds without such covenants lose.\textsuperscript{124} And another empirical study has found that companies generally offer to pay substantial amounts

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\textsuperscript{120} See Marcel Kahan \& Bruce Tuckman, Private vs. Public Lending: Evidence from Covenants (June 1994) (unpublished manuscript, on file with the Northwestern University Law Review).

\textsuperscript{121} See supra notes 12-13.

\textsuperscript{122} See MARK CAREY ET AL., BOARD OF GOVERNORS OF THE FED. RESERVE SYS., THE ECONOMICS OF THE PRIVATE PLACEMENT MARKET 37 (1993); Kahan \& Tuckman, supra note 84, at 502; .

\textsuperscript{123} See Kahan \& Tuckman, supra note 120; Eugene A. Finover \& Sander E. Ash, Non-Traditional Financing: The Pros and Cons of Public Markets and Private Placement, N.Y.L.J., Aug. 17, 1994 at 5 (making similar arguments with respect to real-estate financings).

\textsuperscript{124} See Paul Asquith \& Thierry A. Wizman, Event Risk, Covenants, and Bondholder Returns in Leveraged Buyouts, 27 J. FIN. ECON. 195 (1990); Masulis, supra note 9, at 171 (finding that in debt for equity exchange offers, sample of bonds with debt covenants gained 0.18%, and sample without covenant lost 0.77%).
\end{flushleft}
to bondholders to remove covenants. These studies clearly establish that covenants are valuable to bondholders.

g. Concluding remarks.—The evidence on the institutional setting of the bond market largely supports the notion that legal terms of bonds are accurately priced. Information about the legal terms is readily available. And even though information about the content of complex legal terms is hard to assess, especially for unsophisticated investors, several factors counterbalance the problems created by complexity. Most important, the market for corporate bonds is dominated by institutional investors who have both the ability and, due to their concentrated holdings, strong incentives to value even complex terms. Second, standardization of legal terms reduces the costs of evaluating customary terms. Third, courts have employed contract law and the securities laws to close loopholes that were difficult to detect by investors. Fourth, the investment bank acting as lead underwriter is likely to fulfill some certification function with respect to the legal terms. Finally, the empirical evidence is inconsistent with the notion that covenants have so many loopholes that they have little or no value to investors.

Taken together with the evidence on the pricing of legal terms, the institutional evidence indicates that the market for legal terms works rather well. Residual market imperfections are most likely to exist in the pricing of specific details of complex terms and in the pricing of novel terms.

B. Externalities and Agency Costs

Even if legal terms were perfectly priced when a company issues bonds, the legal terms might be inefficient if they affected parties other than the company's shareholders and the bond purchasers. In particular, legal terms may be inefficient for two reasons. First, terms that benefit third parties might not be included even if such terms are efficient ("positive externalities"), or terms that create costs for third parties might be included even if they are inefficient ("negative externalities"). Second, as a result of agency costs of equity, a company's managers might include inefficient terms that create benefits for themselves or exclude efficient terms that generate costs for themselves. This section examines why externalities or agency costs of equity might result in inefficient legal terms and assesses whether mandatory terms are needed to correct any such inefficiencies.

125 See Kahan & Tuckman, supra note 84, at 510-12 (finding that the average initial consent payment offered was $20.51 per $1,000 principal amount and that in 42% of the solicitations, the initial payment offered was subsequently increased by an average of $40.28 per $1,000 principal amount).

126 See supra text accompanying notes 34-61.
1. Externalities.—The legal terms of a bond may generate two kinds of externalities. An “intrafirm externality” occurs when the legal terms of a certain bond issue of a company affect other creditors of the same company. An “innovation externality” occurs when the originator of a novel legal term is not able to capture the full benefits of the innovation.

   a. Intrafirm externality.—A potentially important externality generated by the legal terms of a bond lies in their effect on other, pre-existing creditors of the company. Consider, for example, a covenant restricting the payment of dividends. The covenant assures that more assets remain within the company and thus makes it more likely that the bondholders whose indenture includes the covenant will be repaid. But, by the same token, the covenant also makes it more likely that the company will repay its other creditors. Thus, the inclusion of the covenant generates positive externalities: it benefits creditors of the company at large, not just the holders of the bond that contains the covenant.

   The dividend covenant is not a unique example. Many other legal terms—for example, covenants prohibiting the incurrence of liens, restricting the ability of the company to engage in non-arm’s-length transactions with controlling shareholders, or limiting the types of investments the company may make and the amount of additional debt the company may incur—may generate positive externalities. Thus, a company may fail to include them in the indenture even if they are efficient.

   Upon closer scrutiny, however, the problem of positive externalities is less significant than it initially appears. For one, even legal terms that seem to benefit creditors at large might in fact benefit primarily the bondholders in whose indenture they are contained. To be sure, creditors at large would benefit if, say, a dividend covenant induced the company not to declare a dividend. But the company might instead have the covenant removed in a manner that benefits exclusively the holders of the bond issue that includes the covenant and leaves the company’s other creditors in the cold. For example, if the company wants to pay dividends despite the covenant, it could obtain the consent of the holders of the pertinent bonds to amend the indenture, or it could redeem the bonds. In either case, the dividend restriction would not benefit any other creditors of the company.

127 See, e.g., SUPERMARKETS GENERAL HOLDINGS CORP., supra note 72, at 57 (limitation on liens), at 55 (limitation on transactions with affiliates), at 58 (limitation on investments), at 51 (limitation on indebtedness).

128 Most indentures permit amendments to their legal terms if the holders of either the majority or two-thirds of the principal amount of bonds consent. See Kahan & Tuckman, supra note 84, at 501-02.
Empirical evidence confirms that companies regularly take actions to remove burdensome covenants. A study of leveraged buyouts found that 71% of the bonds with strong protection, but only 12% of the bonds with no protection, were retired in the wake of the buyout. Bonds that are retired gain on average 5.8% as a result of the buyout, while bonds that remain outstanding lose 5.9% in value. In each instance where the same company had issued bonds with strong protection and bonds with no protection, the bonds with no protection fared worse than the bonds with strong protection. Another study documents that companies often make payments to bondholders to induce their consent to the removal of restrictive covenants. These studies suggest that legal terms such as dividend restrictions often benefit only the holders of the bonds that contain the terms.

Furthermore, even to the extent that a covenant benefits a company’s creditors at large, the company internalizes the resulting externalities as it repays existing creditors and issues new debt. Consider, for example, newly issued bonds that mature in ten years (the “new bonds”) and whose indenture contains a covenant restricting dividends. This covenant may incidentally also benefit the holders of a pre-existing bond issue (the “old bonds”) that matures two years from now and does not contain a similar covenant. However, after two years, when the company issues yet another set of bonds to refinance the old bonds, it could include the same covenant and issue them at a lower interest rate than it could otherwise. Thus, from that point on, the company will capture the benefit of the dividend restriction. Taken together, the ability of a company to confine the benefits of a covenant to those bondholders whose bonds contain it and its ability to internalize the benefits of a covenant as the make-up of its creditors changes greatly diminishes the magnitude of positive externalities.

Analogous issues are raised by legal terms that generate negative externalities. Consider, for example, a promise by a company to pay its new bonds ahead of its old bonds. Obviously, the old bondholders would be harmed by the preferential treatment of the new bondholders. Again, however, the significance of legal terms with negative intrafirm externalities should not be exaggerated. As with legal terms

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129 Cf. William A. Klein et al., The Call Provision of Corporate Bonds: A Standard Form in Need of Change, 18 J. Corp. L. 653, 682-83 (1993) (arguing that companies use calls to get rid of onerous covenants); Michael Liebowitz, Morgan Stanley LBO Begins Refinancing in Private Mart, Investment Dealers’ Dig., Apr. 27, 1992, at 14 (reporting Silgan Corporation’s plan to refinance debt to remove dividend covenant). Covenants may also be removed by acquiring all outstanding bonds by market purchases or by pledging treasury securities with payments corresponding to those due under the bonds in trust for the bondholders (defeasance). See, e.g., Supermarkets General Holdings Corp., supra note 72, at 48, 63-64 (providing for optional redemption and describing defeasance).

