Debt Financing: An Emerging Influence on Corporate Governance?

by

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ABSTRACT

The business corporation is an important engine for the creation of wealth and it plays a vital role in promoting economic development and social progress in both domestic and international economies. Hence companies must operate within a governance framework that keeps them focused on their objectives and accountable for their actions. There is the need to establish adequate and credible governance arrangements. The degree of observance to the basic principles of good corporate governance is an important factor for investment decisions.

Traditional corporate doctrine has taken the separation of ownership from control as the core problem of corporate governance. On this view, the principal function of corporate law is to devise strategies and mechanisms to ensure that corporate decision-making is based only on shareholders' interests. However, corporate managers are subject to influence from many other sources. Thus, the study of corporate governance must take account of all factors that affect managerial decision-making.

In this thesis, I examine the influence that debt financing brings to bear on corporate governance and examine whether debt-holders should be beneficiaries of corporate fiduciary duties. I conclude that any such duty should be narrowly cast.

RESUME

La société par action est un moteur important pour la création de la richesse et elle joue un rôle essentiel en favorisant le développement économique et le progrès social dans des économies domestiques et internationales. Par conséquent les compagnies doivent opérer dans un cadre de gouvernance qui les oriente vers leurs objectifs et rende responsables de leurs gestes. Il faut en plus que ce cadre soit adéquat et croyable puisque la bonne gouvernance est un facteur important pour les investisseurs.

Traditionellement, selon la théorie des entreprises, la séparation de la propriété du contrôle est au cœur de la gouverance. Sous cette angle, la fonction principale d'une loi sur la société par actions est de concevoir des stratégies et des mécanismes pour s'assurer que les décisions de l'entreprise sont basées seulement sur l'intérêt des actionnaires. Cependant, les directeurs de l'entreprise sont sujets à l'influence de beaucoup d'autres sources. Ainsi, l'étude de la gouverance de l'entreprise doit tenir compte de tous les facteurs qui affectent le procéssus décisionnel.

Dans cette thèse, j'examine l'influence que le financement par emprunt applique sur la gouvernance de l'entreprise et examine si les créanciers devraient bénéficiés d'une obligation fiduciaire de la part des directeurs.

J'arrive à la conclusion qu'une telle obligation, si elle existe, devrait être étroitement délimitée.

TABLE OF CONTENTS

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INTRODUCTION

A business corporation serves as a medium through which the investment objectives of individuals and institutions are carried out. Persons who share similar investment objectives may pool their resources together by way of subscribing to and acquiring shares in the corporation that is used as the investment vehicle under various arrangements. Those who acquire the shares in the corporation, called the shareholders, delegate the responsibility for the management of the corporation to a group of people called the directors. The corporation's operations are financed with the proceeds of the issues of the shares but very often this proves to be inadequate, especially if the corporation is expanding its operations. There are several modes of financing plans available to corporations that corporate directors employ. One of these is debt financing. Particularly, in countries where stock markets are poorly developed, or where the stock markets concentrate on shares, corporations are forced to rely on debt.

Debt plays a very significant role in the operations of business corporations as most expansionary operations of these corporations are financed through various debt facilities, thus enabling them to obtain the benefits of economies of scale. Since the very essence of business involves risk taking, debtholders often take various measures to ensure that they recover the debt facilities granted to these corporations. The relationship between a debtholder and a corporate debtor is usually regulated by contract in which the rights and obligations of the parties are enshrined. An emerging issue in corporate governance is whether the employment of debt financing does, or should influence corporate decision-making. Core to this issue is the question whether corporate directors owe fiduciary duties to debtholders of the corporation in addition to those owed to equityholders. This issue becomes particularly relevant when directors have to balance the interests of debtholders and equityholders in certain circumstances such as corporate restructurings, securitizations, and leveraged transactions. Also of importance to resolving this issue is the fact that as a result of dynamic financial engineering, there are numerous hybrid corporate finance instruments that render the distinction between debt and equity less useful for corporate decision making for a choice of a finance model.

One commentator has made the point that one of the most enduring legal problems of corporate finance is the "moral hazard" that investors in corporate debt securities face due to the universal corporate law principle of limited liability for stockholders.[1] Tauke uses the term "moral hazard" in his article to mean the danger that one party to a contract may engage in opportunistic self-serving behaviour not anticipated by the other party to the contract and

[1] Dale B. Tauke, "Should Bonds Have More Fun? A Reexamination of the Debate Over Corporate Bondholder Rights" (1989) Columbia Bus. L. Rev. 1 at 2, online: LEXIS (Canada, CANJNL).

not completely resolved by the terms of the contract.[2] Debtholders face the problem that the corporation may take actions that do not actually render the corporation insolvent but do increase the risk of insolvency. Two of the principal ways by which debtor corporations can act contrary to the interests of debtholders are distribution of corporate assets through dividends, stock repurchases or other means, and undertaking riskier courses of action than the corporation was pursuing at the time it acquired the debt.

It has been the traditional view of numerous commentators of corporate problems that managerial decision making in business corporations should solely be on the basis of equityholders' interests, that is, that directors fiduciary duties are owed only to equityholders of the corporation. They argue that the rights of corporate debtholders are governed exclusively by the terms of debt agreements.

Other commentators have argued that the directors' fiduciary duties should be extended to debtholders. One class of the proponents of the extension argue that the duty should be extended to debtholders only when the corporation is insolvent or near insolvency because in those circumstances, the assets of the corporation are held in trust for the corporations debtholders whose interests supercede those of the shareholders.

[2] *Ibid.*, n. 1.

Another class of the proponents of the extension argues that the duty should be extended to debtholders even when the corporation is solvent. They argue that certain corporate actions, which are incapable of regulation by contract, impermissibly transfer the value of debtholders' investments to shareholders. They argue, further, that given that the business corporation is characterized by the doctrine of limited liability, the absence of a fiduciary duty on directors to debtholders will make it impossible to recover unpaid debts from directors given the opportunistic behaviour by corporate directors that unduly transfer debtholders' investments to shareholders, whiles on the other hand, the existence of such a duty will make it possible for debtholders whose claims are unsatisfied, upon proof of a breach of the fiduciary duty, to recover damages for their losses resulting from the breach of the duty.

The objective of this thesis is to investigate the influence of debt financing on corporate governance. In order to reach this objective, I will examine the nature and purpose of a business corporation and its operations and the importance of corporate governance, the importance of debt financing in the operations of a business corporation, the nature and scope of fiduciary relations and its link to corporate actions, and the structure of standard corporate debt covenants and how the courts interpret these covenants before and during corporate insolvency and also determine the extent to which those covenants influence decision-making in corporations. I will also examine statutory provisions dealing with corporate insolvency and to trace the shifting nature of debtholders' interests during the different stages of corporate solvency. Further, I will examine the statutory provisions on the remedy of oppression and examine the cases in which debtholders have invoked the remedy in support of debt-based claims and to examine the *ratio decidendi* of those cases.

With respect to the issues at stake, I will argue that given the nature of business operations, fiduciary relations and the structure of debt covenants, it is not necessary to create fiduciary relations between a solvent corporate debtor and its debtholders. Further, I will argue that as the corporation becomes insolvent or certain corporate actions tend to bring the corporation near insolvency, a fiduciary relationship is created between the corporate debtor and its debtholders.

Chapter one sets out the theoretical basis of the existence and survival of the corporation. It examines the nature of corporations, their purpose and their operations of business corporations. This is followed by an examination of the historical origins of Canadian business corporations. The issue of limited liability as a basic corporate law doctrine is also examined. The debate about the scope of corporate governance is also examined here.

Chapter two examines the nature and scope of fiduciary relations and the relationship between fiduciary relationships and corporate governance. The need for and importance of the imposition of fiduciary duties in corporate actions is discussed here. I make an examination of the circumstances in which fiduciary duties ought to be imposed in corporate actions. I also examine the importance of fiduciary duties in corporate governance and how the courts enforce these duties.

