1984

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THE ECONOMICS AND JURISPRUDENCE OF
CONVERTIBLE BONDS

WILLIAM W. BRATTON, JR.*

Professor Bratton examines judicial regulation of issuer-bondholder
conflicts of interest within three different, but closely related doctrinal
frameworks: neoclassical contract interpretation; contract avoidance; and
corporate law fiduciary restraint. After discussing the elements of convertible
bond valuation and their interaction with issuer actions giving rise to conflicts of
interest, he evaluates the case for judicial intervention to protect bondholder
interests. He concludes that bondholder protective intervention is fair and
tolerably efficient, provided it is kept within the bounds of contract
interpretation. But he finds that more aggressive judicial intervention under the
frameworks of contract avoidance and fiduciary restraint carries an unnecessary
risk of causing substantial costs in the marketplace. Thus, he advocates that
intervention under the latter two approaches be avoided.

INTRODUCTION

The stockholder-bondholder relationship is one of debtor to
creditor, and is pervaded by conflicting interests.1 The management
of a corporation with outstanding bonds2 can take any number of

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University; A.B., 1973, J.D., 1976, Columbia University. A number of colleagues, including
David Carlson, Arthur Jacobson, Paul Shupack and Elliott Weiss, provided helpful
comments and criticism.

1. “Conflicting interests” here mean conflicts between the self interest of an indi­
vidual or legal entity and its legal or moral obligations to others. See Anderson, Conflicts of
Interest: Efficiency, Fairness and Corporate Structure, 25 U.C.L.A. L. REV. 738, 738 & n.1
(1978).

2. A “bond” is a long term promissory note issued pursuant to a trust indenture—
the “bond contract” referred to in the text of this Article. A “trust indenture” is a contract
entered into between the corporation issuing the bonds and a trustee for the benefit of the
holders of the bonds. It delineates the rights of the bondholders and the issuer. It sets forth the
mechanics of payment, states the issuer’s sinking fund obligations and redemption rights,
regulates the conduct of the issuer’s business, and defines events of default and the role of the
By channelling the administration and enforcement of all these contract provisions through a
single party, the indenture trustee, the trust indenture makes it feasible to borrow small
amounts of money on a long term basis from large numbers of lenders on identical terms. See
V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 83 (2d ed. 1979).

In referring to all promissory notes issued pursuant to trust indentures as “bonds,” this
Article ignores a nicety of corporate practice—the distinction between “debentures,” un­
secured long term notes issued pursuant to trust indentures, and “bonds,” long-term notes
actions that benefit the stockholders at the bondholders' expense, even assuming no present prospect of a payment default. Consider, for example, a bond issuer that increases its dividend rate and concomitantly decreases the rate at which it reinvests earnings. This increases the risk of nonpayment of the bonds and, given a fixed interest rate, reduces their value without necessarily reducing the value of the stockholders' participation in the issuer. A similar effect might result if the issuer incurred additional debt or substituted riskier assets for existing ones. 3

Courts traditionally have directed bondholders to protect themselves against such self-interested issuer action with explicit contractual provisions. Holders of senior securities, such as bonds, are outside the legal model of the firm for protective purposes: a heavy black-letter line bars the extension of corporate fiduciary protections to them. 4 On the contract law side of the black letter line, judicial response to bondholder requests for protection has been

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Stockholder wealth is maximized if the issuer distributes to the stockholders all capital which the issuer cannot invest for a rate of return higher than that available to the stockholders elsewhere. Such a distribution might take any one of a number of forms—an ordinary cash dividend, a spin-off or other distribution in kind, or a payment in connection with a redemption or other repurchase of outstanding shares. In contrast, the issuer maximizes bondholder wealth if it retains all earnings and other capital which it can reinvest for a positive return. Distributions to stockholders are not in the bondholders' interest because any decrease in the value of the issuer's assets increases the likelihood of default on the bonds. See Smith & Warner, On Financial Contracting, An Analysis of Bond Covenants, 7 J. Fin. Econ. 117, 121 (1979).

Stockholder-bondholder conflict has been particularly acute where issuers have undergone fundamental corporate changes. Long term bondholders whose interests have depreciated due to rising interest rates seek recovery of face value and seize on any pretext to force acceleration of their bonds. Conversely, rising interest rates give issuers an enhanced interest in keeping old, low interest bond issues locked into their capital structures. See, e.g., Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 521 F. Supp. 104, 118 (S.D.N.Y. 1981), aff'd in part and rev'd in part, 691 F.2d 1039 (2d Cir. 1982), cert. denied, ___ U.S. ___ (1983) (sale of substantially all the assets and liquidation of an issuer of bonds).

shaped by the traditional ethic of creditor self-protection. The "classical" contract law view that the promisee bears the burden of obtaining explicit contractual protection has dominated.⁵ Protective doctrines from "neoclassical" contract law have rarely found a place in judicial decisions.⁶

This Article takes a new look at judicial regulation of conflicts between corporate debt and equity interests in the limited context of the convertible bond relationship. Convertible bonds—bonds incorporating the privilege of conversion⁷ into common stock or other securities of the issuer—combine debt and equity features in a single hybrid security. Convertibles reduce conflict between stockholders and bondholders by creating a class of securityholders whose interests go to both sides of the debt-equity line. Consider an issuer that revamps its business so as to increase the value of its equity at the expense of a class of straight bondholders. This result still obtains if convertibles are outstanding, but now the action also increases the value of the conversion privilege⁸—a result not in the stockholders' interest.⁹ Even so, convertibles do not eliminate all incentives for

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Only when a corporation's business affairs have deteriorated so far as to make fraudulent conveyance doctrine applicable does the law directly protect creditors' interests. For the leading discussion of fraudulent conveyance doctrine in the corporate context see Clark, The Duties of the Corporate Debtor to its Creditors, 90 HARV. L. REV. 505 (1977).

⁶ Instead, "business covenants" in standard form bond contracts have been the predominant means of protecting bondholder interests.

⁷ "Conversion" is the act of exchanging one class of securities for another. The conversion right is created by a contract between the issuer and holder, and the exchange is effected by a surrender of the original security and the issuance to the holder of a new security in its place. See Hills, Convertible Securities—Legal Aspects and Draftsmanship, 19 CALIF. L. REV. 1, 2 (1930). See also Buxbaum, Preferred Stock—Law and Draftsmanship, 42 CALIF. L. REV. 243, 279 (1954); Fleischer & Cary, The Taxation of Convertible Bonds and Stock, 74 HARV. L. REV. 473 (1961). Denomination of conversion as a "privilege" rather than as a "right" is both customary, see Justice Field's opinion in Hotchkiss v. National Banks, 88 U.S. (21 Wall.) 354, 357 (1874), and juridically accurate. See Berle, Convertible Bonds and Stock Purchase Warrants, 36 YALE L.J. 649 (1927).

As a contractual device, conversion remains subject both to business exigencies and the ingenuity of the subsequent drafter. Bonds and preferred stock are not the only securities to which a conversion privilege may be attached and common stock is not the only available underlying security. Bonds can be made convertible into preferred stock of the issuer or common stock of a subsidiary or sister corporation; junior debt or preferred stock can be made convertible upward into an issue of senior debt. Conversion need not necessarily be optional with the holder; bonds convertible at the option of the issuer have appeared in the past. See B. GRAHAM, D. DODD & S. COTTLE, SECURITY ANALYSIS 618 (4th ed. 1962); Hills, supra, at 2; Kaplan, Piercing the Corporate Boilerplate: Anti-Dilution Clauses in Convertible Securities, 33 U. CHI. L. REV. 1 (1965).

⁸ See infra notes 18-37 and accompanying text.

⁹ This diminution in the scope of stockholder-bondholder conflict reduces the agency costs of the debt portion of the issue causing a lower interest rate and thus making the
issuer action in derogation of bondholder interests. They may even create new incentives for issuers to take actions that benefit stockholders by diluting or destroying the bondholders' claim on issuer equity. The legal status of these special convertible bond conflicts is the central concern of this Article.

A longstanding judicial consensus on the treatment of these convertible bond conflicts disintegrated recently. The traditional and still widely followed approach turns on the characterization of convertibles as being wholly "debt" as opposed to being "equity." This "debt" or "equity" stage of analysis facilitates instant categorization of convertibles inside existing structures of legal doctrine. It recurs under the various doctrinal regimes applicable to corporate securities despite its denial of the convertible's essentially hybrid nature. Whether the characterization turns out to be "debt" or "equity" depends on the particular context.10 The "debt" characterization traditional in corporate conflicts of interest rationalizes the court's refusal to intervene: being an incident of "debt," the conversion privilege creates a wholly "contractual" interest in the issuer; not being "equity" it does not bridge the black letter line separating bondholders from corporate fiduciary protections.11 As with straight bonds, bondholder protection has come from elaborate contractual provisions, such as the "anti-dilution" provisions customary in convertible bond contracts.

Recently, a number of courts have characterized convertibles as "equity"12 and have applied a range of protective devices. These

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opinions draw on the contractual duty of good faith to support expansive bondholder-protective contract interpretations. Where explicit bond contract provisions have blocked bondholder-protective constructions, some courts have gone a step further to draw on doctrines for avoiding harsh provisions and restraining oppressive exercises of contract rights. Finally, some opinions cross the black letter line into corporate territory to assert that issuers and those who control them owe fiduciary duties to convertible bondholders.\[^{13}\]

This breakdown of the rigid debt-equity distinction, duly accompanied by pointed dissents, has taken place in the federal courts of appeals. A panel of the Second Circuit drove the entering wedge in 1975 in Van Gemert v. Boeing Co. (Van Gemert I).\[^{14}\] Although agreeing on a bondholder-protective result, the panel disagreed on whether contract law avoidance doctrines or corporate law fiduciary duties provided the more appropriate means to achieve it. In Broad v. Rockwell International Corp. (Broad I),\[^{15}\] a panel of the Fifth Circuit picked up and expanded upon the Second Circuit’s protective lead, bringing to bear all available tools—contract interpretation, restraints on the exercise of contract rights, and corporate fiduciary duties. On rehearing en banc (“Broad II”), however, the Fifth Circuit rejected the panel opinion on every point and reinstated the traditional strict contract positions.\[^{16}\] More recently, the Third Circuit dissonantly raised its voice on the matter in Pittsburgh Terminal Corp. v. Baltimore & Ohio Railroad.\[^{17}\]

This Article discards conclusory “debt” or “equity” analysis and considers anew the case for going beyond the express provisions of the bond contract to protect the interests of convertible bondholders when they conflict with stockholder interests. It asks two questions: first, whether there is reason to believe that issuers unfairly advance stockholder interests at convertible bondholders’ ex-

\[^{13}\] See infra text accompanying notes 186-206.
\[^{14}\] 520 F.2d 1373 (2d Cir.), cert. denied, 423 U.S. 947 (1975).
\[^{15}\] 614 F.2d 418 (5th Cir. 1980), vacated, 642 F.2d 929 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981).
\[^{16}\] 642 F.2d 929 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981).
pense; and second, whether the doctrinal dichotomy—corporate law for stockholders and contract law for bondholders—continues to be a justifiable part of our system of securities regulation. It answers both questions in the affirmative.

Part I of this Article provides a detailed background picture of the convertible bond relationship. Part II examines the fairness question and concludes that much self-interested issuer conduct against convertible bondholders is unfair, albeit not especially so, and that judicial intervention against it would cause no significant economic harm. The Article shows that neoclassical contract theory provides ready doctrinal justification for such intervention, at least so long as the risk of the issuer conduct has not clearly been allocated to the bondholders by the bond contract.

Part III examines the question of whether the doctrinal dichotomy is justified. It finds a weakening of the assumptions on which the doctrinal dichotomy is based, but shows that the conventional corporate law model of fiduciary duty is ill suited to the relations of issuers and convertible bondholders. Thus the Article concludes that the doctrinal dichotomy serves a useful function and should be accorded continued, albeit qualified, respect.

I. The Conversion Privilege—Valuation and Vulnerability

The bondholder case against self-interested issuer action rests on two assertions: first, that the action transfers value from the bondholders to the stockholders; and second, that the bondholders cannot fairly be deemed to have assumed the risk of the transfer. Evaluation of these assertions requires a grasp of the complicated economic and legal underpinnings of the convertible bond relationship.

A. Valuation—The Economic Background

Convertible bond valuation is a complicated matter involving a large set of stochastically related variables. The following simplified model identifies the most significant variables and some of their basic interrelationships. It focuses most closely on the elements of the value of the conversion premium, paying particular attention to the variable of issuer call rights. Call rights bear significantly on the valuation uncertainties resulting from stockholder-bondholder conflicts.
1. PRINCIPAL VARIABLES

The issuer incorporating a conversion privilege into its bonds grants a future claim on its equity. For investors, this future claim gives convertible bonds the advantage of combining desirable features of straight bonds, such as fixed income payments and principal repayment, with the upside potential of common stock.\(^{18}\) In exchange for the future equity claim, bondholders customarily accept a coupon rate lower than that of an equivalent straight bond,\(^{19}\) less restrictive business covenants, and subordinated status. To issuers, these concessions give convertibles advantages over straight debt, such as cost savings, increased future capacity to incur senior debt, and greater flexibility to advance the interests of the common stockholders.\(^{20}\) The value of the conversion privilege stems from these mutual perceptions of advantage.

The following Figure\(^ {21}\) illustrates the upside and downside interrelations of the three constituent elements of value—debt value, conversion value, and conversion premium—for a typical convertible.

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\(^{19}\) For the past few years, 300 basis points has been the rule of thumb on the coupon rate differential. See Soldofsky, supra note 18, at 81.


\(^{21}\) Some of the slopes of the curve graphed in the Figure are derived from convertible bond valuation curves plotted by the economists Brennan and Schwartz. See Brennan & Schwartz, Analyzing Convertible Bonds, 15 J. FIN. & QUANTITATIVE ANALYSIS 907, 918-23 (1980) [hereinafter cited as Brennan & Schwartz, Analyzing Convertibles]; Brennan & Schwartz, Convertible Bonds: Valuation and Optimal Strategies for Call and Conversion, 32 J. FIN. 1699, 1710-14 (1977) [hereinafter cited as Brennan & Schwartz, Convertible Valuation]. Also, the presentation in the Figure was influenced by the graph in R. HIGGINS, FINANCIAL MANAGEMENT 277 (1977).
ble bond at various possible values of the issuing corporation.

22. The bond has a 20 year term. Conversion is optional with the holder at any time over the entire term of the bond. The issuer may redeem the bond for its face value plus a small premium at any time during the term. The coupon rate is 300 basis points below the rate available on a comparable nonconvertible bond.

23. Theoretical option valuation models have been applied to convertible bonds. Only the nature of the variables identified in this body of scholarship need be noted for purposes of this article.

The seminal, theoretical article is Black & Scholes, The Pricing of Options and Corporate Liabilities, 81 J. Pol. Econ. 637 (1973), which sets forth an equilibrium pricing model for put and call options grounded in stochastic calculus. See also Cox, Ross & Rubinstein, Option Pricing: A Simplified Approach, 7 J. Fin. Econ. 229, 229-30 (1979); Smith, Option Pricing, 3 J. Fin. Econ. 3 (1976).

The model is applied to the problem of convertible bond valuation in Brennan & Schwartz, Analyzing Convertibles, supra note 21; Brennan & Schwartz, Convertible Valuation, supra note 21; Ingersoll, A Contingent-Claims Valuation of Convertible Securities, 4 J. Fin. Econ. 289 (1977) [hereinafter cited as Ingersoll, Contingent Claims]. This work supersedes a series of earlier convertible valuation models. The earlier models valued convertibles at the greater of debt or conversion value at some future point and discounted that amount to present value. For sophisticated examples, see Jennings, An Estimate of Convertible Bond Pre-
Debt value\(^{24}\) is the value of an equivalent straight bond with the same coupon rate. It is sensitive to the variables dominant in straight bond valuation, such as interest rate levels and the issuer’s equity cushion. Conversion value is the value of the amount of common stock into which the bond can be converted. It depends on the market value of the underlying common stock and the price, the “conversion price,” at which the bonds, taken at their face value, are convertible.\(^{25}\) If the conversion price is a constant, conversion value is subject to the same determinants as the stock price, and goes up and down in lockstep with it. Although arbitrage possibilities prevent the bond from selling below the lower of debt or conversion value,\(^{26}\) nothing prevents it from selling above the higher of these two values. Conversion premium is the amount by which market value exceeds debt or conversion value.\(^{27}\) If we characterize the conversion privilege as a long term option\(^{28}\) on the underlying common, the premium represents the option’s value.

Assume that the bond illustrated in the Figure is priced, issued and sold for its $1000 face value with a conversion price of $50. As-
sume further that at the time of the bond’s issue the issuer’s stock is trading at $40 and the issuer’s value is at D. Debt value at issue is $900, reflecting the convertible’s lower coupon rate. Conversion value is $800, reflecting that the $50 conversion price exceeds the $40 market price of the underlying common. The premium at issue is $100, the difference between the higher of debt or conversion value and the initial $1000 market price. Valuation at issue reflects the expectation that the issuer’s value will increase substantially during the early years of the bond’s term.

Looking to the right of D in the Figure, we see the bond’s conversion value and market value rising in tandem with higher issuer values, illustrating the convertible bond’s upside potential. Debt value, in contrast, is limited by a fixed coupon rate and does not rise significantly. As issuer values increase, the market behavior of the convertible increasingly mirrors the market behavior of the underlying common stock and the premium accordingly becomes progressively smaller. Eventually, at G, the issuer’s value and the dividend payout on the underlying common have increased so much that the expected return on the underlying common exceeds the expected return on the bonds. As a result, the premium disappears and the holders convert.

We see the bond’s downside market behavior by looking to the left of D. Conversion value declines in tandem with the issuer’s value and the premium disappears as the decline in value becomes extreme. Debt value, protected by the bond contract, shows more stability and resilience. At B, the bond’s market value has fallen so far as to have become nearly contiguous with debt value; this is the “bond floor.” As the issuer’s value goes into extreme decline to the left of B, even the bond floor begins seriously to give way. With the issuer’s value at A, we reach the end of the line—a hypothetical bankruptcy liquidation pursuant to which the holders of the convertible issue receive $500 per bond and the stockholders receive nothing.

29. For a description of the pricing process for new issues of convertible bonds, see Alexander & Stover, Pricing in the New Issue Convertible Debt Market, FIN. MGMT., Fall 1977, at 35-36.

30. See generally J. WESTON & E. BRIGHAM, supra note 20, at 600-01.

31. If the Figure were to show the convertible’s value as a function of different levels of prevailing interest rates, rather than of different firm values, then movement to the right on the horizontal axis would cause the debt value line to drop.

32. The bankruptcy risks facing convertible bondholders are discussed in Ingersoll, Contingent Claims, supra note 23, at 309; Brennan & Schwartz, Convertible Valuation, supra note 21, at 1710.
2. ELEMENTS OF THE CONVERSION PREMIUM

We have seen that calculating the conversion value, given a constant conversion price, is a matter of valuing the underlying common, and that calculating the debt value is a matter of straight bond valuation. Valuing the conversion premium, in contrast, is a matter of valuing the conversion privilege. Sorting out the interrelated variables which constitute and affect the premium is the central problem of convertible bond valuation.