130 See Asquith & Wizman, supra note 124.

131 Kahan & Tuckman, supra note 84, at 502.
with positive externalities, the company will internalize the externalities as the make-up of its creditors changes. Thus, when the company refinances its old bonds, the prospect of being paid only after the new bondholders are paid will increase the interest rate that the company will have to pay on its refinancing bonds. Furthermore, it is often easy for creditors to protect themselves against such negative externalities. For example, to make the promise of preferential treatment of the new bondholders enforceable, the company either has to secure the new bonds by a lien on its assets, or it has to obtain the affirmative agreement of the old bondholders to be subordinated to the new bonds.\textsuperscript{132} To protect themselves, the old bondholders thus merely need to obtain a covenant restricting such liens and to refrain from agreeing to subordination. Unsurprisingly, restrictions of liens are among the most frequently encountered bond covenants, and most corporate bonds contain no subordination provision.\textsuperscript{133}

Finally, it should be noted that legal terms with intrafirm externalities can be contained in agreements with any creditor, not just bondholders, and tend to affect the company's other creditors generally, whether they are bondholders or not. Thus, if mandatory terms are justified, they should be imposed by general debtor-creditor law and not by laws dealing specifically with bonds. Indeed, general debtor-creditor law contains a number of mandatory rules that, for example, restrict the ability of insolvent companies to pay dividends\textsuperscript{134} or to engage in sweetheart deals,\textsuperscript{135} make preferential repayments of certain creditors recoverable,\textsuperscript{136} or mandate public filings in order to create an enforceable lien.\textsuperscript{137}

\textbf{b. Innovation externality.}—The development of novel legal terms in bonds involves costs that are not otherwise present. Lawyers, accountants, and investment bankers have to detect a deficiency in the existing terms, devise a suitable way to correct the deficiency, draft

\begin{itemize}
\item \textsuperscript{132} See, e.g., U.C.C. art. 9 (1992) (providing for creation of security interests); American Bar Foundation, supra note 17, at 559-83 (discussing subordination agreements in indentures).
\item \textsuperscript{133} See McDaniel, Bondholders and Corporate Governance, supra note 12, at 425 (reporting that indentures of 82 of 84 Fortune 100 companies for which data were available contain restrictions on secured debt).
\item \textsuperscript{134} See, e.g., Delaware General Corporation Law § 170, Del. Code Ann. tit. 8, § 170 (1991) (providing that dividends may only be paid out of surplus or out of current and/or preceding year's net profits).
\item \textsuperscript{135} See, e.g., Unif. Fraudulent Transfer Act, §§ 4, 5, 74 U.L.A. 652-58 (1985) (indicating that a transfer is fraudulent if transferee did not receive fair equivalent value and was left insolvent or with unreasonably small capital in relation to its business).
\item \textsuperscript{136} See, e.g., 11 U.S.C. § 547 (1993) (providing for avoidance in bankruptcy of preferential payments of creditors).
\end{itemize}
the language of the new term, and market the term to issuers and investors. But, the originators of the novel term will not be able to appropriate for themselves all, and often not even the bulk, of the benefits from novel terms. Unlike technical inventions or books, bond terms cannot be effectively protected by patenting or copyrighting them. Nor can novel terms be kept confidential: the prospectus describing bond terms, and the indenture containing them, must be made available to the public. Thus, once a novel term is used for the first time, other companies and investment bankers, who had no role (and incurred no cost) in originating the term, can free-ride by copying the term into their indentures.

Anecdotal evidence confirms that such free-riding occurs. In November 1988, Northwest Pipeline Corporation and Harris Corporation issued the first two bonds with super poison put covenants, with The First Boston Corporation and Salomon Brothers acting, respectively, as lead underwriters. By the end of 1989, at least forty-eight bonds issued by other companies contained super poison put covenants. The lead underwriters for these bonds included Bear, Stearns & Co.; William Blair & Company; Dillon, Read & Co.; Goldman, Sachs & Co.; Kidder, Peabody & Co.; Merrill Lynch Capital Markets; and Shearson Lehman Hutton.

To be sure, some factors may constrain one's ability to free-ride on terms originated by others. Some novel legal terms might be specifically designed for a single company and be of little use to others. Also, the originators of novel terms might have a better understanding of the terms they create. To that extent, they may obtain a competitive advantage that lasts beyond the first use of a novel term. Finally, an innovation might generate reputational benefits to or signal the quality of the underwriter. Nevertheless, the innovation externality is likely to cause the number of novel terms to be inefficiently small. This problem is compounded by the difficulties discussed above in assessing novel terms.

The innovation externality may justify subsidies for, or cost sharing arrangements with respect to, the development of novel legal terms—for example, funding research or setting up industry-wide bodies to develop such terms. The innovation externality, however,

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138 See Kahan & Klausner, supra note 5, at 970.
139 See, e.g., BECTON, DICKINSON & CO., PROSPECTUS SUPPLEMENT, Mar. 13, 1989, at S-2 to S-4 (Goldman, Sachs); CATERPILLAR INC., PROSPECTUS SUPPLEMENT, June 7, 1989, at S-3 to S-4 (Shearson); FEDERAL EXPRESS CORP., PROSPECTUS, Oct. 10, 1988, at 7-9 (Kidder, Peabody); GRUMMAN CORP., PROSPECTUS, Jan. 5, 1989, at 6-8 (Dillon, Read); MONSANTO CO., PROSPECTUS SUPPLEMENT, Dec. 6, 1989, at S-3 to S-5 (Merrill Lynch); SAFETY-KLEEN CORP., PROSPECTUS SUPPLEMENT, Sept. 11, 1989, at S-2 to S-4 (Blair); UNITED-TECHNOLOGIES CORP., PROSPECTUS SUPPLEMENT, Nov. 6, 1989, at S-4 to S-6 (Bear, Stearns). Examining the law firms involved yields similar results.
140 See supra text accompanying notes 86-89.
does not provide a rationale for the imposition of mandatory terms. The problem created by the innovation externality is that private arrangements result in insufficient innovation, not that bond indentures include inefficient terms once novel terms are created. Thus, whether or not one provides additional stimulus for the creation of novel terms, the innovation externality provides no justification for forcing companies to adopt any specific terms. Indeed, given the difficulty of amending laws,\textsuperscript{141} the imposition of mandatory rules would tend to stifle, rather than encourage, the development of novel terms.

2. Agency Costs of Equity.—A final argument for the imposition of mandatory terms is that managers might set bond terms in a manner that furthers their parochial interest, rather than maximizes the value of the firm. Such managers might include inefficient terms that increase their personal benefits, or they might fail to include efficient terms that run adverse to their interests.

Managers may have a number of personal interests that run counter to the interests of shareholders and bondholders. First, they might want to retain a maximum of managerial power and flexibility and thus would oppose covenants that reduce their power and flexibility. They might oppose, for example, restricting the company's ability to incur additional debt, to make investments or acquisitions, or to merge—even if including these restrictions would increase the company's value. Second, managers might be particularly averse to restrictions on transactions that would provide them with a direct personal benefit. Examples of such transactions include management buyouts and self-dealing transactions. Third, managers might actively seek to include legal terms that would encumber hostile control changes. Such terms might, for example, provide bondholders with additional rights if management were to be ousted in a hostile takeover or in a proxy contest.

The prospect of such intrusions of managerial interest is real. In another article, Mike Klausner and I showed that certain bond provisions, which we term Hostile Control Change Covenants, are best explained by managerial self-entrenchment.\textsuperscript{142} In the same article, we discuss other instances in which managerial interest may have detracted from the efficient design of covenants.\textsuperscript{143}

\textsuperscript{141} See infra part IV.C.

\textsuperscript{142} Kahan & Klausner, supra note 5, at 952-55. Hostile Control Change Covenants give bondholders a right to force the company to buy back their bonds, sometimes at a premium, in case of a hostile takeover or a successful proxy contest (but not in any other case), regardless of whether the takeover or the proxy contest had an adverse effect on the bondholders.

\textsuperscript{143} Id. at 974-77, 978-80 (arguing that management’s desire to maintain flexibility to engage in friendly mergers, restructurings, and management buyouts may explain the use and decline of super poison put covenants).
Mandatory Terms in Bonds

To the extent that the parochial interests of managers result in inefficient legal terms, the company's shareholders are the ones who suffer losses. As long as the legal terms are accurately priced, shareholders bear the costs of the failure to include efficient covenants or of the interference with wealth-increasing control changes. Thus, whether agency costs of equity justify mandatory terms with respect to bonds ultimately depends on the need for mandatory terms in the shareholder-manager relationship.144

In sum, externalities and agency costs of equity may justify governmental intervention, but not necessarily mandatory legal terms for bonds. The intrafirm externality may call for mandatory rules governing generally the relationship between a company and its creditors, though not for specific rules for bondholders. The innovation externality may justify certain subsidies, but no mandatory terms. And agency costs of equity may justify mandatory terms related to bonds that are grounded in the broader framework of mandatory terms on stocks.

III. MANDATORY TERMS AT THE AMENDMENT STAGE

This Part examines whether there is a justification for imposing mandatory restrictions on the ability of companies to change the original terms of bonds through indenture amendments once bonds have been issued. Currently, indentures generally provide that most terms of a bond can be changed with the consent of a specified majority of the bondholders. Certain principal economic terms, however—such as the rate of interest or the maturity of the bond—can be changed only by the unanimous consent of the bondholders.

