Financial Innovation in Corporate Law

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I. INTRODUCTION

When Corporate Law was published in 1986, scholars and practitioners took a relatively simple approach to applying the insights of finance theory to corporate law. Although Fischer Black, Myron Scholes, and Robert Merton had published formulas for evaluating options, scholars, lawyers, and corporate managers did not yet understand how those formulas mattered to corporate law. Financial innovation was neither prevalent nor particularly relevant to legal doctrine, and over-the-counter financial derivatives were virtually unknown. Questions of capital structure were relatively straightforward: complex hybrids played a minimal role in corporate financing, venture capital preferred issues were nascent, and new securities designed to capture regulatory arbitrage

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1. ROBERT CHARLES CLARK, CORPORATE LAW (1986).
3. See FRANK PARTNOY, INFECTIOUS GREED 217 (2004) (demonstrating that even as late as 1996, financially sophisticated companies such as General Electric had never had board-level discussions about derivatives).
opportunities associated with rules related to tax, accounting, and credit ratings did not exist. Moreover, a hostile takeover market deterred managers from using financial innovation in a way that disadvantaged shareholders. And, finally, there was a widely accepted theory about how corporate voting did and should work.\(^4\)

Today, financial innovation is pervasive. Virtually every company uses option pricing theory, for a variety of purposes, and the formula is taught in basic business school courses and in law school.\(^5\) The over-the-counter derivatives market has a notional value of a quarter of a trillion dollars.\(^6\) Capital structures are unfathomably complex, and a booming venture capital industry has reengineered how private companies use preferred stock to raise funds. Hybrid securities have proliferated so that the right-hand sides of many public company balance sheets contain many more slices than merely equity and debt.\(^7\) Managers, protected by legal devices and structures from takeovers, commonly employ financial engineering, for good and ill. Corporate voting theory and practice are no longer well understood, if they ever were.\(^8\)

Even after taking these changes into consideration, Clark’s treatise appears prescient in retrospect, particularly in its choice of topics and focus. It begins with, and focuses on, questions of capital structure and duties to creditors.\(^9\) The treatise stresses the tensions among the participants in the corporate enterprise.\(^10\) It contains an entire chapter each on executive compensation and the details of the system of shareholder voting, both issues that have been impacted substantially by financial innovation.\(^11\) It includes a brief mathematical appendix on valuation.\(^12\) In other words, it raises all of the important issues necessary to understand how financial innovation today affects corporate law theory and practice. It was simply born too early.

The question I would like to address for this symposium is the following: If we were to try to update Dean Clark’s treatise to account for the dramatic financial innovation during the past two decades, what would the update include? To what extent do these changes matter to corporate law? Which are most important? How dramatically do we need to rethink basic corporate law theory? Which changes in practice should be reflected in a basic treatise?

My answer, in overview, is that the update would indeed include dramatic changes, both to the theory and practice of corporate law. Some of the basic principles of corporate

\(^4\) See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403-06 (1983) (arguing that corporate law properly allocated votes to common shareholders as the residual claimants to a corporation’s income and defending one-share one-vote as the prevailing and optimal practice).


\(^7\) For example, the cover page of J.P. Morgan Chase’s most recent Form 10-K lists 26 different classes of securities. JPMorgan Chase & Co., Annual Report (Form 10-K), at 1 (Mar. 2, 2005), available at http://investor.shareholder.com/jpmorganchase/secfiling.cfm?filingID=950123-05-2539.


\(^9\) See Clark, supra note 1, chs. 2-3, 14, 17.

\(^10\) Id. chs. 4-5, 7, 14-18.

\(^11\) Id. chs. 6 & 9.

\(^12\) Id. app. B.
law have weathered the past two decades, but many have not. In this Article, I will argue that financial innovation requires a rethinking of fundamental corporate law principles.

In Part II, I describe how financial innovation has changed the way scholars should think about the nature of corporate fiduciary duties. In Part III, I turn to the influence of complex hybrid securities. In Part IV, I discuss some related insights drawn from the implications of the "vicinity of insolvency" doctrine. These areas of focus, particularly fiduciary duty, are not the only areas relevant to corporate law that have changed dramatically because of financial innovation. Much ink has been spilled over the duties of managers with respect to complex financial instruments, the role of gatekeepers, the rules-standards debate (particularly with respect to accounting), the duty to hedge (or not to hedge), the difficulty of supervising speculative activities, and the imposition of criminal liability for complex financial fraud—all of which I believe should be of interest to corporate law scholars.

However, in this Article, I will accept the argument by some scholars that the above issues are too esoteric, or even that they are ancillary to our understanding of corporate law, and belong, if anywhere, in the study of corporate finance. I want to ignore the more complex issues for now, and stick close to the corporate law home, to try to persuade scholars that the pace and breadth of financial innovation have been so extraordinary that they require a fundamental rethinking of basic corporate law concepts, concepts so central that they would belong in an updated version of Clark's treatise.

II. FINANCIAL INNOVATION AND FIDUCIARY DUTY

The first way financial innovation has challenged traditional models of corporate law is by injecting new and complex variables into the consideration of basic fiduciary duty concepts. Although it is tempting to regard fiduciary duty as a comfortable and never changing concept central to corporate law, its history contradicts that assumption.

The fiduciary duties that corporate law imposes on officers, directors, and certain shareholders of corporations have evolved in a manner similar to that of common law more generally. First, courts that had imposed duties on trustees in managing trust property naturally extended those duties to directors of the earliest charitable corporations. Then courts adjudicating disputes between shareholders, on one hand, and managers or directors, on the other hand, created a set of default rules designed to approximate the rules the parties would have specified absent transaction costs. This
evolution continues today. Most recently, with courts in Delaware suggesting that there is a third, perhaps equally important, fiduciary duty—that of good faith.\(^\text{16}\) Numerous legal scholars have attempted to explain why and when fiduciary duties arise, a topic that is beyond the scope of this Article.\(^\text{17}\)

Yet one aspect of the corporate law conception of fiduciary duty has not moved much during the past two decades: the notion that the duties owed to corporations are for the primary benefit of shareholders, not other participants in the corporate capital structure.\(^\text{18}\) With few exceptions, the doctrinal approach to fiduciary duty has two simple components: (1) non-shareholder participants in the capital structure generally obtain legal protection through contract, not through the operation of corporate law; and (2) duties can shift from shareholders to bondholders in the "vicinity of insolvency." I would like to show how financial innovation, in both theory and practice, renders these two components contradictory and meaningless.

\textbf{A. The Shareholder Value Rationale for Fiduciary Duties}

In the introduction to his treatise, Clark describes the ultimate purpose of the corporation as making profits for its shareholders. He notes that although corporate statutes do not explicitly set forth such a shareholder-focused objective, lawyers, judges, and economists usually assume that "corporate managers (directors and officers) are supposed to make corporate decisions so as to maximize the value of the company's
He follows the standard law and economics argument in favor of maximizing share value rather than profits.\textsuperscript{20}

The rationale for this objective is that "it is the shareholders who have the claim on the residual value of the enterprise, that is, what's left after all definite obligations are satisfied."\textsuperscript{21} Accordingly, the argument goes, managers have an affirmative open-ended duty to increase this residual value, rather than the wealth of some other group. Managers should maximize share value subject to the constraint that the corporation must meet all its legal obligations to others who are related to or affected by it. According to Clark, those others include "employees, creditors, customers, the general public, and governmental units," in no particular order.\textsuperscript{22} This view was the standard law and economics perspective at the time; scholars writing just before the publication of Clark's treatise argued that a legal structure that gave stockholders the vote and made debt purely "contractual" was efficient.\textsuperscript{23}

Additionally, in Clark's formulation, the law affords creditors some special protection in the form of a minimum set of mandatory protections binding all parties, even if they did not bargain to be bound by them.\textsuperscript{24} In other words, creditors are protected not only by their own contract terms, but also by an automatic standard contract provided by law.\textsuperscript{25} However, the standard contract is limited, and the mandatory protections do not rise to the level of protections afforded to shareholders, that is, the benefits of fiduciary duties.

\textbf{B. Option Theory Conundra}

I begin my critique with the question of how option theory affects these base level assumptions about the allocation of director and officer duties to shareholders. The starting point is the leading article by Fischer Black and Myron Scholes, in which they...
developed what is now known as the Black-Scholes option pricing formula.\textsuperscript{26} Although most scholars look to that article primarily for the statement and derivation of the formula, it also contains important insights into the theory of the firm.