The premium arises, first and foremost, from investors’ perception that advantages lie in having two imperfectly correlated elements of value—debt value and conversion value—combined in the same security. One advantage of the combination comes from the bond’s limited downside risk. The downside risk of holding the bond is less than that of holding the amount of common into which it is convertible because debt value provides a floor should issuer values decline. The limited downside risk causes the bond to sell for more than its conversion value even when we are to the right of D’ in the Figure, where higher issuer values cause conversion value to surpass debt value. But since the relative importance of bond floor protection decreases as issuer values increase, the premium also decreases as issuer values increase.

Another advantage comes from the bondholder’s potential upside participation. The bond in the Figure still sells at a premium to the left of D, even though debt value exceeds conversion value at these lower issuer values. This premium results not from bond floor downside protection but from the market’s hopes that conversion value has upside potential. Since this upside potential’s relative importance decreases as issuer values decrease, the premium diminishes so as to disappear entirely when bankruptcy liquidation is reached at A.

The premium also results from the convertible’s income stream. So long as the convertible’s coupon rate exceeds the underlying common’s dividend payout rate, it is a more advantageous holding than the common. Indeed, so long as the coupon rate exceeds the dividend rate, arbitrage possibilities will prevent the bond from selling as low

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33. This floor also gives the convertible greater price stability than the underlying common possesses. One therefore can expect a positive correlation between the size of the premium and the size of the variance in the price movements of the underlying stock.
34. See J. WESTON & E. BRIGHAM, supra note 20, at 597; Jennings, supra note 23, at 33; Walter & Que, supra note 23, at 718; Weil, Segall & Green, supra note 23, at 446-47.

Cost advantages of bond over stock investment, arising from lower brokerage fees and less restrictive margin rules on bonds, also increase the conversion premium. See Fleischer & Cary, supra note 7, at 475; Weil, Segall & Green, supra note 23, at 446.
as conversion value, except immediately prior to declaration of a dividend or an adverse change in conversion terms.\textsuperscript{35} Conversely, as is the case in the Figure, if the dividend payout rate eventually exceeds the coupon rate at higher issuer values, the premium will be entirely eliminated.\textsuperscript{36}

The premium is also sensitive to the conversion privilege’s durability—the longer its life, the greater its value. Conversely, the premium is reduced if the issuer retains the power to shorten the duration of the conversion privilege.\textsuperscript{37} Issuers customarily retain this power in the form of a redemption or “call” right—the right to pay off the bond prior to maturity at the “call price,” usually fixed at par plus a small premium.

3. CALL RIGHTS AND CONVERTIBLE BOND VALUATION

Call rights will reduce the size of the conversion premium in varying degrees depending upon the likelihood that the issuer actually will exercise them. Issuer call policies in turn depend on a number of factors, including bond contract provisions, market restraints on management actions, and, at bottom, management awareness.

Most issuers reserve the right to call issues of convertible bonds at any time.\textsuperscript{38} The idea is to force conversion at such time as issuer growth causes conversion value to exceed the call price. Since conversion value is the higher figure, the bondholder converts.\textsuperscript{39} Forced conversion through call advances stockholder interests: if the total

\textsuperscript{35} See Brennan & Schwartz, \textit{Convertible Valuation}, supra note 21, at 1702. Given the stated condition, the bond always sells above its conversion value and the investor will not find it optimal to convert at any time prior to maturity, since conversion would result in the premium’s destruction. \textit{Id.; see also B. GRAHAM, D. DODD & S. COTTLE, supra note 7, at 607; Ingersoll, An Examination of Corporate Call Policies on Convertible Securities, 32 J. Fin. 463, 464 (1977) [hereinafter cited as Ingersoll, \textit{Corporate Call Policies}].

\textsuperscript{36} At that point, voluntary conversion should occur, preventing the occurrence of a negative premium. \textit{See J. WESTON & E. BRIGHAM, supra note 20, at 598.}

\textsuperscript{37} Thus convertible bond contract provisions affect the valuation calculus by their effect on the duration of the conversion privilege.

\textsuperscript{38} Until recently only a minority of currently publicly traded convertible bond issues contained contract provisions prohibiting call, and even within this minority the protection tended to apply only during the first five years of the issue’s life. \textit{See 13 VALUE LINE CONVERTIBLE SURV. 262 (May 3, 1982).}

Due to investor pressure, in 1982 new convertible bond issues began to contain call prohibitions applicable for the first two years of the issue’s life. \textit{See N.Y. Times, Mar. 6, 1983, § F, at 10, col. 1.}

\textsuperscript{39} On the redemption date both bond and conversion privileges disappear and are replaced with the right to claim the call price. Needless to say, the conversion premium disappears also.
value of the issuer is the sum of the value of the debt and equity claims upon it, then permitting convertibles further to appreciate in value as the issuer grows permits the bondholders' claim on the issuer's equity to increase at the stockholders' expense.

In theory, then, a stockholder optimal call policy dictates call as soon as the bond's conversion value exceeds its call price. In the real world, however, such a call policy would have to permit conversion value to rise somewhat higher than that—probably about 20% higher—in order to assure that a drop in the market price of the stock during the period between the call and the redemption date does not discourage voluntary conversion and force the issuer to cash out bondholders on the redemption date.

Actual issuer call practices fall short of this stockholder optimal point by a wide margin. The median issuer delays call until conversion value exceeds call price by 43.9%, a surprising result in view of issuers' assiduous reservation of the contractual right to pursue a stockholder optimal policy. One financial economist, not finding a rational explanation for this phenomenon, concluded that the comprehensive and symmetric market rationality routinely assumed by economists cannot realistically be applied to convertible bond pricing.

A lawyer might take this irrationality to infer managerial negligence, and such an inference has some empirical support. This bondholder beneficial conduct may, however, have a calculated and rational aspect in cases where the issuer expects to return to the long

40. See Brennan & Schwartz, Analyzing Convertibles, supra note 21, at 910; Ingersoll, Corporate Call Policies, supra note 35, at 464-65; Ingersoll, Contingent Claims, supra note 23, at 298-99. To the contrary, it is not optimal for the issuing corporation to call the convertible when its call price exceeds its market value. The amount paid in excess of market value would amount to a wealth transfer from the stockholders to the convertible bondholders.

41. See J. Weston & E. Brigham, supra note 20, at 599; Ingersoll, Corporate Call Policies, supra note 35, at 466-67.

42. Trust indentures specify a notice period of 30 to 60 days between the call notice and the redemption date.

43. See Ingersoll, Corporate Call Policies, supra note 35, at 466. Ingersoll based his study on all convertible bond issues called between 1968 and 1975.

44. Market rationality theory assumes that each party, firm, and investor pursues an optimal strategy and expects all others to do the same. See Brennan & Schwartz, Convertible Valuation, supra note 21, at 1701.

45. See Ingersoll, Corporate Call Policies, supra note 35, at 472.

46. See Klein, supra note 11, at 568-69.

47. Brigham, supra note 20, at 52. Brigham's study, conducted between 1961 and 1963, found that 23% of the issuers surveyed had an internal policy to force conversion with a call as soon as conversion value exceeded call price by 20%. Another 23% of the issuers surveyed reported an internal policy to encourage voluntary conversion by raising common stock dividends. The remaining 54% did not bother to formulate any defined call policy. Id.
term debt market for future financing. By letting the convertibles ride with the common as conversion value surpasses the stockholder optimal call point, the issuer signals the financial community that it is less than punctilious in its insistence on its contractual rights. Investor confidence that management will take bondholder interests into account in resolving stockholder-bondholder conflicts of interest might well redound to the issuer’s benefit in the form of lower agency costs\textsuperscript{48} for its next issue of debt securities.

The call problem illustrates the riskiness of investment in the conversion premium. According to one analyst, it is an average of six times more risky than investment in the underlying common.\textsuperscript{49} The same analyst tells us that the investors exact a high rate of return—49% annually—for bearing this risk.\textsuperscript{50} These market statistics indicate that the bargain embodied in convertible securities, although peculiar in some particulars, at bottom is sound because an efficient market correctly perceives the risk and requires a commensurately big return. This conclusion would not meet with approval in all quarters, however. Legal and financial commentators have been complaining for decades that the conversion privilege is an inherently bad deal for both investors and issuers—so bad that even market pricing mechanisms cannot mitigate the ensuing damage.\textsuperscript{51}

\textbf{B. Vulnerability—The Legal Background}

In general, the rational convertible bondholder does not exercise the conversion privilege until immediately prior to maturity. Earlier conversion is suboptimal because it fixes conversion value as an upper limit on the investment’s value and thereby sacrifices the

\textsuperscript{48} “Agency costs” are costs incurred by the principal in the agency relationship. They fall into three categories: (a) monitoring costs incurred to limit actions by the agent not in the principal’s interests; (b) bonding costs, or the costs of payments by the principal to the agent to induce the agent not to take actions harming the principal; and (c) residual loss, or the costs of any other decisions of the agent not maximizing the principal’s welfare. Jensen & Meckling, supra note 3, at 308.

\textsuperscript{49} See R. Brealey, supra note 26, at 201.

\textsuperscript{50} See id. at 199, 201. The study covered 164 convertible bond issues floated between 1948 and 1963. Id. at 195.

\textsuperscript{51} On the legal side, one finds Berle and Means attacking warrants, see A. Berle & G. Means, The Modern Corporation and Private Property 200-02 (1933), and the early Securities Exchange Commission weighing in against warrants and convertibles. See, e.g., In re Childs Co., 24 S.E.C. 85, 120-22 (1946). Professor Klein’s recent work redirects these arguments against convertibles. See Klein, supra note 11. On the financial side, numerous commentators have questioned the value of investing in convertibles. See 1 A. Dewing, supra note 2, at 268-69; B. Graham, D. Dodd & S. Cottle, supra note 7, at 601-02; Lewellen & Racette, Convertible Debt Financing, 8 J. Fin. & Quantitative Analysis 777, 784-86, 791 (1973).
conversion premium. Selling the unconverted bond, in contrast, permits the rational investor to realize on both conversion value and conversion premium prior to maturity.

There are exceptions to the rule, however. If pending actions by issuers will eliminate the bond’s conversion premium or eliminate all or part of its conversion value, then immediate conversion will be more advantageous than continued holding of the bonds. Call is one such action, and issuers usually reserve the right to take it at any time. Another issuer action—increasing the expected return on the underlying common so as to be greater than the expected return on the bonds—benefits the bondholder even while causing the premium to disappear. Still other issuer actions have the effect of diluting or destroying conversion value and thus might precipitate preemptive conversion. These diluent and destructive actions are the source of the sharpest conflicts between convertible bondholder and stockholder interests. To the extent the issuer is free to take them, the bondholders’ investment in the conversion privilege is vulnerable to recapture for the stockholders’ benefit.

The following subparts describe and critique the prevailing legal model for resolving these conflicts and allocating the risks of dilution and destruction. The discussion focuses on the analysis employed in this model, its apparent efficiency advantages, and its persistent shortcomings.

1. DILUTION, DESTRUCTION AND CLASSICAL CONTRACT LAW

A number of issuer actions can dilute or destroy conversion value and give rise to the conflicts that the legal model must resolve. Conversion value is diluted when the issuer increases the number of outstanding common shares without proportionately increasing its value. The result is a decline in the price per share of the common and, unless an adjustment is made, in conversion value. Stock splits, stock dividends, and issuer sales of additional common below market value are the best examples. Conversion value is destroyed whenever, as with a dividend, the issuer disorges assets for less than equivalent consideration. The extent of the destruction depends on

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52. Consider a bond with a conversion price of $20. The stock price has risen to $20 from $15 at the time of the bond’s original issue. If the issuer splits the common stock two-for-one, the price per share of the stock drops to $10, destroying much of the value of the conversion privilege. The issuer achieves the same result through four consecutive quarterly 25% stock dividends, assuming its value stays constant during the period. If the issuer were to mount a successful rights offering to its existing common stockholders, it also could cause the common stock price to fall to $10, provided that it priced the shares offered below $10 and sold a sufficient number.
the amount of assets disgorged. For example, a spin-off of a subsidiary containing half of an issuer’s business, halves the value of both the issuer’s equity and the convertible bondholders’ claims, yet leaves the stockholders with a substantially equivalent economic participation in two entities. The total destruction of conversion value occurs when the issuer, the underlying common, or both cease to exist altogether. This can result from a recapitalization, a merger or consolidation with another corporation, or liquidation and dissolution.

Early convertible bond contracts did not include provisions respecting such diluent and destructive actions. This omission fostered a series of cases at the turn of the century dealing with such issuer actions. The cases, still often followed today, always rejected bondholder claims to the sort of fiduciary protections granted stockholders.

In the leading case of *Parkinson v. West End Street Railway*, Judge, later Justice, Holmes characterized the conversion privilege as “an option to take the stock as it may turn out to be when the time for choice arrives.” Thus pictured, the conversion privilege

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53. A fundamental corporate change, such as the sale of all or substantially all of the issuer’s assets to another entity, similarly might partially destroy the value of the conversion privilege if carried out for less than fair consideration.


56. The turn-of-the-century corporate law system of protection against self-interested actions might have supported implied in law anti-dilution protections had the courts seen fit to grant corporate status. *See*, e.g., *Marsh, Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36-43 (1966).

57. 173 Mass. 446, 53 N.E. 891 (1899). *Parkinson* and two earlier Massachusetts cases dealing with consolidations, *Day v. Worcester N. & R.R.R.*, 151 Mass. 302, 23 N.E. 824 (1890) and *John Hancock Mut. Life Ins. Co. v. Worcester N. & R.R.R.*, 149 Mass. 214, 21 N.E. 364 (1889), recognize a limited class of situations where the conversion privilege will be enforced against the successor corporation because the consolidation is a merely formal change leaving the issuer's capital structure largely intact. According to *Buxbaum, supra* note 7, at 288, this exception no longer is accepted.

58. 173 Mass. at 448, 53 N.E. at 892.

more closely resembled the fragile unaccepted offer of contract law than the bundle of rights bound up in a share of common stock. Corporate law categorization thereby was precluded and with it the possibility of fairness scrutiny of issuer actions.

Once characterization was completed and convertibles categorized on the contract side of the line, the turn-of-the-century issuer had all but won the war. Classical contract law tended to allocate the burden of drafting an explicit provision to the party seeking to enforce the right. The courts stated that they had no business making contracts for the parties and that this approach effectuated the parties' expectations. The reasoning in the convertible bond cases fell into this mold. Since the conversion privilege imported no inherent protection against dilution, parties expecting protection explicitly would provide for it. Moreover, because the conversion privilege was a speculation, the courts inferred that the parties intended the bondholder to bear the risk of dilution and destruction. Judicial intervention to protect the conversion privilege would deprive the issuer of the necessary flexibility to initiate fundamental corporate changes.

None of this analysis stands up today. The characterization of the naked conversion privilege as a fragile option, while perfectly felicitous, is by no means inevitable. One can with equal felicity characterize the premium paid for the conversion privilege at original issue as an “equity” investment in the issuer and go on from

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60. Stockholder rights accrued only upon the holder’s acceptance of the “offer” in the time, place and manner specified therein. Pratt v. American Bell Tel. Co., 141 Mass. 225, 230, 5 N.E. 307, 311 (1886). Far from conferring stockholder rights, the conversion privilege was separate and independent from the bond, albeit physically attached to it. Hotchkiss v. National Banks, 88 U.S. (21 Wall.) 354, 357 (1874); Hills, supra note 7, at 2.

The courts did impose on the issuer an implied duty to use reasonable diligence to keep the underlying stock available for lawful issuance upon conversion pursuant to the bond contract. See Marony v. Wheeling & L.E. Ry., 33 F.2d 916, 917 (S.D.N.Y. 1929); Bratten v. Catawissa R.R., 211 Pa. 21, 25, 60 A. 319, 320 (1905).


62. See Farnsworth, Disputes over Omissions in Contracts, 68 COLUM. L. REV. 860, 862-63, 870 (1968) [hereinafter cited as Farnsworth, Omissions].


64. See Lisman v. Milwaukee, L.S. & W. Ry., 161 F. 472, 476 (E.D. Wis. 1908), aff’d per curiam, 170 F. 1020 (7th Cir.), cert. denied, 214 U.S. 520 (1909).


66. Berle found the old cases uncompelling 50 years ago, proposing that the issuer be required to “maintain the integrity” of the underlying shares. Berle, supra note 7, at 654-56. See also Keith, supra note 18, at 32-33.
there to require corporate law treatment of diluent and destructive issuer actions.

Nor would the issuer win today on the contract side of the line. Courts no longer confine themselves to classical assumptions about contract relations. Under today's neoclassical approach, the old rubric that the "court will not make a contract for the parties" gives way to the directive that the parties act in "good faith" so as not to destroy or injure the right of the other party to receive the fruits of the contract. The neoclassically inclined court seeks to effectuate the parties' expectations without a preconceived placement of the drafting burden. It assumes that both parties are equally situated so far as self-protection through drafting is concerned—the promisor can insist on an express condition just as easily as the promisee can insist on an additional express promise.67

Finally, subsequent events show that the classical courts probably incorrectly divined the parties' intentions concerning risk allocation. Investors and lawyers quickly responded to the courts' rulings by developing sophisticated bondholder protective provisions and making them the norm in convertible bond contracts. By the 1920's these anti-dilution measures contained the principal constituent elements of today's standard form provisions.68 They protect against diluent and partially destructive actions by triggering proportionate reductions in the conversion price.69 Conversion value remains unaffected by the action in question as a result. They protect against destructive events such as mergers, recapitalizations, and liquidations by creating a right to convert into the same securities or other consideration being distributed to the common stockholders in con-


68. Hills' thorough description of the provisions of the conversion instrument of the late 1920's usefully can be compared point for point with the anti-dilution provisions of the ABF's model indenture. Compare ABF COMMENTARIES, supra note 2, at 543-50 (Sample Provision § 13-6, Alternate 1), with Hills, supra note 7, at 22-38. Hills' standard provisions respecting stock splits, id. at 22, stock dividends, id. at 23-24, news issues of common stock, id. at 25-26 (conversion price formula), recapitalizations, id. at 22-23, and mergers, consolidations, asset sales and liquidations, id. at 31-35, do not differ in substance from the provisions in the model indenture. See also the forms for warrants appearing in Garner & Forsythe, supra note 18, at 286-88, app.; Keith, supra note 18, at 20-24.

69. ABF COMMENTARIES, supra note 2, at 543-57 (Sample Provision § 13-6).

A second generation standardized form of trust indenture recently appeared under the auspices of the Committee on Developments in Business Financing of the Section of Corporation, Banking and Business Law of the American Bar Association. This "Model Simplified Indenture" is billed as a "plain language" form. See Section of Corporation, Banking and Business Law, American Bar Ass'n, Model Simplified Indenture, 38 BUS. LAW. 741, 742 (1983) [hereinafter cited as Model Simplified Indenture]. The Model Simplified Indenture contains conversion provisions. Id. at 764-69 (Sample Provisions, article 10).
connection with the particular transaction. They remain the norm today.