In chapter three the issue of the employment of debt in the financing of corporations is outlined. I examine the nature and importance of corporate debt financing, while trying to explain the importance of the distinction between debt and equity and the emergence of hybrid forms of financing models that make the distinction difficult at times. I also examine the standard types of debt financing models employed by corporations, the nature of standard debt covenants in debt agreements and how the courts interpret these covenants. I also examine the issue as to whether these debt covenants are adequate to protect the interests of debtholders.

In chapter four of the thesis, I make an analysis of the results of the previous chapters to determine whether corporate directors should or do owe fiduciary duties to debtholders of the corporation prior to and or during insolvency, and consequently whether the employment of debt financing does or should influence the governance of a corporation. I consider the pros and cons of creating corporate fiduciary obligations for debtholders and suggest an alternative for protecting the rights of debtholders. I also examine the remedy of oppression as a means of obtaining an influence on corporate governance by debtholders and the scope of the availability of this remedy to debtholders in different jurisdictions. I also discuss other causal factors of the impact debtholders have on corporate governance.

The main issues arising out of the above chapters are highlighted in the conclusion and the implications of the effect of debt financing on corporate governance are discussed.

CHAPTER ONE

THE NATURE AND GOVERNANCE OF THE BUSINESS CORPORATION

1.1 The Nature of the Business Corporation

A business corporation (hereafter referred to as corporation)[3] is a type of business organization and the latter may be defined as an enterprise organized for the purpose of making a profit through trade or service.[4] The corporation serves a medium through which various investment objectives are carried out. Persons who share similar investment objectives may acquire shares of varying percentages in a corporation under certain arrangements.

The neo-classical economic theory holds that the modern corporation is a creature of private contract, more specifically an agency contract between shareholder-principals and manager-agents, and that the corporation exists

[3] There are non-profit making corporations. For the purpose of this thesis, reference to corporation means a corporation formed for the purpose of making profits. A "corporation" is defined in Bryan A. Garner, ed., *Blacks' Law Dictionary*, 7th ed. (St. Paul: West Group, 1999) 341, as "an entity (usually a business) having authority under law to act as a single person distinct from the shareholders who own it and having rights to issue stock and exist indefinitely". The terms "company" and "corporation", although often used interchangeably, are not synonymous. A company is an association of two or more persons formed to conduct business or some other activity in the name of that association. A corporation is one type of such association and differs from the others in that it is incorporated. See: Kevin P. McGuiness, *The Law and Practice of Canadian Business Corporations* (Toronto: Butterworths, 1999) at 8. Despite these technical distinctions, *some* jurisdictions, for example the United Kingdom, use the term "company" whiles others, such as Canada and the United States use the term "corporation" with reference to the same kind of entity. In this thesis, the two terms will be used interchangeably.

[4] McGuiness, *supra* note 3 at 5.

for the purpose of maximizing shareholder wealth.[5] However, proponents of the communitarian theory hold that the modern corporation is a large powerful economic institution in which many people have a vital stake.

By its very nature, ownership and control of a corporation, at least in theory, are separated. The shareholders delegate authority to a group of people ("directors") to manage the affairs of the corporation. Directors also delegate responsibility to professional managers ("officers"). The modern business corporation, which is designed to facilitate the raising of capital from a large number of investors and the utilization of the capital by entrusted expert managers, is formed with the purpose of making profit and it enables the investors to share in the profits of the enterprise.[6]

The corporation is a type of firm. The firm is the coordination of production by fiat within an organization rather than by contracts among independent contractors specifying the price, quantity and quality of the inputs into end products,[7] although it has been argued that there is no such fiat and the

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[5] Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law,* 4 (1991) Harvard University Press, 90.

[6] See L. C. B. Gower, *Principles of Modern Company Law,* 5th ed. (London: Sweet & Maxwell, 1992), 10.

[7] Richard A. Posner, and Kenneth E. Scott, *Economics of Corporations Law and Securities Regulation, (Boston and Toronto: Little, Brown and Company, 1980)* 2.

coordination is only one of ordinary market contracting.[8] The emergence of the corporation, as a firm, lies in the ability of the corporation to organize the various factors of production to achieve its maximum output.[9] Coase[10] argues that firms exist as a result of the cost of using the price mechanism on the factor market, namely the cost of discovering what relevant prices are, the cost of negotiating and concluding a separate contract for each transaction which can all be undertaken within the organizational framework of the firm. Bybelezer[11] argues that the post-industrial age "recognized the superiority of team-work over the fragmented initiatives of multinefarious market agents". The ability of the modern corporation to adapt this approach has ensured its survival. This survival also lies in the ability of the firm to collect, process and store market information needed for making informed economic decisions and that is otherwise inaccessible to the individual.[12] The use of contracts is not totally eliminated from the firm but they are minimized. In fact, the modern theory of the firm sees the firm as a legal fiction that serves as a nexus for contracts among all individuals with a consensual claim against it, namely

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[8] Armen A. Alchian & Harold Demsetz, "Production, Information Costs, and Economic Organization", in Posner and Scott, *ibid.*, at 12.

[9] See R. H. Coase, "The Nature of the Firm", in *The Firm the Market and the Law*, 2 (1998) University of Chicago Press.

[10] *Ibid.*

[11] Bybelezer, Henri M., "The Corporate Governance Debate and the Modern Theory of the Firm: Some Lessons", in Lazar Sarna, ed., *Corporate Structure, Finance and Operations – Essays on the Law and Business Practice, Vol. 5* (Toronto: Carswell, 1988) at 60.

[12] *Ibid.*, at 61.

shareholders, managers, creditors, employees, suppliers and customers.[13] The organizational function of the corporation involves risk-taking due to the uncertainty that prevails over the cost and availability of the various unifying input factors of the enterprise. Hence, the equityholders, being the residual claimants, bear the risk of the enterprise. They only take after all other constituents[14] of the corporation have had their claims satisfied.

In most common law jurisdictions, corporations are classified either as private or public. Private corporations are usually characterized by:

i. Limitations on the number of its shareholders;

ii. Restrictions on the transferability of shares; and

iii. Prohibition of any invitation to the public to subscribe for its shares.

Corporations not having these characteristics are referred to as public corporations

1.2 Historical Origins of the Canadian Business Corporation

Although this thesis is not solely on Canadian corporate law, it will set the platform for many of the issues to be discussed. Thus, in order to understand

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[13] Easterbrook & Fischel, *supra*, note 5 at 23. See generally, Michael C. Jenson & William H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 J. Fin. Econ. 305, in Posner and Scott, *supra.*, note 5 at 39.

[14] The main corporate constituents, apart from the equityholders, are debtholders, suppliers, employers, and perhaps the society at large.

the law governing business corporations in Canada, it is necessary to place it in its proper historic context.

Canada operates under a constitution framed as a system of subordinate federalism. Before the 19th century, only two types of incorporation were provided for in Canadian law. A corporation could be incorporated by the exercise of the royal prerogative. In this case, letters patent were issued by the Crown, referred to as a "Royal Charter". Incorporation could also be effected by an enactment of the legislature for special purposes.[15]

In 1850, the United Provinces of Canada enacted a general statute for incorporation[16]. This involved an expeditious process that did not depend on the exercise of the royal prerogative. This statute had three defining characteristics, namely, separate legal personality, limited liability and a limited life of fifty years. In 1864, the United Provinces of Canada enacted a new general incorporation statute[17] reverting to a model based on the exercise of royal prerogative.

[15] See generally J. A. VanDuzer, *The Law of Partnerships and Corporations* (Concord: Irwin Law, 1997) at 68.

[16] An Act to Provide for the Formation of Incorporated Joint Stock Companies, for Manufacturing, Mining, Mechanical or Chemical Purposes, S.C. 1850, c.28.

[17] An Act to authorize the Granting of Charters of Incorporation to Manufacturing, Mining, and Other Companies, S.C. 1864, c.23.