In the context of stocks, commentators have put forward strong arguments that mandatory restrictions on charter amendments are justified even if the company is free to set whatever initial terms it desires at the original issuance stage. These arguments posit that several factors make the amendment process more defective than the original issuance process. First, managers, who tend to own only a small fraction of a company's shares, have incentives to propose amendments that increase their personal wealth even if they reduce share values. Second, shareholders have fewer incentives to become informed about the impact of proposed charter amendments than investors have about the value of shares they consider purchasing. As a result, badly informed shareholders might approve inefficient charter amendments. Third, inefficient charter amendments may be coupled

144 For a relevant discussion of mandatory rules on manager-shareholder relations, see, e.g., articles cited supra note 22.
with other proposals favored by shareholders, thus "coercing" even informed shareholders to approve inefficient amendments.\textsuperscript{145}

This Part first examines the relevance of each of these arguments to the indenture amendment process. Then it discusses their implications for mandatory terms in bonds at the amendment stage.

\textbf{A. The Indenture Amendment Process}

1. The Inefficient Proposal Problem.—It is undoubtedly true that managers might propose inefficient amendments to the terms of a bond issue. Indeed, managers might propose such amendments even if they act in the interest of their shareholders, rather than in their personal interest. Many bond provisions—such as the interest rate or restrictions on dividends—involves obvious conflicts of interest between shareholders and bondholders. Amendments to such provisions—a reduction in the interest rate or removal of the dividend restriction—could easily benefit shareholders if bondholders could be induced to consent to the amendment without adequate compensation. If bondholders were to approve such wealth-shifting amendments, companies would have a strong incentive to propose them, regardless of their effect on aggregate firm value.

Moreover, whereas several market forces align the interests of shareholders and managers to some extent, these forces play a lesser role in aligning the interests of shareholders and bondholders. As other commentators have discussed at length, the market for corporate control, the management compensation system, the managerial labor market, the product market, and the capital market reduce the conflict of interest between managers and shareholders.\textsuperscript{146} But of all these forces, only the capital market affects the relationship between a company and its bondholders: if a company expropriates bondholder wealth, the capital market may make it more costly for the company to issue bonds in the future.\textsuperscript{147} But even these adverse repercussions

\textsuperscript{145} See Gordon, \textit{supra} note 22, at 1573-85; Bebchuk, \textit{supra} note 22.


\textsuperscript{147} Indeed, since companies issue bonds more often than stock, the bond market is a stronger force than the stock market in aligning interests among corporate constituents—but not nearly strong enough to eliminate all conflict of interest. Marriott, for instance, seemed to have had little difficulty raising $150 million in the public bond market shortly after its spin-off. See Kathie O'Donnell, \textit{Marriott's $150 Million Deal Proves Popular Among Some—But Not All—Note Buyers}, \textit{The Bond Buyer}, Dec. 3, 1993, at 2.
can be avoided if a company commits, when it re-enters the bond market, not to engage again in such expropriation.\textsuperscript{148}

Bondholders therefore cannot rely on the inherent incentives of managers not to propose amendments that are against their interests. Rather, whatever protection bondholders might have against such amendments must lie in the requirement to obtain their consent. The issue is therefore whether the requirement of bondholder consent is sufficient to protect them against wealth-appropriating amendments. In particular, the issue is to what extent bondholders approve amendments that run against their interests because they lack adequate information or because they are "coerced" to give their approval.

2. The Inadequate Information Problem.—In theory, the same kind of well-known collective action problems that lead to uninformed shareholder voting also lead to inadequate incentives for bondholders to acquire information.\textsuperscript{149} First, any individual bondholder, like any shareholder, who owns only a fraction of a particular issue, does not bear the full cost or obtain the full benefit of a proposed amendment. Second, some bondholders will consider their vote unlikely to affect the outcome of the vote on the proposed amendment. Both of these factors reduce the incentive of bondholders to acquire information on the effect of a proposed amendment.

In practice, however, the collective action problems for bondholders are not as great as they are for shareholders. Since bond ownership is highly concentrated,\textsuperscript{150} individual bondholders bear a much higher portion of the total costs or benefits of an amendment and will consider their votes as much more likely to be determinative than will their shareholder counterparts. Moreover, the smaller number of bondholders makes it easier to coordinate their actions and thereby to collectivize their costs.\textsuperscript{151} Thus, collective action problems are substantially less significant for bondholders than for shareholders.\textsuperscript{152}

\textsuperscript{148} See, e.g., Trans-Resources Deal Has 'No-Riklis' Clause, M\textsc{erger} \& A\textsc{cquisitions} R\textsc{ep.}, Mar. 29, 1993, at 2 (reporting that bonds issued by Trans-Resources, Inc., contained covenant intended to prevent involvement of Meshulam Riklis in company; Riklis has a reputation of not paying off bonds in cash and has been involved in numerous lawsuits).

\textsuperscript{149} See, e.g., Lucian A. Bebchuk \& Marcel Kahan, A Framework for Analyzing Legal Policy Towards Proxy Contests, 78 C\textsc{al.} L. R\textsc{ev.} 1071, 1080 (1990) (discussing inadequate shareholder incentives in proxy contests).

\textsuperscript{150} See supra part II.A.2.b.

\textsuperscript{151} Note that, unlike shares of public companies, most bonds are not registered under the Securities Exchange Act of 1934 and thus not subject to the proxy rules.

\textsuperscript{152} See Kahan \& Tuckman, supra note 84, at 512 (documenting that coordination among bondholders in response to consent solicitations happens frequently and is highly effective). In light of the relatively small number of bondholders, their high degree of concentration, their homogeneity, and the fact that they tend to be repeat players, it is also unlikely that bondholder collective action will suffer from a significant free rider problem. See generally Edward B. Rock,
Furthermore, inadequate information is not a sufficient reason to justify restrictions on the ability to pass amendments; rather, it must also be shown that bondholders, because of inadequate information, vote in favor of amendments that run against their interests. In the context of charter amendments, commentators have argued that shareholders (rather blindly) vote for any amendment proposed by managers. Such shareholders either naively assume that managers always act in their interest, or they assume that most proposed amendments are beneficial because they involve no significant conflict of interest between themselves and the managers.¹⁵³

Whatever the validity of this argument in the shareholder context,¹⁵⁴ it lacks any plausibility in the bondholder context. As explained above,¹⁵⁵ bondholders have no a priori reason to believe that proposed amendments will be in their interest. It would thus be highly irrational for uninformed bondholders to vote in favor of any amendment presented to them. Rather, uninformed bondholders would probably do better to vote against all proposals than to vote in favor of them.

Indeed, the empirical evidence is inconsistent with the notion that bondholders are severely underinformed and systematically vote for adverse amendments. In a study of consent solicitations, Bruce Tuckman and I found that less than half of all consent solicitations succeed on their initial terms: in 42% of the solicitations the company had to improve the initial terms offered, and 17% of the solicitations ultimately failed.¹⁵⁶ These figures suggest that bondholders generally possess enough information to resist wealth-shifting amendments.

3. The Coercion Problem.—At first blush, the argument that shareholders are “coerced” into approving adverse charter amendments because they are coupled with other favorable proposals might seem illogical. The argument acknowledges that shareholders benefit from the amendment and the other proposal taken as whole. But if shareholders benefit, what is wrong with the fact that they are induced to approve the amendment?

The argument makes sense only if one further stipulates that the shareholders ought to get the benefit of the other proposal regardless of whether they approve the amendment. One example given for the

¹⁵³ See Bebchuk, supra note 22, at 1836-40; Gordon, supra note 22, at 1576.
¹⁵⁴ See Roberta Romano, Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws, 89 COLUM. L. REV. 1599, 1608-10 (1989) (suggesting that strategy of always voting “yes” on proposed amendments is not optimal).
¹⁵⁵ See supra text accompanying notes 146-48.
¹⁵⁶ See Kahan & Tuckman, supra note 84, at 503, 512. The average increase in the consent payment offered was $40.28 per $1,000 principal amount.
coupling of two proposals is a charter amendment that contains both a fair price provision in case of a freeze-out merger (posited to be good for shareholders) and a 90% vote requirement for a merger (posited to be bad for shareholders, but good for managers). But managers, as fiduciaries of their shareholders, should have proposed only the first prong of the amendment. From that perspective, it is indeed "coercive" to force shareholders to take the bad with the good.

Although this line of argument is plausible in the context of charter amendments—where managers, who are supposed to act in the interest of shareholders, sneak in provisions for their personal benefit—it lacks plausibility in the context of bonds. Unlike shareholders and managers with respect to charter amendments, bondholders and managers (acting on behalf of shareholders) stand in an openly adversarial position with respect to indenture amendments. Thus, it is entirely proper for a company to couple an item that is good for bondholders, such as a consent payment, with an item that is bad for bondholders, such as the relaxation of a dividend restriction.