This emphatic response implies that parties to the early bond contracts never contemplated that the conversion privilege has no protection against dilution and destruction, and that the contracts' lack of explicit protections did not compel the conclusion that the parties intended that the bondholders bear the risk. The problem may not have even occurred to the drafters, the issuers, or the holders. Even if it did occur to some or all of them, the only "intent" involved may have been a conscious decision to leave the risk unallocated.

This response also shows that the courts need not have worried about tying management's hands. The devices just described left management's hands free while simultaneously preventing transfers of value from bondholders to stockholders.

The old cases never have been judicially overruled, however. They survive not because they allocate risks in such a way as to provide the marketplace with a sound basis for issuing billions of dollars worth of bonds, but rather because the standard bond contract so effectively overrides their allocation of the risks of dilution and destruction. Consequently, decades passed before bondholders had cause to return to the courts to request that the cases and their restrictive approach be overruled.

2. EFFICIENCY ADVANTAGES OF THE CLASSICAL CONTRACT LAW APPROACH

The old cases extended an implied invitation to the marketplace to come up with its own express alternative allocation of risks. And just as the marketplace response explains the survival of the old cases, so might it also justify future adherence to them. If the standard form bond contract both efficiently allocates the risks of dilution and destruction and adequately protects the bondholders' expectations, no further supplemental or regulatory judicial action may be necessary, even under a neoclassical approach.

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70. See ABF Commentaries, supra note 2, at 528-30, 547, 549-50 (Sample Provisions §§ 13-6(C), Alternate 1 and 13-6(G), Alternate 1). See also Model Simplified Indenture, supra note 69, at 755 (Sample Provision 5.01).

Advance notice requirements provide a lesser order of protection. Like call notice provisions, these permit the holder to realize the bond's conversion value prior to consummation of the diluent or destructive action. They afford cold comfort if the conversion price exceeds the conversion value.
The turn-of-the-century cases in effect chose standard form contract terms over judge-made rules as the mode for allocating the risks of convertibility. Standard form contracts serve the same risk-allocating functions with respect to some publicly-traded securities that contract law gap-filling rules and judge-made and statutory provisions of corporate law do with respect to others. Standard forms save costs by filling in terms of the relationship when *sui generis* negotiation is too expensive, and by facilitating efficient market pricing. On the latter point, consider the case of bonds. If traders safely can assume that known standard provisions govern each bond, they can value the bond based on a smaller and more manageable set of variables without inspecting the contract governing the particular issue. 71

Standard form anti-dilution provisions doubtless have performed these risk-allocating functions as efficiently as judge-made rules would have done. Indeed, there are many reasons to conclude that the contractual mode is the more efficient choice. Development of a precise system of corporate law anti-dilution rules might very well have been difficult and costly as courts took the time to choose between competing anti-dilution theories. In contrast, contractual anti-dilution provisions have proved comparatively inexpensive. Most of the costs of their development were incurred prior to 1929, and the marketplace has been reaping positive returns on the investment ever since, as the corporate bar has merely used the same form over and over again. A few material changes in the form have been introduced gradually, 72 and only a minimal amount of litigation respecting the form has been reported. 73

Today’s standard form bond contract apparently continues to save costs. It achieves a degree of clarity and certainty which approaches that of a statutory scheme and which a corporate law anti-dilution system, whether based on arbitrary line-drawing or on judicial intuitions of fairness, could not equal. The American Bar Foun-

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72. The principal changes are discussed infra notes 76, 111, 170, and text accompanying note 86.

73. See Hills, supra note 7, at 1. According to Hills, 30 cases concerning the conversion privilege were reported during the period 1860-1880, and another 30 cases during the period 1880-1930. Research done in connection with the preparation of this Article suggests that less than 30 such cases have reached appellate courts since 1930 (excluding tax cases and cases raising issues only under the federal securities laws).
dation’s readily available Model Indenture precisely “restates” the standard form. A high degree of uniformity exists among the provisions governing different issues of bonds, as was shown by a survey of trust indentures covering convertible bonds first issued and sold between October 1, 1981 and September 30, 1982, made in connection with the preparation of this Article.

The history of standard anti-dilution provisions shows that the form also has been responsive to shifting market conditions. The standard provisions draw fine lines between stockholder and bondholder interests, some of which have been redrawn as views on the overall function of anti-dilution provisions have changed. Such developments show that the marketplace actors who generate these standard risk allocations, whether they be issuers, market traders, or market intermediaries such as underwriters and corporate lawyers, can arrive at precise and well-considered answers to anti-dilution questions, despite standardization.

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74. See supra note 69.

75. Forty-six trust indentures were surveyed, covering convertible bonds publicly issued between October 1, 1981 and September 30, 1982. To cite one example of their uniformity, 43 of the 46 contained “market price” clauses covering subsequent issues of common stock.

76. For example, during the last 25 years the once universal “conversion price” clause covering new issues of common stock and rights to acquire common stock has almost entirely disappeared from public issue bond contracts to be replaced by a “market price” clause covering a smaller class of transactions.

The discarded “conversion price” formula provided for downward adjustment of the conversion price whenever stock was sold below the conversion price. For further explanation, see ABF Commentaries, supra note 2, at 530-31. This approach reflected the financial community’s original conception of the conversion privilege as an option on a specified proportion of the issuer’s earnings. See Kaplan, supra note 7, at 18 n.27. This percentage ownership concept went into eclipse in the 1950’s and 1960’s and was replaced by two distinct notions. The first was that what needed protection in convertible bond contracts was not a percentage ownership claim but the current market level of conversion value and conversion premium. The second notion was that anti-dilution provisions should operate only when stockholders receive a benefit at the bondholders’ expense, and that otherwise there should be parity of treatment. Id. at 20, 21 n.31. “Market price” anti-dilution clauses followed from these notions. At their narrowest, market price clauses provide for downward adjustment of the conversion price only in response to below market offerings of new stock and rights to existing common stockholders. For further explanation, see ABF Commentaries, supra note 2, at 532-33. See also Model Simplified Indenture, supra note 69, at 766 (Sample Provision 10.07); Kaplan, Some Further Comments on Anti-Dilution Clauses, 23 Bus. Law. 893 (1968).

In the survey undertaken in connection with the preparation of this Article, all but five of the trust indentures contained the market price formula in the narrow version. See supra note 75.


77. Some changes in the drafting of convertible bond contracts clearly have stemmed from investor demands on underwriters for additional protection. See N.Y. Times,
Finally, being contract terms, standard form provisions can respond to the aberrant case more flexibly than can judge-made and statutory provisions. Indeed, anti-dilution protection can be quite sensitive to exercises of bargaining power. In a heavily negotiated private placement of convertible bonds, the holder's bargaining strength might be manifested by anti-dilution provisions offering less flexibility to the issuer than the "standard" scheme.

If, indeed, standard form contracting protects convertible bondholder interests and allocates risks of dilution and destruction more efficiently than common law processes would have done, then standard anti-dilution provisions probably would have come into existence even if the early courts had been more interventionist. Judge-made bondholder protective rules need not, and probably would not, have been formulated as unwaivable rules entirely grounded in fiduciary concepts of fairness. They more likely would have functioned as equitable gap-fillers, subject to variation by agreement. Given the usual uncertainties which attend the development of judicial rules, the marketplace would have found it cost effective to force the judge-made rules to yield to its own more precise formulations. In sum, classical judicial restraint and the marketplace contracting process have interacted with apparent success to allocate the risks of dilution and destruction. The burden to justify judicial intervention is correspondingly high.

3. SHORTCOMINGS OF THE CLASSICAL CONTRACT LAW APPROACH — RESIDUAL RISKS OF DILUTION AND DESTRUCTION

Under the classical approach, the drafter who wants to prevent a given risk of dilution or destruction from being automatically allo-

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supra note 38, § 3, at 10, col. 1, concerning the rapid standardization of two year call prohibitions in response to investor pressure. In the case of the transition from conversion to market price formula, discussed supra note 76, the impetus for change could just as easily have come from market intermediaries and changes in their notions of reasonableness and fairness as from the exercise of economic power between buyers and sellers.

78. Private placements of debt securities tend to take place among medium and small sized issuers and institutional investors, such as insurance companies and pension funds, sufficiently large and sophisticated to appraise the risks entailed. See generally V. Brudney & M. Chirelstein, supra note 2, at 121-22.

79. For example, destructive actions such as mergers and liquidations could be prohibited entirely. An eminent law firm recommends that anti-dilution clauses in private placements forbid triangular mergers where neither the surviving corporation nor its ultimate parent is publicly traded. Debevoise, Plimpton, Lyons & Gates, Investments in Warrants and Convertibles 17 (June 11, 1980) [hereinafter cited as Debevoise, Plimpton, Investments in Convertibles].

cated to the bondholders must foresee, identify, and deal with the risk explicitly. This is a considerable task, since any change in the issuer’s equity structure, asset base, or identity creates a risk of dilution or destruction. Whatever its efficiency advantages, today’s standard public-issue form does not attain this ideal of a complete contingent contract. It covers the most likely contingencies and many unlikely contingencies as well, but it neither covers all foreseeable types of diluent or destructive action, nor provides explicit instructions for treatment of all of the variant situations which can arise respecting issuer actions that are covered. Any one of these untreated residual contingencies can seriously erode the value of the conversion privilege. Not surprisingly, much of the last decade’s convertible bond litigation has concerned these residual risks. A few examples of these risks follow.

Included among the residual risks is the creation of a new class of preferred stock, and its offer on a rights basis to existing common stockholders on attractive terms. The higher the dividend rate on the new preferred, the greater the diminution in value of the common stock and, hence, of the conversion privilege. The standard form’s failure to include a clause dealing with this device is surprising and commentators have flagged the dangers of the omission.

Another diluent device, not anticipated until recently by the standard form, is the spin-off of the stock of subsidiaries, which became popular after World War II. Spin-offs hold out the possibility of substantial or total destruction of conversion value, depending on the size of the subsidiary spun off. Yet even in the early 1970’s

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81. See infra notes 88-92 and accompanying text.

82. See Kaplan, supra note 7, at 17-18. While the anti-dilution provisions in the ABF’s model indenture fail to pick up burdensome preferred, they easily could be adjusted to do so through extension of the definitions of “Common Stock” and “Additional Stock” to cover designated new issues of preferred. See ABF COMMENTARIES, supra note 2, at 541, 544-45, 550-51 (Sample Provisions §§ 13-1 and 13-6, Alternates 1 and 2).


The device has been used with devastating effectiveness to impair the value of issues of preferred stock. See Barrett v. Denver Tramway Corp., 53 F. Supp. 198 (D. Del. 1943), aff’d, 146 F. 2d 701 (3d Cir. 1944) (creation of senior issue of preferred stock exchangeable for existing preferred as device to eliminate existing preferred’s dividend arrearages).

many anti-dilution provisions made no mention of spin-offs.\textsuperscript{85} The financial community and corporate bar have since apparently become fully aware of this risk and have determined that the bondholders should not bear it. All of the recent anti-dilution provisions surveyed in connection with the preparation of this Article provided for conversion price adjustments in respect to spin-offs.\textsuperscript{86}

Other residual risks arise when standard contract language is applied to cases coming within its literal scope, but not foreseen in all particulars by the original drafter.\textsuperscript{87} The application of standard merger language in the context of a cash out merger provides an example. The language was first formulated in the 1920's, and continues to be used today in substantially similar form.\textsuperscript{88} It provides a right to convert the bond “into the kind and amount of stock, securities or assets receivable upon such . . . merger . . . by a holder of the number of shares of Common Stock into which such [bond] might have been converted immediately prior to such . . . merger . . . .”\textsuperscript{89} Literal application of this language in the case of a cash out merger freezes the value of the conversion privilege and destroys its upside growth potential. This question of contract interpretation was the subject of the \textit{Broad v. Rockwell International Corp.}\textsuperscript{90} litigation and is dealt with in detail below.\textsuperscript{91}

The standard form’s limitations and the resulting residual risks have not escaped the notice of the corporate bar. The bar has devised the so-called “good faith” anti-dilution provision, designed to dispose of the entire problem. This provision catches all actions not otherwise covered which “materially and adversely affect the conversion rights of the . . . holders,”\textsuperscript{92} thereby shifting the residual

\textsuperscript{85} See 1 \textsc{Value Line Convertible Bond Serv.} 3 (Dec. 9, 1968). Resulting litigation is discussed infra notes 101-26.

\textsuperscript{86} See supra note 75. Examples of anti-dilution provisions fully covering spin-offs can be found in \textsc{ABF Commentaries}, supra note 2, at 553 (Sample Provision § 13-6(C), Alternate 3) and in the \textit{Model Simplified Indenture}, supra note 69, at 766-67 (Sample Provision 10.08).

\textsuperscript{87} See also infra note 99 and accompanying text.

\textsuperscript{88} See Hills, supra note 7, at 35.

\textsuperscript{89} \textsc{ABF Commentaries}, supra note 2, at 550 (Sample Provision § 13-8(G), Alternate 1). See also \textit{Model Simplified Indenture}, supra note 69, at 755 (Sample Provision 5.01).

\textsuperscript{90} 614 F.2d 418 (5th Cir. 1980), vacated, 642 F.2d 929 (5th Cir.) (en banc), cert. denied, 454 U.S. 985 (1981).

\textsuperscript{91} See infra note 103 and accompanying text.

\textsuperscript{92} Kaplan, supra note 7, at 18 n.27 (quoting provision from trust indenture). One law firm comments that “This [type of provision] may seem like lazy lawyering, but in an area as complex as this we believe such a provision is the better part of discretion.” Debevoise, Plimpton, Investments in Convertibles, supra note 79, at 17.
risk from the bondholders to the issuer, and overriding the results of the turn-of-the-century cases.

The good faith clause has not found its way into the standard form, however. Thus, the door remains open to judicial intervention for the protection of bondholders in the convertible bond context.

II. JUDICIAL INTERVENTION IN THE CONVERTIBLE BOND RELATIONSHIP—THE VEHICLE OF INTERPRETATION

This Article now turns to the question of whether some expectations arising from the convertible bond relationship, although unprotected in the bond contract, are important enough to justify judicial intervention. The analysis is divided into two parts. The first part sets forth the doctrinal framework for intervention—neoclassically expanded contract interpretation. The following part considers the appropriate judicial allocation of the risks respecting convertible bonds, centering upon the operation of the bond market, and its place in shaping and limiting the expectations of issuers and holders.

A. Interpretation and Intervention

Judicial intervention into contractual relationships often occurs within the doctrinal framework of contract interpretation. When a contract is ambiguous, the court called upon to enforce it must intervene to clarify the meaning of its terms or to fill in such terms as the parties failed to include. The degree of judicial intervention varies with the situation. The more ambiguous the contractual language, the more the court must serve as the relationship’s law giver.

In making protection of the parties’ expectations the goal of the interpretive process, contract law tries to let the parties define the fair result for themselves and to limit judicial intervention. But such limited intervention is not always possible. In some cases neither text nor context provides a reliable indicator of the parties’ expectations, leaving to the court the entire job of formulating law for the relationship. Here a court might impose its own conception of fairness by finding the result which best preserves equivalence in

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94. For a definition of fairness keyed to the parties’ expectations, see Anderson, supra note 1, at 746 n.25.
the values exchanged by the parties. Or it might subordinate the merits as between the particular parties and look for the most efficient result. On this latter level of inquiry, minimal future transaction cost and maximal marketplace certainty are paramount considerations.

The degree of intervention also varies with the court's doctrinal approach to interpretation. Classical contract doctrine tends to confine the court to linguistic, structural, and textual analysis bounded by the "four corners of the document." Neoclassical analysis, based on the insight that texts do not have immutable meanings, is more expansive. It bids the court to consider the entire circumstances of the relationship to assure selection of the meaning most consonant with the parties' expectations. Through freely interpolated good faith duties, neoclassical interpretation also brings ethical restraints to bear on self-interested conduct damaging to the interests of other parties to the contract.

Courts tend to draw on classical contract law principles when interpreting bond contracts. They assume that each clause of an exhaustively drafted document, such as a bond contract, embodies an exact allocation of risk. As a result they tend to interpret bond contracts in search of a hidden, true meaning to be found by applying the correct, classical interpretive calculus. But these judicial perceptions are inaccurate. A limited classical approach to bond contract interpretation often fails to protect some of the expectations at stake.

Issuer and bondholder expectations do not coalesce around an easily ascertainable standard usage in every case. Even all the lawyerly care lavished on the standard form trust indenture does not guarantee the absence of vagueness and ambiguity. In addition,
possibilities for error abound whenever the standard form is modified to suit the requirements of a particular transaction. Such errors easily can create situations in which a classical interpretation, based on standard English usage or the document’s apparent regulatory scheme, does not accord with the market’s expectations concerning the contract’s meaning.\textsuperscript{100}

Similar variances can arise in routine transactions when unforeseen events come within the literal scope of long-standing standard language. Such a situation arose in \textit{Broad v. Rockwell International Corp.}\textsuperscript{101} and a number of similar convertible bond cases.\textsuperscript{102} In these cases involving cash mergers, issuers applied the standard anti-dilution provision for carry over conversion rights in mergers so as to limit the bondholders’ future conversion rights to the amount of the cash consideration offered in the merger. The issue was whether the cash was “other property” within the meaning of a standard clause providing for carry over conversion rights into the “stock, securities or other property” receivable in the merger by the underlying common.\textsuperscript{103} Under one standard usage, “property” includes “cash.”

\begin{itemize}
\item \textsuperscript{100} See, e.g., Harris v. Union Elec. Co., 622 S.W.2d 239 (Mo. App. 1981).
\item \textsuperscript{101} 614 F.2d 418 (5th Cir. 1980), vacated, 642 F.2d 929 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981).
\item B.S.F. Co. v. Philadelphia Nat’l Bank, 42 Del. Ch. 106, 204 A.2d 746 (Sup. Ct. 1964), concerned the sale for cash of 75% of the assets of an issuer of convertible bonds. The purchaser of the assets did not grant conversion rights into its stock, even though the trust indenture provided that in case of a sale of assets or merger the bonds would be convertible into common shares of the issuer or common shares of the acquiring company. The court held that this language was unambiguous, and would apply only in a case where stock of the purchaser was consideration for the assets. The court reasoned that since the issuer added the cash consideration to its asset base, and the bondholder could participate in it by converting into common stock, the transaction did not prejudice the holder. \textit{Id.} at 750-52.
\item The court’s analysis must be questioned. The language also could be read to require a choice of conversion into the issuer’s or purchaser’s stock. Moreover, if all of the assets with upside potential were sold for cash and the cash remaining after provision for payment of the bonds transferred to the stockholders by means of a dividend, then the bondholders in effect would have been deprived of most of their conversion value. On the other hand, if the cash were reinvested in equities or some other volatile asset, then the bondholders really would not have any cause to complain. Given the lack of clarity and the bondholders’ vulnerability, the court appropriately could have decided the case in their favor.
\item Another issue of interpretation presented in \textit{B.S.F. Co.} is discussed in \textit{Bratton, supra} note 93, at 386-87.
\item 614 F.2d 418 (5th Cir. 1980), vacated, 642 F.2d 929 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981). The trust indenture in \textit{Broad} provided for the right to “convert
The *Broad II*\(^{104}\) court so held, taking a rigidly classical approach based on the "plain meaning"\(^{105}\) of the language read within the confines of the document.