In 1975, based upon the recommendations of the Dickerson Committee,[18] the federal government enacted a new corporate law statute, the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 (hereafter "the CBCA"). The CBCA adopted the articles of incorporation approach as against the memorandum and articles of association approach provided for under English law. The CBCA also had detailed provisions on the protection of the rights of minority shareholders by the use of the oppression remedy.

It is pertinent to note that the various provinces have the power to enact their own corporate statutes. Most provinces in Canada have corporate law statutes based upon the CBCA model. The issue arising is the division of powers between the federal authorities and the provincial authorities with respect to the incorporation and regulation of corporations.

<u>Jurisdiction in Corporate Matters</u>

Section 92(11) of the Constitution Act, 1867 provides that the provinces have jurisdiction over the incorporation of companies with provincial objects. VanDuzer[19] is of the view that the limitation imposed by the reference to provincial objects has nothing to do with the nature of the corporation's business operations, nor does it impose an effective limitation on the territory within which the corporation operates. He argues that all it means is that a

[18] R. V. W. Dickerson, J. L. Howard & L. Getz, *Proposals for a New Business Corporations Law for Canada*, 2 vols. (Ottawa: Information Canada, 1971).
[19] VanDuzer, *supra*, note 15 at 73.

province is not capable of endowing a corporation with the right to carry on a business in any other jurisdiction, including any other province. The Privy Council has held, however, that a province can grant a corporation the capacity to carry on business in another jurisdiction subject to obtaining the permission of the other jurisdiction.[20] The nature of provincial jurisdiction is reflected in section 16 of the Ontario Business Corporations Act, R.S.O. 1990, c. B.16 [OBCA] as follows:

> *A corporation has the capacity to carry on its business, conduct its affairs and exercise its powers in any jurisdiction outside Ontario to the extent that the laws of such jurisdiction permit.*

The Constitution Act grants the federal government limited powers to incorporate in certain areas such as banking but contains no express general power of incorporation. However, the Privy Council has held that a general power of incorporation is implicit in the federal government's residual jurisdiction to make laws for the peace, order and good government of Canada, in relation to all matters not coming within the classes of subjects by the Constitution Act assigned exclusively to the legislatures of the Provinces.[21] Federally incorporated corporations have a right to carry on business in each province.

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[20] Bonanza Creek Gold Mining Co. Ltd. V. R., [1916] A.C. 566 (P.C.).

[21] *Citizens Insurance Co. of Canada* v. *Parsons* (1881) 7 App. Cas. 96 (PC).

Provinces can legislate to affect directly, the way in which federal corporations exercise their powers if

a) the legislation can be justified as primarily in relation to a provincial head of jurisdiction of section 92 of the Constitutions Act; and

b) the legislation is not inconsistent with federal law.

The federal government may not regulate provincial corporations directly in relation to their corporate status or characteristics. It may directly affect the way provincial corporations exercise their powers if the legislation can be justified as primarily in relation to an area of jurisdiction assigned to the federal government.[22]

1.3 Limited Liability of the Corporation

Canadian corporate statutes and those of several other jurisdictions have provisions on the doctrine of limited liability of the corporation.[23] The doctrine of limited liability means that the investors in the corporation are not liable for more than the amount they invest with respect to the debts or other obligations of the corporation.[24] Limited liability is often characterized as a

[22] See Peter Hogg, *Constitutional Law of Canada*, 3d ed., (Toronto: Carswell, 1992) chapter 23.

[23] See CBCA, s.45(1).

[24] See F. H. Easterbrook & D. R. Fischel, "Limited Liability and the Corporation" (1985) 52 U. Chi. L. Rev. 89 at 89 – 90; McGuiness, *supra*, note 3 at 23 – 24; David L. Perrot, "Changes in Attitude to Limited Liability – the European Experience", in Tony Orhinal, *ed.*, *Limited Liability and the Corporation* (London and Canberra: Croom Helm, 1982) 81 at 82.

doctrine that shifts the risk of business failure away from shareholders and directors to creditors. This is seen as unfair, particularly to unsecured creditors, and this gives creditors cause for concern. Shareholders and directors have the incentive to gamble with creditors money, and they can adopt a casual attitude to what creditors have at stake. It is argued that why should members of a company who allow a company to be mismanaged, and their management (especially where the members may have little *de facto power* of control over management) whose incompetence led to the company incurring liabilities beyond its trading resources or even beyond its own capital, be able to shift those liabilities to the company's creditors by hiding behind the abstraction of corporate identity?[25]

Despite these concerns, the doctrine still remains in the statute books of most jurisdictions due to its importance in the survival of the corporation as a nexus of contracts.[26] The existence of the concerns expressed above has given impetus to recent debates as to whether, some exception should be made to the doctrine by the evolution of a fiduciary duty by corporate directors to debtholders, in which case breach of this duty will enable aggrieved debtholders to recover unpaid corporate debts from the directors.

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[25] Perrot, *supra*, note 24 at 84 – 85.

[26] For a detailed discussion of the positive attributes of the doctrine of limited liability, see Brian R. Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford: Clarendon Press, 1997) at 499 – 504; Easterbrook and Fischel, *supra*, note 24 at 92 – 103.

1.4 Corporate Governance

The term "corporate governance" has no universally accepted definition, but instead, experts in the area have subjected its boundaries to different prescription.[27] Cheffins explains that in so doing, some have narrowed the issue to those who supply equity finance to companies, and for such people the key goal of corporate governance is to improve investor returns by upgrading the standards of managerial accountability. Cheffins cites as an example the Hampel Committee, which was the final panel in the trilogy of committees set up to investigate United Kingdom corporate governance during the 1990s.[28] Others have extended the concerns of corporate governance beyond the risks faced by a shareholder and focus rather on the whole community of interests that contribute to or are affected by the corporate entity. Thus, it has been argued that given the view that a firm is a nexus of contracts, it should not be analyzed by way of a distinction between who is "inside" and who is outside, but rather, it should be analyzed by the terms of what each class contributes to the joint production effort in order to determine how the wealth of each one of them will be maximized.[29] One

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[27] Brian R. Cheffins, "Teaching Corporate Governance" (1999) 19 Legal Studies 515 at 517.

[28] *Ibid.* The Hampel Committee, in its 1998 report stated that corporate governance is primarily concerned with the systems by which companies are directed and controlled and stressed that the single overriding objective of all publicly quoted companies 'is the preservation and the greatest practicable enhancement over time of their shareholders' investment. The Cadbury Committee discussed corporate governance in similar terms.

[29] McGuiness, *supra*, note 3 at 23.

writer[30] has also commented that most commentators, failing to acknowledge that problems and appropriate solutions may vary with corporate size, still look to the largest, publicly traded corporations for their models of corporate governance. These comments call for an all-embracing prescription of the bounds of corporate governance problems and their solutions.

One such all-embracing prescription of corporate governance is that provided by the Organization for Economic Co-operation and Development (OECD). Corporate governance is described as follows in the OECD Principles of Corporate Governance:

> *Corporate governance is the system by which business corporations are directed and controlled.*
>
> *The corporate governance structure specifies the distribution of the rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it provides the structure through which company objectives are set, and the means of attaining those objectives and monitoring performance.*[31]

It is submitted that this prescription of corporate governance offered by the OECD is to be preferred since it takes into consideration, all players in the life

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[30] Robert L. Knauss, "Corporate Governance – A Moving Target" (1981) 79 Mich. Law Rev. 478 at 478.

[31] Online at http://www.oecd.org/daf/governance/Q&As.htm.

of the corporation and does not exclude any kind of corporation on the basis of size, as is the case of the Hampel Committee Report.