Bondholders might, however, be subject to a different form of "coercion." This coercion could arise if bondholders voting in favor of an amendment are not treated equally with bondholders voting against an amendment, even though the amendment would bind all bondholders if it passed. Consent solicitations regularly entail such discrimination. In most solicitations, only bondholders who vote in favor of an amendment either receive a consent payment or are permitted to participate in an exchange or tender offer for their bonds. As a result of this disparate treatment, even fully informed bondholders might vote for amendments that lower the value of their bonds.

Assume, for example, that XYZ Corporation proposes an amendment that lowers the value of its $100 million in debentures by $1 million (or $10 per $1,000 principal amount), but offers consenting bondholders a payment of only $5 per $1,000 principal amount held if the amendment is approved. The amendment is thus clearly not in the interest of the bondholders. But if Investor, a holder of $1 million of the debentures, believes that enough other bondholders will vote for the amendment, she should also vote in favor: the value of her bonds would decline by $10,000 anyhow, so she might as well cash in the $5,000 consent payment. And if other bondholders reason in the same way, their expectations become self-fulfilling, and the adverse amendment will pass.

157 See Gordon, supra note 22, at 1580-81.
158 See Kahan & Tuckman, supra note 84, at 506-07. Note that such coercive tactics are permitted in the context of bondholder voting, but generally not in the context of shareholder voting. See supra note 23.
159 See Kahan & Tuckman, supra note 84, at 504-06 (presenting a game-theoretic model of bondholder voting decisions); see also Lucian A. Bebchuk, Toward Undistorted Choice and
The "coercion" in these proposals results from the discriminatory treatment of consenting and nonconsenting bondholders. Assume that Investor receives the "consent payment" whenever the amendment is approved, regardless of how she voted on it. Her vote would then affect her payoff only if it is her vote that determines whether the amendment passes. Thus, Investor would have an incentive to vote in favor only if she considers the amendment beneficial. And if enough other bondholders agreed with her assessment, only such amendments would pass. For that reason, several commentators advocate a mandatory prohibition of such discriminatory treatment. Part V discusses whether such a prohibition is justified.

B. Implications for Mandatory Terms

The previous section identified two potential sources of imperfection in the amendment process. First, bondholders might possess inadequate information and, as a result, approve some inefficient amendments (though this problem is substantially less severe than in the shareholder context). Second, companies might use "coercive" structures to pressure bondholders to approve adverse amendments.

But even to the extent these imperfections in the amendment process exist, they do not necessarily justify mandatory terms. To be sure, imperfections in the amendment process may make it desirable to have special provisions to regulate that process. For example, a company seeking to amend an indenture could be required to furnish certain information to bondholders, "coercive" solicitations could be prohibited, or certain indenture terms could be made nonamendable. But the rules governing the amendment process, including rules that certain terms may not be amended at all, are part of the original legal terms at the issuance of a bond. Thus, with one exception, only imperfections in the original issuance process can justify the imposition of such rules as mandatory terms. The one exception re-


 If Investor's vote is determinative, the amendment passes and she receives the consent payment if she votes in favor; and the amendment fails and she receives no payment if she votes against. If the amendment fails regardless of her vote, she never receives the consent payment. In the case of differential treatment discussed before, however, Investor would not receive the consent payment if the amendment passed but Investor voted against it.

 See Brudney, supra note 12, at 1853-56 (favoring categorical prohibition of coercive structures); Coffee & Klein, supra note 13, at 1271-72 (favoring prohibition of coercive structures on either contractual or mandatory basis).

 See, e.g., Model Simplified Indenture, 38 Bus. Law. 741, 763 (§ 9.02) (1983) (proposing a contractual rule making certain provisions non-amendable and imposing two-thirds majority requirements for most other amendments); Coffee & Klein, supra note 13, at 1251-53 (proposing contractual prohibition of coercion).
lates to terms that are mandatory when a bond is originally issued and therefore not subject to amendment by the regular amendment process. If such terms cease to be mandatory, the question arises as to what rules should govern their amendment—whether they should become subject to the same amendment rules as the other terms or whether they should remain nonamendable. If the indenture does not provide for this contingency, it is a priori unclear how this issue ought to be resolved.\(^\text{163}\)

This question of what rules should govern the amendment of terms that used to be mandatory is of major significance for stocks: many important terms governing the relation between shareholders and managers are,\(^\text{164}\) or until recently were,\(^\text{165}\) mandatory. Commentators have urged that many of the remaining mandatory terms be made optional.\(^\text{166}\) And whenever a mandatory rule becomes optional, shares issued while the term was still mandatory will constitute for a very long time the bulk of all publicly-issued shares.

For bonds, however, this issue is minor. Only few bond terms are now mandatory, and most of those are relatively insignificant or have generated little controversy. In contrast to stocks, the main debate is not whether currently mandatory provisions should be made optional, but whether additional mandatory provisions should be adopted. But the issue of what rules should govern amendments to previously mandatory terms would, of course, arise only when existing mandatory terms are repealed, not when new mandatory terms are adopted.

The only current rule that is mandatory and that commentators have urged be made optional is the "unanimous consent" rule for changes in interest and maturity imposed by the Trust Indenture Act of 1939.\(^\text{167}\) Section 316(b) of the Act literally provides that all affected holders have to approve any amendment that "impairs" the right of any bondholder "to receive payment of the principal of and interest on" her bond.\(^\text{168}\) If that rule were repealed, the issue would arise

\(^{163}\) Cf. Bebchuk, supra note 22, at 1831-32 (making analogous argument with respect to charter amendments).

\(^{164}\) These mandatory terms include the rules on takeover defenses, self-dealing, the duty of care, insider trading, annual election of directors, and demand requirements for derivative suits.

\(^{165}\) See, e.g., Delaware General Corporation Law, § 102(b)(7), DEL. CODE ANN. tit. 8, § 102(b)(7) (1991) (permitting opt-out for personal liability for breaches of duty of care).


See Model Simplified Indenture, supra note 162, at 757 (§ 6.07).
whether the "unanimous consent" rule in bonds issued before the repeal should be made amendable by the regular amendment process, by some special process, or not at all. If the indenture does not provide for that contingency, it might be desirable to have a mandatory rule governing such amendments in bonds issued prior to a repeal of Section 316(b).  

Conveniently (and quite peculiarly) indentures invariably contain a second provision that is not mandated by the Trust Indenture Act. This purely contractual provision typically provides that no amendment may "reduce the rate of or change the time for payment of interest [or] reduce the principal or change the fixed maturity" of any bond "without the consent of each [bondholder] affected," and it provides further that this provision itself may be amended only with the consent of each affected holder. This nonmandatory provision covers essentially the same territory as the mandatory provision in Section 316(b) of the Trust Indenture Act, and the contractual rules governing the amendment process prohibit the amendment of this provision without the consent of each affected holder. By duplicating Section 316(b) with an equivalent nonmandatory provision, and by devising special requirements for the amendment of that provision, the indenture in effect provides for the contingency that Section 316(b)—the one mandatory provision that has generated controversy—might be repealed.  

The issue of special mandatory terms at the amendment stage is thus negligible. If imperfections in the amendment process call for restrictions on the ability to amend bond terms, these restrictions can be (and are) part of the initial terms of the bond. With the exception of terms that are mandatory when the bond is initially issued and have since been made optional, making such restrictions mandatory can be justified only by imperfections in the original issuance process. But only few terms are currently mandatory, and most of them are insignificant or uncontroversial. And with respect to the one mandatory term that is significant, and the repeal of which has been urged, a contractual indenture provision prohibits amendments even if such a repeal were to be enacted.  

Note that even where the issue of such transitional amendment rules arises, the issue is of less importance in the bond context than in the stock context. Unlike stocks, bonds are issued with a fixed maturity, ranging generally from several months for medium-term notes to 30 years for long-term corporate bonds. According to estimates, the average maturity of publicly issued bonds is about 14 years. See Carey et al., supra note 77, at 4 n.2. This suggests that within 10 years after a repeal of a mandatory provision a substantial fraction, and within 30 years almost all, of the then-outstanding bonds would be issued under a new nonmandatory regime.  

See Model Simplified Indenture, supra note 162, at 763 (§ 9.02); see also American Bar Foundation, supra note 17, at 305-08 (equivalent provision).
IV. POTENTIAL DRAWBACKS OF MANDATORY TERMS

To the extent that there are imperfections in the contractual terms of bonds, it does not follow that one should enact mandatory terms to correct them. As already demonstrated, certain imperfections call for actions other than the enactment of mandatory bond terms. More importantly, however, mandatory terms involve drawbacks even with respect to those imperfections that theoretically would call for such terms. Thus, mandatory terms are desirable only if these drawbacks are less severe than the imperfections the mandatory terms are meant to correct.