1. Shareholders and Creditors as Holders of Options

Specifically, Black and Scholes suggested that the shareholders of a firm can be viewed as having the right to purchase the assets of the firm from the creditors for the face amount of the debt, plus interest, until maturity. In other words, the shareholders purchased, and the creditors sold, a call option.\textsuperscript{27} Thus, Black and Scholes were the first to recognize that equity in a firm could be recharacterized using option theory.\textsuperscript{28}

Describing equity and debt as having option-like asymmetric characteristics illuminates important concepts, including limited liability and the conflicts among participants in the firm. For example, a long call option profits when the value of the underlying firm assets increases. If the value of the firm's assets is greater than the exercise price of the option, the shareholders can be thought of as having the right to purchase the assets of the firm from the creditors for an amount below the value of those assets. Thus, shareholders will capture all of the firm's value above the interest and principal owed to debt. The shareholders have a leveraged position in the underlying firm assets, another way of describing the general characteristics of a call option.

Option theory reveals an important conflict between shareholders and creditors. Shareholders, who hold a call option, will benefit if the firm takes on riskier or more volatile projects; conversely, creditors will suffer. As a result, creditors will seek to obtain protections that restrict the shareholders' ability to appropriate such economic value.

A few corporate law scholars have examined the question of how option theory illuminates the conflict between shareholders and bondholders with respect to decisions about risky projects,\textsuperscript{29} and numerous finance scholars have considered how option theory affects the theory of the firm.\textsuperscript{30} However, few scholars have considered the implications

\textsuperscript{26} Fischer C. Black & Myron S. Scholes, \textit{The Pricing of Options and Corporate Liabilities}, 81 J. POL. ECON. 637, 649-50 (1973). The Black-Scholes equation, or model, states that the price of an option on a stock depends on six variables: (1) the price of the stock; (2) the exercise price; (3) the time until expiration of the option; (4) the risk-free interest rate during that period; (5) the dividend yield on the stock, and (6) an applicable measure of volatility.

\textsuperscript{27} The first portion of this discussion about option theory is taken from Frank Partnoy, \textit{Adding Derivatives to the Corporate Law Mix}, 34 GA. L. REV. 599, 609 (2000). This call option is a European call option because it can only be exercised by repaying the debt at the maturity date of the debt. However, if the debt were callable, the call option could be thought of as an American call option. The premium can be thought of as the present value of interest payments made over time.

\textsuperscript{28} See id. at 649-50 (likening the holding of stocks to the equivalent of an option on company assets).

\textsuperscript{29} See, e.g., Margaret M. Blair & Lynn A. Stout, \textit{Director Accountability and the Mediating Role of the Corporate Board}, 79 WASH. U. L.Q. 403, 411-14 (2001) (describing the tension between equity and debt for option holders); Peter H. Huang, \textit{Teaching Corporate Law from an Option Perspective}, 34 GA. L. REV. 571, 571 (2000) (proposing the introduction of the option perspective into the teaching of corporate law and describing some pedagogical devices for doing so); Frank Partnoy, \textit{Adding Derivatives to the Corporate Law Mix}, 34 GA. L. REV. 599 (2000) (describing the tension between equity and debt for option holders); Thomas A. Smith, \textit{The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty}, 98 MICH. L. REV. 214, 221 (1999) (arguing that duties should be owed to the firm and enforced by each class of investors).

of option theory for basic corporate law doctrines, such as fiduciary duty. 31 That is why, for most scholars, the option theory story of equity versus debt stops here, with what I have called the call option perspective. 32 Characterizing shareholders as holding a call option has important analytic consequences. In particular, the notion of shareholders as holding a call option contradicts the notion that shareholders own the assets of the firm.

If the shareholders have purchased a call option, they cannot be viewed as owning the underlying assets of the firm. Instead, the creditors must own the assets of the firm. They have purchased a full interest in the firm's assets and profits, but have given up some of the "upside" associated with those assets by agreeing to sell them to the shareholders in the event they are worth more than the future value of the creditor's investment. In turn, the shareholders have agreed to pay a premium, in the form of periodic interest payments, for the right to purchase the assets of the firm from the creditor. In a nutshell, the shareholders own a call option while the creditors own the underlying assets of the firm and have sold a call option.

If the shareholders do not own the underlying firm assets, how can it make sense to say the officers and directors of the firm owe fiduciary duties to shareholders, not creditors? Is ownership such a trivial concept? What is the rationale for having officers owe fiduciary duties to non-owners, but not to owners? Ownership generally has been central to the analysis of the firm and fiduciary duties. The central conflict in corporate law, after all, stems from the separation of "ownership" and control. It is unclear how that central conflict might be recharacterized to fit the above discussion.

For scholars who believe ownership is important, it is possible to characterize debt and equity as having option-like characteristics, while nevertheless preserving the idea that equity owns the underlying assets of the firm. This characterization requires a different option theory perspective from the one Black and Scholes initially suggested, and the one many scholars typically assume. The key to this new perspective is the concept of put-call parity, the notion that it is possible to express equalities among various sets of contingent claims, including put and call options. For example, under certain assumptions, owning a portfolio of one share and one put option is roughly equivalent to owning a portfolio of one call option plus cash. 33 Suppose that according to this new view the shareholders own the underlying assets of the firm, and also have


31. Albert Barkey concluded from the Black-Scholes model that bondholders were the owners of the corporation, and that therefore directors should be charged with maximizing the overall value of the firm. See Albert H. Barkey, The Financial Articulation of a Fiduciary Duty to Bondholders with Fiduciary Duties to Stockholders of the Corporation, 20 CREIGHTON L. REV. 47, 68 (1986) (advocating a "generic managerial fiduciary duty" to utilize assets efficiently for the joint benefit of stockholders and bondholders). However, it is unclear why Barkey concludes that bondholders necessarily have "first equitable ownership" of corporate assets when there are alternative conceptions in option theory that would allocate ownership of corporate assets to shareholders. See id. at 69.

32. See Partnoy, supra note 29, at 609.

33. This assumes that the exercise prices of the option are equal to the share price, and that the amount of cash is equal to the present value of the exercise prices. In simplified terms, the (equity holder) payoffs generated by ownership of a call option are the same as those generated by ownership of the underlying assets plus a put option. Similarly, the (debt holder) payoffs generated by ownership of the underlying assets plus a short call option are the same as those generated by a short put option. This put option is not unlike other put options traded on exchanges. If the owner of a share of stock wishes to insure temporarily against losses beyond a certain amount, that owner may create limited liability through the purchase of a put option.
purchased a put option from the creditors. The put option gives the shareholders the right to sell the firm's assets to the creditors at a specified exercise price, the face value of the debt, until the maturity date of the debt. The cost of this put option—its "premium"—is simply the present value of the expected interest payments to be made to creditors during the life of the option.

From the put option perspective, shareholders, not creditors, have a full interest in the firm's assets and profits. Shareholders have limited liability from the put option because the creditors have agreed to suffer all losses if the assets decline in value below the exercise price of the put option. The shareholders can be thought of as purchasing an insurance policy from creditors to limit their losses. The put option provides limited liability.

The creditors have sold a put option, and therefore make money—that is, keep the "premium" in the form of interest payments—so long as the value of the underlying firm assets does not decline. However, if the value of the firm's assets falls below the face value of the debt, creditors will suffer the additional losses.

2. Insights and Implications

Fine, one might say, it is interesting that shareholders and creditors can be recharacterized using option theory. But that discussion does not really matter to the theory of the firm. Nor does it affect thinking about fiduciary duties. Shareholders are the beneficiaries of fiduciary duties—whether they are considered owners of call options or owners of assets and put options—because they have the residual claim on the corporation's assets and income, not because they have a particular label. As this response might go, it is the economics of the position, not the label, that matters.

However, a scholar who makes such a response to the option theory perspective on the firm will be trapped in a number of intractable dilemmas. Consider the following thought experiment: suppose two firms, DebtCo and OptionsCo, each are precisely equivalent in every way except capital structure—that is, they have the same assets and the same potential projects. Their capital structures are depicted below in Table 1.

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Note that both firms have the same market capitalization: $1500, which is consistent with the assumption that their assets and future projects are equivalent. Now assume that one year from today the managers of both firms engage in self-dealing that reduces the value of the firm by $100. The new capital structures of the firms after one year are depicted below in Table 2.

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<td>Equity</td>
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Assume that both the equity holders of DebtCo and the option holders of OptionCo sue for breach of fiduciary duty. If the court follows the rule that only shareholders can sue for fiduciary duty breaches, it will rule in favor of the equity holders of DebtCo, but against the option holders of OptionCo. If instead the court follows the rule that only residual claimants can sue for fiduciary duty breaches, it will rule in favor of both the equity holders of DebtCo and the option holders of OptionCo. The option theory perspective suggests that there is no way to approach fiduciary duty in a consistent manner without either (1) taking into account changes in capital structure, or (2) ignoring the labels of financial instruments and focusing instead on their economic characteristics.

In fact, a Delaware court likely would frame the question as follows. Fiduciary duties are owed to the corporation, not to any particular group, but can be enforced only by shareholders unless some exception applies, for example, if the corporation is in the "vicinity of insolvency." In addition, any non-shareholder group also might have a claim for fraud or breach of contract, depending on the terms of their agreement with the corporation. I have assumed for purposes of this hypothetical that such claims are not relevant.