The traditional corporate doctrine has taken the separation of ownership from control as the core problem of corporate governance. On this view, the principal function of corporate law is to devise strategies and mechanisms to ensure that those who are in control of the shareholders' property use it strictly for the shareholders benefit.[32] The shareholder-centered corporate law doctrine has been challenged. Dodd has argued that the modern corporation should be seen as existing for the benefit of society generally, and that the board of directors should have the broad discretion to manage the corporation for the benefit of all.[33] The OECD description seems to be in accord with the view expressed by Dodd[34] and in line with the general equitable principle that directors' fiduciary duties are owed to the corporation and to the corporation alone and not to any particular member.[35]

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[32] Terry O'Neill, "The Patriarchal Meaning of Contract: Feminist Reflections on Corporate Governance Debate", in Fiona Macmillan Patfield, ed., *Perspectives on Company Law*, Vol. 2, (The Hague-London-Boston: Kluwer Law International, 1997) 27.

[33] See generally E. Merrick Dodd Jr., "For Whom Are Corporate Managers Trustees?" (1932) 45 Harv. L. Rev. 1145.

[34] *Ibid.*

[35] See generally Gower, *supra.*, note 6 at 551. See *infra* chapter 2 for a more detailed discussion on the subject of directors' fiduciary duties.

The business corporation is an important engine for the creation of wealth. It has a vital role to play in promoting economic development and social progress. It is the engine of growth in both domestic and international economies and is increasingly responsible for the provision of employment, public and private services, goods and infrastructure. Hence companies must operate within a framework that keeps them focused on their objectives and accountable for their actions. There is the need to establish adequate and credible governance arrangements. The degree of observance to the basic principles of good corporate governance is an important factor for investment decisions. Adherence to these principles by corporations and governments will ensure market confidence and encourage more stable long-term domestic and international investment flows, thus reducing the cost of capital and inducing more stable sources of finance for the corporation. Due to increasing global competition for capital, investment capital will follow the path to those countries and corporations that have adopted efficient governance standards. Corporate governance can be considered a powerful micro-economic policy tool for supporting macro-economic policy and an effective lever for change at the business enterprise level.

The major players in the governance of a corporation are the controlling shareholders who seek to exercise governance rights; individual shareholders concerned about obtaining fair treatment from controlling shareholders and management; creditors who have the potential to serve as external monitors over corporate performance; employees and other stakeholders who have an important role in contributing to the long-term success and performance of the corporation; and governments which establish overall institutional and legal framework for corporate governance. These relationships are subject, in part to law and regulation and, in part, to voluntary adaptation to market forces.[36]

In most common law jurisdictions, the legal framework for corporate governance has been established by the promulgation of corporate statutes that spell out the rights and duties of core players of the corporation. These statutes regulate the relationship between the directors and equityholders, and the protection of investors (equity or debt) rights. Statutes dealing with other issues, particularly those affecting the interests of other corporate stakeholders, such as employees, example Labor Acts, and the wider society, example Environmental Protection Acts, have also been enacted. The enactment of these statutes reveal the commitment of governments to ensure that corporations become responsible not only to those who invest equity or debt in the corporation, but also to other sections of the population who contribute, directly or indirectly to the well-being of the corporation.

The search for the appropriate role of the corporate director remains the central problem of corporate governance.[37] This thesis will conduct an inquiry

[36] See preamble to OECD Principles of Corporate Governance. Online at http://www.oecd.org/daf/governance/principles.htm.

[37] Knauss, *supra*, note 30 at 487.

into this issue with emphasis on the role of the corporate director when the corporation employs the use of debt financing. The role of debtholders has not been part of the original corporate governance debate. This is due to the fact that debtholders have always been seen as a constituent whose rights are limited to their debt agreements. Thus they need no further protection beyond what they contracted for. This argument is becoming less tenable as it is increasingly being demonstrated by some commentators that it is possible for a performing party to a contract to behave contrary to the other party's understanding of their contract, but not necessarily contrary to the agreement's explicit terms, leading to a transfer of wealth from the other party to the performer – a phenomenon that has come to be known as a opportunistic behaviour.[38]

[38] See Timothy J. Muris, "Opportunistic Behaviour and the Law of Contracts" (1981) 65 Minn. L. Rev. 521 at 521.

CHAPTER TWO

FIDUCIARY RELATIONS AND CORPORATE ACTIONS

2.1 Nature and Scope of Fiduciary Relations

In order to appreciate the issue as to whether debtholders influence corporate governance, it is essential to understand fiduciary relations in the corporation, as fiduciary principles regulate and give direction to corporate governance.

Various types of fiduciary relations have evolved over time. In the business realm, the fiduciary duties of corporate directors and officers originated with the formation of corporations. The nature, source and scope of corporate fiduciary duties are not clearly defined,[39] as it seems an impossibility.[40] Judges have only given broad outlines. The identification of a corporate fiduciary is not always a precise exercise. The famous statement of Mr. Justice Stewart in *Jacobellis* v. *Ohio*[41] probably expresses the *sub silentio* view of many courts faced with this problem as well as it described his evaluation of an obscene publication as follows: "I shall not today attempt to define the kinds of material I understand to be embraced within that

[39] R. Flannigan, "The Fiduciary Obligations" (1989) 9 Oxford Journal of Legal Studies 285.

[40] See *In Re City Equitable Fire Insurance Co.* [1925] 1 Ch. 407 at 426 where Romer J. made the observation that "[i]t is indeed impossible to describe the duty of directors in general terms, whether by way of analogy or otherwise".

[41] 378 U.S. 184, 197 (1964).

shorthand description; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it, ...".[42]

One commentator has suggested that the issue of fiduciary relations is better understood if analyzed in terms of when fiduciary obligations have been breached rather than what they actually mean.[43] It is submitted, however, that despite the difficulty in defining the scope of fiduciary duties, the obligations arising from fiduciary relations cannot be properly enforced if they are not adequately prescribed. It will pose compliance problems for those upon whom fiduciary obligations are placed and courts will have difficulties in deciding whether there are any breaches of fiduciary obligations.

According to Flannigan,[44] the fiduciary status is associated with (1) trust relationships in which conflict of interest and duty tend to arise; (2) relationships that raise a presumption of undue influence; and (3) relationships in which confidential information may be misused. Conflicts of interest and duty are common in relationships such as principal and agent – a classic example being a company and its directors - and trustee and beneficiary relationships. Undue influence arises in normal client-solicitor, patient-doctor relationship. Misuse of confidential information arises in an

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[42] *Ibid.*, in Leslie W. Jacobs, "Business Ethics and the Law: Obligations of a Corporate Executive" (1973) 28 Bus. Law. 1063 at 1064.

[43] Razeen Sappideen, "Fiduciary Obligations to Corporate Creditors" (1991) J. Bus. L. 365 at 383.

[44] Flannigan, *supra*, note 39 at 286.

employer-employee relationship where the employee is entrusted with, for example, trade secrets such as a client list or secret manufacturing process.

According to Frankel,[45] the central features of fiduciary relations is that the fiduciary serves as a substitute for the entrustor and the fiduciary obtains power from the entrustor or from a third party for the sole purpose of enabling the fiduciary to act effectively. The term "power" here means the ability to make changes that affect the entrustor. The delegation of powers creates a fiduciary relationship only to the extent that the powers are necessary to the performance of the fiduciary's function. These features describe the relations between shareholders (as entrustors) and directors/managers (as fiduciaries). The shareholders entrust their funds to the directors/managers expecting the fiduciaries to maximize the returns on their investments.

The structure and nature of the fiduciary relationship makes the entrustor vulnerable to abuse by the fiduciary because often, the purpose for which the fiduciary is allowed to use his delegated power is narrower than the purposes for which he is capable of using that power. The extent of abuse depends on: (1) the purposes for which the relationship was established and the nature of power that must be delegated; (2) the extent of the powers delegated; and (3) the availability of protective mechanisms that reduce the probability of abuse. These mechanisms are either costly or substantially reduce the benefit the

[45] Tamar Frankel, "Fiduciary Law" (1983) 71 Calif. L. Rev. (No. 3) 795 at 800 – 810.

entrustor expected from the relationship. And the mechanisms may be inadequate to deal with one-time defalcations, for example when the manager concludes that the opportunities of the moment exceed any subsequent penalties in the employment market.[46] Thus, because the entrustor cannot satisfactorily protect himself from the fiduciary's abuses while maintaining the benefits of the fiduciary relation, the law must intervene to protect him from those abuses by rules that are sensitive to the dangers posed to the entrustor by the relationship.