Consideration of the origin of the language at issue in *Broad II* shows that rigid adherence to standard usage readings led the court to overlook inherent vagueness and ambiguity in bond contract language. The language in question was first formulated in the 1920's, at about the time that Florida became the first state to permit cash mergers.\(^{106}\) It was many years, however, before cash consideration statutes achieved general application. Although California followed Florida in 1931,\(^ {107}\) it was not until 1961 and 1967, respectively, that New York and Delaware followed suit.\(^ {108}\) At the time the trust indenture in *Broad II* was executed in 1967, the issuer's state of incorporation, Iowa, did not provide for cash mergers.\(^ {109}\)

Since, for all intents and purposes, cash out mergers did not exist in the 1920's,\(^ {110}\) the anti-dilution language in *Broad II* could not originally have been formulated with a cash out merger in mind. Of course, the current form of the language...
course, it reasonably might be inferred from the language's verbatim survival for five decades, from the gradual proliferation of the cash out merger, and from expectations of literalistic judicial interpretation, that the language survives unmodified because of a conscious allocation of the cash out merger risk to the bondholders. But it just as reasonably might be inferred that the standard form's failure specifically to mention cash out mergers reflects decades of thoughtless use of the same form. Even today, cash consideration is only beginning to be mentioned in the merger clauses of standard anti-dilution provisions.111

Another well-known convertible bond case, Harff v. Ker-korian,112 also shows the potential for extensive judicial intervention. There a group of convertible bondholders unsuccessfully challenged113 a large cash dividend as a breach of fiduciary duty. The case might better have been characterized as one of contract interpretation. The governing contract, unlike the standard contract being drafted today,114 contained no explicit provision covering cash dividends. Thus viewed, Harff is a garden variety "omitted term" case in which interpretation shows only that the parties failed to provide any contract term relevant to their dispute.115 On this anal-

111. The modifications reinforce the Broad II result by adding cash as a type of "other property." Approximately half of the indentures surveyed in connection with the preparation of this Article, see supra note 75, included a modified version of the language at issue in Broad. The most popular technique is addition of the phrase "or cash" after the phrase "other property."


113. The Chancery granted a motion to dismiss on the grounds that no fiduciary duty obtained, and that the bondholders in any event assumed the risk of an issuer dividend policy designed to destroy conversion value. 324 A.2d at 219, 222. The Delaware Supreme Court reversed, looking again at the complaint and construing it to allege "fraud." Both courts agreed that a "fraudulent" dividend was actionable by the bondholders. Unfortunately, neither attempted precisely to explain the concept of fraud intended. Since the possible meanings of "fraud" in the Harff context range from a traditional misrepresentation, through fraud on creditors, to a constructive fraud close in nature to the breach of a corporate duty of loyalty, the Harff opinions remain difficult to decipher.

114. Of the 46 indentures surveyed for this Article, see supra note 75, 35 permit cash dividends out of surplus without adjustment, while 11 permit all cash dividends without adjustment. Forty-four of the 46 provide pro rata adjustments for spin-offs and other distributions in kind.

The relevant provisions of the Model Indenture are §§ 13-6(B)(3), Alternate 1 and 13-6(C), Alternate 1. ABF Commentaries, supra note 2, at 546, 547. See also Model Simplified Indenture, supra note 69, at 766-67 (Sample Provision 10.08).

115. Restatement (Second) of Contracts § 204 (1981) provides: "When the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court." For discussion of this provision, see Speidel, Restatement Second: Omitted Terms and Contract Method, 67 Cornell L. Rev. 785 (1982).
ysis, no doctrinal barrier prevented the *Harff* court from filling the gap with a term protecting the bondholders.

The courts' normally safe assumption that standard bond contract provisions reflect exact allocations of risk proved to be unsafe in both *Broad II* and *Harff*. Much of the justification for interpretation based on standard usage readings and internal structural analysis disappears along with that assumption.

As the inquiry in such cases is opened to encompass circumstances from outside the four corners of the document, it becomes more difficult to justify any one meaning as "plainly" advancing the parties' expectations. Consider the evidence presented above regarding the meaning of the language at issue in *Broad II*. It permits conflicting inferences to be drawn, so that it cannot be said that one meaning more probably protects expectations. To resolve such a case, the court must intervene on the basis of external, substantive considerations, either ethical or economic.

116. Of course, if inquiry into the circumstances produces evidence that a given meaning in fact is attached by the parties, that meaning should prevail. For consideration of the case where the bondholders attach one meaning and the issuer a different meaning, see *Bratton*, supra note 93, at 376-77.

117. Cf. *Broenen v. Beaunit Corp.*, 440 F.2d 1244 (7th Cir. 1970), which concerned the same anti-dilution provisions as *Broad*. The case involved a triangular merger. Literally applied, the standard form merger language was adverse to the holders' tax interests. *Id.* at 1245-46.

Here, as in *Broad*, the standard language applies without apparent ambiguity or vagueness when construed within the four corners of the document. But here consideration of the entire circumstances reinforces the conclusion in favor of the issuer. These bondholders, unlike those in *Broad*, retained an unimpaired equity participation in the combined entity. Moreover, the tax risks at issue customarily are allocated by means of explicit representations, opinions of counsel and other similar devices. The standard public convertible bond transaction lacks these tax trappings. And since so many standard and mass produced tax transactions exist, even uninformed investors would be unlikely to form expectations of issuer responsibility for tax results concerning the bonds.

If the contract itself did not provide an answer in this case and the question were open to judicial intervention, bondholder protection might make a great deal of sense. This merger's structure entirely serves the parent's interests; triangular mergers result in significant cost savings, here obtained at the expense of an adverse tax result for the bondholders. For another case distinguishable from *Broad* as a matter of interpretation, see *Prescott, Ball & Turben v. LTV Corp.*, 531 F. Supp. 213 (S.D.N.Y. 1981).

This is not to say that extrinsic evidence of the history of the standard form or the market's understanding of the language in question always is persuasive. For an instance in which an interpretation within the four corners of the document properly was held to outweigh an interpretation with outside backing, see *Wood v. Coastal States Gas Corp.*, 401 A.2d 932, 939-40 (Del. 1979). See also *Judah v. Delaware Trust Co.*, 378 A.2d 624, 630 (Del. 1977) (preferred stock of Shanghai Power & Light), for effective use of extrinsic evidence.

118. This is the process traditionally called "construction." The *Broad II* court recognized its necessity, at least *sub silentio*. The "plain meaning" veneer in *Broad II* masked the substantive judgment that the holders "got what they paid for." And the court followed its interpretive ruling with an unnecessary defense of the ruling's factual fairness.
Some recent interpretation cases dealing with the residual risks of dilution and destruction reached this level of substantive discussion only to make pointed citations to Parkinson v. West End Street Railway\(^{119}\) and reaffirm allocation of the drafting burden to the bondholder. The cases took this approach even while paying all due obeisance to the notion that good faith duties apply to all promisors.\(^{120}\) Their analysis centered upon both the expectations of convertible bondholders and issuers and the needs of the bond market.\(^{121}\) As to expectations, the courts reasoned that bondholders make a "knowledgeable gamble" from an equal bargaining position\(^{122}\) and bear only the risks they pay to bear. As for the market, certain and consistent constructions are essential to its smooth operation. Staying with the classical approach preserves these expectations and keeps bond contracts out of the hands of unpredictable juries.\(^{123}\)

This continued classicism regarding convertibles accords with the courts' traditional treatment of all debt securities, providing no rights other than those expressed in the contract.\(^{124}\) From a broader perspective, one perceives a judicial tendency to leave the classical allocation of the drafting burden in place in contract contexts in-

\(^{956-57}\). Other gratuitous discussions of the equities appear in Wood v. Coastal States Gas Corp., 401 A.2d 932, 942 (Del. 1979) (dilution of convertible preferred stock by spin-off); and B.S.F. Co. v. Philadelphia Nat'l Bank, 42 Del. Ch. 106, 204 A.2d 746 (Sup. Ct. 1964) (dilution of convertible bond by sale of substantially all assets).


\(^{123}\). This is the Broad II view, 642 F.2d at 947-48 n.20.


volving large amounts of money and parties sophisticated in business and finance. 125

A small but growing body of case law reverses the classical presumption, invoking good faith notions to place the drafting burden on the convertible bond issuer where its actions benefit the stockholders by diminishing the value of the conversion privilege. This is done without a great deal of explication. At best, the courts tell us that the good faith duty protects the parties' expectations in the fruits of the contract, and the issuer action in question deprives the bondholders of those fruits. 126

All of these opinions rest on judicial intuitions concerning fairness and efficiency. These in turn rest on fragmentary pictures of the relationship created by the convertible bond contract. Indeed, the emergence of conflicting judicial approaches hardly comes as a surprise. The relationship is complex enough to yield substantial justifications for both approaches. A more coherent judicial allocation of risks requires a more thorough understanding of the entire circumstances of the contractual relation. The following subpart provides this.

B. A New Look at Judicial Allocation of the Risks of Convertible Bondholding

As previously discussed, neoclassical interpretation under the good faith rubric permits, but does not compel, creation of a common law of bondholder protection for cases where the bond contract

125. See Berman, Excuse for Nonperformance in the Light of Contract Practices in International Trade, 63 COLUM. L. REV. 1413, 1416-17 (1963); Farnsworth, Omissions, supra note 62, at 884-86.


This good faith strain has shown up clearly only in the last decade or so. Even so, a few older cases incline toward placement of the drafting burden on the issuer. See, e.g., Merritt, Chapman & Scott Corp. v. New York Trust Co., 184 F.2d 954 (2d Cir. 1950); Mueller v. Howard Aircraft Corp., 329 Ill. App. 203, 70 N.E.2d 203 (1946). (Since Merritt was decided, the financial community has developed unambiguous standard terms covering stock dividends, see ABF COMMENTARIES, supra note 2, at 546 (Sample Provision § 13-6(B)(3), Alternate 1), and has made it clear that anti-dilution protection protects the underlying shares' economic value and does not insure a percentage of the total number of underlying shares.) See also Stephenson v. Plastics Corp. of America, 276 Minn. 400, 150 N.W. 2d 668 (1967) (spin-off). Cf. Carey v. Rothman, 55 Wis. 2d 732, 200 N.W. 2d 591 (1972) (employee stock option; creation of holding company).
fails clearly to allocate all risks. This subpart takes up the resulting question of whether such judicial intervention is morally and economically justified in the circumstances of the convertible bond relationship. To this end, it draws a detailed picture of the expectations of the disparate group of investors in convertible bonds, focusing on their informational sophistication respecting residual risks of dilution and destruction and its relationship to the market pricing of bonds. The effects of judicial intervention on the costs of drafting bond contracts, as well as the costs of pricing and trading bonds are considered. This subpart concludes that Parkinson\textsuperscript{127} now safely can be overruled and the drafting burden placed on the issuer, at least in cases where the bondholder can be afforded relief through adjustment of the conversion price or transfer of the conversion privilege to the common stock of a successor issuer.\textsuperscript{128}

1. BONDHOLDER EXPECTATIONS AND BONDHOLDER INFORMATION LEVELS

Some legal commentators characterize the bond investor as one who makes investment decisions based on six or seven standard features conveniently summarized by a financial service like Moody's Bond Survey, without scrutinizing other matters pertaining to the bond contract.\textsuperscript{129} Such an investor makes decisions in ignorance or conscious disregard of the existence of the residual risks of dilution and destruction. Even an investor who checks the prospectus\textsuperscript{130} of

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\textsuperscript{127} Parkinson v. West End St. Ry., 173 Mass. 446, 53 N.E. 891 (1899). See supra note 57 and accompanying text.

\textsuperscript{128} Thus, the presumption would not give the bondholders a right to block a liquidation which is to be followed by a dissolution. Short of forcing the issuer to stay in business or awarding speculative damages based on the deprivation of “upside” participation in future equity, complete relief is afforded in a dissolution by the standard anti-dilution provision’s pro rata right to convert into whatever the stockholders receive in the dissolution proceedings.

It should be noted that only a rule of construction is proposed. To the extent that the bond contract expressly and clearly puts all or part of the risk of dilution or destruction on the bondholders, the presumption does not operate.

The question whether the courts ever justifiably might override an explicit allocation of risk to the bondholders in the context of a publicly traded bond is treated infra notes 186-259 and accompanying text.


\textsuperscript{130} Mandatory disclosure of the existence of the residual risks at least might ameliorate this investor ignorance. Yet neither the Securities Exchange Commission nor the New York Stock Exchange requires such disclosure. The survey of prospectuses respecting converts newly issued between October 1, 1981 and September 30, 1982 done in connection with the preparation of this Article shows that a uniform practice prevails. The anti-dilution provisions are accurately, but literally, summarized in the main body of the prospectus. Their
an issue, will find no warnings of residual risks and will indeed be surprised when a merger impairs conversion value six months later. This investor ignorance of the residual risks implies investor expectations that the conversion privilege purchased with the bonds will survive for their full term.

Services and handbooks directed to prospective convertible bond investors support this picture of investor expectation. They caution the investor to check the call provisions and to check that the bond contract contains standard anti-dilution provisions, but they do not warn the investor of the shortcomings shared by all standard provisions.131

The financial economic literature also fits this picture. In concocting theoretical valuation models for convertibles, financial economists tend either to ignore residual risks of dilution and destruction entirely or, while recognizing their relevance, nonetheless find them unsuited to their models.132

import with respect to risk allocation, however, is not discussed. As a result, the prospectus, taken alone, dispels no misconceptions concerning the scope of anti-dilution protection.

For criticism of the descriptions of anti-dilution provisions contained in prospectuses, see Kaplan, supra note 7, at 27 & n.37; 12 VALUE LINE CONVERTIBLES 105 (Sept. 21, 1981).

The New York Stock Exchange’s listing requirements, although requiring that notice of expiration of conversion rights prior to maturity be placed on the bond, New York Stock Exchange Company Manual § A12(I), do not require notice of possibilities of dilution and destruction.

131. Graham, Dodd and Cottle’s classic text for analysts recommends a check to make sure anti-dilution provisions are included in the trust indenture. The text goes no farther than that in detailing risks of dilution and destruction. See B. GRAHAM, D. DODD & S. COTTLE, supra note 7, at 615. T. NODDINGS, THE DOW JONES-IRWIN GUIDE TO CONVERTIBLE SECURITIES 10 (1973), goes a few steps further.

Value Line Convertibles, which describes itself as the all-in-one service for convertibles and warrants, publishes bi-weekly a table describing all publicly traded convertible bonds. One item covered is anti-dilution protection. Most issues are designated as having “full protection.” But “full protection” means only that the bonds are subject to anti-dilution provisions fully adjusting for stock splits and stock dividends. See 3 VALUE LINE CONVERTIBLE SURV. 203, 204 (June 19, 1972).

Finally, Moody’s Bond Survey analyzes new issues as they appear, without noting residual anti-dilution risks. See, e.g., 73 MOODY’S BOND SURV. 603, 646, 699, 760, 761, 763, 769, 805, 826 (1981).

132. See Jennings, supra note 23, at 34, and Weil, Segall & Green, supra note 23, at 446, 448, for studies which recognize the risk but leave it out of the model.

The more recent “contingent claims” valuation studies, see supra note 28, ignore the risks entirely. See, e.g., Brennan & Schwartz, Analyzing Convertibles, supra note 21, at 913-14, 924-25.

Of course, theoretical valuation models are based on perfect markets assumptions which do not obtain in the real world. See, e.g., Ingersoll, Contingent Claims, supra note 23, at 292-93. The models nevertheless are relevant evidence. Despite their theoretical character economists devise them with an eye towards real world usefulness. Cf. Brennan & Schwartz, Analyzing Convertibles, supra note 21, at 907-08 (extending theory to cover more complex real
The picture's accuracy is further supported by the results of an elaborate empirical study of the variables affecting convertible bond premiums. The study suggests that convertible bond prices are insensitive to variations in the degree of anti-dilution protection. Other more casual observers make the same point. Similarly, market professionals—underwriters, brokers and traders responding to a questionnaire distributed in connection with another study—reported that a substantial number of investors buy convertibles without understanding even their fundamental investment characteristics.

Not all investors lack knowledge of the existence of residual risks, however. The investor who regularly reads a special convertible bond reporting service like Value Line should be well aware of the limited protection afforded by standard bond contract provisions. Value Line provides reports on diluent and destructive issuer actions such as calls, stock dividends, recapitalizations and cash out mergers, and occasionally runs pieces explaining anti-dilution provisions in detail thus warning investors of their limitations. The existence of Value Line and its $300 plus annual subscription price fairly imply the existence of a class of well-informed investors in convertibles.

This does not imply that such a class makes all bond investment decisions with complete knowledge, however. Even a sophisticated investor rationally might determine that the costs of ascertaining and evaluating the residual risks exceed the benefits accruing in the form of a more accurate valuation.

Moreover, even if an investor does know that residual risks exist, it does not automatically follow that the investor's expectations perfectly accord with actual rights under the bond contract. The investment community becomes aware of some latent residual risks only as events point to their existence. Value Line, for example, had to modify and expand its coverage of the residual risks to account

world conditions); Ingersoll, Corporate Call Policies, supra note 35 (modifying model to cover observed suboptimal call policies).
133. Jennings, supra note 23, at 34.
134. See Kaplan, supra note 7, at 27-28. Kaplan, upon inquiry made to market professionals, found that the market made no apparent pricing distinctions between issues with conversion price-based and market price-based anti-dilution clauses.
136. See 12 VALUE LINE CONVERTIBLES 105 (Sept. 21, 1981); 3 VALUE LINE CONVERTIBLE SURV. 201 (June 19, 1972); 1 VALUE LINE CONVERTIBLE BOND SERV., 1 (Dec. 9, 1968).
for new developments respecting mergers. Its commentary on dilution problems around 1970 either ignored mergers or noted the possibility that a merger might adversely affect the conversion premium. 137 In the mid-1970's, however, a number of cash out mergers occurred which destroyed the value of outstanding warrants and thereby demonstrated the vulnerability of convertibles. Value Line and other commentators 138 asserted that the allocation of the risk of cash out mergers to the holders was unjustified. It demanded that "investor confidence be restored" and "the . . . stock exchanges . . . take the initiative and make full protection a condition for listing." 139 The stock exchanges and the drafters of new trust inden­tures never met these demands, however, and by 1980 Value Line was content to note only the existence of the merger risk and to recom­mend that bondholders pay close attention to pending takeovers and mergers. 140

The foregoing evidence permits a rough differentiation of bondholders into groups according to their levels of informational sophis­tication. The best informed investors go into the first group. These investors, although not necessarily conscious of all remote diluent and destructive contingencies, at least know that the class of risks exists. For purposes of contractual fairness analysis, these bondholders’ expectations are qualified by knowledge of the residual risks.

Occupying a middle level are investors well-informed enough to know of the more obvious risks placed on the holder by the bond contract, such as call and subordination to other indebtedness. These holders incur some costs in monitoring for bond contract risks, but they are unaware of the residual risks. To the extent that they are at all aware of the possibility of dilution and destruction, they assume that the issuers bear the risk.

At the bottom are investors in over their heads. These investors are entirely unaware of standard bond contract provisions, such as call rights, which make investment in the conversion privilege an especially risky venture. These investors also are unaware of the special need for monitoring investments in convertibles.