This Part presents a brief overview of the potential drawbacks of mandatory terms, which completes the framework for analyzing the desirability of mandatory terms. The next Part applies the framework in an assessment of whether either fiduciary duties to bondholders or a prohibition of coercive structures in consent solicitations should be enacted as mandatory terms.

A. The Inferior Term Problem

The most evident potential drawback of a mandatory term is that it may be inferior to a contractual term, even if the contractual term is not perfectly efficient. Unlike companies and bondholders, the persons who design mandatory terms—legislators, regulators, or judges—do not have their own money at stake and thus have inadequate incentives to determine which terms are optimal. Moreover, legislators, regulators, and judges may lack the appropriate expertise; they may be subject to political pressures; or they may be unduly influenced by self-serving declarations of companies and bondholders as to what terms are optimal.

Thus, the choice is not between imperfect contractual and perfect mandatory terms, but between imperfect contractual and imperfect mandatory terms. Merely pointing to an imperfection in the contractual process provides no assurance that a mandatory term would be superior to a contractual one.

171 See supra text accompanying notes 134-37, 141.
172 See also Clark, supra note 22, at 1731 (noting differential incentives); Easterbrook & Fischel, supra note 22, at 1421 (finding that managers and investors have incentives to devise value-maximizing contract terms); Romano, supra note 154, at 1606 (noting that managerial groups dominate corporate law-reform process).
173 This refers to the so-called “Nirvana Fallacy,” which devout free-market scholars regularly accuse more interventionist scholars of perpetrating. Of course, free-market scholars may fall prey to the beguiling “Heavenly Market Fallacy”—the assumption that free markets are always preferable to regulation because regulation is imperfect. See Eisenberg, supra note 22, at 1524-25; cf. Fred S. McChesney, Economics, Law and Science in the Corporate Field: A Critique of Eisenberg, 89 COLUM. L. REV. 1530, 1543 (1989) (arguing that issue is not whether securityholders have full information, but whether securityholders or governments have better information).
The potential for inferior mandatory terms is heightened if companies are heterogeneous, that is, if different terms are optimal for different companies. In that case, any uniform mandatory term would be inefficient for some companies, even if it were the best uniform term available. Take, for example, a restriction on a company's ability to pay dividends. A restriction that is too loose might lead a company to pay dividends instead of making investments in profitable projects. But if the restriction were too tight, the company might invest too much in inefficient projects. How much dividends ought to be restricted thus depends on the company's supply of investment projects. A tighter restriction would be more desirable for a company with many profitable projects than for one with few such projects.

This problem, of course, could be averted if different mandatory terms were imposed on different companies. Theoretically, it is possible to devise the optimal term for each similarly situated group of companies, and to impose it on a mandatory basis. In practice, however, substantial heterogeneity among companies makes it more likely that a contractual term will be superior to a mandatory one.\footnote{Note that the potential for inferior mandatory terms tends to be greater when the imperfection in the contractual term is caused by imperfect information, rather than by externalities or agency costs of equity. If externalities or agency costs cause the imperfection, the desirable direction of a mandatory term is usually evident. I argued above, for example, that agency costs of equity cause bond indentures to impose overly strict limitations on hostile takeovers, but insufficient limitations on management buyouts. See supra text accompanying notes 142-44. The optimal term would reduce the limitations on hostile takeovers and increase those on management buyouts, though it is unclear by how much. But if the imperfection is caused by imperfect information, even the direction of a mandatory term might not be clear. Assume, for example, that bondholders misvalue complex covenants. This imperfection provides less of an indication whether the optimal covenant is stricter or less strict than the contractual term. Thus, it would be even harder to devise a superior mandatory term. In some instances of imperfect information, however, the direction of the mandatory term will be clear. If misvaluation is the result of a holder's failure to note the existence of covenants or a holder's assumption that covenants will be ridden with loopholes, the misvaluation will cause covenants to be less strict than optimal.}

B. The Application Problem

A second aspect of potential deficiencies in mandatory terms lies in the application of these terms. Even a term that is efficient in the abstract may become inefficient if courts apply the term "incorrectly." Take, for example, a rule prohibiting the payment of dividends whenever such a payment would reduce bondholder wealth by more than it increases shareholder wealth. Such a rule is efficient as stated: it permits dividends only if they do not decrease aggregate company value. As applied, however, it would be likely to prevent some desirable dividend payments and permit other undesirable ones.

Associated with the problem of incorrect application is the problem of vagueness. Legal terms that lend themselves to incorrect appli-
cation because they provide insufficient guidance to courts also provide little guidance to companies and bondholders. Thus, even supposing that judges never err in applying a rule, the rule might nevertheless create inefficiencies. For one, vague terms may result in costly litigation over how they ought to be interpreted. Moreover, uncertainty as to the scope of permitted actions may deter companies from undertaking desirable, permitted actions. For instance, a company might fail to pay a dividend that would increase company value because it fears that the dividend will be found to violate the hypothetical dividend rule described above.175

The problem of vagueness is of particular concern in the context of legal terms of bonds. One reason bond terms are highly complex is that they supply precise provisions for numerous contingencies. The high degree of precision in contractual terms suggests that companies and bondholders consider the clarity of bond terms to be very important.176 And they do so for good reasons. For companies, the penalty for violating ambiguous legal terms is high: bondholders might declare a default and accelerate the repayment of their bonds, which in turn might trigger a cross-default on other debt and force even a healthy company into bankruptcy. And for bondholders, the lack of ambiguity means that they have speedy access to remedies (a crucial factor for creditors of financially shaky companies) and cannot be dragged into lengthy litigation over the meaning of a covenant.177

C. The Inertia Problem

Finally, barriers to revisions in mandatory terms can detract from their efficiency. Even mandatory terms that are optimal when enacted

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175 Cf. Marcel Kahan, Causation and Incentives to Take Care Under the Negligence Rule, 43 J. LEGAL STUD. 427, 437-39 (1989) (finding that uncertainty over the level of due care may cause injurers to exercise more than optimal care if their liability exceeds the additional costs of accidents).

176 This assumes that the precision of contractual terms is not itself a result of a contractual imperfection.

177 Moreover, clarity allows a bondholder to detect more easily whether a company is complying with all indenture provisions. Bondholders often rely in this regard on self-monitoring by companies. Most bond indentures require companies to supply periodic officer's certificates as to their compliance with all indenture provisions. An ambiguous term makes it easier for a company to claim compliance and thus harder for bondholders to determine the extent to which the company has in fact complied with the indenture. See also Kahan & Tuckman, supra note 120 (finding that covenants in privately placed bonds are more ambiguous than covenants in publicly issued bonds and arguing that these differences can be explained by differential abilities to monitor compliance and to renegotiate). To be sure, initially vague mandatory legal rules may become clearer as precedent interpreting these rules is generated. It would be preferable, however, to fashion less vague legal rules to start with, which would provide clarity at least with respect to the most likely fact patterns to which they might be applied. See infra note 195. For a general discussion of the comparative benefits of ex ante precision in legal rules, see Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 DUKE L.J. 557 (1992).
may not remain so as the economy develops or as the institutional setting of the bond market changes. At that future point, however, legislative inertia may impede a revision in the mandatory term.

If a mandatory term were to be imposed by statute or regulation, it could be amended only by a legislative or regulatory body. This would require not only a realization by that body that an amendment is desirable, but a host of procedures such as committee hearings, debates and discussions, several readings, votes, and notice and comment periods. If a mandatory term were imposed by a court, one might also hope that the court would modify its mandatory rule, if necessary, in an appropriate case. Either way, the process of changing a mandatory term is likely to be protracted, and its outcome uncertain.

D. Concluding Remarks

The various drawbacks of mandatory terms point to several factors that may make the imposition of mandatory terms more or less appropriate. The problem of inferior terms means that mandatory terms are more appropriate the more significant the contractual imperfection is and the easier it is to establish a superior mandatory term. The application problem suggests that mandatory terms should try to provide clear guidance to courts, companies, and bondholders as to what actions violate these terms. The inertia problem indicates that one should be careful of imposing mandatory terms where economic or institutional factors that affect the desirability of a term change frequently.

V. Mandatory Fiduciary Duties and Prohibitions of "Coercive" Consent Solicitations

This Part applies the analytical framework developed in this Article to two specific proposals for mandatory terms—that companies be subjected to a mandatory fiduciary duty to bondholders and that coercive structures in bondholder consent solicitations be prohibited.

A. Fiduciary Duties to Bondholders

Probably the farthest reaching reform proposal is the imposition of a fiduciary duty by companies to bondholders. Several commentators have advocated such a duty, though the particulars vary. Morey McDaniel, for example, proposes a fiduciary duty to maximize firm value, that is, the sum of the value of the firm’s shares and of its bonds. If such maximization results in losses to the bondholders, a company should then make side-payments to the bondholders to com-
Larry Mitchell criticizes McDaniel's proposal and instead advocates a three-prong test. To establish a breach of duty, bondholders would first have to show that the company took actions that were inconsistent with their reasonable expectations. Then, the company could defend itself by proving that these actions had a legitimate business purpose. The company would, however, still be liable if bondholders demonstrate that other reasonable means which would have been less harmful to bondholders could also have achieved that purpose.