The imposition of fiduciary duties can be explained by at least seven theories,[47] as follows:

(i) Unjust Enrichment Theory – According to this theory, a fiduciary relationship exists where one person obtains property or other advantage which justice requires should belong to the other.

(ii) Commercial Utility Theory – According to this theory, a fiduciary relationship will be found by the court in every situation in which the court feels it necessary to hold a person or a certain class of persons to a higher than average standard of ethics or good faith in the interests of protecting the integrity of a commercial enterprise.[48]

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[46] Easterbrook & Fischel, *supra*, note 5 at 92.

[47] See generally J. C. Shepherd, "Towards a Unified Concept of Fiduciary Relationships" (1981) 97 L. Q. Rev. 51.

[48] See also E. J. Wenrib, "The Fiduciary Obligation" (1975) 25 U. T. L. J. 1 at 9 – 15.

(iii) Reliance Theory – According to this theory, a fiduciary relationship exists where one person places trust or confidence or reliance in another.

(iv) Unequal Relationship Theory – According to this theory, a fiduciary relationship exists wherever there is established an inequality of footing between the parties. This inequality can be of two types, that is, *de jure,* which is a result of particular defined relationships such as trustee and beneficiary, and *de facto*, the result of the dominion by one person over the other.[49] This theory is implicit in cases in which vulnerability or inequality of bargaining power is central to the problem.[50]

(v) Property Theory – This theory postulates that a fiduciary relationship exists where one person has legal title and/or control over property or advantage, and another is the beneficial owner thereof.

(vi) Undertaking or Contractual Theory – According to this theory, a fiduciary relationship exists where one person relies on or trusts another, and such reliance or trust has been accepted by that other person, if not by contract *per se*, at least like a contract in form.[51]

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[49] See also *Follis v. Township of Albemarle* [1934] 1 D.L.R. 178, at 181 – 182.

[50] See *McKenzie* v. *Bank of Montreal* (1975) 55 D.L.R. (3d) 641.

[51] See also Austin Scott, "The Fiduciary Principle" (1949) 37 Cal. L. J. 521 at 540.

(vii) Power and Discretion Theory – According to this theory, a fiduciary relationship exists where one person has the power to change the legal position of another, and a discretion in the exercise of that power.[52]

It has been suggested that the imposition of fiduciary obligations on directors with respect to the corporation, shareholders and debtholders can be justified under each of the above theories.[53]

2.2 Fiduciary Duties and Corporate Governance

In the modern corporation, particularly in widely held public corporations, those who invest in the corporations delegate authority for the management of the corporations to directors who in turn delegate authority to other agents. Delegation of authority produces some beneficial effects. Firstly, it enables skilled managers to run enterprises even though they lack personal wealth, and it enables wealthy people to invest even though they lack managerial skills. Secondly, it reduces the risks that investors must incur, because it enables them to spread investments among many enterprises. Thirdly, delegation helps managers to pool enough capital to take advantage of available economies of scale in production, to reduce the costs of bargaining

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[52] See also Wenrib, *supra*, note 48 at 7.

[53] Sappideen, *supra*, note 43 at 383.

and contracting, and to obtain the benefits of productive information that must be used in secret or not at all.[54]

Given that the modern corporation is a web of agency relationships,[55] the economic function of fiduciary duties is to regulate the complex web of agency relationships that comprise the structure of the corporate enterprise.[56] Trust is crucial to progressive economic performance of the firm. However, as in all cases of fiduciary relationships, the directors, as agents, who are entrusted with the management of the corporations by the shareholders, as principals, have the tendency to engage in activities that promote their own interests and jeopardize the interests of the shareholders. Thus, despite the benefits of delegation of authority, the interests of agents may diverge from the interests of principals after the delegation. This divergence of interests between principals and agents may be controlled by the operation of markets for employment, corporate control and products. However, as Easterbrook and Fischel point out, much as these market mechanisms reduce the divergence of interests between the agents and principals, they do not eliminate the costs of the agency relationship because these mechanisms do

[54] See generally F. H. Easterbrook, and D. R. Fischel, "Corporate Control Transactions" (1982) 92 Yale Law Journal 698 at 700.

[55] An agency relationship is an agreement in which one or more persons (the principal) delegates authority to another person (the agent) to perform some service on the principal's behalf. See Easterbrook & Fischel, *ibid.*

[56] *Ibid.*

not work without costly and extensive monitoring.[57] Thus, there is the need for some supervision of the corporate actions of directors.

The fiduciary principle is an alternative to direct monitoring. It is a relatively low-cost approach, substituting deterrence for costly and ineffective direct supervision of agents' behaviour. Acting as a standard form penalty clause, its elastic contours reflect the difficulty that contracting parties have in anticipating when and how their interests may diverge.[58]

The fiduciary concept also helps to define the factors directors should take into account in making decisions for the corporation.[59] If corporate directors know the categories of corporate stakeholders to whom they owe fiduciary duties, they are likely to have those persons in mind and this will influence the decisions they make which affect those persons. The fiduciary principle is very important to corporate governance because the concept clearly identifies the director's obligations to the corporation and permits flexibility in the director's role according to the nature of the enterprise, and the search for the appropriate role for the corporate director is the central problem of corporate governance.[60]

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[57] *Ibid.*, at 701.

[58] Easterbrook and Fischel, *supra*, note 53 at 702

[59] Knauss, *supra* note 30 at 498

[60] Knauss, *supra*, note 30 at 487

It is not difficult to see why it is desirable for managers to owe a fiduciary duty to shareholders, and why the corporate governance debate has for a long time centred on the shareholders interests. Given that the corporation is a complex set of contractual relationships between various participants, which relationships are comparable to principal agent relationships, the creation and continuance of the principal agent relationship may entail certain costs referred to as the agency costs. This is because the agent in the principal agent relationship has the tendency of promoting his own welfare, which does not always coincide with the welfare of the principal. The shareholders are the owners of the company (they have residual income rights and residual control rights) and yet, particularly in the case of a large public company, they have very little involvement in the day-to-day business decisions.[61] They delegate these to management, who have a great deal deal of power, which it can use both for good – to increase the value of the firm – and for bad – to line its own pockets.

One way of minimizing the agency costs is to employ the use of contractual terms to prohibit certain actions of the agent that are inimical to the interests of the principal. However, this method is not feasible in minimizing the agency costs of the shareholder-director relationship in the corporate enterprise. The decisions that face the officers and directors of corporations are sufficiently complex and difficult to predict. Thus, it is difficult and prohibitive in costs to

[61] Oliver Hart, "An Economist's View of Fiduciary Duty" (1993) 43 U. T. L. J. 299 at 303

write a contract that specifically rules out all possible bad actions that management might undertake, and it would not be feasible to specify in advance how such officers and directors should respond to a wide range of future contingencies. Also, and particularly with widely-held corporations, the fact that many investors will become stockholders of the corporation and partake of the benefits of the same investment contract will tend to reduce the incentive of each stockholder to become knowledgeable and negotiate effective contractual protections (this is referred to as the "free rider" problem).[62] Each investor knows he or she is likely to benefit from any contractual protections negotiated by other parties and, thus, is unlikely to invest adequately in negotiating a proper contract with the corporation. Further, most stockholders lack the expertise to conduct the business of the corporation, and thus rely on the expertise of management. Corporate decision-making requires the exercise of discretion by management in the light of constantly changing circumstances in order to be most effective. Without discretion to act as particular circumstances require, corporate management would be bound to particular courses of action even though new developments and changes in circumstances might suggest that other courses of action are more appropriate. A contract that binds corporate management in detail necessarily restricts their discretion, thereby depriving stockholders of the full benefit of the expertise of corporate management.

[62] See generally Tauke, *supra* note 1 at 16 – 17 for discussion on the infeasibility of contractual arrangements in the stockholder-director relationship.