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137. See Value Line Convertible Bond Serv. 1, 3 (Dec. 9, 1968); 2 Value Line Convertible Surv. 289 (Mar. 22, 1971).
139. 5 Value Line Convertible Surv. 265, 268 (Apr. 15, 1974). See also 3 id. at 381 (Jan. 1, 1973).
140. 11 Value Line Options & Convertibles 105, 108 (Sept. 15, 1980).
The corporate lawyers who draft convertible bond contracts and, presumably, the underwriters and issuers they represent, also can be differentiated according to their respective levels of informational sophistication. Information concerning residual risks is readily available to anyone in the corporate bar or the financial community prepared to listen. Yet the bar and the financial community continue to use a standard form that fails to allocate these risks.

The “good faith” clauses discussed above\(^\text{141}\) could remedy the residual risk problem by placing such risks on the issuer. But such clauses did not appear in any of the trust indentures surveyed for this Article. A minority of counsel did modify the standard form, but did so to place all residual risks clearly on the bondholders. Twenty-five per cent of the indentures surveyed provide that no anti-dilution adjustments may be made except as explicitly required by the anti-dilution provisions.\(^\text{142}\) Given the straightforward drafting choice that residual risks thus present, it must be inferred that most trust indentures either are mindlessly marked up by drafters unaware of the form’s limitations or are marked up by drafters who see the problem but leave the risk unallocated.

While these different pictures do not provide a complete working model of bondholder expectations, they do suffice to show the inaccuracy of the model used by the courts in which every investor on the bond market clearly grasps and foresees the residual risks, applies the classical risk allocation approach, and values the bond accordingly. The justification that “they got what they paid for” must be questioned, at least in part, because “they” are a disparate group. Although all investors have access to information concerning the residual risks, different individual investors in fact possess different amounts of information. Bondholders accordingly lack a unitary set of expectations.

These pictures also begin to justify invocation of good faith principles to protect bondholders from the residual risks. Allocating the residual risks to the bondholders tends to frustrate their expectations, in every case where the bondholder is unaware that the residual risks exist, and, where the residual risk is latent, in the case of a well-informed bondholder as well. Where the bondholder is uninformed, diligence in gathering available information could have

\(^{141}\) See supra note 92 and accompanying text.

\(^{142}\) See, e.g., Trust Indenture, between National Medical Enterprises, Inc. and Morgan Guaranty Trust Co. of New York, Trustee, § 10.12 (Nov. 30, 1981) (on file with author). It is noted that good faith clauses tend to be included in contracts covering privately placed convertible securities. See Debevoise, Plimpton, Investments in Convertibles, supra note 79, at 17.
prevented the bondholder’s expectations from exceeding bond contract protections. Yet, this apparent fault can be balanced against the issuer’s own lack of diligence. Bondholder expectations persistently outpace contract protections and are frustrated by remote risks. We can ascribe to the issuer knowledge of this, since it has a direct role in the drafting process. The issuer thus can be faulted for failing to correct these mistaken expectations with a bond contract that is crystal clear. It is not immediately apparent which party, the uninformed holder or the lackadaisical issuer, is more at fault, and further inquiry does not promise a clear answer.

Once fault is put aside we can focus on frustrated bondholder expectations. If we accept the above evidence that convertible bond prices are insensitive to residual risks, it turns out that the bondholders have not been compensated by lower bond prices for bearing the residual risks. Thus, protecting bondholders against the residual risks could be justified on the grounds that they are entitled to the benefit of their bargain.

2. EFFICIENT BOND MARKETS

The above case for bondholder protection is based on an incomplete picture of convertible bond pricing. A very different picture obtains under the theory of efficient capital markets, particularly on the question of compensation for bearing residual risks. An “efficient” market price fully reflects all available information. The securities markets are efficient because free competition results in the generation, dissemination and digestion of information about the securities traded on them.

Since the bond market is efficient, the theory tells us that bond prices reflect full information of residual risks. In an efficient market, the best-informed traders scan bond contracts for shortcomings in the protection of the conversion privilege. Then, making the generally accepted economic assumption of symmetric market ration-

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143. See Bratton, supra note 93, at 374-77, discussing reason to know and fault ascription in bond contract interpretation.
145. See, e.g., E. FAMA & M. MILLER, THE THEORY OF FINANCE 335-36 (1972); R. POSNER, ECONOMIC ANALYSIS OF LAW 315-21, 324-26 (2d ed. 1977). For a cogent summary, see Easterbrook & Fischel, The Proper Role of a Target’s Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161, 1165-66 & nn. 14, 15 (1981). The competitive process keeps price and value in line because arbitragers rush in to bid up or down the price of the security whenever new information material to its value reaches the market. Id.
146. Smith & Warner, supra note 3, at 119.
ality, they project the likelihood of future diluent issuer actions and discount the value of the bonds accordingly. They further scan for provisions requiring issuer notice of actions affecting the value of the conversion privilege, project the monitoring costs necessary to overcome any shortcomings in them, and discount the bond price to compensate for these costs. All these activities cause prices to reflect the residual risks fully and compensate all bondholders for bearing such risks, whether or not the risks figured into their individual expectations. Arguably, then, judicial protection of contrary bondholder expectations is unjustified, and allocation to the bondholders of the burden of drafting against the residual risks is consistent with good faith.

This efficient markets model is too simplistic, however. It must be modified to account for all the valuation variables which arise out of the real world body of information concerning the risks of holding convertibles. For example, the model’s assumption that the best-informed investor will assume symmetric market rationality may not be sound. We have already seen that the laxity of issuers in exercising call rights implies a largess toward bondholders at odds with symmetric market rationality. Similar largess has been shown in cash out mergers. Some acquiring corporations have offered settlements to warrantholders, even though their investments otherwise would have been rendered valueless because the warrant’s exercise price exceeded the cash price per share under the merger. Other acquiring corporations have offered partial compensation and still others no compensation at all. A model based on symmetric market rationality would be inaccurate to the extent that “irrational”

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147. For discussions of symmetric market rationality and security pricing, see Smith & Warner, supra note 3, at 118-19, and Anderson, supra note 1, at 750-51.
148. The role of monitoring costs in security pricing is discussed in Jensen & Meckling, supra note 3, at 338.
149. Empirical evidence both supports and contradicts efficient markets theory. See, e.g., E. Fama & M. Miller, supra note 145, at 336. Barry, The Economics of Outside Information and Rule 10b-5, 129 U. P.A. L. Rev. 1307, 1330-54 (1981), reviews the theoretical and empirical literature on the efficient capital markets hypothesis. Barry concludes: “[A]lthough the market appears reasonably efficient at reflecting historical price information in current prices, the evidence suggests that it is less efficient with respect to current developments and noticeably inefficient with respect to non-public information.” Id. at 1348.
150. See supra text accompanying notes 43-48.
151. 3 VALUE LINE CONVERTIBLE SURV. 381 (Jan. 1, 1973); 3 VALUE LINE CONVERTIBLE SURV. 130, 132 (Aug. 28, 1972). Value Line attributes this to issuer recognition of the equities of the holders’ case.
152. 4 VALUE LINE CONVERTIBLE SURV. 89, 92 (Oct. 1, 1973); 3 VALUE LINE CONVERTIBLE SURV. 381 (Jan. 1, 1973).
motives, such as the sense of fair play, led acquiring corporations to take less than full advantage of the bondholders.

Whatever the acquiring corporations' motivations, the very possibility of more than one outcome results in yet another valuation variable for the efficient market's pricing mechanism. The best informed investor in convertibles would have taken this range of possibilities into account in assessing the destructive potential of the residual risks. Since this modification decreases the expected magnitude of the residual risks, recognition of it theoretically should result in a higher bond price.

This modified picture is still one in which the market discounts the bond price in recognition of the issuer's right to take diluent actions, thereby compensating the bondholder for bearing the residual risks. That the market also offsets the discount with the possibility that the issuer voluntarily might not enforce these rights neither negates the existence of these rights nor alters the logic of imposing the risk of their exercise on the bondholders, because the efficient market compensates them for bearing such risk.

But this analysis is affected if the model is further modified to account for uncertainty in the outcome of judicial interpretation of contract terms. Contemporary courts differ in their approaches to allocating the residual risks. However remote the resulting set of contingent outcomes may be for a particular bond, they create yet another real world pricing variable for the best-informed investor. Since dilution and destruction continue to be possible outcomes under this variable, the efficient market price still compensates the bondholders for bearing the risk. Nevertheless, the fairness picture changes because the variable also includes the risk that a court will allocate residual risks to the issuer. The bond price reflects both possibilities. If occasional judicial allocation of the risk to the issuer cannot be found unfair, the efficient markets model thus leads to a "fairness neutral" result.

Substantial objections can be raised against using even this modified efficient markets model as a device for resolving this fairness question. If the bondholder "expectations" to be protected are neoclassically conceived as the total set of reasonably held individual understandings regarding rights under the bond contract, and the total set of individual valuations based on such understandings, then the efficient markets model fails to consider all relevant factors. By looking solely to the price level set by the best-informed investor, the model ignores possible differences in the subjective risk prefer-

153. See supra notes 12-17, 119-26 and accompanying text.
ences of individual investors. If the less informed investors were more risk averse, they would pay less for the security if made aware of the residual risks. As to them, therefore, the model's market price would be too high. Even under efficient markets theory, therefore, they cannot be said to have "gotten what they paid for." 154

A similar point can be made regarding the monitoring costs of investors having bond portfolios of different sizes. Incurring the $300 per year cost of a Value Line subscription plus the cost of the time spent reading the service each week would be rational for an investor with a $10,000,000 convertible bond portfolio, but would not be rational for an investor owning one convertible bond with a $1000 face value. Since the large investor efficiently can minimize the residual risks through monitoring and diversification, the same $1000 face value bond will be worth more to it than to the small investor even though both investors have identical risk preferences.

Finally, it must be noted that the model elaborated above is based on the strong version of the efficient markets model. 155 Other, weaker versions in the economic literature permit construction of a pricing model falling somewhere in between the efficient markets model and the touchstone picture discussed above with respect to differing bondholder sophistication. 156 For example, Grossman and Stiglitz recently formulated a model in which prices only partially reflect the information level of the most sophisticated trader. The price becomes more informative as the number of well-informed individuals trading the security increases. The price is completely accurate only if all traders have full information. 157

154. This risk-preference based criticism runs up against the "capital asset pricing model." According to this model, the prices of assets in the capital markets adjust until assets with equivalent risks have the same expected rates of return. See generally Modigliani & Pogue, An Introduction to Risk and Return: Concepts and Evidence, 30 FIN. ANAL. J. 68 (1974). Commentators have noted that the model provides cold comfort to an investor who, out of ignorance, errs in assessing the riskiness of an investment. Cf. Jennings, supra note 23, at 52, where an entire valuation model for convertible bonds is limited by the factor of investor risk preference.


156. See supra text accompanying notes 124-43.


The Grossman and Stiglitz model has great intuitive appeal to anyone who resists the strong efficient markets assertion that costs incurred in developing market information are wasted. The model holds out the possibility that these expenditures will be rewarded.
Under this model, convertible bond prices do not reflect all of the risks assumed by the bondholders unless all investors are fully informed regarding such risks. The less informed the investor group, the higher its expectations and the higher the bond price. The more distorted the price, the greater the disappointment of bondholder expectations when the issuer takes diluent or destructive action. The more palpable the denial of expectations, the stronger the case for allocating the risk to the issuer.

Regardless of the accuracy or usefulness of the weaker efficient markets model, it does permit one point to be made in the present context. Given the suppositions of neoclassical contract law, strong efficient markets theory is too blunt an instrument to be adopted as a fairness guide respecting the relationship governed by a public-issue bond contract. Only a model sensitive to differing bondholder information levels will differentiate bondholder expectations with sufficient accuracy to resolve a controversy turning on conflicting interests of bondholders and issuers.

3. FAIRNESS IMPASSE

If actual bondholder expectations are aggregated and netted out and the resulting average expectation taken as the relevant one, then the traditional strict contract law approach can be defended as an accurate reflection of compensated bondholder expectations, even under the weaker efficient markets model. Since institutions hold most convertible bonds,\(^{158}\) it reasonably can be inferred that most convertible bonds are held by well-informed investors. Analyzing this fact under the weaker efficient markets model, and assuming that convertible bond prices are sensitive to allocations of the residual risks, leads to the conclusion that prices largely take account of residual risks and that the bondholders bear them.

The flaw in this defense of the traditional approach is the average of bondholder expectations on which it is based. Under this view the expectations of holders at lower information levels cannot be singled out for protection. This conflicts with one of the good faith doctrine’s more attractive fairness precepts—that the reasonable expectations of all parties be protected to the greatest extent possible.

The expectations of the uninformed bondholders are viable candidates for protection. Under a weak efficient markets model, the uninformed holders will not be fully compensated \textit{ex ante} for bearing the residual risks. They likewise will not be compensated for the

\(^{158}\) See Alexander & Stover, supra note 29, at 36.
transfer of wealth to the stockholders which results from diluent or destructive issuer action. And as already seen, they are not cognizably at fault in expecting the conversion privilege to be unimpaired by the residual risks.\footnote{159. See supra note 143 and accompanying text.}

But if we resolve interpretive questions concerning the residual risks against the issuer, we create new problems. This approach would protect the expectations of the uninformed holders, but it simultaneously would shift the residual risks away from the well-informed bondholders who have been compensated for bearing them. This approach thus would effect a wealth transfer from the stockholders to the well-informed bondholders even while preventing a wealth transfer from the uninformed holders to the stockholders.

When the position of the issuer is taken into account the matter becomes more complicated still. The issuer and its common stockholders are compensated for the conversion privilege at the bonds' initial issue when the underwriters pay the purchase money. If underwriters are at the highest information level, then it follows that the price paid at original issue would come close to reflecting fully the residual risks. As the bonds later were traded on the market, however, institutions and individuals with less information would buy into the bondholder group and the bond price would tend less and less to reflect the residual risks. Any corresponding rise in the bond price would redound not to the issuer's benefit, however, but to the benefit of well-informed bondholders selling out to bondholders at lower information levels.\footnote{160. In practice, the shortfall in compensation to the issuer would be larger still. Convertibles, like other bonds, tend to be underpriced at original issue in order to promote quick sale and reduce the underwriters' risk. See Alexander & Stover, supra note 29, at 37-39.} Thus, the existence of uncompensated risks for some bondholders does not imply that the excess price such bondholders pay is received by the issuer.

Finally, present uncertainty as to the direction of the courts further complicates the search for fairness. Resolution of this uncertainty, whether in favor of issuers or holders, will result in wealth transfers. Because bond prices now reflect this uncertainty, a firm rule in favor of issuers would transfer value—the amount reflecting holders' hopes of a favorable ruling—to issuers. A firm rule the other way would transfer value to bondholders. An efficient market would account for the present majority rule favoring issuers and would price bonds expecting judicial placement of the residual risks on the holders. Thus the price rise in response to a bondholder protective
rule would be greater than the price decline in response to a rule favoring the issuer. Counterbalancing this is the historical tendency for bondholder expectations of anti-dilution protection to outpace the actual scope of the explicit protections in the standard contract provisions, even in the informed segments of the market. In addition, although the actual market response to new dilution problems cannot be predicted with certainty, historically the marketplace has responded to most of them by revising the standard form in the bondholders’ favor.

If the fair result in a case allocating risks among parties to a contract is the result that protects paid for expectations, then the above goes to show that such a case concerning convertible bonds does not admit a perfectly fair result. Since a single bond contract governs the rights of different parties with different expectations, that contract is ill-suited to application of principles keyed to protect individual expectations. Selecting among the various possible approaches, then, is a matter of selecting a fair and workable approach falling somewhat short of the ideal result.

4. ALTERNATE ROUTES TO THE FAIREST RESULT

a. Individualized justice

Some of these problems would be ameliorated if a court could tailor its relief to individual expectations, adjusting conversion price only as to bondholders whose expectations require protection. Each holder would receive what he or she paid for, and the issuer’s expectations would receive maximum protection. Such an approach, however, would reward ignorance and thereby lessen bondholder incentive to gather information and to monitor bond market events.\textsuperscript{161} In addition, individualized inquiry into expectations would involve inordinate time and expense, given large numbers of bondholders and the nebulous nature of inquiry into individual information levels. A rough-cut classification, such as a division between institutions and individuals, could avoid many of these costs, but at the expense of accurate results. The clients of the incompetent institution would be penalized while the sharp individual would be rewarded.

Differing treatment of holders of the same bonds, whether individually or by category, itself creates fairness problems. Just as deprivation of paid for expectations is thought unfair under one line of contemporary values, so differing treatment of parties having the same status under a single contract is thought unfair under another line of contemporary values. All other things being equal, perhaps the benefits flowing from an individualized approach would surmount this “equal protection” objection. But all other things are not equal and weigh against an individualized approach.

b. Protection of the status quo

Another way out of this fairness impasse might be to ignore allocation of the drafting burden and to focus instead on the values at stake at the time the diluent or destructive action is challenged. The emphasis, accordingly, would shift from protection of expectations to preservation of the status quo.

Under such an approach different results might be reached in similar-looking cases. Consider again the cash out merger question raised in *Broad v. Rockwell International Corp.* The magnitude of the harm that cash out mergers cause instrumentals greatly varies with the circumstances. At one extreme lies a case where, even at the cash out merger price, the per share conversion value substantially exceeds the conversion price. Here the merger’s effect of cutting off further appreciation of conversion value does not seem especially unfair. The bondholders have received some or all of the capital appreciation for which the issuer was compensated at original issue, the cash out price in all probability includes a premium over the underlying common’s pre-merger market price, and the bonds

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162. *Restatement (Second) of Contracts* § 211(2) and comment e (1981).
163. *See supra* notes 101-05 and accompanying text.
164. Mergers tend to benefit convertible bondholders of transferor corporations, giving them little legitimate cause for complaint. A stock-for-stock merger, for example, will enhance conversion values if synergistic or other gains increase the value of the combined entity. And whatever the form of the consideration paid to the transferor’s stockholders, the debt value of its convertible bonds will increase if the acquiring corporation has a credit standing superior to that of the original issuer. This certainly was the case in *Broad.* See *Broad II,* 642 F.2d at 935.

Indeed, debt value may increase even if the acquiring corporation’s credit standing is not higher than the original issuer’s. The increased debt capacity of the combined entities may have a “coinsurance effect.” The theory is that so long as the earnings streams of the two firms are less than perfectly correlated, the risk of default is reduced and borrowing capacity is increased. *See Lewellen, A Pure Financial Rationale for the Conglomerate Merger,* 26 J. Fin. 521 (1971). *See also Galai & Masulis, The Option Pricing Model and the Risk Factor of Stock,* 3 J. Fin. Econ. 53 (1976); *Higgins & Scall, Corporate Bankruptcy and Conglomerate Mergers,* 30
were prime candidates for forced conversion through call in any event. At the other extreme lies a case like *Broad*, where the issuer has performed poorly and debt value is higher than conversion value at the cash out merger price.\(^{165}\) Here any damage to the bondholders resulting from the freezing of conversion value is highly speculative. Of course, so long as some slight chance remains that conversion value will exceed bond value at some time prior to the bonds' maturity, the conversion privilege has a value that the merger destroys. Such value will have been more theoretical than real, however.