The advocates of fiduciary duties have not gone unchallenged. Other commentators have presented forceful arguments that a fiduciary duty to bondholders would be undesirable. For one, such a duty would be vague and create great uncertainty as to whether a given action would violate it or not. As a result, the duty would be difficult to enforce and would likely result in significant litigation costs. These uncertainty costs are particularly striking in the context of bonds, where contractual indenture provisions are highly-detailed and complex in order to avoid just such uncertainty.

The vagueness of the proposed fiduciary duties, of course, also means that courts would face a difficult task in applying the standard. Judges would be likely to make many errors in deciding what actions maximize firm value and what side-payments would compensate bondholders, and they would be little better in figuring out the "reasonable expectations" of bondholders, the company's "legitimate pur-

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178 See McDaniel, Bondholders and Stockholders, supra note 12, at 307-12; see also Barkey, supra note 12, at 68-69 (favoring duty to maximize firm value and to compensate bondholders for losses from wealth appropriating transactions).

179 Mitchell, supra note 12, at 1217-20, 1224-26. Mitchell bases his arguments in favor of fiduciary duties primarily on fairness rather than efficiency. Much of the evidence discussed in this Article is relevant even from a fairness perspective. If the legal terms of bonds are accurately priced, it may not be unfair to allow these terms to be set by the bond market. Indeed, one of Mitchell's main arguments in favor of fiduciary duties is that bondholder interests are not represented when the legal terms of a bond are determined. Id. at 1178-85. But if legal terms are priced, it is irrelevant whether bondholders are physically present when the terms are set, since the company will already have incentives to incorporate bondholder-protective terms if the benefits to the bondholders exceed the costs to the company. Indeed, if the costs to the company exceed the benefits to the bondholders, a company would refuse to include such terms even if bondholders were present. Moreover, since most bondholders are large institutional investors (larger, indeed, than most companies), the appeal of fiduciary duties on fairness grounds declines: if fairness includes protecting the weak against the strong, multi-billion dollar insurance companies and mutual funds are unlikely objects for a fairness-based fiduciary duty.

180 Brudney, supra note 12, at 1839-41; Hurst & McGuiness, supra note 12, at 200-02; Macintosh, supra note 12, at 436-40; Tauke, supra note 12, at 62-63. At least one advocate of fiduciary duties seems to see a benefit in uncertainty. Mitchell, supra note 12, at 1125-26 (arguing that uncertainty has a prophylactic function).

181 See Kanda, supra note 12, at 446 (finding that bondholders want more concrete provisions).
poses,” or the availability of other “reasonable means” to achieve these purposes.\textsuperscript{182}

Indeed, it is exactly this problem that has led courts to develop the “business judgment rule” in analyzing alleged breaches of fiduciary duties to shareholders.\textsuperscript{183} The business judgment rule assures that courts review only cases involving gross negligence or egregious conflicts of interest between managers and shareholders. Even in those cases, process factors often determine the outcome.\textsuperscript{184} In the bondholder context, however, no equivalent to the business judgment rule seems to be contemplated.\textsuperscript{185} Courts would be asked to rule on many commonplace corporate actions, any of which might easily harm bondholders, such as dividend payments, debt-for-equity exchange offers, spin-offs, acquisitions of new business lines, debt redemptions,

\textsuperscript{182} See Tauke, \textit{supra} note 12, at 65 (arguing that courts are not adept in deciding what is best for a corporation).

\textsuperscript{183} See, e.g., Solash v. Telex Corp., 1988 WL 3587 (Del. Ch. Jan. 19, 1988) ("[B]usinessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts . . . . [Therefore] courts have long been reluctant to second-guess [their] decisions when they appear to have been made in good faith."); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (holding that the business judgment rule recognizes the limited institutional competence of courts to assess business decisions).

\textsuperscript{184} See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (holding that proof of good faith in a takeover defense is materially enhanced if a majority of independent directors approve defense); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (holding that freeze-out mergers must comply with the standards of fair price and fair dealing, the latter involving process considerations); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (reviewing the recommendation of the special litigation committee to dismiss derivative suits for whether the committee was independent and acted in good faith and informed manner).

\textsuperscript{185} See, e.g., McDaniel, \textit{Bondholders and Stockholders, supra} note 12; Mitchell, \textit{supra} note 12. In contrast, Brudney, an advocate of extra-contractual bondholder rights, argues that if the business judgment rule applied to a fiduciary duty to bondholders, such a duty would be ineffective. Brudney, \textit{supra} note 12, at 1841-43. In commenting on an earlier draft of this Article, Morey McDaniel accepted the need for an equivalent to the business judgment rule that would afford remedies to bondholders only in egregious and unusual circumstances. He further argued that, in an efficient market, changes in bond prices as a result of management actions provide an easy way to determine bondholder losses. Although these modifications would greatly alleviate the application problem, a substantial problem would remain. A “business judgment rule” turning on the magnitude of bondholder losses is fundamentally different from the business judgment rule in the corporate context, which turns on adequate procedures and financial disinterestedness, and would probably be less effective as a liability filter. Moreover, changes in bond prices are for several reasons a highly imperfect way of measuring bondholder losses. If bondholders are entitled to be compensated for any losses they suffer, bond prices would not change in response to otherwise wealth-shifting transactions. Also, many bonds are only infrequently traded in the secondary market, and for them no reliable information on price changes can be obtained. Furthermore, even in informationally efficient markets, bond prices change when “new” information becomes public; but information becomes public only gradually, and, on any given day, many items of information may become public. For example, on one day, the price of a bond may decline both because the likelihood of a future leveraged buyout has increased from 5% to 20% and because the company announced lower than expected quarterly profits. Thus, on an individual company basis, price changes are not a good basis for measuring the impact of a single event. See MacIntosh, \textit{supra} note 12, at 436-37.
sale-leaseback transactions, underfunding of pension plans, or failures to comply with environmental laws. The absence of a “business judgment rule” for bonds would thus compound the uncertainty, litigation costs, and danger of judicial error that would be created by the vague “fiduciary duty” standard.¹⁸⁶

Even apart from these application problems, a fiduciary duty to bondholders might be inefficient because it would reduce the accountability of managers to shareholders. As many observers have noted, managers already have great leeway to put their own interest ahead of those of shareholders.¹⁸⁷ A duty to bondholders would aggravate this problem by affording managers another opportunity to benefit themselves under the guise of satisfying their fiduciary obligations to the bondholders.¹⁸⁸

Finally, the complete absence of any attempt to impose a fiduciary or a similarly sweeping duty on the company by contract augments the doubts over whether a legally mandated fiduciary duty is desirable. This absence of attempts is not confined to public bondholders—who do not directly negotiate with the company—but extends to banks and purchasers of private placements, that is, to highly sophisticated and well-informed institutions that bargain with the company directly over legal terms.¹⁹⁰

¹⁸⁶ The absence of a business judgment rule would also have the ironic consequence of making it easier for bondholders than for shareholders to bring a claim for breach of fiduciary duty.¹⁸⁷ See, e.g., Bebchuk & Kahan, supra note 149, at 1122-26 (arguing that rules on compensation of management expenses in proxy contests are too generous); William L. Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 YALE L.J. 663 (1974) (arguing that Delaware law gives insufficient rights to shareholders); Randall S. Thomas, Judicial Review of Defensive Tactics in Proxy Contests: When Is Using a Rights Plan Right?, 46 VAND. L. REV. 503, 560 (1993) (concluding that courts should apply stricter standards in reviewing management defenses against proxy challengers).

¹⁸⁷ See Bratton, supra note 12, at 735-38 (arguing that duty to bondholders would conflict with duty to stockholders); Kanda, supra note 12, at 444 (finding that a duty to bondholders would make a duty to shareholders more difficult to enforce). Note in that regard that the fiduciary duty managers owe to preferred stockholders is rather limited. See, e.g., Rosan v. Chicago Milwaukee Corp., No. C.A. 10526, 1990 WL 13482 (Del. Ch. Feb. 6, 1990) (holding that matters related to liquidation preference of preferred stockholders must be evaluated as strictly contractual rights and that fiduciary duty is confined to rights shared equally by preferred and common stockholders).

¹⁸⁸ An example of such a similar duty would be a duty not to take any intentional action that would destroy the investment-grade rating of the bonds. See, e.g., Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1516 (S.D.N.Y. 1989) (involving plaintiffs urging the court to imply such a duty in RJR Nabisco bonds).