If the court found that shareholders of both firms were entitled to recover $100 from the wrongdoing directors, the firms' capital structures, after the dispute, would look like those depicted in Table 3.

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Obviously, this result is a strange one and is difficult to justify based on any economic rationale. In reality, the results would not be as perverse for derivative actions, where the recovery accrues to the corporation. Nevertheless, the results would hold for direct actions, and also to the extent gains are realized by particular groups, through settlements or fees, rather than by the corporation as a whole.

Difficulties also arise if the actions bring a corporation into the "vicinity of insolvency," an issue I discuss in greater detail in Part IV. For example, suppose that managers of both firms engaged in $490 worth of self-dealing, so that the situation looked as shown in Table 4 (note that DebtCo is not actually insolvent).

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<td>Equity</td>
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At this point, the court might find that the debt holders of DebtCo had a claim, because DebtCo was in the "vicinity of insolvency." Note that the "vicinity" issue applies only to DebtCo, even though the same tensions that exist between the debt and equity of DebtCo also exist between the equity and options of OptionCo. In each case, if officers and directors understand that the application of fiduciary duties will be different
depending on capital structure, the officers and directors of each company will have different incentives. In other words, if fiduciary duties run to shareholders of DebtCo, but not to the options of OptionsCo, the officers and directors will have incentives to behave differently, even though the firms are equivalent in every other way.

Returning to Table 1 above, suppose each firm faces two choices. The “Risky Strategy” pays $10,000 with a 10% probability, and pays nothing with a 90% probability. The “Conservative Strategy” pays $1,500. The firm and society are better off if each firm selects the “Conservative Strategy.” Yet, if management’s duty is to maximize shareholder value, managers will choose different projects for the firms. Assuming risk neutrality, management of DebtCo will choose the “Risky Strategy” over the “Conservative Strategy.” In contrast, management of OptionsCo will choose the “Conservative Strategy” over the “Risky Strategy.”

Alternatively, a maximize-debt-value rule would lead DebtCo to choose the “Conservative Strategy,” but would provide no guidance at all for management of OptionsCo, a no-debt firm. A maximize-options-value rule would lead OptionsCo to choose the “Risky Strategy,” but would provide no guidance at all for management of DebtCo, a firm without warrants. As in the above example, there is no good reason for treating economically equivalent participants in firms differently.

These various perspectives enrich our understanding of the differences between equity and debt. Corporate law generally assigns control to equity; debt then bargains for specific contractual provisions to protect its interests. Similarly, under normal circumstances, managers owe duties to shareholders but not to bondholders. The put option and call option perspectives demonstrate that the legal rule could be the opposite: corporate law could assign control to debt and force equity to bargain for contractual protection. In any event, a rule giving priority to equity will lead to perverse results depending on capital structure, and will encourage officers and directors of firms with relatively more options and less debt to be unduly conservative, and officers and directors of firms with relatively fewer options and more debt to be too risky.

The various option perspectives thus allow for greater depth of discussion about why control would be assigned to equity. Why, based on these perspectives, should duties necessarily run to equity over debt? Is there something about a long call option position (when compared to ownership of the underlying assets plus a short call position) or a long put position plus ownership of the underlying assets (when compared to a short put position) that generates a special entitlement? Both participants have asymmetric payoffs. Both participants hold contingent claims and would need to specify a variety of contingencies in any contract with management or between each other to avoid expropriation.

One answer to these questions is that the initial conception of ownership by equity simply fits our intuition better than the initial conception of ownership by debt. Another answer is that law needed a singular starting point, either equity or debt. Then, given a particular starting point—equity—the development and reliance on equity-based legal rules made it too costly to switch to a regime in which duties would run to debt, not equity. Still another answer is that it is easier and less costly to specify contractual provisions for debt, which in most cases will be paid a fixed amount and will default only infrequently, than it is to specify contractual provisions for equity, which in most cases will be paid a variable amount based on the performance of the firm. On the other hand,
the assumed relative simplicity of debt is belied by the length and complexity of modern debt contracts, including OTC derivatives, which have become more, not less, complex in recent years.

Perhaps one simplistic answer is that not all firms have debt or options. If we must choose one slice of the capital structure whose value officers and directors should maximize, we might as well choose the one we know all firms will have, even if that choice might lead to perverse incentives. But if that simplistic rationale is the best corporate law can do, it might be worth considering whether the courts also should take into account capital structure when companies in fact have issued debt or options, to avoid incongruous results like those described above. Courts might specify a default rule that would apply to firms with only equity, but note that the duties of managers would change as capital structures became more complex.

Of course, such an inquiry would be justified only if the costs exceeded the benefits. But even if the costs of parsing corporate capital structure are too high in practice, the discussion above nevertheless provides some important theoretical insights. In particular, financial innovation suggests that the sturdiest rationale for a shareholder-centered corporate law is not the shareholder primacy notion that there is something special about the residual nature of the shareholder’s claim, but rather the fact that the transaction costs of parsing corporate capital structure would be prohibitively high.

C. Forwards Contracts and Some Intertemporal Challenges

Apart from the asymmetric problems associated with options, potential and actual forward transactions—contractual obligations to buy or sell stock at a specified time and price—introduce additional intertemporal challenges. Professor Henry Hu has noted some of these challenges in arguing that the process of financial innovation has generated numerous conflicts that render the notion that corporations are to be run for the benefit of their shareholders “intolerably ambiguous.”35 Hu pointed to the increase in stock turnover as one culprit.36 He also noted that the problem of fiduciary duty with respect to the changes in shareholders over time is intractable, because it is unclear which generation of shareholders the management should favor.37

I want to add to this literature by giving another, perhaps even more troubling, example of how the roles of participants can change over time, particularly given financial innovation in the market for futures and forward agreements. Suppose a firm has one shareholder, Mr. Present, and that the value of the firm is $1000. Ms. Future agrees today to purchase all of Mr. Present’s shares one year from today at a price of $1100.

To whom should management owe a duty? Mr. Present, a shareholder, has been transformed economically into a debtholder. To see this transformation, consider the performance of Mr. Present’s investment. As long as the firm has a value of at least

36. Id. at 1287.
37. Id. at 1300; see Steven L. Schwarcz, Temporal Perspectives: Resolving the Conflict Between Current and Future Investors, 89 MINN. L. REV. 1044 (2005) (noting the pervasiveness of this problem).
$1100, Mr. Present will receive $1100 in one year, equivalent to $1000 face amount of debt plus 10% interest. If the firm is worth less than $1100 in one year, Mr. Present will suffer all of the losses in excess of $1100. Mr. Present will not participate in any upside above $1100. Through this forward contract, Mr. Present, the shareholder, has become Mr. Present, the bondholder. Moreover, Mr. Present’s return now depends more on Ms. Future’s fortunes than on those of the firm. Does it really make sense for duties to run in favor of Mr. Present?

In contrast, Ms. Future has become the real shareholder. Ms. Future will capture any increases in the value of the firm above $1100, the value of the “debt” owed to Mr. Present. Should management then owe duties to Ms. Future? What if Ms. Future had agreed to purchase all of Mr. Present’s shares at a price of $1500? Or $500?

This hypothetical example does not present an unusual type of transaction. Forward transactions in various types of financial assets are becoming increasingly common. Consider, for example, the variable prepaid forward transaction (“VPF”), a very popular transaction among large shareholders. In a VPF, an existing shareholder agrees to pay out any income or capital gain on her stock in exchange for fixed payments over time. A VPF presents the same types of questions as a forward sale of stock: Why should a duty run to shareholders who engage in such transactions?

Equivalently, a shareholder could synthetically replicate a short forward position using options. Suppose a sophisticated hedge fund believes that publicly traded options on a corporation’s stock are mispriced. That hedge fund could exploit this mispricing through an arbitrage strategy that would lead it to become a major shareholder of the corporation; at the extreme, the hedge fund could own all of the shares. Specifically, suppose the hedge fund believes that call options are dear and put options are cheap. Then consider the strategy of buying shares, selling call options, and buying put options. For each share of stock the fund purchases, it also sells one at-the-money call and buys one at-the-money put. The shareholder then manages all of the positions over time to remain neutral with respect to changes in the price of the corporation’s stock. The shareholder seeks to profit from the mispricing of the options relative to the price of the stock, not from changes in the absolute level of the stock price.

Meanwhile, suppose other investors have decided they are not interested in owning shares of the corporation’s stock because those shares, even if purchased or sold on full margin, do not provide them with sufficient leverage. Instead, investors who believe the company’s stock price will increase have purchased calls and sold puts. As a result, the true—that is, economic—residual interest in the corporation’s stock is held by individual option purchasers and sellers, while the corporation’s shareholder is wholly indifferent to movements in the price of the stock.

This analysis presents a difficult case for scholars who believe fiduciary duties should run to shareholders because they hold a residual interest. In the above example, the residual interest is not held by shareholders. If management of the corporation breached their fiduciary duties to the corporation, which set of investors would have the

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39. The VPF typically includes a collar.

right to sue? If only shareholders could enforce a claim, no one would have the incentive to do so.