The fiduciary principle, given the costly nature of resorting to contracts, is an alternative structure for regulating the stockholder-director relationship. Fiduciary duties serve to reduce agency costs by penalizing and deterring management conduct that departs from the goal of maximization of stockholder wealth. Making management a fiduciary of shareholders puts a break on the self-serving activities of the corporate manager, in general terms, by exposing a manager who acts openly to enrich himself at the expense of shareholders to a lawsuit.

The fiduciary principle is also a mechanism invented by the legal system for filling in the unspecified terms of shareholders contingent contacts.[63] Thus, in a fiduciary relationship, good faith and fair dealing, rather than legal obligation, form the basis of the transaction.[64]

2.3 Enforcement of Corporate Fiduciary Obligations

The obligations arising out of fiduciary relations can only be useful for the purposes for which they were created if they can be adequately and effectively enforced. Implicit in the concept of the separate personality of the corporation is the point that the corporation is the appropriate party to bring actions to enforce duties owned to it and for wrongs done to it. Directors owe

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[63] See generally Jonathan R. Macey, and Miller, Geoffrey P., *Corporate Stakeholders: A Contractual Perspective* (1993) 43 U. T. L. J. 401.

[64] S. L. Schwarcz, "Re-thinking a Corporations' Obligations To Creditors" (1996) 17 Cardozo L. Rev. 647 at 655.

corporate fiduciary obligations directly to the corporation. However, being the residual income owners of the corporation, the interests of the corporation often coincide with those of the shareholders, making shareholders beneficiaries of directors' corporate fiduciary duties.

In enforcing the director's fiduciary duties, the courts distinguish between the duty of due care and the duty of loyalty. Scott[65] aptly makes this distinction as follows:

> *The duty of care demands that top officers and members of the board of directors invest a certain amount of time and effort and exercise a certain level of skills and judgment in the operation of the firm. The duty of loyalty requires that officers and directors put the interests of the stockholders ahead of their personal gain and subjects them to oversight in transactions involving conflicts of interests.*[66]

Corporate law treats abuses of the duty of loyalty more harshly than abuses of the duty or care. This is partly due to the law's greater comfort in dealing with unfairness than with inefficiency because unfairness, that is self-dealing,[67] is the more serious problem. Acting on the basis of the business

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[65] Kenneth E. Scott, "Corporation Law and the American Law Institute Corporate Governance Project" (1983) 35 Stan. L. Rev. 927.
[66] *Ibid.*, at 927 – 928

[67] Self-dealing transactions involve contracts or transactions concluded between the directors and officers of the corporation, either directly or through their interest in another entity, and the corporation itself. Insiders contracting with the corporation have a strong incentive to cause the corporation to enter into transactions with the corporation that favour the insider. The costs occasioned by self-dealing transactions constitute another form of agency costs. The courts are now moving from the rigid position of categorical prohibition against self-dealing to more flexible rules that consider the procedural and substantive fairness of self-interested transactions. See, for example, *Aberdeen Railway Co.* v. *Blaikie Bros.* [1843 – 60] All ER. Rep. 249; *Transvaal Lands Co.* v. *New Belgium (Transvaal) Land and Development*

judgment rule,[68] the courts defer to the decisions of directors and officers that involve no self-dealing and minimize the threat of liability for erroneous decisions.[69] This counters the concerns raised by Fischel & Bradley[70] about liability rules that a poor outcome will be equated with poor performance, and if agents are penalized for poor outcomes as well as poor performance, they will tend to undertake lower risk projects.[71]

There are two principal ways of bringing a fiduciary complaint, namely a derivative action, and a personal action. Apart from these traditional ways, fiduciary duties can also be enforced through the statutory provisions of oppression and winding up. For the purpose of this thesis, I will limit my self to a discussion of the derivative action and the statutory oppression remedy.

Co. [1914] 2 Ch. 488; *The Liquidation of Imperial Mercantile Credit Association* v. *Edward John Coleman and John Watson Knight* [1873] L.R. 7 E & I App. 189 (HL); *Gray* v. *New Augarita Porcupine Mines Ltd.* [1952] 3 D.L.R. 1(P.C.). In Canada, there have been legislative attempts to regulate contracts with directors or officers through a full disclosure mechanism. See *CBCA*, s.120.

[68] The business judgment rule is "[t]he presumption that in making business decisions not involving direct self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best interest. The rule shields directors and officers from liability for unprofitable or harmful corporate transactions if the transactions were made in good faith, with due care, and within the directors' or officers' authority." See Garner, *supra*, note 3 at 192.

[69] See Donald E. Schwartz, "In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley" (1986) 71 Cornell L. Rev. 323 at 325.

[70] Daniel R. Fischel, & Michael Bradley, "The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoritical and Empirical Analysis" (1986) 71 Cornell L. Rev. 261.

[71] *Ibid.*, at 270.

2.3.1 Derivative Actions

A derivative action is an action brought in the name or on behalf of a corporation or any of its subsidiaries, or an intervention in an action brought by or against the corporation or its subsidiary by a shareholder or other complainants to assert or defend rights to which the corporation or its subsidiary is entitled.[72] A derivative action is a class action brought in a representative capacity and is binding on all shareholders. Thus when there is a breach of directors' fiduciary duties to the corporation, any number of shareholders can bring a derivative action to remedy the wrong. The derivative suit is a striking exception to the fundamental principle of majority rule in corporate law.[73] Management's greatest liability exposure is for breaches of the duty of loyalty. As a matter of practice derivative suits are limited mostly to breaches of the duty of loyalty rather than the duty of due care.[74]

Proponents of the derivative suit argue the derivative suit is essential to enforce the fiduciary duties of loyalty and care. They argue that in the absence of such an enforcement mechanism, corporate managers could engage in wrongdoing with impunity so long as they decline to sue themselves.[75] However, Fischel & Bradley argue that because of his small

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72 McGuiness, *supra* note 3 at 920.

73 See Fischel and Bradley, *supra*, note 70 at 271.

74 See Schwartz, *supra*, note 69 at 327.

75 See Fischel & Bradley, *supra*, note 70 at 262.

stake in the enterprise, the complaining shareholder (or his attorney) has very little incentive to consider the effect of the action on other shareholders who ultimately bear the costs. They argue, further, that small-stake shareholders and their attorneys lack the expertise and access to relevant information to enable them determine which management actions are inconsistent with maximizing the value of the firm. They argue that there are real costs to the derivative suit because of the risk of strategic behaviour and uninformed decision-making.[76] It is submitted that the criticisms leveled against the derivative suits by Fischel and Bradley do not take into consideration the important distinction between the fiduciary duty of loyalty and the fiduciary duty of care, in that they fail to recognize that most derivative suits are targeted at the fiduciary duty of loyalty, whiles their criticisms largely relate to the fiduciary duty of due care, and the fact that the business judgment rule has to a large extent negated the liabilities that corporate directors and managers would attract with respect to the fiduciary duty of due care.

2.3.1.1 Common Law Origins of Derivative Suit

The common law origins of the derivative suit are found in the decision of *Foss* v. *Harbottle*.[77] This decision was based on two corporate law principles: (1) the separate legal personality of the company corporation and (2) majority rule in internal corporate affairs.

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[76] Fischel and Bradley, *supra*, note 70 at 271-274.

[77] (1843) 2 Hare 461; 67 E. R. 189 (Ch.).