¹⁹⁰ See, e.g., Kahan & Tuckman, supra note 120 (finding that no such broadly defined contractual duties are imposed by covenant). Companies have also not made use of the opportunity to grant voting rights to bondholders. See Delaware General Corporation Law, § 221, DEL. CODE ANN. tit. 8, § 221 (1991). Given the lack of contractual creation of fiduciary or similar duties, such duties could still be justified as second-best solutions, since the types of firm-specific contractual protections negotiated by sophisticated lenders would be difficult to impose as
To be sure, that even these well-informed parties do not contract for a fiduciary duty does not conclusively establish that a legal fiduciary duty is undesirable. Ian Ayres, for example, has argued that it is more efficient to create vague rules by law than by contract: initially vague legal rules are more likely to generate clarifying precedents over time; but given likely variations among vague contractual rules, a useful body of precedent is less likely to develop. Whatever the merits of Ayres’ argument in general, it does not justify the imposition of mandatory terms on bonds. For one thing, Ayres merely argues that there is a benefit from having nonmandatory legal rules that are vague, but does not advocate mandatory rules. Secondly, his argument that vague contractual rules will not engender a useful body of precedent is less pertinent to indentures: many indenture terms tend to be highly standardized, and courts have clearly stated that standardized indenture provisions are to be interpreted uniformly, as a matter of law and without regard to the parties’ intent, in order to enhance certainty. Thus, a case interpreting a standard clause in one indenture would constitute a useful precedent for interpreting an equivalent clause in another indenture.

In light of these countervailing arguments, the question whether a fiduciary duty to bondholder is desirable is at least debatable. In my judgment, the argument that a duty to bondholders is not efficient is mandatory terms. See supra text accompanying note 174. For such a justification to be valid, of course, a heightened degree of imperfection in the contractual terms would be necessary.


The strength of Ayres’ argument crucially depends on two factors: the extent to which prior court cases turn on generalized principles applicable to future cases, as opposed to particularized issues of fact (and, on a related front, the extent to which they result in reasoned decisions by judges, as opposed to jury verdicts); and the difficulty of generating such generalized principles ex ante by contract. The presence of these factors will, of course, vary by context. In the context of fiduciary duties to bondholders, I suspect that court cases interpreting the duties as proposed by McDaniel and Mitchell are likely to turn on particularized facts and will not significantly diminish legal uncertainty.

See Ayres, supra note 191, at 1403-08. But see Gordon, supra note 22, at 1565-66 (arguing in principle that mandatory rules could be efficient if they preclude an inefficient splintering of precedent).

See, e.g., Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1048 (2d Cir. 1982).

It could be argued along similar lines that a transitional mandatory fiduciary duty is necessary to stimulate the development of precedent. According to such an argument, companies would opt out of a newly created optional fiduciary duty to bondholders lacking any precedent (as they fear they would be the object of the “precedent”), but would not opt out once the precedent is created. But this argument overlooks the possibility of creating an optional fiduciary duty that has precedent “built-in,” for example, by making specifications for certain fact patterns or by including an official comment explaining how the duty ought to be applied to such patterns. To be sure, such a duty would be a novel term involving innovation externalities, see supra text accompanying notes 138-41; but, as explained, innovation externalities do not provide a rationale for mandatory terms.
probably stronger than the argument that such a duty is efficient. However, a much lesser showing suffices to oppose a mandatory imposition of the duty. The proponents of a duty base their argument on the failure of bondholders to appreciate that many bonds provide little or no protective legal terms. But, contrary to their suggestions, the evidence on the pricing of legal terms and on the institutional setting of the bond market shows that bondholders know about the legal terms of bonds and take them into account.\(^\text{196}\) To the extent that there are imperfections, they are likely to lie in easily overlooked loopholes in supposedly protective terms. A fiduciary duty, of course, sweeps far beyond the mere closing of loopholes. Given the weak case for contractual imperfections, the arguments in favor of a fiduciary duty are not sufficient to impose such a duty as a mandatory term.

Furthermore, a mandatory fiduciary duty cannot be justified by intrafirm externalities or agency costs of equity. Intrafirm externalities do not affect companies that have no significant other debt when they issue bonds. That no such companies have included a fiduciary duty to bondholders in their contract is inconsistent with the notion that intrafirm externalities are responsible for the lack of such duties. Agency costs of equity may account for the absence of terms that constrain managerial discretion. But the creation of fiduciary duties to multiple constituents would be likely to increase, rather than decrease, managerial discretion, and such agency costs do not affect privately held companies—who also do not contract for fiduciary duties. Thus, the question of whether a company should have fiduciary or similar duties to its bondholders should be left to the parties’ contractual resolution.

**B. Coercive Structures in Consent Solicitations**

As explained above,\(^\text{197}\) a consent solicitation may be structured in a way that creates incentives for individual bondholders to consent to an amendment that is not in the collective interest of the bondholders. Such “coercion” may result if the bondholders who consent to an amendment are treated differently from bondholders who do not consent—even though the amendment would bind all bondholders equally. Companies accomplish such discriminatory treatment by making a “consent payment” exclusively to consenting bondholders, or by giving such holders the exclusive right to participate in an exchange or tender offer, if the requisite majority of consents are received. In such coercively structured solicitations, a bondholder may consent to an amendment that reduces bond values, fearing that she

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196 See supra part II.A.
197 See supra text accompanying notes 157-61.
would lose even more if she did not consent and the amendment passed anyway.\textsuperscript{198}

Coercive structures can easily be eliminated by prohibiting discrimination between consenting and nonconsenting holders. Thus, if a company wanted to offer a payment as inducement to consent, it would have to make the payment to all (consenting and nonconsenting) holders if the requisite majority of consents is received; or if a company wanted to conduct a concurrent exchange or tender offer, it would have to open the offer to all bondholders if the requisite majority of consents is received. In consent solicitations structured in such a nondiscriminatory manner, only holders who thought the amendment increased the value of their bonds (after taking account of the payment or the offer) would have an incentive to consent.\textsuperscript{199}

Professors Coffee and Klein and Professor Brudney have, in separate articles, proposed mandatory rules to prohibit coercively structured consent solicitations.\textsuperscript{200} There are indeed several factors that would commend such a prohibition. The theoretical case that coercion can result in inefficient amendments is strong. Unlike a fiduciary duty to bondholders, a prohibition of coercion would create little uncertainty and could be easily applied. And such a prohibition would not seem to entail other apparent inefficiencies.

Nevertheless, there are grounds to hesitate. Even as a theoretical matter, coercion can work only if bondholders are too dispersed to coordinate. But bondholdings tend to be highly concentrated,\textsuperscript{201} and studies have shown that bondholders are not systematically pressured into consenting to disadvantageous terms. To the contrary, bondholders systematically gain when coercively structured consent solicitations are announced.\textsuperscript{202} To be sure, this does not prove that coercive structures never induce bondholders to consent to adverse amendments, but it certainly detracts from the case for a mandatory prohibition of such structures.

Moreover, the question arises why indentures do not, and ought not be left to, prohibit coercive structures contractually. Consent payments and conditional exchange or tender offers have been around for

\textsuperscript{198} See supra text accompanying notes 158-61.

\textsuperscript{199} See Coffee & Klein, supra note 13, at 1243-46; Kahan & Tuckman, supra note 84, at 506.

\textsuperscript{200} See Brudney, supra note 12, at 1853-56; Coffee & Klein, supra note 13, at 1267-69. Coffee and Klein would apparently prefer a contractual prohibition of coercive structures, but favor a mandatory prohibition if no contractual prohibition is forthcoming. Id. at 1251-53, 1271.

\textsuperscript{201} See supra text accompanying notes 79-84.

\textsuperscript{202} See Kahan & Tuckman, supra note 84, at 510; see also Lewis S. Peterson, Who's Being Greedy? A Theoretical and Empirical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers, 103 YALE L.J. 505, 530-32 (1993) (finding that bondholders gain from "coercive" offers).
some time, courts have held that indentures as currently drafted do not prohibit coercively structured consent solicitations, institutional investors have recognized the potential for coercion, and academics have made life easy for the drafters of indentures by proposing ways to solve the coercion problem. Thus, the possibility of coercion is no longer an easily overlooked detail in the maze of complex indenture terms, but a relatively straightforward issue of which many sophisticated investors are aware. Yet, public bonds still fail to include provisions that ban coercive structures.

Moreover, neither intrafirm externalities nor agency costs of equity can explain the absence of such contractual responses. The rules for amending covenants in a bond indenture concern primarily the holders of these bonds and involve at most minimal intrafirm externalities. And, since coercive structures may make it cheaper for companies to obtain consents to amendments, significant agency costs of equity are not involved.