There exists a middle ground in which cash out mergers more palpably damage convertible bondholders. Consider a bond issue a year or so old and a cash out merger which freezes conversion value at a figure just under the conversion price. Here conversion value reasonably might have been expected to rise above the conversion price in due course. The merger thus deprives the bondholders of the chance for equity capital appreciation for which the issuer was compensated at original issue. Moreover, as a glance at the Figure will confirm,\(^ {166}\) freezing conversion value in this case will destroy a substantial conversion premium.

With these three different cash out merger cases compare a case involving a spin-off of fifty percent of an issuer's assets where the anti-dilution provisions are silent on the matter of spin-offs. Here the balance of values more clearly favors the bondholders. An adjustment of the conversion price leaves the status quo in place; the division of value between the stockholders and bondholders remains unchanged even while the issuer action goes forward. Conversely, failing to protect the bondholders permits the stockholders to appropriate the value of the conversion premium to themselves without any justifying business necessity.

It must be questioned whether preservation of the status quo is a value of sufficient moment to sustain a jurisprudence thus ridden with inconsistencies. Furthermore, this approach's unpredictable aspect detracts from its fairness and makes it inefficient. Since the outcome depends to a great extent on the valuation picture at the time of the issuer's action, it gives the market little guidance as to the outcome in the next case. If the marketplace takes expectations

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\(^{165}\) It is noted that a bondholder desiring an equity participation in the combined entity can sell the bond at the increased debt value and use the proceeds to buy common stock of the acquiring corporation on the market.

\(^{166}\) See *supra* text following note 21.
concerning judicial outcomes into account as a valuation variable, then judicial certainty facilitates the market pricing process. An ad hoc judicial approach increases the range of future possible values, making valuation more expensive and bond investment riskier. As a result, bonds become less valuable to risk averse investors.\(^{167}\) Clear judicial rules and predictable judicial results increase the likelihood that both issuers and well-informed bondholders will appraise bond packages accurately and have their expectations satisfied over time.

c. Reconstructed negotiation

The same ad hoc aspect impairs the utility of yet another mode of devising a result according with the parties' expectations where the parties' actual expectations are unexpressed. This mode has the judge insert the term that the parties would have negotiated had they thought about the unprovided for contingency.\(^{168}\)

Applied to the standard form bond contract, this reconstructed negotiation amounts to judicial speculation as to the financial community's response to the allocation of the risk at issue—speculation likely to be more intuitive than informed.\(^{169}\) Even a prediction grounded in knowledge of the financial community's assumptions and predilections would be very uncertain, given the erratic pattern of marketplace behavior in this context. Consider recent modifications of the standard form explicitly allocating residual risks. Spin-offs now receive full anti-dilution protection,\(^{170}\) while the opposite result seems to be obtaining regarding cash out mergers.\(^{171}\) Marketplace responses such as these resist the formulation of a predictive model.

d. Fault

Contemporary contract doctrine takes into account punishment for fault and recompense for injury, as well as the more tradi-


\(^{168}\) Williams describes this as the "non-logical" judicial implication of a term. See Williams, Language and the Law (pt. IV), 61 LAW Q. REV. 384, 400-04 (1945).

\(^{169}\) Cf. Farnsworth, Omissions, supra note 62, at 879.

\(^{170}\) All but two of the 46 recent trust indentures surveyed in connection with preparation of this Article, see supra note 75, provided for conversion price adjustments in case of spin-offs.

\(^{171}\) Approximately half of the trust indentures in this Article's survey contained merger provisions redrafted explicitly to freeze conversion value to the cash consideration paid in the merger, thus ratifying the Broad II result. See also Model Simplified Indenture, supra note 69, at 755 (Sample Provision 5.01).
tional contractual objective of protection of expectations. A survey of the bond relationship for a party at fault ultimately points to the drafter. Faulting the drafter or, to use the contract law maxim, construing against the drafter,\textsuperscript{172} would seem not only to punish the culprit but also to place the drafting burden on the party best positioned to remedy the matter in subsequent transactions.

Unfortunately, closer inspection shows that this fault analysis neither persuasively isolates the equities of bond disputes nor contributes to bond market efficiency. The drafters at fault here are the underwriters and their counsel, who remove themselves from the relationship immediately after its inception and are not parties to subsequent contract disputes. Of course, the issuer could be faulted as against the holders as the only remaining party that might have influenced the drafting. Whether the issuer's lawyer might, in the best of all possible worlds, have dealt with a remote contingency two, five, or ten years earlier, does not impress one as the most crucial circumstance in what amounts to a pie-splitting contest between a group of public stockholders and a group of public bondholders, however. Furthermore, as already noted,\textsuperscript{173} the issuer's fault in drafting an imperfect document is counterbalanced by the holders' fault in failing to educate themselves about such imperfections.

Duties of care and sanctions for failure to meet them can be justified as prods prompting greater perfection in planning business arrangements. But the bond market does not seem to need such judicial prodding, at least with respect to risk allocation in trust indentures. The large amounts of money at stake in the typical public bond issue and the financial community's custom of retaining eminent counsel to draft bond contracts suggest that the standard form will be duly modified whenever serious drafting flaws come to light, irrespective of the mode of dispute resolution chosen by the courts.

\textit{e. Bondholder protection}

The alternate approaches being unacceptable, the result is a choice between a rule in the issuer's favor, which does not protect the expectations of uninformed bondholders, and a rule in the holders' favor which does.

Certainly, substantial reasons support the traditional rule favoring the issuer. Not the least among them is the still powerful ethic of creditor self-protection. The main parties in interest, issuers

\textsuperscript{172} See \textit{Restatement (Second) of Contracts} § 206 (1982).

\textsuperscript{173} See \textit{supra} text accompanying note 143.
and institutions, are well able to protect themselves, whether through contract provisions or through portfolio diversification. The small, unsophisticated investor occupies a somewhat incidental place in the overall picture. Furthermore, imposing a rule favoring the bondholders risks wealth transfers to all members of the bondholder group, no matter how well informed, at the expense of a public stockholder group which might easily be comprised of a larger proportion of less informed investors.

Even so, charity counsels selection of the bondholder protective rule. We have here a publicly sold security so complex that even the financial theorists have failed to settle upon a common set of valuation variables. Coupled with this complexity is the persistent phenomenon of sudden material realignments in the relationship, springing from arcane contract provisions. Among the entire group of interested parties, the uninformed bondholders are the least well-situated to accomplish self-protection against these risks. Thus, investor protective impulses such as those behind the federal securities laws come to bear, albeit with less than full force. Moreover, solicitude for the weak motivates extant good faith doctrine. One modern maxim of contract construction directs courts to protect the reasonable expectations of the average member of the public subject to the contract, despite any advantages given to similarly situated, but better informed contracting parties.174 This principle encourages protection of uninformed investors despite resulting windfalls to sophisticated investors.

Beyond this balancing of the different virtues of the interested parties lies a more conventional case for a bondholder protective approach. It is based on the overall structure of the convertible bond relationship, particularly its basic apportionment of value. As already indicated, the convertible bond creates bondholder claims against the issuer's equity in consideration of a lower interest rate. Unremedied diluent and destructive actions permit the issuer to recapture a potentially substantial part of the equity claim without refunding any portion of the bondholders' consideration. Nothing in the standard bond contract sanctions so fundamental a realignment. The flexibility the issuer supposedly seeks by including anti-dilution provisions certainly does not do so. So long as judicial bondholder protection only affords relief through adjustment of the conversion

174. See Restatement (Second) of Contracts § 211 comment e (1981). See also Keeton, Insurance Law Rights at Variance with Policy Provisions, (pt. I), 83 Harv. L. Rev. 961, 967 (1976), recommending, as a corollary to the principle of resolving ambiguity against the drafter, that insurance policies be construed as laymen would construe them and not according to the interpretation of sophisticated underwriters.
price or transfer of the conversion privilege, no inhibitions on issuer flexibility can occur.

For an illustration of this point consider once more Broad v. Rockwell International Corp.,175 and the cash out merger.176 The original issuer is worth more to the acquiring corporation to the extent its capital structure contains low coupon, fixed-rate debt, particularly in a period of rising interest rates. It is worth more still to the extent the acquiring corporation can lay hold to such advantageous capitalization without conceding a claim upon its own equity. By allocating the merger risk to the bondholders, Broad II permits the stockholders to keep this slice of the merger pie, even though its very existence results from the obliteration of the bondholders’ contract claim against the original issuer’s equity. Good faith principles counsel that the burden to justify such a substantial restructuring of the fundamentals of the contractual relationship lie with the party benefitted thereby, here the issuer.177

5. EFFICIENCY

The fairness advantages of a bondholder protective approach must be weighed against the efficiency advantages of the traditional approach. As already noted, the traditional approach forced the development of an efficient, if imperfect, standard form and has facilitated swift judicial decisions.178

175. 614 F.2d 418 (5th Cir. 1980), vacated, 642 F.2d 929 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981).

176. This Article’s rejection of the Broad II approach respecting cash out mergers should not be taken as approval of the Broad I opinion. Broad I surveys the entire trust indenture and finds ambiguities where none exist—in the standard provision regulating supplemental indentures, for example. 614 F.2d at 427-28. On the fiduciary duty applied in Broad I, see infra notes 188-89 and accompanying text.

177. This analysis can be applied to a number of different cases. See, e.g., Kessler v. General Cable Corp., 92 Cal. App. 3d 531, 155 Cal. Rptr. 94 (1979) (tender offers); Levine v. Chesapeake & O.R.R., 60 A.D.2d 246, 400 N.Y.S.2d 76 (1977).

This line of reasoning also may encompass Harff v. Kerkorian, 324 A.2d 215 (Del. Ch. 1974), rev’d, 347 A.2d 133 (Del. 1975), discussed supra notes 112-13 and accompanying text. Large, extraordinary cash dividends materially realign the relationship. Uninformed bondholders are likely to have valued the bonds assuming continued “regular” sized dividends without awareness of the residual element of risk. See Model Simplified Indenture, supra note 69, at 804-05. Of course a difficult line-drawing problem is presented. “Regular” dividends should not result in price adjustments. The informed market expects them, and a succession of small, judicially-mandated conversion price adjustments in the bondholders’ favor over several years might increase substantially and unexpectedly the value of the conversion privilege. But in any event this line drawing problem probably never will reach the courts. Today’s standard form includes explicit dividend provisions. See supra note 114.

178. See supra notes 71-80 and accompanying text.
Further efficiency claims can be made for the traditional approach under the "costly contracting" hypothesis of financial theorists like Jensen and Meckling, and Smith and Warner. This holds out the possibility of an optimal set of financial contracts for each firm and suggests that standard form bond contracts may be optimal. It asserts that bond contracts resolve stockholder-bondholder conflicts efficiently by causing management to maximize firm value while simultaneously reducing the monitoring and agency costs of the stockholder-bondholder relationship to the lowest level. The business covenants contained in bond contracts restrict self-interested stockholder actions that would decrease the bonds' value, and lower the costs bondholders otherwise would incur in monitoring stockholder conduct. In exchange for these bondholder benefits the issuer pays a lower interest rate.\footnote{179}

The costly contracting hypothesis can be expanded into a standard microeconomic argument against any departure from the legal status quo respecting a corporate financing device. In the context of convertible bonds the argument would be that judicial interpolation of bondholder protective terms, contemplated by neither the issuer nor the well-informed class of bondholders, disturbs this optimal contractual relationship, first, by imposing additional and unnecessary costs on the issuer, and second, by causing the transaction costs of modification of the standard form to obviate the judicial risk allocation and restore certainty. Ultimately, the risk of costly judicial meddling to restrain self-interested issuer conduct not explicitly prohibited by the bond contract might cause the issuer to refrain from taking steps which increase the overall value of the firm.\footnote{180}

That an efficiency justification for contractual good faith doctrine does not obtain in the convertible bond context further supports this view. Good faith rules that shift the drafting burden to the

\footnote{179. See Jensen & Meckling, supra note 3, at 337-39; Smith & Warner, supra note 3, at 120-22.

180. The costly contracting hypothesis represents one side of an ongoing debate among financial theorists on the question whether the way in which the bondholder-stockholder conflict is controlled affects the total value of the firm. The Modigliani-Miller "irrelevance hypothesis" embodies the opposing view. Modigliani and Miller take the position that the value of the firm and its cost of capital are independent of its capital structure; the firm's value is determined solely by the capitalization of its earnings stream. See Modigliani & Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, 48 AM. ECON. REV. 261 (1958).

If the Modigliani-Miller hypothesis is correct, then the value of the firm is not at stake when a court decides a question of stockholder-bondholder conflict. Only wealth transfers back and forth between bondholders and stockholders would be involved. Arguably, the Modigliani-Miller hypothesis sanctions more aggressive judicial umpiring of bondholder-stockholder disputes, since only a wealth transfer is at stake.
party best able to protect itself are said to be efficient because that
duty. The alternative, having the weaker party protect itself with an ex-
haustive list of express promises, costs more because that party
lacks information concerning the other's discretion.\textsuperscript{181} This sort of
cost picture might obtain as between bondholders and issuers after
the initial issue and sale of the bonds, but it would not necessarily
obtain at the time the bond contract is drafted. At that point the
parties would be the issuer and the underwriters, and an efficiency
analysis of the allocation of the drafting burden between them
would point to the underwriters, whose expertise in financial affairs
would more than match the issuer's knowledge of its own future
plans. Moreover, whichever legal approach happens to entail the
lowest cost, most of the necessary costs of clearly allocating the risks
of dilution and destruction were incurred decades ago, when stan-
dard anti-dilution provisions were developed in response to the turn-
of-the-century cases.

But since the basic costs of allocating the risks respecting con-
vertible bonds already have been incurred, adoption of a bondholder
protective approach should neither result in the incurrence of any
significant additional costs nor prove materially less efficient than
the traditional approach's exclusive reliance on the drafting process.
The protective approach proposed herein has a gap-filling character:
it comes into play only when the contract fails to allocate a risk and
yields to an explicit contract provision providing for a different re-
result. Looking once again at the large amounts of money at stake and
the eminence of the drafting counsel in each bond transaction, it
safely can be assumed that any judicial allocation of risk seriously at
variance with expectations of issuers and informed traders promptly
and explicitly would be overridden in subsequent bond contracts.\textsuperscript{182}
Of course, this extra bit of effort is costly. But if history is any guide,
a bondholder protective result more often than not will prove conson-
ant with actual market expectations. Moreover, some of these
costs will be incurred in any event. The very existence of litigation
over an ambiguity in a clause in the standard form will cause the

\textsuperscript{181} See Burton, supra note 61, at 393-94.
\textsuperscript{182} Recent adjustments to the standard form to ratify the Broad I I result, see supra
note 171, show the responsiveness of the corporate bar to new problems with the standard
language.
better informed and more cautious segment of the corporate bar to redraft the clause to effect a precise result.\textsuperscript{183}

With respect to bond contracts, then, efficiency requires judicial consistency and clarity more than judicial results perfectly according with actual market expectations. The benefits of the traditional approach now having accrued fully, it safely can be abandoned in order to protect the expectations created by the well-drafted standard form,\textsuperscript{184} so long as its efficiency yielding aspect is carried over into the new approach. With the ultimate power to allocate risks left in the financial community, occasional rulings at variance with market expectations, while perhaps theoretically causing wealth transfers between existing bond issuers and holders, will neither cause suboptimal bond contracting nor otherwise materially affect market efficiency.\textsuperscript{185}

III. JUDICIAL REALIGNMENT OF THE CONVERTIBLE BOND RELATIONSHIP—CONTRACT AVOIDANCE AND FIDUCIARY RESTRAINT

Bondholder protective contract interpretation could never protect all bondholder expectations. It yields to the drafter, who will not necessarily be bondholder protective. Consider a change in the standard form favoring the issuer. Bondholders may not pressure issuers and underwriters to redraft the contract, but may not, as well, adjust their expectations. Bondholders, either lacking in sophistication or rationally deciding to save on monitoring costs, may fail to review and assimilate the drafter’s change. If this informational breakdown occurs, subsequent issuers will have little incentive to offer a term more favorable to the bondholders. Since the bondholders are unlikely to notice such an issuer concession, they are unlikely to pay for it, thus removing any competitive incentive. The following discussion considers the proposition that such refrac-

\textsuperscript{183} The cautious lawyer knows that he cannot rely upon the next court to take the same view of the issue and in any event wishes to prevent litigation. See supra note 171 on the bar’s response to the \textit{Broad} litigation.

\textsuperscript{184} The approach recommended in no way impinges on the integrity of management’s corporate law duty to advance stockholder interests, because it arises out of the contract and remains subject to control by the contracting parties.


\textsuperscript{185} The question arises whether bondholder protective gap fillers similarly should be formulated for other bondholder-stockholder conflicts. Obviously, the answer depends on the particular kind of bond contract provision at issue and the interests at stake.
tory bondholder expectations be protected through judicial avoidance of bond contract provisions or fiduciary restraints on issuers.

A. Existing Case Law

A fragmentary body of contemporary case law protects bondholder expectations through avoidance of convertible bond contract terms. These cases offer only conclusory reformulations of contract and fiduciary principles to justify their approach.

*Broad I,* for example, experimented with simultaneous contract and fiduciary duties. It imposed a good faith duty that overrode contract terms. Under the duty, evidence that the bondholders expected the conversion privilege to remain intact for the life of the bond made a jury question of the fairness of the issuer’s diluent or destructive action, despite an explicit contract right authorizing such action. Oddly, the accompanying fiduciary duty did not override contract terms. It was fully discharged by compliance with the bond contract’s terms and violated only when the issuer committed a bad faith breach.

The Second Circuit’s *Van Gemert v. Boeing Co.* decisions shared this experimental quality and doctrinal confusion. In *Van Gemert I,* the first of two opinions, the court imposed a “duty of
reasonable notice” on the convertible bond issuer, determined that a set of standard provisions for notice of call did not measure up to the duty, and overrode the provisions. The court held that the notice provisions fell short in two respects. First, they did not appear in the bond itself, but were buried in the bond contract where unsophisticated investors were unlikely to see them. Second, the actual newspaper notices provided for were inadequate to inform the unsophisticated bondholder “in Dubuque or Little Rock or Lampasas.” According to the court, the unsophisticated holder expects reasonable notice as well as capital appreciation “and it is his reliance on this expectancy that the courts will protect.”

The court’s theory in Van Gemert I appears to go a step beyond the Broad I court’s enhanced good faith duty. Van Gemert I emphasized bondholder reliance, showing a tendency to conceive of the issuer-bondholder relationship in terms of the bondholders’ dependence upon the issuer as well as in terms of the bondholders’ bargained for expectations. Concurring in his own opinion, the author of the Van Gemert I opinion took the reliance point yet another step closer to a fiduciary concept. Had he alone decided the case, he would have dispensed with a contract law rationale entirely and invoked an “underlying duty of fair treatment . . . owed by the corporation or majority stockholders or controlling directors and officers” to the bondholders. Despite this, a second panel of the same court in a later phase of the same case reverted to the contractual idea of protecting bargained for expectations and labelled Van Gemert I a “good faith” case.