With respect to the former, if the corporation is a legal person separate from its members, it follows that for a wrong done to it, the corporation itself is the only proper plaintiff. Thus, in *Foss* v. *Harbottle*, the plaintiffs alleged a sale by the directors of their own property to the company at inflated prices. The court held that the wrong alleged was a wrong to the company and thus, the plaintiffs had no *locus standi* to sue on behalf of the company. On the latter principle, since shareholders could approve or ratify breaches of duty to the corporation, it would be an inappropriate interference with majority rule for courts to permit actions by minority shareholders where the action had been or could be ratified by the majority. Moreover, the decision whether or not to bring an action in the name of the company belongs at common law to the general meeting where majority rules. The court in *Foss* v. *Harbottle*, was of the opinion that the will of the majority had not been ascertained and the plaintiffs were non-suited. The only exceptions to the rule in *Foss* v. *Harbottle*, which allowed a minority shareholder to sue for an injury to the corporation were in situations where (1) a fraud was being committed on the minority by giving corporate assets away to the majority shareholder, (2) where the act complained of was *ultra vires,* (3) where there was a defect in the process of majority approval, and (4) where personal rights of a shareholder has been infringed.[78]

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[78] See *Edwards* v. *Halliwell* [1950] 2 All ER 1064 per decision of Jenkins L. J.

2.3.1.2 Statutory Interventions

Several jurisdictions have made statutory intervention in the rule of *Foss* v. *Harbottle* with the view to making it easier for shareholders and other corporate stakeholders to obtain protection from breaches of directors' fiduciary duties. In Canada, sections 238 - 240 and 242 of the CBCA deal with the derivative action. Also under section 122 (3) of the CBCA, the curative effect of ratification has been abolished.[79]

Sections 238 and 239 of the CBCA confer upon a shareholder the right to apply to a court for leave to bring or intervene in a derivative action in the name and on behalf of the corporation or one of its subsidiaries to enforce a right of the corporation. Leave will only be granted if:

a) The complainant has given reasonable notice to the directors of his intention to apply to the court for leave if the directors do not bring or diligently prosecute the action;
b) The complainant is acting in good faith; and
c) The action appears to be in the best interests of the corporation.

These provisions are only procedural and do not provide any directions as to the substantive basis for bringing such an action. But the authors of the

[79] See VanDuzer, *supra*, note 16 at 253. But see F. H. Buckley, Mark Gillen, & Robert Yalden, *Corporations: Principles and Policies*, 3d *ed.* (Toronto: Emond , 1995) at 709.

CBCA explain that circumstances under which a derivative action may be brought include:

a) Actions against directors for breach of duty owed to the corporation alleging self-dealing or negligence,

b) An action for an injunction to preclude a threatened injury to a corporation, or

c) An action to restrain an act outside the scope of the authority of the corporation, its directors or officers. [80]

Professor Gower provided a more substantive basis for bringing a derivative suit when he drafted the Companies Code of Ghana.[81] Section 210 of the Companies Code, 1963 (Act 179) provides, *inter alia*, that a company or any shareholder of the company may institute proceedings to:

a) Recover from a director any liabilities the company may incur under the Ghana Act 179 as a result of the directors breach of his duties imposed under the Ghana Act 179, or

b) Restrain any threatened breach of any of those duties, or

c) Recover from any director of the company any property of the company.

[80] Dickerson, Howard and Getz, *supra, note* 18 vol. 1 at 160.

[81] See L. C. B. Gower, *Final Report of the Commission of Enquiry into the Working and Administration of the present Company Law of Ghana* (Accra: Assembly Press, 1961).

In his comments to the above section, Prof. Gower stated that the section attempts to make the directors' duties more readily enforceable in two ways – (a) by making it easier for actions to be brought in the name of the company and (b) by allowing an individual member to institute proceedings more readily than under the rule in *Foss* v. *Harbottle* and its judicial exceptions.[82]

In Canada, the rule in *Foss* v. Harbottle is abolished by section 242(1) of the CBCA, which provides that evidence of shareholder ratification or possible ratification of conduct complained of, is not determinative of whether derivative litigation should proceed, although shareholder ratification may be taken into account by a court in determining whether the proposed litigation would be in the best interests of the corporation.[83]

Under section 242(2) of the CBCA, the stay discontinuance or settlement of a derivative suit, once filed, without the prior approval of the court is prohibited. This provision is of American origin[84] and has two main objectives. First, it is designed to prevent corporations from settling "nuisance" or "strike" suits where a shareholder brings a frivolous suit to extort a financial settlement out of the corporation, and second, it may prevent corporations from buying off a

[82] See Gower, *supra*, note 81 at 152.

[83] See VanDuzer, *supra* note 16 at 254 – 255; Buckley, Gillen, and Yalden, *supra*, note 79 at 701

[84] See Buckley, Gillen, and Yalden, *supra*, note 79 at 701. A similar provision is also found in section 210(9) of Ghana's Act 179

shareholder who has obtained the leave of court to commence an apparently meritorious action for the benefit of the corporation.[85]

In order to assist an impecunious shareholder to take actions in the corporations' interest, a shareholder cannot be required to give security for the corporation's costs, and a court may award an impecunious shareholder interim costs to assist him or her to pay her legal expenses through the action, although she may be required to repay them is she is unsuccessful.[86] These rules do not exist in the United States and in Ghana.

It is apparent from the above discussion on derivative suits that statutory ameliorations into the common law rule in *Foss* v. *Harbottle* has made it easier for the fiduciary duties of directors to be enforced by minority shareholders in circumstances in which for self-serving reasons, corporate directors refuse to take required action on behalf of the corporation against corporate directors and managers in order to preserve corporate assets.

2.3.2 The Statutory Oppression Remedy

The oppression remedy, which originates from England and now found in the corporate statutes of most common law jurisdictions, is a creation of statute to offer a remedy against certain corporate actions for which remedies could not be obtained under the existing derivative actions, that is, to circumvent the

[85] See VanDuzer, *supra*, note 16 at 255

[86] See *CBCA*, s. 242(3),(4).

limitations of the existing law of fiduciary duties that denied minority shareholders a remedy where it was thought that one should be available. As previously discussed, the derivative action serves as a mode of enforcing corporate fiduciary duties. With respect to discussing the enforcement of corporate fiduciary duties, it then becomes necessary to raise an inquiry as to the relevance of the oppression remedy, given the existence of the derivative suit as a mode of enforcing fiduciary duties. This calls for a distinction between conduct that constitutes a breach of a director or officer's fiduciary duty, and conduct that is oppressive, unfairly prejudicial, or that unfairly disregards (collectively referred to as conduct that is "oppressive").

There is a significant overlap between fiduciary duties and the oppression remedy. The substantive ground for invoking the oppression remedy is unfairness, and this substantive ground is almost always broader than the substantive ground for invoking an enforcement mechanism for the breach of fiduciary duties. Consequently, the courts have routinely characterized directorial conduct that is in breach of a fiduciary duty as oppressive,[87] but it is important to note that not all oppressive actions would amount to breaches of fiduciary duties. The overlap of the fiduciary duties and the oppression remedy accounts for the common occurrence of actions alleging breach of fiduciary duties also alleging oppression.

[87] J. S. Ziegel *et al.*, *Cases and Materials on Partnerships and Canadian Business Corporations*, 3d ed. (Toronto: Carswell, 1994) at 1190.

One obvious reason for resorting to the oppression remedy for breach of fiduciary duties is that the remedies available under the oppression remedy are far broader than those available in an action for breach of fiduciary duties.

Being a statutory remedy, the scope of the oppression remedy varies from jurisdiction to jurisdiction. In recent years, the remedy has been resorted to, not only by shareholders, but also by debt holders, creditors and employees as a vehicle for advancing claims against shareholders or the corporation.[88]

[88] See Buckley, Gillen, and Yalden, *supra*, note 79 at 744.

CHAPTER THREE

DEBT FINANCING

3.1 Nature and Importance of Corporate Debt Financing

Debt financing is one of the two basic sources of financing for corporations, the other being equity financing. The term "debt" has no fixed legal meaning, but takes shades of meaning from the occasion of its use and the context in which it appears.[89] Generally, however, a debt is a certain sum of money that is owed by one person ("the debtor") to another ("the creditor"). A debt is a type of liability and is distinguished from other types of liabilities by the character that a debt is an obligation to pay a fixed sum of money at a specific time. A debt denotes, not only the obligation of the debtor to pay, but also the right of the creditor to receive and enforce payment.

A debt may be either secured or unsecured – secured debt being a debt for which the creditor has some security in addition to the mere personal liability of the debtor.