Finally, plausible arguments can be made that a prohibition against discrimination between bondholders is not necessarily effi-

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203 See Roe, supra note 21, at 248 n.46 (citing several exchange offers conditioned on consent in 1986 consent solicitations).
205 See Letter by Robert C. Pozen, General Counsel and Managing Director of FMR Corp. to Jonathan G. Katz, Secretary of the Securities and Exchange Commission (Nov. 16, 1990), cited in Coffee & Klein, supra note 13, at 1207 n.182 (on file with the University of Chicago Law Review) (advocating regulations against coercively structured consent solicitations).
206 See Coffee & Klein, supra note 13, at 1251-53; Kahan & Tuckman, supra note 84, at 506.
207 See, e.g., GIANT INDUSTRIES, INC., INDENTURE FOR 9-3/4% SENIOR SUBORDINATED NOTES DUE 2003 (Nov. 29, 1993). Some indentures contain provisions that require the company to offer the same consent payments to all holders who consent to an amendment. See, e.g., RJR HOLDINGS CAPITAL CORP., INDENTURE FOR FIRST SUBORDINATED INCREASING RATE NOTES § 12.17 (Feb. 9, 1989). Such provisions do not prohibit discrimination between holders who consent and holders who do not consent (they merely require the company to give each holder an equal opportunity to consent) and therefore do not inhibit coercive structures. Indeed, the fact that a slight variation in these provisions (requiring the company to make the same consent payment to all holders if the requisite consents are received) would inhibit coercive structures suggests that these provisions are intended to preserve such structures. By contrast, private placements frequently contain provisions that prohibit coercively structured consent solicitations. See Kahan & Tuckman, supra note 120 (finding that 60% of agreements require that consent payments be made to all holders). Given the high ownership concentration of privately placed bonds, however, it is implausible that these provisions are meant to protect holders against coercion. Rather, these provisions seem addressed to conflict among bondholders (i.e., they are designed to “protect” smaller holders against larger ones).
208 If the substantive rules are taken as given, making amendments more difficult will result in positive externalities. But making amendments more difficult will make it less likely that an indenture contains substantive protections to start with. See Kahan & Tuckman, supra note 120 (arguing that public bonds contain fewer covenants than private placements because amendments are more difficult).
cient. Consent payments, for example, may to some extent remunerate bondholders who take the trouble to evaluate the proposed amendment and to return the consent form and thus help reduce free-rider problems among bondholders.\textsuperscript{209} Alternatively, coercive structures may counterbalance the presence of bondholders who \textit{never} consent to amendments, either because they cannot be effectively reached or because their holdings are too small to make it worth their while to respond to consent solicitations. If coercion causes another, similarly sized, group of bondholders \textit{always} to consent to amendments, the determinative votes will be held by a group of large bondholders who analyze proposed amendments, are not coerced, and consent only to beneficial amendments.\textsuperscript{210} To be sure, the arguments that coercive structures in consent solicitations may actually be efficient are far from compelling. Rather, they are theoretical constructs based on empirical postulates that are to some extent inaccurate. But so are the arguments that coercive structures cause bondholders to approve adverse amendments. The arguments that coercive structures can be efficient, then, are not offered to prove that they are desirable, but merely to show that the case against them is not as unequivocal as one might initially assume.

In the final analysis, although I regard the issue as close, I do not favor a \textit{mandatory} prohibition of “coercive” consent solicitations and would leave that matter to contractual resolution. While there are

\textsuperscript{209} Consent payments, of course, are an imperfect form of remuneration. Payments are available to holders who did not evaluate the amendment and merely returned the consent form, and unavailable to holders who evaluated the amendment but ended up opposing it. Nevertheless, the most inactive holders who do not even look at materials sent to them, and who gain most by free-riding on the efforts by others, would not receive the consent payment. And as most consent solicitations gain the requisite consents (if only after the initial terms are improved), most active holders will in the end receive the consent payment.

This argument, however, suggests a separate possible reason why consent payments should be prohibited. If consent payments discriminate between active and nonactive holders, and if active holders set the price for covenants, then nonactive holders are not protected by the pricing mechanism. In other words, the problem of consent payments is not that they enable the company to exploit bondholders at large, but that they enable active holders to “exploit” nonactive holders. Of course, the argument above suggests that some “exploitation” by active holders of nonactive holders is desirable to counterbalance the free-rider problem. There is no empirical evidence on whether the degree of “exploitation” permitted by discriminatory consent payments exceeds or falls short of the desirable degree of “exploitation.” In light of the fact, however, that any holder can obtain the consent payment at the low cost of returning a consent form, the case for outlawing consent payments in order to protect nonactive holders does not appear compelling.

\textsuperscript{210} These arguments, in turn, suggest that holding distribution and the identity of bondholders may be important factors in determining whether a prohibition against discrimination is desirable. The distribution of bond holdings and the identity of the holders affect the ability of bondholders to coordinate their opposition to adverse proposals, the magnitude of potential free-rider problems, and the need to counterbalance passive bondholders. Thus, a heterogeneity problem surfaces: even if a prohibition against discrimination is efficient for some companies, it may not be efficient for all companies.
sound theoretical arguments for the prohibition, the empirical grounds are weak, bondholders can obtain contractual protection, and there is some concern that a prohibition might not be efficient.

VI. Conclusion

Bonds are a prime source of capital for American companies. Yet, commentators have paid little attention to how the legal terms of bonds ought to be determined. In this Article, I develop a framework for analyzing the desirability of mandatory terms in bonds. I then apply that framework to the proposals to create a fiduciary duty to bondholders and to prohibit coercive structures in bondholder consent solicitations.

Three reasons might justify mandatory terms when bonds are originally issued: imperfect information, externalities, and agency costs of equity. In the bondholder context, the imperfect information argument boils down to the question of whether legal terms are accurately priced when a bond is issued. Though the direct evidence on pricing is sparse, there do not appear to be substantial imperfections in the pricing of legal terms: the bulk of the relevant studies shows that legal terms are priced and that the market for newly-issued bonds works well. The evidence on the institutional setting of the bond market also indicates that substantial imperfections are unlikely: information about the legal terms is readily available, the market is dominated by institutional investors, bondholdings are highly concentrated, standardization of covenants and the reputations of underwriters aid investors in the assessment of covenants, and courts provide some protection against hidden loopholes in the legal terms. To the extent that some imperfections remain, they most likely lie in easily overlooked loopholes in supposedly protective terms.

Externalities and agency costs of equity point to other potential market imperfections. The intrafirm externality—the effect of legal terms in bonds on other creditors of the company—might justify mandatory terms that apply generally to debtor-creditor relations. The innovation externality—the possibility that novel legal terms might be copied by other companies—may justify subsidies or sponsored research for the development of novel terms, but does not justify mandatory terms. And agency costs of equity may justify mandatory rules in the manager-shareholder context that affect bond terms.

Even if contractual freedom should prevail at original issuance, there might be a justification for imposing mandatory terms on bonds when the initial terms are sought to be amended. Indeed, proponents of mandatory terms for stocks have advanced strong arguments for limiting contractual freedom at the amendment stage. These arguments, however, generally do not apply to bonds. Therefore, no spe-
cial mandatory restraints should be imposed on the ability to amend bond terms.

I conclude the analytical framework by briefly identifying and examining three potential drawbacks of mandatory terms. First, the process of setting mandatory terms contains its own imperfections, which may result in inferior mandatory terms even if the contractual terms are not optimal. Second, vague mandatory rules may lead to errors in application, provide insufficient guidance to companies and bondholders about their rights, and result in costly litigation. And third, legislative inertia may create barriers to the amendment of mandatory terms once they become outdated.

Overall, my analysis establishes a presumption against the use of mandatory terms in bonds. This presumption, however, is qualified in several respects. First, for certain kinds of provisions, such as loophole-closing provisions or provisions meant to reduce agency costs of equity, the case for market imperfections is stronger, and some mandatory rules may be justified. Second, even for other kinds of provisions, it may be possible to adduce evidence of the need for a mandatory rule that is sufficient to overcome the general presumption against such rules. Third, and most importantly, the general presumption against mandatory rules is contingent on, and thus limited by, the existing institutional and financial evidence. If the institutional setting should change significantly or if the existing evidence is for some reason not applicable (with respect to bonds issued in other countries, for example), the general presumption against mandatory terms may need to be revised.

With respect to the two specific proposals for mandatory terms that I analyze—a fiduciary duty to bondholders and a prohibition of coercive structures in consent solicitations—I conclude that the presumption is strong enough to counsel against the adoption of mandatory rules. While a valid argument can be made that a fiduciary duty to bondholders is desirable, there are also strong arguments that such a duty is not desirable. Thus, the case for fiduciary duties falls short of what would be required to justify their imposition as a mandatory term. The theoretical case for a prohibition of coercive structures is significantly stronger. Nevertheless, the empirical evidence that such structures do not actually hurt bondholders, and some theoretical arguments that such structures may be desirable, lead me to conclude that this issue should also be left to contractual resolution and that no mandatory prohibition should be imposed.