In such an example, corporate law would have duties run to the wrong parties. Why should duties run to the hedge fund shareholder, but not to the individual purchasers and sellers of options? To see the perverse effects of current fiduciary duty law, suppose managers contact the hedge fund and say they are planning to engage in a self-dealing transaction that will make the shares worth only half of their current value. The hedge fund shareholder might approve this transaction, which would not negatively impact its investment. Individual investors in options would lose half of their investment as a result of this self-dealing, and yet would have no corporate law remedy.

Finally, scholars who find the above options examples implausible might consider how financial innovation has in fact led to a shift in who holds equity securities. The proliferation of both hedge funds and exchange traded funds has created an environment where common shares often are not held by parties who would want to enforce fiduciary duty rights, whereas other parties who have non-share residual-like positions, and would want to enforce such rights, are not permitted to do so. These examples demonstrate the challenges financial innovation poses to the nature of the firm and fiduciary duties. The more owners of financial assets engage in such complex transactions, the less sense it makes to speak of fiduciary duties running to one particular class of investors, and the less sense it makes to think about shareholders as the residual interest that uniformly enforces breaches of fiduciary duty.

III. HYBRID FINANCIAL INSTRUMENTS

Today, most publicly traded corporations do not have only equity and debt. Instead, their capital structures are composed of numerous slices of different hybrid instruments, each with combinations of equity-like and debt-like characteristics. For example, corporations commonly issue exchangeable preferred securities that have various mixed features. Even equity and debt are no longer simple categories; corporations issue multiple classes of equity, with different voting or dividend rights, and multiple classes of debt, with different seniority and cash flow rights.

Not surprisingly, shareholders are not the only plaintiffs to sue for breaches of duty and other claims. Holders of various hybrid securities have been plaintiffs in major cases, including two of the largest securities class actions in history: *Cendant* and *Enron*. In the *Cendant* litigation, the major plaintiffs were holders of instruments known as “Feline Prides.” In the *Enron* litigation, parties seeking recovery include holders of various private placements and other debt instruments, as well as numerous swap counterparties.42

Many of the features of new hybrid instruments are not really new. Indeed, instruments with similar characteristics were created during the 1920s. Corporate law

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41. See *In re Cendant Corp. Litig.*, 264 F.3d 201 (3d Cir. 2001).
42. See *PARTNOY*, supra note 3, at 269-349. Indeed, recent changes in bankruptcy law have given derivative counterparties, particularly swaps, priority over both shareholders and most creditors. See 11 U.S.C. § 548(a)(1) (2006) (listing examples of how a “trustee may avoid any transfer of an interest of the debtor in property”).
scholars discussed the puzzles those instruments presented at that time.43 In contrast, scholars have not yet discussed the corporate law implications of these new forms of securities.44

Section A briefly discusses the historical approach to hybrids. Section B describes the evolution of some of the most complex forms of hybrids that are not well understood today and have not been the subject of much scholarly discussion. Section C concludes by examining how corporate law doctrine might more thoroughly account for the existence of these new instruments.

A. Early Approaches to Hybrids

Professor Adolf A. Berle, Jr., wrote his major study of corporate finance during the mid to late 1920s, a time of tremendous financial innovation, when new forms of securities were proliferating, including non-voting stock, numerous kinds of participating preferred stock with dividends and conversion rights that varied over time, and a variety of convertible obligations.45 Although today's hybrids are more complex than these instruments, they share many of the same characteristics.46

Given the financial complexities of these hybrids, Berle suggested reconstructing corporate law in order to redirect management to the goal of serving the balanced interest of all investors. Berle threw up his hands at the confusion associated with parsing the different elements of corporate capital structure and concluded that it was impossible to do so. It is worth setting forth his words at length, as he easily could have been writing today.

Consequently, in exploring the somewhat amorphous field of corporation finance our search must be for relationships and their incidents. We discover, for example, that a bondholder is a creditor of the corporation. But he may also have a relationship to the management—especially if the corporation is on the brink of insolvency. A preferred stockholder has a charter clause governing his rights; but he also has a relation to the management which may entail additional duties of fidelity and fair dealing. Both of these may have a relationship with an investment banking house which acted as intermediary in securing the investment of their funds in the corporate securities. A holder of common stock, or any stock having an unlimited participation in earnings, may have a different relationship to all three. Conceivably, groups of corporate security holders may enter relationships one with the other.

Unlike the law of trusts or the law of carriers, we shall probably never be in a position accurately to list and define all of the relationships which exist. New ones are being invented daily. A participating preferred stockholder is in a

43. See, e.g., ADOLF A. BERLE, JR., STUDIES IN THE LAW OF CORPORATION FINANCE (1928) (describing novel types of hybrid securities issued during the 1920s).
44. There has been some attention to the tax implications of exchangeable preferred securities.
45. BERLE, supra note 43, at 111-13, 131-33.
46. During the 1920s, market participants also increasingly used subsidiaries for various purposes, including some that closely resemble the use of special purpose entities today, and Berle recognized problems associated with using subsidiaries to take advantage of various participants in a corporation's capital structure. See id. at 169.
different situation regarding the common stockholder than an old line fixed dividend preferred stockholder. A bondholder to whose bond is attached a stock purchase warrant may have a different set of rights than a bondholder without such warrant. . . . Only by a close study of the business mechanism, the expectations of the parties, the business standards involved and the respective positions of the various parties in the situation, can we undertake to indicate the result which the law should strive to reach. . . . In every new financial form, accordingly, it becomes necessary not merely to consider the draftsmanship of the papers, but also the possible results of any relations which may have been created.\footnote{Id. at 192-94. It was during this time that Professor William Ripley was warning of the dangers of the overcomplication of corporate structure. See generally William Z. Ripley, Main Street and Wall Street 3-15 (1976) (explaining the dangers of overcomplication in corporate structure following World War I).}

Since the 1920s, advocates of Berle's approach have rejected the "nexus-of-contracts" conception of the corporation, and instead have considered the firm to be an entity with various interested and related groups who pursue their own goals subject to the power of management. As this argument goes, stocks, bonds, and hybrids are simply different mechanisms available for making an investment in firms.\footnote{Interestingly, Berle was more skeptical of the rights of holders of options. He argued that "[t]he holder of a privilege to acquire shares enforceable upon election is in no sense a stockholder. Any rights he has must be derived from his contract." Berle, supra note 43, at 137.} Because there is no rationale for privileging one over the other, managers should have a duty to maximize the value of the firm from these groups' combined perspectives.

Several scholars have since addressed the question of whether hybrid instruments deserve duties. Two years before Clark published his treatise, Professor William Bratton wrote the first of several articles analyzing the tensions between shareholders and the holders of hybrid instruments, particularly convertible bonds.\footnote{William W. Bratton, Jr., The Economics and Jurisprudence of Convertible Bonds, 1984 Wis. L. Rev. 667 (1984).} Bratton noted in 1984 that some courts started characterizing convertible bonds as equity, and therefore entitled them to judicial protection, whereas other courts had not.\footnote{Id. at 671, 720-23 (citing Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R. Co., 680 F.2d 933, 941 (3d Cir. 1982), cert. denied, 459 U.S. 1056 (1983) (characterizing the bonds as equity); Broad v. Rockwell Int'l Corp., 642 F.2d 929, 940-41 (5th Cir. 1981) (en banc), cert. denied, 454 U.S. 965 (1981) (discussing the contractual complexity of debt security); Green v. Hamilton Int'l Corp., No. 76-5433, slip op. at 17 (S.D.N.Y. July 13, 1981). Green is particularly interesting as it called for (1) treating the debt aspects of convertible bonds as contracts, and (2) giving the equity aspects of convertible bonds the benefits of corporate law. The Commodity Futures Trading Commission has tried a similar approach with respect to hybrid derivative instruments that contain exposure to one or more commodities. See, e.g., Frank Partnoy, The Shifting Contours of Global Derivatives Regulation, 22 U. Pa. J. Int'l Econ. L. 421, 434 (describing CFTC regulation).} Bratton was skeptical of the various judicial approaches, noting that "[w]e have here a publicly sold security [convertible debt] so complex that even the financial theorists have failed to settle upon a common set of valuation variables."\footnote{Bratton, Jr., supra note 49, at 715. Bratton has also been critical of judicial decisions discussing the source and nature of fiduciary duties owed to bondholders. See William W. Bratton, Jr., Corporate Debt Relationships: Legal Theory in a Time of Restructuring, 1989 Duke L.J. 92, 119-21 [hereinafter Bratton, Jr., Corporate Debt Relationships] (stating that "[i]n most cases, however[,] the duty remains subject to the contract's terms; it takes a breach of contract to breach the duty").} Citing Berle, Bratton was especially critical of
cases finding that convertible bondholders were not owed a duty.\textsuperscript{52}