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194. 520 F.2d at 1383.
195. Id. at 1379, 1383.
196. The Van Gemert holders were hapless indeed. As the result of missing the call notice, the plaintiff failed to convert prior to the call date and thereby failed to realize on a substantial increment of conversion value over call price.
197. 520 F.2d at 1385.
198. Id. at 1382-83 n.19 (Oakes, J.).
199. Van Gemert II, 553 F.2d 812 (2d Cir. 1977).
200. Id. at 815.
Like Van Gemert I, the Third Circuit's Pittsburgh Terminal v. Baltimore and Ohio Railroad decision imposed a notice duty on the issuer based on overlapping good faith and fiduciary theories. The Pittsburgh Terminal issuer failed to give the bondholders advance warning of a large spin-off. Conversion prior to the record date for the spin-off would have been a value maximizing action for bondholders, because the governing anti-dilution clause did not provide for a conversion price adjustment in the spin-off's wake.

Reading Van Gemert I and Pittsburgh Terminal together, we see an issuer duty to give adequate notice respecting matters material to the conversion decision. This particularized bondholder protective and contract overriding duty may be here to stay, whereas Broad I's more expansive imposition of fairness restraints directly on diluent and destructive corporate actions is not. Broad II emphatically rejected Broad I and declined to extend Van Gemert I, but did not question the notice duty's validity.

A similar distinction between notice and more broadly ranging fairness duties was drawn in the original sequence of cases restraining destructive issuer action, Zahn v. Transamerica Corp. and Speed v. Transamerica Corp. In Zahn the Third Circuit imposed a fiduciary duty directly against the exercise of call rights by an issuer where the call negatively affected conversion value, but

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202. 680 F.2d at 936-38. Judge Gibbons' opinion treats the bondholders' claim under Rule 10b-5; the contract law duty to speak is utilized to provide the duty to speak required in a 10b-5 action by Chiarella v. United States, 445 U.S. 222, 228 (1980).

Judge Garth's concurring opinion avoids the contract good faith notice question by predicating the 10b-5 duty to disclose on Rule 10b-17. 680 F.2d at 944-47 (Garth, J., concurring).

Judge Adams' dissent applies the Broad II approach. The absence of contractual notice provisions or anti-dilution adjustments decides the good faith point: 'By its terms, the principle of fair dealing . . . applies only when one party infringes the other's rights 'to receive the fruits of the contract.' Here, under the well-settled Parkinson doctrine, Pittsburgh Terminal had no right, under the contract, to receive advance notice of the . . . dividend. . . .'' Id. at 951-52 (Adams, J., dissenting).

Under the analysis of this Article, the good faith issue would be decided in the bondholder's favor as a matter of contract interpretation.

203. 162 F.2d 36 (3d Cir. 1947).

204. 235 F.2d 369 (3d Cir. 1956).

205. Zahn and Speed concern an issue of preferred stock (termed "Class A common" but preferred in all substantive respects), convertible into common (termed "Class B common") on a one-to-one basis and having a two-to-one liquidation preference. At the time of the issuer action challenged in the case, conversion value substantially exceeded the call price and liquidation value substantially exceeded both. The issuer, planning to liquidate, called
then backed away from this direct restraint in *Speed*, the damages phase of the same case. *Speed* affirmed the issuer’s discretion to exercise call rights in its own interest, and granted damages to the *Zahn* plaintiffs as if liability in *Zahn* had been based on the issuer’s failure to notify them of material facts that would have prompted conversion prior to the call date.206

Despite all the doctrinal avenues they travel, these cases fail to grapple directly with the basic issue they all share: whether the benefits stemming from judicial protection of uninformed bondholders justify inefficiencies stemming from mandatory judicial regulation of the bond contract’s allocation of risks. The following subpart considers this issue. It concludes that courts should avoid overriding provisions which, like anti-dilution clauses, allocate substantive risks, but justifiably may impose additional notice requirements.

**B. Overriding the Bond Contract Under Contract Law**

Applying contract avoidance principles to bond contract provisions seems a frivolous exercise at first. The drafter is generally assumed to have the final world in competitive financial transactions. Standard form anti-dilution provisions fit into this mold—they result from on-going competition between issuers and investors and do not disproportionately favor the issuer. Barriers to the full circulation of information do result in a vulnerable class of uninformed in-

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Like the *Van Gemert* and *Pittsburgh Terminal* notification duties, the *Speed* duty admits of characterization as a product both of the issuer’s contractual good faith duties and its fiduciary duties.
vestors, but any resulting competitive imbalance is held in check by market pricing that responds to valuations mostly made by well-informed investors. The competitive picture is drastically different in a classic avoidance case such as *Henningsen v. Bloomfield Motors.*

Consideration of the bond contract’s history, however, shows judicial control of bond contract terms to be a serious proposition. Llewellyn singled out financial contracts for regulation in his basic work on adhesion contracts. And far from being held sacred, the terms of the public issue bond contract have been regulated intensively by both courts and legislatures. Courts forced indenture trustees to assume fiduciary duties decades ago and in so doing overrode explicit exculpatory provisions in the bond contract. The Trust Indenture Act of 1939, which applies to every public issue bond contract, prescribes verbatim inclusion of provisions containing minimum standards of conduct for the trustee. Both instances of regulation stemmed from a judgment of market failure to produce contractual mechanisms adequate to protect the bondholders’ interests.

Contract law avoidance doctrines stand ready to afford justification should contemporary courts decide that further regulation of bond contracts is needed to protect bondholder interests. Not only the enhanced good faith principles invoked in *Broad I* and the *Van Gemert* opinions, but avoidance doctrines developed for adhesion

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207. 32 N.J. 358, 161 A.2d 69 (1960). There oligopoly power resulted in greatly unequal bargaining strength and a wholly one-sided form contract.
208. Llewellyn, supra note 71, at 733-34.
209. See Dabney v. Chase Nat'l Bank, 196 F.2d 668 (2d Cir. 1952), 201 F.2d 635 (2d Cir. 1953); York v. Guaranty Trust Co., 143 F.2d 503 (2d Cir. 1944), rev'd on other grounds, 326 U.S. 99 (1945). Hazzard v. Chase Nat'l Bank, 159 Misc. 57, 287 N.Y.S. 541 (Sup. Ct. 1936), is a leading case going the other way. See also Llewellyn, supra note 71, at 733.
contracts are available. Bond contracts are inherently adhesive because the post facto nature of the holder's entry into the relationship prevents all bargaining other than over price. The Restatement (Second) of Contracts provides a basis for small scale attacks on particular adhesive provisions in order to remedy informational disparities. A bondholder could utilize it if, as seems plausible, it could be shown that convertible bond issuers have reason to know that many bondholders are uninformed regarding fine points in the bond contract, and that such provisions frustrate "dominant" bondholder expectations.

1. DILUENT AND DESTRUCTIVE PROVISIONS

These neoclassical avoidance doctrines should not be applied too rigidly. Otherwise, they would create an avoidance case every time a contract term frustrates a party's reasonable expectations. They best are approached as invitations to painstaking relational inquiries into the fairness and efficiency of avoidance. Thus, in the convertible bond context the avoidance inquiry raises again all the conflicting considerations which went into the interpretation discussion in Part II of this Article.

We first consider the avoidance case respecting bond contract provisions permitting dilution and destruction. The case is close. Such diluent provisions frustrate bondholder expectations. These frustrated expectations are much smaller in magnitude than in the usual avoidance case. The group interested in the bond contract tends to be sophisticated, making cases of other mass produced financial contracts, such as insurance policies, easily distinguishable because the unsophisticated general public has the primary stake in such contracts. Even focusing solely on the expectations of uninformed bondholders, diluent and destructive actions only partially

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213. Both contract overriding good faith duty and adhesion contract avoidance doctrine commission the courts to protect the weaker party's expectations from the contract rights of the stronger party. They differ as to the means to that end. Adhesion contract doctrine looks at the terms of the writing and avoids hidden fine print found unacceptable in the overall circumstances of the contract relation. Good faith arises from the circumstances of the particular contract relation. It imposes duties independent of the terms of the contract and may override terms whether or not buried in hidden fine print.

214. Restatement (Second) of Contracts § 211 comment f (1981).

215. Carried to its logical conclusion, this approach would approximate Professor Keeton's rule for insurance policies: no qualifications inconsistent with expectations of a holder having an ordinary degree of familiarity with the type of instrument in question should be enforced. See Keeton, supra note 174, at 968-69.

216. Professor Keeton formulates an unconscionability rule which results in per se invalidation of provisions which mislead most insurance policy holders. Keeton, supra note
frustrate such expectations. Take an uninformed investor who pays $1000 for a convertible bond unaware of limitations on the conversion privilege and expecting complete protection. Although such an investor would not manifest assent to the contract at a price of $1000 if he knew of the limitation, he might, depending on his risk preferences, manifest assent for $800 or $990. And even if an unexpected diluent event occurs, the bond's debt value limits the magnitude of his disappointed expectations.

In addition to these individual benefits, avoidance increases investor confidence in the market. It also would reduce the agency costs of subsequent transactions, causing lower coupon rates.\(^{217}\)

Now contrast the undesirable effects of judicial bond contract avoidance. First comes the wealth transfer phenomenon discussed in connection with bondholder protective contract interpretation.\(^{218}\) Avoiding a term favoring the issuer will make the bond more valuable, transferring wealth from the stockholders to the bondholders. But the transfer will be greater in magnitude than in an interpretation case. Since avoidance concerns explicit terms rather than ambiguities and omissions, the market's valuation of the bonds will tend to reflect clear contractual expectations regarding the allocation of risk rather than uncertainty.

Second, and perhaps more significant, are the costs of the uncertainty and technical problems caused by judicial bond contract avoidance. The courts in theory would alter contract terms to conform to investor expectations. As a practical matter, however, courts do not have the resources to ascertain the actual expectations of a group of bondholders. But if they did, inquiry would show that even among the informed bondholder group no monolithic expectation exists for quick translation into a trust indenture provision. In the end, therefore, the courts would be basing avoidance and substitute provisions on intuition. Line drawing problems and conflicting judicial rulings easily could result, along with all associated costs.

These uncertainty costs are likely to be higher than the uncertainty costs of intuitive judicial interpretation. The yielding aspect of rules of interpretation make certainty the end result by returning

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174, at 974. In Keeton's view, some provisions are so complex that they cannot be brought to holders' attention in the ordinary marketing situation. \(\text{Id.}\)

217. The scenario is as follows. Bondholders come to expect judicial protection against opportunistic issuer conduct. Since judicial protection reduces the risks of holding bonds and the bond market is competitive, the return required on bonds declines. For discussion of agency costs and judicial protection of common stockholders against management misconduct, see Scott, \textit{Corporation Law and the American Law Institute Corporate Governance Project}, \textit{35 Stan. L. Rev.} 927 (1983).

218. \textit{See supra} text accompanying notes 158-60.
the subject matter to the marketplace for explicit treatment in future bond contracts. Moreover, some interpretation is unavoidable, since there is no such thing as perfect drafting. In contrast, courts avoiding bond contract terms create uncertainty because the bond market cannot absolutely rely on the enforceability of bond contract provisions. Given case-by-case balancing of particular deprivations of uninformed bondholder expectations against issuer expectations and the need for certainty, even an efficient market would be hard pressed accurately to quantify the likelihood of avoidance. The resulting uncertainty would reduce the bonds’ utility as a financing instrument.

Finally, even though judicial regulation of terms to protect bondholders reduces agency costs in future transactions, it may not improve on the standard form’s efficiency. Costs or other factors may make the contract worth more to the issuer if a given risk is allocated to the bondholders than the contract is worth to the bondholders if such risk is allocated to the issuer. Since efficiency is a function of these subjective valuations of risk, judge-made terms formulated to protect the uninformed subgroup of bondholders are unlikely to be as efficient as standard terms formulated through the marketplace interaction of issuers, underwriters and informed bondholders. One may object that with an obscure risk there arises the real possibility of a widespread informational breakdown regarding the contract provision allocating it and the real possibility that such provision does not embody an exchange between the issuer and the bondholders at all, much less an efficient one. The problem is that courts have no practical way of confirming whether this sort of informational breakdown in fact has occurred.

As a practical matter, of course, the market could adjust to all manner of disruption and uncertainty resulting from judicial avoidance of bond contract terms.219 One suspects that only avoidance of fundamental terms, such as those setting interest rates and prepayment rights, seriously would impair market processes and the utility of the convertible bond contract as a financing tool. Avoidance of such terms is unlikely. The more fundamental the term, the less likely it is there will be a significant informational disparity regarding it, and the less likely will be the need for judicial intervention on behalf of uninformed bondholders.

219. Convertible bonds survived the treatment of turn-of-the-century jurists, which bespeaks a certain resiliency in the securities markets. See supra notes 55-62 and accompanying text. But then so does their survival of federal regulation and the corporate governance movement.
Legislation promulgated by either Congress, the Securities Exchange Commission or the New York Stock Exchange could provide a better means of achieving bondholder protection than does ad hoc judicial avoidance. Any one of several legislative approaches could be taken. A statute or stock exchange rule might regulate contract terms, mandating express provisions in the manner of the Trust Indenture Act. Such legislation, while removing the risk-allocating function from the marketplace, at least would not sacrifice the certainty of terms required for accurate market pricing. Alternatively, legislation might require the marketplace to inform the uninformed bondholder. This would require abandoning the present prospectus-based disclosure model, with its hyper-technical descriptions of contract language, and its exclusive focus on new issues. The problem calls for delivering the simplest possible explanation of the risks of convertible bondholding to all market purchasers of convertibles. Finally, the entire burden of educating investors prior to purchase of a convertible could be imposed on brokers through a particularized application of the SEC’s suitability requirement.

Since none of these legislative solutions is likely in the foreseeable future, the judicial intervention issue cannot be avoided. This subpart has shown that the problem stems not from any intrinsic unfairness in the standard form, but from disparate investor information levels. At least as regards anti-dilution provisions and other provisions allocating substantive risks, convertible bonds present a comparatively small information problem. Judicial intervention, however, carries a cognizable risk of minor market inefficiencies. The balance falls against intervention.

2. NOTICE

The case for an issuer duty to give reasonable notice of actions bearing materially on the conversion decision is marginally stronger than the case for overriding anti-dilution and other substantive provisions. The two cases share the objective of protecting bondholders from imperfect information dissemination, but differ in their means to this end. Avoidance of substantive provisions remedies the failure

220. See supra note 130 for a description of the prevailing standards for prospectus disclosure of bond contract terms.


222. See 17 C.F.R. § 240.15b10-3 (1982), which provides that market professionals making recommendations to customers have “reasonable grounds to believe that the recommendation is not unsuitable for such customer. . . .”

223. See supra text accompanying notes 129-42.
of market information channels to make all contract risks clear to all investors prior to bond purchase by shifting the risks. In contrast, the notice cases leave the holder bearing the risk of the issuer action. They involve judicial intervention only to assure that the holder has the information necessary to take value-maximizing steps in response.\footnote{224}

Both the costs and the benefits of the notice duty are fewer than those respecting avoidance of substantive provisions. The benefits are reduced because the practical protective effect fluctuates with the market. However well-notified the bondholder, forced choice between conversion and redemption will be a Hobson's choice if the conversion price exceeds conversion value. The costs are reduced because notice duties create less of an uncertainty problem. Notice duties lend themselves to precise statement and, to the extent that lines need to be drawn, a highly developed jurisprudence provides guidance. Notice duties also leave management free to take whatever stockholder beneficial action it deems appropriate.

This is not to say that notice duties will not confer unearned benefits on well-informed bondholders or disturb efficient allocations of risk. The standard form provides for advance notice of dividends out of surplus, rights offerings, mergers, large asset sales, recapitalizations, and liquidations,\footnote{225} in addition to the anti-dilution provisions covering these events. Additional judge-made notice requirements therefore shift back to the issuer monitoring costs that the contract places on the holders. Theoretically, this disrupts the pricing assumptions of the issuer and well-informed investors, causing yet another wealth transfer to well-informed investors. But this effect would be temporary. Furthermore, judicial notice duties cannot be particularly inefficient so long as their materiality standard has a basis in reality. If the information subject to the duty has economic significance to the bondholders, issuers will receive compensation for bearing the duty in subsequent transactions.

\footnote{224. The duty imposed in \textit{Speed} and \textit{Pittsburgh Terminal} in effect requires disclosure of inside information of management's intention to take action materially affecting conversion values. \textit{See supra} notes 201-06 and accompanying text. \textit{Van Gemert} requires the issuer to take steps to assure the widest possible dissemination of widely disseminated market information. Thus, \textit{Speed} and \textit{Pittsburgh Terminal}, like Rule 10b-5 and other federal disclosure requirements, protect outside investors at all levels of sophistication, while \textit{Van Gemert}, like other good faith based decisions respecting bond contracts, specifically protects uninformed investors.}

\footnote{225. \textit{See ABF Commentaries, supra} note 2, at 556-57 (Sample Provision \S 13-10).}
In sum, the innocuous nature of the costs of judicially imposed notice requirements may make the resulting bondholder protective benefits worthwhile.\(^{226}\)

\[\text{C. Fiduciary Duties to Convertible Bondholders}\]

In addition to extending the benefits of neoclassical contract avoidance principles to convertible bondholders, some of the case law imposes a fiduciary duty upon the issuer.\(^ {227}\) The following is a preliminary appraisal of this duty.

1. FIDUCIARY DUTIES TO BONDHOLDERS AND TRADITIONAL NOTIONS OF CORPORATE STRUCTURE

Clearly articulated doctrinal theories support excluding bondholders from the protection of corporate fiduciary duties. The traditional fiduciary duties of the corporation’s directors, officers and other employees spring from their agency relationships with the corporation. They are owed to the corporate entity as principal, rather than to individual stockholders or creditors.\(^ {228}\) Because the corporation is the beneficiary of these duties, it must be the plaintiff in actions to enforce them.\(^ {229}\) The stockholders’ right to sue deriv-

\(^{226}\) One caveat based on Van Gemert should be entered. It purported to protect uninformed investors by requiring a clearer description of notice provisions on the bond itself and publication of additional notices of call in a newspaper of general circulation in Manhattan between 30 and 90 days prior to the redemption date. 520 F.2d at 1376. One doubts that these additional notices actually would catch the unsophisticated investor’s eye. Van Gemert naively supposes that the uninformed investor reads the fine print on the back of the bond and monitors the Wall Street Journal for call notices. At least one observer tells us that some investors sleep so deeply that only full registration, notification by certified mail and follow up telephone calls will flush out 100% of an issue for conversion prior to the redemption date. Miller, *How to Call Your Convertibles*, 49 HARV. BUS. REV., May-June 1971, at 66-68.

The case’s result can still be justified as an *ad hoc* remedy for a particular denial of bondholder expectations. That the opinion lays down an unworkable rule, while not a point in its favor, is not much of an objection either. The costs imposed on issuers were trivial and the set of situations to which the rule was to apply was fast disappearing.

\(^{227}\) *See supra* notes 186-206 and accompanying text.

Neither Broad II, 642 F.2d at 940 n.10, 958-59, nor the dissenting opinion in *Pittsburgh Terminal*, 680 F.2d at 946-52, 954 n.11 (Adams, J., dissenting) categorically rejects the proposition that a fiduciary duty to the bondholders exists. Both contain a strong edge of skepticism, however.