Most recently, several scholars, including Bratton, have revisited the issue of hybrid interests and fiduciary duties in the context of venture capital preferred stock.\textsuperscript{53} Of course, the venture capital industry was barely alive when Clark was writing his treatise. In 1980, venture firms raised and invested less than $600 million.\textsuperscript{54} Although venture capital, particularly buy-out funds, became more popular later in the 1980s, they were not especially successful even then, for good reason. By 1990, the average long-term return on venture capital funds was less than 8%.\textsuperscript{55} In contrast, today private equity and venture capital are booming, and the scope of contract innovation is unprecedented.\textsuperscript{56}

Bratton has argued, consistent with Berle, that modern venture capital deals have the characteristics of relational contracts.\textsuperscript{57} Preferred shareholders obviously participate in key negotiations, including decisions as to choice of the state of incorporation and crucial charter provisions, and frequently have the right to elect directors. Just as obviously, venture capital term sheets do not specify every contingency. As Bratton puts it, venture capital contracts are incomplete and ripe for "ex post judicial umpiring."\textsuperscript{58}

In general, courts have held that venture capital firms with directors elected by common shareholders owe fiduciary duties only to those shareholders, not to preferred shareholders.\textsuperscript{59} Put another way, directors are thought to owe only contract duties to preferred shareholders. However, at least one Delaware case has suggested that, in the venture capital context, when preferred shareholders control the board, the board does not owe fiduciary duties exclusively to the common shareholders.\textsuperscript{60} In addition, Delaware courts have held directors to a duty to treat preferred shareholders fairly when making decisions about share repurchases\textsuperscript{61} or the allocation of merger proceeds,\textsuperscript{62} both

\textsuperscript{52} Bratton has noted that the Delaware courts' assumption that corporate creditors historically have not benefited from legal protection was incorrect. See Bratton, Jr., \textit{Corporate Debt Relationships}, supra note 51, at 199-221.


\textsuperscript{55} Id.


\textsuperscript{57} See Bratton, supra note 53, at 863-64.

\textsuperscript{58} Id. at 864.


\textsuperscript{61} See Gen. Motors Class H S'holders Litig., 734 A.2d 611 (Del. Ch. 1999) (explaining the duty of fair treatment for preferred shareholders).

essentially “zero sum” decisions in which directors might favor one class of the capital structure over another.

In a recent paper, Jesse Fried and Mira Ganor have seized on this approach in putting forth a proposal that would impose a duty of loyalty on directors not to favor one class of shares over another if the proposal had no net benefit (i.e., the proposal would benefit one class of shares less than it would cost another class of shares). Their notion is that the concept of fiduciary duty should be sufficiently open-ended so as to permit shifting of duty when economic analysis dictates. Setting aside the difficult questions associated with determining the benefits and costs of a particular decision to each class, this proposal has the attractive feature of avoiding many of the logical puzzles set forth above.

The debate about venture capital terms is beyond the scope of this Article, but I want, at minimum, to note here that a modern corporate law treatise would need to confront these issues. It is not sufficient to focus merely on control or to try to glean which class of securities has the residual claim. Indeed, judges who attempt such an approach have reached questionable results. Instead, courts should be forced to grapple with, as Berle put it, the relationships between management and the various parties, including not only common shareholders, but the various classes of hybrid instruments, including the series of preferred shares issued to venture capitalists.

B. A Brief History of Complex Hybrids

Although there is considerable literature on the use of hybrids in venture capital contracts, there has been little discussion of more complex hybrids. Next, I consider the history of these other hybrids in some detail. These complex hybrids have had wide use, among both private and public companies. My goal is not to be exhaustive, but to begin to build a literature of modern complex hybrids by setting forth some institutional detail about these instruments.

First, recall that, regardless of which methodology one might use to value common stock, the payouts on stock are composed of at least two pieces: dividends plus any change in stock price. At roughly the time of publication of Clark’s treatise, clever investment bankers began separating these two pieces, just as they split apart the interest and principal payments on mortgages by putting them into a common stock trust, which then issued two securities, one conservative that received dividends plus a portion of any increase in the stock price, and one riskier security that received any additional increase in stock price.

63. See Fried & Ganor, supra note 59.
64. See Eliasen v. Itel, 82 F.3d 731 (7th Cir. 1996), in which Green Bay Western Railroad had three slices to its capital structure: common shares, Class A debentures, and Class B debentures. The contract terms for the classes stated that the Class B debentures were in the residual economic position with respect to both dividends and payment in the event of liquidation. Nevertheless, Judge Posner allocated rights not based on the language of the contract, but based on assumptions about control. He assumed that participants would have allocated residual claims to the party with control, even though the contract language did not support such an interpretation. The case is unique because the contract terms were many decades old and were ambiguous and conflicting in ways that would be highly unusual today.
65. See PARTNOY, supra note 3, at 218-23 (discussing hybrid use in different settings).
66. See id. (describing one well-known 1980s version called Americus Trust and other such instruments...
Even such a simple transaction generates difficulties for corporate law scholars. Assume the trust contains all of a corporation’s shares. To whom should fiduciary duties run: the instruments entitled to dividends or the instruments entitled to capital gain? Obviously, there would be tensions between holders of the two separate securities, particularly with respect to dividend payouts.67

In 1988 Morgan Stanley created a security called “PERCS,” based on the more conservative piece of the Americus Trust deals.68 PERCS stood for “Preferred Equity Redemption Cumulative Stock,” and resembled a preferred stock with cumulative dividends that were higher than the dividends paid on common stock.69 The key twist was that in three years PERCS automatically converted into common stock, according to a specified schedule. For example, PERCS would convert into one share of common stock if the common stock was at $50 or lower, but convert into fewer shares if the price was above $50, so as to limit the upside of PERCS. Essentially, an investor buying PERCS committed to buy a company’s stock in three years and also sold some of the upside potential of that stock by selling a three-year call option. The company bought the three-year call option from the investor and paid the investor a “premium” in the form of a cumulative dividend for three years.

The first PERCS deal, in July 1988, was done by Avon Products Inc.70 Avon’s common stock had fallen to around $24, but was still paying a $2 dividend. Avon wanted to cut the dividend to $1, but worried that doing so would disappoint investors and drive down its share price even more. The solution was to offer to exchange common shares for PERCS, which would still have a $2 dividend but would convert into common shares in three years. The price cutoff for converting PERCS into common shares declined during the three years, wiping out any gain from the additional dividend, but that was much more subtle than simply slashing the dividend by one dollar. If Avon’s common stock were below $32 in three years, the PERCS would each receive one share of common; otherwise, they would get less.71 Perhaps surprisingly, investors did not complain about the effective decline in the dividend. The company received some favorable regulatory treatment: the rating agencies treated PERCS as equity, as did Avon’s accountants, although the dividends on PERCS were not tax deductible.

Without the tax benefit, PERCS lacked mass appeal. Investors generally preferred to buy either common shares, which retained all of the upside associated with the corporation’s performance, or corporate bonds, which were a safer fixed claim. The main advantage to PERCS was that a company could “borrow” money using them without increasing its debts, at least in the minds of officials at the major credit rating agencies. In the early 1990s, a few debt-laden companies—whose credit ratings were lower than their competitors—issued PERCS instead of debt: Citicorp, General Motors, K-Mart, RJR Nabisco, Sears, and Tenneco.72 The credit rating agencies did not count these securities

that were used in the United States, Europe, and Japan).

67. Similar tensions arise with tracking stock.
68. See PARTNOY, supra note 3, at 219.
69. See id. The acronym suggested that this would be a “perq” for the investor.
72. See Larry Light, “Peres” You May Be Better Off Without, BUS. W., Apr. 20, 1992, at 107; Citicorp
as debt in their analyses, even though these companies’ short-term obligations were increasing. The companies protected their credit ratings and were willing to pay large fees for the deals. Morgan Stanley doubled its income in 1991, due in large part to the sale of about $7 billion worth of PERCS.

Then, in 1993, Salomon Brothers introduced “DECS” (Dividend Enhanced Convertible Stock), which added a twist to PERCS by giving the investor more upside. PERCS had two payout zones, above and below a specified exercise price. Below that price, the investor received one common share for each PERC. Above that price, the investor received a diluted amount of shares, capping the investor’s upside. DECS added a third zone, at a higher stock price, above which the investor received the upside of common stock.

For example, Salomon did a DECS deal for First Data Corporation, the data processing subsidiary of American Express. If an investor purchased 100 DECS, her payout in three years would fall into one of three zones, divided by common stock prices of roughly $37 and $45. If the common stock were below $37 in three years, she would receive 100 common shares. Between $37 and $45, she would receive fewer shares, to maintain a constant value of $37. That meant that if the price went up to $40, she would still only receive $37 worth of shares per DECS. If the price reached $45, she would receive only 82 common shares. However, in the new third zone, when the price increased above $45, she would still receive 82 shares, signifying no more dilution, regardless of how high the price went. This new upside was the only economic difference between PERCS and DECS.

For American Express and First Data, the regulatory benefits of the DECS were considerable. First, because American Express had agreed to pay the first three years of dividends, the credit rating agencies gave the DECS a high rating based on the credit of American Express, not First Data. The rating agencies also gave the DECS themselves a high rating and treated them as equity in their analyses. Second, Salomon obtained an opinion that the three years of payments—called “dividends” for PERCS but “interest” for DECS—were tax deductible. In other words, DECS were “debt” for tax purposes. Third, accountants did not include DECS among the financial statement’s other debts and obligations, even though others were labeling them debt. Effectively, Salomon had created a financial chameleon that could appear to be equity or debt, depending on the regulatory perspective. The DECS deal for American Express was labeled the “Deal of the Year” in 1993, and Salomon was paid $26 million for that deal. That fee was roughly the same fee Salomon would have received from advising Bell Atlantic on its planned $21 billion takeover of Tele-Communications, Inc., the largest announced takeover since the RJR Nabisco deal in 1989, if that deal had not collapsed in 1993.

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References:


74. Salomon’s Debt Disguised as Equity Doesn’t Impress Big Investors, BLOOMBERG NEWS, Aug. 1, 1993.


By 1994, every major investment bank was copying Salomon's DECS. The various securities enabled companies to achieve higher credit ratings, reduce taxes, and hide debt. An issuer of DECS or DECS-like instruments did not reflect changes in its obligations on these new instruments even as its share price changed; the financial statements did not reflect the fact that the value of the obligation depended on which of the three zones the stock was in.

Accountants at the SEC began questioning this accounting treatment in 1996, after they examined a Merrill Lynch PRIDES deal for AMBAC Inc. When they told officials at Merrill that AMBAC would need to record an ongoing expense for the PRIDES, the deal collapsed. In response, Goldman Sachs invented a new hybrid security called MIPS, for Monthly Income Preferred Securities, which purported to qualify as equity for accounting purposes but debt for tax purposes. Enron was a major issuer of MIPS, and even won a battle with the Internal Revenue Service in 1996 over the tax treatment of such preferred securities.

In 1997, Merrill added the “Feline” twist to its PRIDES. Instead of the company issuing the PRIDES, Merrill created a special purpose trust to issue securities resembling the original PRIDES. The trust would give the money it received from investors to the company in exchange for securities that matched the trust’s obligations on the new securities it had issued. In other words, the trust was simply an intermediary: cash would flow from investors through the trust to the company, and the obligations would flow from the company through the trust to investors. The economics of the deal were essentially the same as those of the original PRIDES, with a few new terms to target specific investor profiles and a longer maturity of five years. By March 1997, Merrill completed its first Feline PRIDES deal for MCN Energy Group Inc. through a special purpose entity called MCN Financing III, which was created especially for the purpose of new issue. The new hybrid securities were tax deductible, treated as equity for credit ratings purposes, and were neither to be included as a liability nor to dilute the common shares on a company’s balance sheet.

On February 25, 1998, just weeks before Cendant’s accounting troubles were uncovered, Cendant announced a public offering of 26 million units of Feline PRIDES, worth about $1 billion in aggregate. Essentially, investors bought a preferred stock that paid a dividend of 6.45% for five years and then automatically converted it into Cendant common stock, according to a specified schedule. The Feline PRIDES were tax deductible, received an investment grade credit rating, and were not included as debt or equity on Cendant’s balance sheet. Merrill Lynch, which had represented HFS in the

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77. Merrill Lynch had Preferred Redeemable Increased Dividend Equity Securities (PRIDES), Goldman Sachs had Automatically Convertible Enhanced Securities (ACES), Lehman had Yield Enhanced Equity Linked Securities (YEELDS), and Bear Sterns had Common Higher Income Participation Securities (CHIPS).

Malcolm Berko, More Than a Five-and-Dime; With Strong Cash Flow and New Management Woolworth is Expected to Have Profitable Year, CHI. TRIB., July 15, 1994, at N11. As I have noted elsewhere, having a facility with acrostics can be more important in derivatives groups on Wall Street than mathematical training. See PARTNOY, supra note 3, at 222.

78. Tom Pratt, AMBAC "Prides" Deal Sunk by SEC Accounting Ruling; Broad Impact on Exchangeables is Feared, INV. DEALERS' DIG., Apr. 1, 1996, at 10.


Cendant merger, created the Feline PRIDES and was one of the lead underwriters for the Cendant deal. This deal turned out to be Cendant’s last gasp for breath, an attempt to raise capital to fund its money-losing businesses without disclosing any new debt or jeopardizing its credit rating.

Today, corporations continue to use Feline PRIDES and similar hybrid instruments. A search of the Lexis EdgarPlus database on May 10, 2006, revealed 1,340 documents discussing issuances of Feline PRIDES, for companies ranging from Ace Ltd. to Kansas City Power & Light Co. to Washington Mutual Investors Fund, Inc. Nor are Feline PRIDES the only such hybrid instrument being used; they are merely Merrill Lynch’s brand. Other major banks have structured similar instruments, which go by other acronyms. Consider as an example the following bewildering description of a restructuring transaction undertaken by Cox Communications, Inc.

During 2003, Cox repaid $2.3 billion of debt, which primarily consisted of the purchase of a portion of its convertible senior notes, the purchase of the majority of all three series of its exchangeable subordinated debentures, pursuant to offers to purchase any and all PRIZES, Premium PHONES and Discount Debentures, and the purchase of its REPS.81

C. How Corporate Law Might Address Hybrids

How should corporate law respond to the existence of these new hybrid instruments? One answer is to treat them as having only contractual rights. However, that argument runs into many of the puzzles presented above in Part II. Another answer, in the tradition of Berle, is to widen the corporate law umbrella so that it includes all slices of the capital structure, including complex hybrids. Consistent with this approach, a court analyzing a particular decision might ask whether directors have benefited one class of securities at the expense of another.82

Although courts have not addressed the issue specifically in litigation involving complex hybrids, they implicitly have accepted the argument that duties run to these hybrids as well as to shareholders. The litigation involving hybrids has not been based on contract terms only. Instead, hybrids have recovered on liability theories similar to those used by shareholders.

Yet another, admittedly costly, approach would be to examine the relationships among participants in the corporate capital structure more closely, to determine the nature of the relationship between a particular class of instruments and the board or management. At the extreme, courts might take into account the other securities positions held by particular plaintiffs. For example, a court might consider the fact that a particular shareholder was also short other slices of the capital structure.

One final important wrinkle is the extent of management participation in various slices of the capital structure. A particularly problematic case would be a corporation whose shares are held exclusively by management, but which also has issued various types of exchangeable preferred shares and/or convertible debentures to other investors. Perhaps courts should take into account two factors: (1) the capital structure of the

82. This is the approach suggested by Fried and Ganor, supra note 59.
corporation, and (2) the extent of director and officer participation in various slices of the capital structure.

The high costs and complexities associated with each of these approaches suggests that when the Delaware courts say that fiduciary duties are owed to the corporation (not to the shareholders), that language should be taken seriously. As with the analysis in Part II, this section shows that financial innovation presents difficult theoretical questions for corporate law. One might decide to ignore the financial complexities of hybrid instruments in the corporate capital structure, but that decision is a function of high transaction costs, not the innate features of shares as compared to hybrids.

IV. THE "VICINITY OF INSOLVENCY" PUZZLE

The questions associated with hybrids and capital structure are naturally related to the puzzling corporate law doctrine in which fiduciary duties are said to shift from shareholders to bondholders in the "vicinity of insolvency." Although a handful of recent cases have addressed this doctrine, the meaning of the term "vicinity of insolvency" remains an open question. No one has identified the precise fulcrum at which duties shift, or how directors should think about the rights they owe to creditors in this "zone."

Corporate law generally is not calibrated to the capital structure of the corporation at issue. This disconnect is particularly true of fiduciary duty law. With rare exceptions, the law of fiduciary duty does not explicitly contemplate capital structure at all, except to the extent the "vicinity of insolvency" doctrine looks at the relative value of equity versus debt.

Such an approach to capital structure differs from the approach taken in other areas of law, particularly tax and prudential regulation of financial services, where questions of

83. These cases have specified circumstances under which officers and directors of near-bankrupt corporations may owe duties to bondholders instead of shareholders. See, e.g., Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 793-95 (Del. Ch. 2004); Geyer v. Ingersoll Publ'n Co., 621 A.2d 784 (Del. Ch. 1992) (holding that "fiduciary duties to creditors arise when one is able to establish fact of insolvency"); Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991) (extending fiduciary duties of managers to creditors when corporation becomes insolvent or approaches insolvency).