\(^{229}\) Agents are not liable for harm to persons other than their principals. *Restatement (Second) of Agency § 352* (1958). *See also* W. CARY, CASES AND MATERIALS ON CORPORATIONS 865 (4th ed. 1969).
tively does not extend to creditors; thus, creditors cannot enforce these duties. Furthermore, no fiduciary duties directly arise between the corporate entity and its creditors because no agency or trust relationship exists between them; the relationship is contractual. Taken together, the black letter proposition emerges that creditors have an inherently and exclusively contractual relationship with the corporation.

Much of the force of this traditional analysis has dissipated under the weight of accumulated, often successful, challenges to its underlying assumptions. Consider first the weakening of other black letter divisions of corporate relationships into neat corporate and contract categories. Corporate law used to tolerate only limited contractual alteration of the terms governing relationships between the corporation and its stockholders. Today, at least with respect to closely held corporations, contractual arrangements between stockholders may restrict the exercise of management discretion granted under the pure corporate model in much the same manner as covenants in bond contracts have done all along.

230. Courts have categorically rejected bondholder assertions of standing to sue derivatively for the corporation, see Harff v. Kerkorian, 324 A.2d 215, 218-19 (Del. Ch. 1974), rev'd on other grounds, 347 A.2d 133 (Del. 1975), even though stockholder and convertible bondholder interests often converge with respect to enforcement against management breaches of its duties of care and loyalty.


232. Note that creditors have limited liability because of their lack of management control. See generally Douglas-Hamilton, Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor, 31 Bus. Law. 343 (1975).

233. The theory was that such agreements unduly impinged on the board of directors' discretion to operate the corporation. See, e.g., Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934). Ironically, the cases undercut the strict contract view of creditor participation by putting the interests of creditors forward as one of the factors relevant to the question of the validity of impinging agreements. See Galler v. Galler, 32 Ill. 2d 16, 29, 203 N.E. 2d 577, 584 (1964); Clark v. Dodge, 269 N.Y. 410, 415, 199 N.E. 641, 642 (1936).

234. The provisions at issue in Westland Capitol Corp. v. Lucht Eng'g Inc., 308 N.W. 2d 709 (Minn. 1981) provide good examples.
Consider further the central point that corporate fiduciary duties arise only out of agency relationships. Fifty years ago many courts permitted this point to block duties running from majority to minority stockholders, as well as duties from issuer to bondholder. The rule as to stockholders was similar to that applied to creditors: absent “fraud” stockholders owed one another no duties.235 Despite the absence of agency relationships between the stockholders, this rule long since has yielded to a duty arising from the majority’s power to control the business.236

No obscure doctrinal complications prevent a court from using the same control of assets rationale as the basis for extending fiduciary protections to convertible bondholders.237 Alternatively, a court could characterize the conversion privilege as an “equity” investment and draw a duty out of the bondholders’ dependence on management’s greater expertise and knowledge concerning the conduct of the business.238

Contemporary academic analyses of the nature of fiduciary duties also undercut the traditional analysis. These extract generally applicable concepts of the essential fiduciary obligation from its particularized manifestations in agency and trust relationships. Professor Arthur Jacobson carries this line of analysis to its farthest point, defining the fiduciary obligation as the “exercise of judgment on behalf of another.”239 This flexible concept permits us to identify numerous interrelating fiduciary obligations in corporate structures. It also permits us to identify obligations arising in contractual relationships as fiduciary. Under this concept the convertible bond relationship is fiduciary: the issuer’s investment of the proceeds of the

235. See, e.g., Palmbaum v. Maguisky, 217 Mass. 306, 104 N.E. 746 (1914) (forgiveness of note invalid as consideration for voting agreement as fraud on other stockholders).
237. See Brod I, 614 F.2d at 430; Zahn v. Transamerica Corp., 162 F.2d 36, 46 (3d Cir. 1947).
sale of the bond involves the exercise of judgment on behalf of the holders.\textsuperscript{240}

Thus the traditional doctrinal analysis supporting the black letter line that blocks extension of fiduciary protections to bondholders has given way. But it should be noted that some practical justifications against extending fiduciary protections to bondholders survive, albeit with substantially diminished force. One such justification is the judgment that so long as the corporate debtor remains able to repay the debt, creditors' interests have not been impaired sufficiently to justify legal restraints on the corporation's self-interested actions. A different judgment is made regarding insolvent corporate debtors. Because insolvency jeopardizes repayment, the balance of interests shifts to favor the creditors, giving rise to creditor protection in law.\textsuperscript{241} Thus, when the Delaware Chancery in Harff v. Kerkerian\textsuperscript{242} tells us that the black letter line yields to "fraud, insolvency or a violation of a statute," the "fraud" very well may be a fraud on creditors and the "statute" the legal capital provisions of the Delaware corporation law.\textsuperscript{243} These rules restrain self-interested conduct of the corporation's affairs by management and stockholders for the creditors' benefit, just as corporate fiduciary principles restrain self-interested conduct of the corporation's affairs by management and controlling stockholders for the stockholders' benefit.\textsuperscript{244}

\begin{footnotesize}\begin{enumerate}
\item Cf. Jacobson, supra note 239, at 527-28, discussing the fiduciary nature of a sale of goods. It is less clear whether Shepherd's theory, see supra note 239, encompasses bond relationships. It would seem to depend on whether Shepherd's concept of power encompasses the investment of borrowed money.
\item The point where balance shifts is identified in UNIF. FRAUDULENT CONVEYANCE ACT § 5, 7A U.L.A. 161 (1978), which provides as follows:

\begin{quote}
Every conveyance made without fair consideration when the person making it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to creditors and as to other persons who become creditors during the continuance of such business or transaction without regard to his actual intent.
\end{quote}

Id. at 237. Professor Clark notes that, literally applied, this provision vitiates corporate actions advancing stockholder or management interests taken just prior to insolvency. Clark, supra note 5, at 510 n.15.

Traditional state legal capital provisions also may restrict transfers of assets out of the corporation prior to insolvency. The degree of restriction depends on the structure of the corporation's capital accounts and is subject to manipulation by the issuer and its stockholders. See generally B. MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL 84-90 (2d ed. 1981).
\item See ABF COMMENTARIES, supra note 2, at 21.
\item See Clark, supra note 5. The "normative ideals of fraudulent conveyance law" described by Clark, id. at 508-13, could be recast as the ideals of management and majority stockholder fiduciary duties.
\end{enumerate}\end{footnotesize}
No change in financial fundamentals has altered the interests of stockholders and creditors of solvent corporations so as to change the relative weights of the interests thus balanced. Even so, the conclusion that creditors deserve no legal protection other than that reserved in a contract no longer holds as an absolute proposition. Congress decided that bondholders deserve quite a bit of legal protection, at least so far as concerns their information levels, when it enacted the federal securities laws. By extending the federal securities laws' protections to bondholders as well as stockholders, Congress opened the door to further judicial traversals of the barriers to legal protection of bondholders. Decades of pari passu federal law treatment of stockholders and bondholders have accustomed the courts to looking beyond the differences between the two and towards their common protective needs.

Importantly, a justification keyed to the relative interests of stockholders and creditors only partially applies to hybrid securities like convertibles. The conversion privilege creates an additional bundle of bondholder interests to be thrown into the balance. One court, recognizing this, hit upon the neat solution of extending management fiduciary duties to convertible bondholders only in cases where the “wrongs alleged [impinge] upon the equity aspects . . . [of the bond].”

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247. It comes as no surprise that the universal citation to support the existence of fiduciary duties to creditors is an opinion of Justice Douglas, a major figure in the early history of the Securities Exchange Commission. The case is Pepper v. Litton, 308 U.S. 295 (1939), which concerned the equitable subordination in bankruptcy of a judgment obtained by the controlling stockholder after the corporation became insolvent but before it declared bankruptcy. Justice Douglas described quite strict “fiduciary standards of conduct which [the controlling stockholder] owes the corporation, its stockholders and creditors.” 308 U.S. at 311.

Broad as the Pepper language may be, put in the context of the facts of the case it only supports the proposition that the law imposes duties to creditors on controlling stockholders after insolvency. This fundamental proposition has always constituted an exception to the state law contract and corporate law dichotomy. See supra note 241. Thus narrowly read, the case does not support duties to creditors prior to insolvency.

248. There may be more common ground from the average investor’s point of view than from the average corporate lawyer’s point of view. According to Llewellyn:

My eyes may be blinded, but to me men do not seem to regard as going to the essence (as distinct from questions of degree of security, and priority in rank) that the legal sanction in the case of bonds goes to payment of certain sums at certain times; while in the case of stocks the legal obligation is built around rather than focussed on payment, built in terms of limiting dissipation in terms of assets and checking manipulation rather than in terms of specified positive performance.

Llewellyn, supra note 71, at 721.

An additional practical support for the black letter barrier to fiduciary protection of bondholders comes from the agency law maxim that an agent cannot fully serve two principals. In the context of the corporate structure, the maxim tells us that fiduciary duties running from management to groups having dependent contract relationships with the corporation, such as suppliers, customers, and creditors, ultimately conflict with and undermine management’s fundamental duty to maximize returns to common stockholders.

But even this justification no longer serves as an absolute bar. More than one generation of commentators by now have urged that the system of management duties centered upon single-minded devotion to stockholder interests be scrapped in favor of a system in which management takes a disinterested, conflict-resolving role for the benefit of all parties interested in the corporation, whether such interests arise contractually or otherwise.

2. FIDUCIARY DUTIES TO BONDHOLDERS AND THE BOND CONTRACT

The preceding discussion, showing that no doctrinal barrier bars fiduciary restraints from the convertible bond relationship and that the broadest notions of fiduciary obligation encompass the convertible bond relationship, does not complete the inquiry. The properties of this particular fiduciary obligation remain to be identified.

The following discussion projects the effects of applying fiduciary principles to the convertible bond relationship. It turns out that fiduciary protections work at cross-purposes with the management-stockholder relationship, once more confirming the maxim that an agent cannot fully serve two principals. It also turns out that fiduci-

250. Restatement (Second) of Agency § 394 (1958) embodies this principle.

Courts have taken such nonstockholder interests into account in sustaining management action not in the stockholders’ best interests. See, e.g., Herald Co. v. Seawell, 472 F.2d 1081 (10th Cir. 1972), sustaining management action to avoid a takeover on the ground that the target’s business of publishing a newspaper made it a “quasi-public institution” with “other obligations besides the making of a profit.” Id. at 1094-95. The case is criticized by Easterbrook & Fischel, supra note 145, at 1192: “A manager responsible to two conflicting interests is in fact answerable to neither.”
ary protections work at cross-purposes with the bond contract’s system of risk allocation while resulting in a minimal flow of benefits to the bondholders, once more confirming the relative insignificance of the creditor interests at stake. Thus, the practical supports to the black letter barrier return to the fore and force strict delimitation of the scope of any issuer-bondholder fiduciary obligation.

a. Fiduciary duties vs. bond contract terms

Let us take management’s investment and dividend policy as a test case for an issuer fiduciary duty. Stockholder and bondholder interests are in harmony concerning new investment out of retained earnings so long as the net present value of projected returns on the issuer’s investments exceeds the issuer’s cost of capital. But when such value falls below the issuer’s cost of capital their interests conflict, with noninvestment and dividends promoting the stockholders’ interests, and retained earnings and investment promoting the bondholders’ interests.253 The law sends a contradictory signal if it imposes a corporate law duty on management to maximize stockholders’ returns and a fiduciary duty on the corporation owing to the bondholders. Unless resolution of the conflict is left to management’s discretion, the law must go a step further and direct that one or the other duty be given priority.

Let us assume that the bondholder duty is granted priority over the stockholder duty. In order for this bondholder duty to have any meaningful protective effect in the dividend and investment area, it must include a license for judicial avoidance of bond contract provisions. The standard form permits cash dividends out of surplus. Given the prevalence of retained earnings financing, such a dividend could destroy the value of the conversion privilege. Thus, a bondholder duty appears to sanction judicial avoidance of bond contract terms.

Fiduciary duties have an inherent tendency towards contract avoidance. One reason the law creates them is to restrain possibilities for abuse in relationships where one party dominates events because of its superior knowledge, and because the other party depends on it to make judgments in that party’s best interests.254 With such a fundamental imbalance of power, a contract fixing the terms of the relationship so as to benefit the dominant party will be

254. See Anderson, supra note 1, at 759-50.
inherently suspect. Since the existence of a fiduciary relationship also tends to imply that market controls will not deter overreaching by the dominant party, one cannot look to market controls to restrain overreaching by the contract’s drafter.

But, thus stated, the general case for avoiding contract terms conflicting with fiduciary duties begins to state a case against granting fiduciary protections to convertible bondholders in the first place. None of these general justifications for fiduciary avoidance of contract terms fully apply here. Furthermore, under a regime of bondholder protective contract interpretation, contract avoidance is the sole practical function which a bondholder fiduciary duty could perform. The standard form bond contract, as protectively construed by the courts, would provide an authoritative source of all of the relationship’s terms, incidentally achieving all of the gap-filling efficiencies which fiduciary duties bring to other corporate relationships.

Under this functional analysis, the case for making an issuer duty to convertible bondholders a strict fiduciary duty, comparable to that of an agent to its principal, becomes a restatement of the case for avoiding convertible bond contract terms. Like the avoidance case, the fiduciary case is more or less compelling depending on the bondholder in view. We see the less compelling case by focusing on the well-informed bondholders. They neither lack knowledge nor depend on the issuer. We see a more persuasive case if we focus on the uninformed bondholders. But, despite the change in doctrinal context, the practical matters at stake remain precisely the matters at stake with contract law avoidance.\textsuperscript{255} The same considerations continue to counsel respect for the integrity of the bond contract.

To sum up, let us return to the case of the issuer’s investment and dividend policy, and assume that the issuer owes a primary fiduciary duty to the bondholders. Under the above analysis the issuer nevertheless should be free to declare cash dividends for the stockholders’ benefit because the bond contract amounts to a waiver of the bondholder’s rights as beneficiaries of the duty and no compelling justification for avoiding the waiver exists. If we change assumptions and make the stockholder duty the primary one, it remains equally difficult to see how a dividend could violate the duty to the bondholders. And even if the bond contract is silent about dividends, all matters relevant to a determination of whether the dividend harms a bondholder interest worthy of legal protection come to bear in the contract interpretation inquiry. Finally, if the

\textsuperscript{255} See supra notes 216-23 and accompanying text.
relative priorities of the bondholder and stockholder duties were left to case by case determination, we again find ourselves restating cases of bond contract interpretation and avoidance. Subordinating the duty to the bondholders would amount to the same thing as refusing to avoid the contract. As with contract avoidance under contract doctrine, the ultimate choice is between the bond contract and contrary judicial notions of fairness.

b. *Fiduciary duties vs. contract law duties*

Under the above analysis an issuer fiduciary duty to bondholders is indistinguishable from contract interpretation informed by a good faith duty. While the duties in theory originate in different places—the contract law duty in the particular contract’s bundles of promises and conditions, and the fiduciary duty in the issuers’ exercise of judgment over the bondholders’ investment—they become functionally identical so long as the bond contract is granted primacy over judicial fairness notions as the source of the relationship’s rights and duties. Both duties justify bondholder protective filling in of contractual interstices and perhaps a generalized duty to disclose, but do nothing more.

Duplicative legal routes to the same destination, while untidy, hardly are unusual and often coexist without causing apparent harm. Perhaps the fiduciary route nevertheless ought to be closed off here because it creates an unnecessary risk of diverting judges to the wrong destination altogether.

The convertible bond relationship presents an area of overlap between contract and fiduciary restraining principles. Outside of the overlap, contract and fiduciary duties go off in different directions, with fiduciary duties centering on protection of the dependent party and contract duties centering on the effectuation of the parties’ allocation of risks. Fiduciary duties such as those between attorney and client, partners, brokers and customers, and even management and corporation, tend to impose a higher degree of selflessness than is imposed on contracting parties subject to the good faith duty. In general, the fiduciary must put the beneficiary’s interests ahead of his own even though the costs to the fiduciary exceed the benefits to the beneficiary. In contrast, under a good faith approach the party under the duty need only give equal consideration to the other

256. *See supra* notes 127-85 and accompanying text.
party's interests, placing them ahead of his own only where the balance of costs and benefits gives primacy to the other's interests.\textsuperscript{257}

A court treating a contractual relationship too easily might be led to an erroneous avoidance of an unobjectionable contractual allocation of risk, by a rhetoric of selflessness that originated regarding very different fiduciary relationships. Such was the result in \textit{Zahn}\textsuperscript{258} where the court's erroneous restraint of the exercise of call rights resulted from too strict a focus on fiduciary concerns.

In sum, the strain of bending fiduciary principles to fit the convertible bond context creates a risk of over-protecting bondholders. Since the results of the effort only duplicate results obtainable through contract law analysis, and since contract law provides a more precise set of analytical tools for resolving conflicts between issuers and bondholders,\textsuperscript{259} the courts ought to abandon this particular experiment in fiduciary protection.

\section*{Conclusion}

This Article examines judicial intervention in the convertible bond relationship to resolve issuer-bondholder conflicts, bringing to bear a detailed description of the relationship's economic and contractual structure. Three different doctrinal frameworks for judicial intervention are evaluated: contract interpretation, contract avoidance and corporate fiduciary duty.

Significant judicial intervention in the relationship occurs in the framework of contract interpretation due to residual imperfections in governing contract provisions. Interpreting judges employing neoclassical concepts of interpretation enjoy surprisingly wide discretion to make law for the relationship. This Article suggests that this discretion be restricted under a norm of bondholder protection. The norm is proposed as a moral response to the issuer opportunism and bondholder vulnerability underlying issuer-bondholder conflicts. Of course, economic theory—in particular the efficient markets point—implies a very different moral response. But, at least in the convertible bond context, the theory's moral force dissipates upon its application to complex real world relationships.

\footnote{257. The distinction is derived from one drawn by Goetz & Scott, \textit{supra} note 80, at 1128.}

\footnote{258. \textit{Zahn v. Transamerica Corp.}, 162 F.2d 36, 46 (3d Cir. 1947).}

\footnote{259. Cf. Chirelstein, \textit{supra} note 129, at 210 (suggesting that the standard fiduciary analytical tools—fair price, arms length dealing and business purpose—are too indiscriminate to provide effective solutions to complex corporate problems and recommending federal legislation as the only practicable solution).}
tion cost scrutiny similarly fails to yield a compelling result in this context. When inadequacies appear in contract provisions governing publicly issued bonds, real world costs and benefits lead to private solutions and render instrumentalist jurisprudence under the efficiency norm unnecessary.

Aggressive judicial intervention in the relationship in the frameworks of contract avoidance and corporate fiduciary duty occurs occasionally but persistently. Such intervention draws on the fiduciary rhetoric characterizing most judicial intervention against opportunism in corporate relationships. But such fiduciary rhetoric implies a norm of issuer selflessness potentially conflicting with the elaborate system of issuer restraints and issuer freedoms contained in bond contracts. The efficiency norm counsels against such costly conflict. Therefore, this Article suggests retreat to the less intense good faith rhetoric of contract law.