84. In his opinion in Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., then-Chancellor Allen stated that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise." Credit Lyonnais, 1991 WL 277613, at *34. In his famous footnote 55, the Chancellor noted that:

[S]uch directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

85. In Kohls v. Kenetech, the Delaware Supreme Court had the opportunity to address the "vicinity of insolvency," but expressly declined to do so. Kohls v. Kenetech Corp., No. 433, 2000, 2002 WL 529908, at *1 (Del. Apr. 5, 2002).

86. To the extent fiduciary duties have been codified, those statutes do not provide for differential treatment of fiduciary duty claims based on capital structure. See Del. Code Ann. tit. 8, § 144 (2005) (codifying common law without any reference to capital structure).
capital structure play an important role. Since Franco Modigliani and Merton Miller
illustrated, as a theoretical matter, that corporations should be indifferent as to their
relative issuance of equity versus debt, numerous scholars have pointed to various ways
in which legal rules weaken the "M&M" capital structure irrelevance proposition. Judges, regulators, directors, lawyers, and other market participants have explicitly
considered capital structure in assessing a range of decisions relevant to firms. However,
the same is not true of the law of fiduciary duty. My research has not uncovered a single
case in which a judge has explicitly considered a corporation's capital structure in
reaching a decision regarding a claim of breach of fiduciary duty. This seems odd,
given that capital structure at least implicitly is the focus of the "vicinity of insolvency"
doctrine.

Although the specific line of "vicinity of insolvency" cases in Delaware began in
1991, and has continued through the Production Resources case from 2004, numerous
cases from a century ago granted bondholders the right to seek relief in equity prior to
insolvency. There is a rich literature on the question of whether fiduciary duties are
owed to bondholders, and indeed Clark foreshadowed some of the doctrinal challenges
associated with the recent "vicinity of insolvency" cases in both his treatise and in an
article on duties owed to corporate creditors. Berle resolved the conundrum in 1928 by noting that the shareholders and creditors were similar in many ways:

Theoretically, there is a wide difference between a stockholder and a
bondholder. In practice and as a matter of finance, the difference is not nearly
as great as that which the law presupposes. Ultimately, the only protection
which most bondholders have is the faithful management of the enterprise; and
they stand in only slightly better position than a preferred stockholder.

However, recent cases have not followed Berle's approach.

Recall that although directors and officers of a solvent corporation generally owe

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88. The decisions in which judges have suggested that directors owe duties to holders of securities other than shareholders focus on voting or control, not capital structure.
90. See BERLE, supra note 43, at 160 n.7 (citing numerous cases from 1887 through 1914).
92. See Robert Charles Clark, The Duties of the Corporate Debtor to its Creditors, 90 HARV. L. REV. 505 (1977). For example, Clark has suggested that there should be constraints placed on decisionmaking in the interests of creditors, including forbidding dividends or new indebtedness under certain circumstances, or that a company in danger of insolvency raise new equity capital. Id. at 559-60. Clark's treatise includes many of these arguments, and begins not with a discussion of duties to shareholders, but with a discussion of duties to creditors. Id. at 506-17. This is no accident, and derives from the fundamental importance of limited shareholder liability in corporate law.
93. BERLE, supra note 43, at 156.
duties to the corporation that typically run to shareholders, when a corporation actually is a debtor in bankruptcy proceedings, in other words, once it is not merely in the “vicinity” but is actually there, those duties instead run to the creditors. The shift in fiduciary duties at the point of bankruptcy is intended to ensure that the asset value of an insolvent corporation is preserved for creditors. It is the creditors, not the shareholders, who care most about corporate assets in bankruptcy. The function of the “vicinity of insolvency” doctrine, then, is to push the line further in from actual bankruptcy to something prior and close to bankruptcy.

As with the examples given in Part II, it is difficult to understand how the insolvency line is conceptually different from other capital structure lines one might draw. Moreover, even as to “debt,” it is unclear how the “vicinity” doctrine would apply to the range of debt and debt-like instruments: trade debt, subordinated debt, secured debt, preferred stock, and numerous types of hybrid securities, as well as derivative instruments, including swaps. Holders of each of these instruments have different economic interests that may shift and conflict over time, particularly when a company’s valuation is near some “trigger” point that affects whether a particular participant in the capital structure will be paid. In general, courts have not distinguished among these various types of instruments, or among the potential triggers. Insolvency is one trigger, but not the only one.

The most recent articulation of the “vicinity of insolvency” doctrine illustrates some of the puzzles. On November 17, 2004, Vice Chancellor Leo Strine held, in Production Resources, that Delaware’s exculpation provision, section 102(b)(7), applied to

95. Note that the discussion in Part II suggests that this approach is too simplistic. Some participants in the capital structure will care more than others. Should fiduciary duties in bankruptcy shift to swap counterparties, who are the first to be paid? Or to a particular class of debt? Alternatively, if a court accepted the notion that some other class of securities, such as options, was owed duties, would those duties be extinguished when the value of the firm’s assets declined (e.g., if the value declined to the point where the options were out-of-the-money)?
96. Some courts have pushed the line further than others. See, e.g., Brandt v. Hicks, Muse & Co. (In re Healthco Int’l, Inc.), 208 B.R. 288 (Bankr. D. Mass. 1997). In Brandt, a Massachusetts bankruptcy court, applying Delaware law, held that directors violated their duty to the corporation by approving a leveraged buyout (LBO) that would treat creditors unfairly by leaving the corporation with an unreasonably small amount of capital. The corporation was not in the vicinity of insolvency. The court noted that “when a transaction renders a corporation insolvent, or brings it to the brink of insolvency, the rights of creditors become paramount.” Id. at 302. The court distinguished the LBO from the “normal” situation in which “what is good for a corporation’s stockholders is good for the corporation.” Id. at 300.
97. Perhaps bankruptcy is unique because of its clarity, because there is no doubt as to when it occurs, but the same cannot be said of the “vicinity.” Moreover, some changes in valuation are just as obvious as bankruptcy—it is just as clear when the stock price rises above or declines below a particular level.
98. See, e.g., Richard M. Cieri & Michael J. Riela, Protecting Directors and Officers of Corporations that are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions, 2 DEPAUL BUS. & COM. L.J. 295, 303 (2004) (noting that “[i]n analyzing the fiduciary duties of directors and officers of corporations in the zone of insolvency, courts have not addressed distinctions among the different classes of debt and equity”).
directors in a suit by creditors.\textsuperscript{100} Specifically, he held that where the corporation’s articles of incorporation included a waiver of the duty of care, that waiver applied equally against creditors as against shareholders.\textsuperscript{101} However, he dismissed only the creditors’ duty of care claims, not other claims (including duty of loyalty claims) that were not exculpated.\textsuperscript{102}

Strine criticized commentators and judges who had relied on the \textit{Credit Lyonnais} decision to sustain creditors’ claims that directors of companies in the “vicinity of insolvency” did not act with due care.\textsuperscript{103} Strine argued that creditors ordinarily have no cause of action against directors who act in good faith, regardless of the duties they owe.\textsuperscript{104} Therefore, according to Strine, \textit{Credit Lyonnais} has only limited applicability: it “provided a shield to directors from stockholders who claimed that the directors had a duty to undertake extreme risk so long as the company would not technically breach any legal obligations.”\textsuperscript{105}

Given these findings, it is worth considering the facts of this case in some detail. NCT Group bought a computer system from Production Resources, a Delaware corporation doing business in Connecticut. When NCT Group did not pay, Production Resources sued in Connecticut state court and obtained a judgment. However, Production Resources was unable to collect, and NCT Group continued to operate even though it appeared to be insolvent. Based on its financial statements it had been unable to pay other debts.

Production Resources sued in Delaware, alleging that NCT Group was in the vicinity of insolvency (or actually was insolvent) and that its directors had breached their fiduciary duties by improperly avoiding paying the judgment. According to Production Resources, the directors had avoided payment in several ways, by issuing more shares than were authorized, by granting inappropriate liens in favor of a director, and by improperly increasing the flow of funds to a subsidiary.

The NCT Group directors argued that the corporation had waived the directors’ duty of care pursuant to section 102(b)(7), and that they owed no duty to creditors. As noted above, the court agreed that NCT Group’s corporate charter could exculpate directors from liability to creditors for a violation of the duty of care, even though the creditors were not a party to the adoption of this waiver. However, the court permitted Production Resources’s claims to proceed to the extent they fell outside the exculpatory provision—that is, to the extent that they alleged bad faith or duty of loyalty breaches.

What is one to make of this decision? At various points, the court suggests it is affirming the general premise that directors do not have fiduciary duties to creditors who are instead protected by contract terms and fraudulent transfer law. Strine described \textit{Credit Lyonnais} as a limited decision that merely gave directors discretion to take less risky decisions than ones they might otherwise take on behalf of shareholders when the

\textsuperscript{100} Id. at 793.
\textsuperscript{101} Id.
\textsuperscript{102} Id. at 795.
\textsuperscript{103} Id. at 789-91.
\textsuperscript{104} Prod. Res. Group, Inc., 863 A.2d at 787. The doctrinal exceptions to the ordinary approach, such as fraud or piercing the corporate veil, do not seem to depend on capital structure.
\textsuperscript{105} Id. at 788.
corporation is in the "vicinity of insolvency."" Consider the following quote:

[T]he fact of insolvency does not change the primary object of the director's duties, which is the firm itself. The firm's insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value and logically gives them standing to pursue these claims to rectify that injury.

The Delaware courts' doctrinal approach of insisting that directors owe duties to the corporation, not to any particular group within the corporation (including shareholders), potentially can resolve some of the fiduciary duty problems outlined in Part II of this Article, provided that the courts mean what they say and are not merely stating that duties are owed to the corporation when what they really mean is that duties are owed to shareholders. Note that this position of the Delaware courts is quite different from the scholarly position that managers should maximize share value because shareholders typically have the residual interest.

Legal scholars and some judges might assume that what is good for the corporation is typically or derivatively good for the shareholders (except in limited instances such as the "vicinity of insolvency"). But as this Article has shown, that is not necessarily the case. Instead, perverse results can follow if fiduciary duty law does not at least contemplate capital structure, even if ultimately the decision is made, based on transaction costs, to favor shareholders.

Note also that Delaware's statement of the law of fiduciary duty does not turn on the shareholder primacy rationale advanced by many corporate law scholars. The doctrine does not say that when a corporation is in the vicinity of insolvency (whatever that means) creditors are suddenly considered the residual owners, and therefore become beneficiaries of the fiduciary duties owed to the residual interest of a corporation's profits. Instead, Delaware law says that directors always owe a duty to the corporation. The judges permit creditors to sue in some cases for prudential reasons, not because of any economic argument about incentives of the holder of the residual interest. Indeed, in the vicinity of insolvency, as contrasted with actual insolvency, it is the shareholder who continues to hold the residual interest.

As such, the vicinity of insolvency cases should remind corporate law scholars to avoid too much focus on shareholders, a point bankruptcy law scholars also have been making. For example, Douglas Baird and Robert Rasmussen recently argued that "traditional approaches to corporate governance focus exclusively on shareholders and neglect the large and growing role of creditors." They have identified private debt

106. "PRG is not a stockholder. PRG has standing to raise fiduciary duty claims, however, because it has pled that NCT is insolvent." Id. at 776.

107. Id. at 792.


covenants as an important area of new focus. However, the force of their argument applies more generally to all creditors, and perhaps even to all slices of the corporate capital structure, including hybrids. 110

It is worth remembering that Revlon involved a claim by bondholders. Recall that Revlon made a defensive exchange offer to its own shareholders and sold debentures with a restrictive covenant that Revlon's independent directors were permitted to waive. When the board waived the covenant the bondholders sued. 111 The court rejected their claim, essentially stating that the company was in "auction" mode, the board no longer could take into account bondholder interests, and instead was required to focus on shareholders. 112 In the takeover context, Delaware courts have permitted the board under certain circumstances to consider a bid's "effect on the corporate enterprise," including "the impact on "constituencies other than shareholders." 113 It is only when in Revlon mode that they cannot. 114

Unfortunately, the language in Delaware cases is not always consistent as to which party is owed duties, and judges sometimes try to have it both ways, insisting that a duty is owed to both shareholders and creditors. 115 Both courts and legal scholars, myself included, tend to be casual about saying duties are owed to parties instead of the corporation. By way of a concluding example, I will return to the first capital structure puzzle presented in Part II.A. The table is reproduced below.


110. Similarly intractable issues arise in cases of "deepening insolvency," where creditors claim that directors artificially prolonged a corporation's life by permitting it to do business and take on new debts, thereby reducing any potential recovery for creditors. New York courts have been skeptical of "deepening insolvency" claims. See, e.g., Kittay v. Atl. Bank of N.Y. (In re Global Serv. Group LLC), 316 B.R. 451 (Bankr. S.D.N.Y. 2004) (granting motion to dismiss "deepening insolvency" claims because merely prolonging a corporation's life, without breaching a duty, does not create liability); see also In re Investors Funding Corp., 523 F. Supp. 533 (S.D.N.Y. 1980) (creating the "deepening insolvency" theory and noting that, "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it"). Suppose directors face a decision about whether to continue to operate and incur more debt. Indeed, the court in Global recognized that "[o]nce insolvency ensues . . . directors owe duties to multiple constituencies whose interests may diverge. At that point, they have (an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.)" Global Serv. Group, 316 B.R. at 460 (quoting Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991)). What is long-term wealth creating capacity? Id.


112. Id. at 182.


114. And, of course, constituency statutes in other states explicitly permit directors to consider the interests of non-shareholders (and non-creditors).

115. For example, in Adlerstein v. Wertheimer the court noted that:

While it is true that a board of directors of an insolvent corporation or one operating in the vicinity of insolvency has fiduciary duties to creditors and others as well as to its stockholders, it is not true that our law countenances, permits, or requires directors to conduct the affairs of an insolvent corporation in a manner that is inconsistent with principles of fairness or in breach of duties owed to the stockholders.

Table 6

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Suppose that the overall value of the firm's assets has declined by approximately $500 so that DebtCo is in the "vicinity of insolvency." Delaware law provides that directors would be permitted to take into account the interests of Debt, and that the board would not simply owe a fiduciary duty to shareholders. Again, why shouldn't the same kind of rationale apply to OptionsCo? The decline in the value of assets is not as dramatic for that firm because it does not threaten insolvency. Yet, it would be reasonable for directors to have a different set of priorities, given that the options are no longer in-the-money. An equivalent doctrinal approach would suggest that directors should focus more on shareholders after the decline in value (i.e., that they should be more conservative).

The crucial question, put in hypothetical bargaining terms, is what one would expect the arrangements between the corporations and the various participants in its capital structure to say about how officers and directors should treat parties as the valuations of different parts of the capital structure change. Contracts with non-equity participants specify certain rights at such valuation points, for example, preferred rights at the IPO or sale. Are other specifications not present in contracts because parties assume they are protected by default rules suggesting that officers and directors owe duties to the corporation, and therefore to all slices of the capital structure? Or are the contracts silent because the parties have agreed that when the courts say duties are owed to the corporation, they really mean duties are owed to shareholders? This Article does not conclusively answer that question, but it does suggest that the question is a more serious one than many scholars might have thought, given the increasing complexity of corporate capital structures and the ways in which finance theory has illuminated contradictions in the shareholder-centered model.

The key point demonstrated by the "vicinity of insolvency" doctrine and literature is that corporate law is about duties owed to corporations, not duties owed to shareholders. Drawing on the discussion from Part II, financial innovation suggests that the "vicinity of insolvency" duty-shifting approach might be an appropriate one, at least from a theoretical perspective, for fiduciary duties more generally. In other words, it might make sense to think about duties shifting along the capital structure, as the value of corporate assets and liabilities change. But if this inquiry is too costly, theory and practice need not coincide. If judges do not explicitly take into account capital structure at points along the spectrum of firm value, it is not because of some notion of shareholders as residual claimants, but rather because the transaction costs associated with parsing a corporation's capital structure, particularly in the complex and ex post factual setting of a dispute, are too high.

V. CONCLUSION

Financial innovation has changed corporate law and the way scholars should conceptualize the nature of the firm and fiduciary duty. Option theory has generated
puzzles about how to conceptualize equity and debt. New hybrid securities have generated further questions about who is owed corporate fiduciary duties.

When combined with the "vicinity of insolvency" doctrine, financial innovation suggests that, from a theoretical perspective, fiduciary duties inevitably are related to capital structure. If a corporation's constituents were only shareholders, the conclusion is easy: managers and directors would owe duties to them. But if the corporation's constituents also include creditors, the conclusion would be more difficult: managers and directors owe duties that can shift as the value of the assets of the corporation declines. This Article has examined the question of whether corporate law might permit some continuum of shifting fiduciary duties between these poles, so that the focus of directors and officers might change depending on changes in the composition and value of the firm's capital structure, not merely in the "vicinity of insolvency." However, it also has noted that even though such duty shifting might make sense in theory, it might be too costly in practice.

During the next decade, judges will adjudicate an increasing number of corporate law cases with competing interests in the capital structure. This Article does not dictate that judges should take into account those competing interests; if such inquiries are too costly, it would be inefficient to undertake them. Instead, it points out that capital structure conflicts are inevitable, and are likely to be pervasive in the future.

It is important that scholars and judges understand the presence of these conflicts, even if the focus remains on shareholders. These issues most likely will arise for companies that have issued large amounts of options, are highly leveraged, or have several series of preferred shareholders. From a theoretical perspective, the primary message of this Article is that corporate law scholars should be more careful in assuming that directors of a corporation have a duty to maximize shareholder value, or even that directors should maximize shareholder value to satisfy their duties to the corporation. Corporate practice is too complicated, and finance theory is too subtle, to permit such simple assumptions.