In the context of corporate financing, debt refers to liabilities of a corporation arising out of loans to the corporation, the sale or other disposition by the corporation of its debt securities, and trade credit extended to the corporation

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[89] See McGuiness, *supra*, note 3 at 431.

by its suppliers. [90] In this thesis, reference to debt shall be limited in meaning to the first two forms of corporate liabilities aforementioned.

Corporations resort to the use of debt financing due to the limited resources available to the corporation to exploit potentially profitable investment opportunities. In most jurisdictions, corporations obtain tax subsidies on interest payments due and made on debt obligations. The resort to debt financing is also a measure to prevent competitors who have the requisite personal wealth from taking up projects.

The resort to debt financing by corporations is of prime importance to the issue of corporate governance. Imposition of fixed obligations under loan agreement forces managers to disgorge free cash rather than use it to bankroll forms of managerial slack.[91] These obligations will also force management to raise funds for future projects in vigilant capital markets, rather than drawing from a pool of available internal funds. This results in effective monitoring of management as there is close monitoring associated with debt sold in capital markets.

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[90] See McGuiness, *supra,* note 3 at 432

[91] George G. Triantis & Ronald J. Daniels, "The Role of Debt in Interactive Corporate Governance" (1995) 83 Cal. L. Rev. 1073 at 1078. The authors, at page 1074, describe managerial slack as managerial behaviour that impedes the maximization of firm value: notably, lapses in managerial competence or effort, managerial entrenchment or empire building, and excessive managerial compensation or perquisite consumption.

When the lender is given either a security interest in assets of the borrower, or some other form of priority rights, these features constrain the ability of the manager to liquidate non-cash assets or to raise new funds by selling debt in the future. This reduces free cash available to managers and thus, reduces the risk of managerial slack. Also, the ability to obtain loans is a sign to other stakeholders of the quality of the corporate borrower.

The right of a corporation to contract a debt obligation is not inherent in the corporation. It must be conferred by its incorporating instrument or by statute.

3.2 Types of Corporate Debt

The range of debt financing arrangements available to corporations may be limited to a large extent only by the imagination of debtholders and debtor corporations. This is because there are very few legal restrictions on debt financing to corporations.

3.2.1 Formal Loan Agreement

A formal loan agreement is usually utilized in the case of direct lending of funds by a bank or other institutional lender to a corporation. A loan agreement usually establishes the lender's intended rights and remedies and covers the administration of the loan in the ordinary course, in a workout, and under the mechanisms of bankruptcy statutes.[92] A loan agreement is basically of two types, namely a term loan agreement and a demand loan agreement.

A term loan agreement is essentially a constant or reducing loan, incapable of increase without an amendment or special terms. Term loans usually make provision for the advances to be made by the lender to the borrower, either by single funding or incremental takedowns that may be tied to the passage of time or the occurrence of certain events. They may provide for a single payment at the expiration of their term, or for any schedule of amortization, either with or without a "balloon" payment at the end. With a term loan, funds repaid before the expiry of the commitment period cannot be redrawn as fresh credit. Even if an early payment is made, the borrower has no right to a re-advance of those funds.

A line of credit or revolving credit agreement is the most common form of a demand loan agreement. This facility is, in effect, a committed line of credit, in that it permits the borrower to borrow, repay, and re-borrow in stated amounts, not exceeding a stated maximum at any time to be outstanding, until the arrival of an agreed upon termination date, unless the occurrence of an event or default terminates the arrangement. The ability of the borrower to draw funds under the revolving credit may be absolute or may be tied to a borrowing base related to inventory, accounts receivable, or any other

[92] See Richard T. Nassberg, Loan *Documentation: Basic But Crucial* (1981) 36 Bus. Law. 843.

criterion. The advantage with this method of financing is that interest will be paid only on the part of the advances utilized and outstanding from time to time. However, a commitment fee is payable by the borrower to the lender in consideration of keeping the utilized portion of the facility open for the borrower should it choose to draw upon it.

Loan agreements may also differ as to whether and how they may be collateralized and the presence or absence of guarantees, pledges of securities, participations, and subordinations.[93]

3.2.2 Investment Securities

Debt may also be incurred under a variety of publicly sold investment securities such as bills of exchange or promissory notes, referred to as commercial paper, which is normally unsecured. A corporation can raise debt financing through the sale of secured debt instruments such as debentures and bonds.

3.2.2.1 Bonds and Debentures

The term "bond" is defined as a written promise to pay money or do some act if certain circumstances occur or a certain time lapses.[94]

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[93] See Nassberg, *supra*, note 92 at 844 – 845.

[94] Garner, *supra*, note 3 at 169.

The "term" debenture is defined as a bond that is backed only by the general and financial reputation of the corporate insurer, not by a lien or corporate assets.[95] A debenture is, therefore, a form of a bond.[96] Bonds and debentures are usually issued by corporations, sometimes in series, usually under corporate seal[97] and pursuant to a trust indenture. A trust indenture contains the terms of the debt contract and appoints a trustee to represent the interests of the disparate debt holders.[98] It specifies the rights of the bondholders and the issuer, sets forth the mechanics of payment, states the issuers' sinking fund obligations and redemption rights, regulates the conduct of the issuers' business, and defines events of default and the role of the trustee.[99] The purpose of using the trust indenture vehicle is to simplify the administration of the bonds or debentures, as the corporation may deal with the trustee rather than with the holders at large.

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[95] Garner, *supra*, note 3 at 408.

[96] But see William W. Bratton, "The Interpretation of Contracts Governing Corporate Debt Relationships" (1984) 5 Cardozo L. Rev. 371 at 371 n.1. The writer makes the point that corporate practice distinguishes "bonds" from "debentures", describing the former as secured long-term notes issued pursuant to a trust indenture, and the latter as unsecured long-term notes issued pursuant to a trust indenture. For the purpose of this thesis, the two terms are used interchangeably to denote all long-term debt issues.

[97] See McGuiness, *supra*, note 3 at 494.

[98] Triantis & Daniels, *supra*, note 91 at 1088.

[99] William W. Bratton, "The Economics and Jurisprudence of Convertible Bonds" (1984) Wis. L. Rev. 667 at 667.

Some bonds are sometimes referred to as convertible bonds.[100] These are bonds incorporating the privilege of conversion into common stock or other securities of the issuer. Convertible bonds combine debt and equity features in a single hybrid security. Whiles having the capacity to reduce stockholder-bondholder conflict by creating a class of security holders whose interests go to both sides of the debt-equity line, convertible bonds do not eliminate all incentives for opportunistic behaviour by issuers that transfer wealth from bondholders to stockholders.

The issuer incorporating a conversion privilege into its bonds grants a future claim on its equity. This future claim, to investors, gives convertible bonds the advantage of combining desirable features of straight bonds, such as fixed income payments and principal repayments with the upside potential of common stock. In consideration for the future equity claim, convertible bondholders customarily accept a coupon rate lower than that of an equivalent straight bond, less restrictive covenants, and subordinated status. To issuers, these concessions give convertible bonds 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.

[100] This discussion following is based on Bratton, *ibid.*

Despite the benefits investors expect to reap from convertible bonds, certain issuer actions have the effect of diluting[101] or destroying[102] conversion value, and this is source of conflict between convertible bondholders and stockholders.

3.2.3 Public versus Private Issues of Debt

In a private issue of a debt arrangement, such as a bank lending or private bond issues, the borrower and the lender negotiate the terms of the debt. On the other hand, with a public issue of a debt arrangement, such as public bond issues, the prospective bondholders do not negotiate the terms of the trust indentures. The issuers and the lead underwriters usually do the negotiation. In *Metropolitan Life Insurance Co.* v. *RJR Nabisco, Inc.*,[103] the court stated that "indentures are often not the product of face-to-face negotiations between the ultimate holders and the issuing company[;] ..... the underwriters ordinarily negotiate the terms of the indentures with the issuers".[104] It should be noted that underwriters are not parties to the indenture.

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[101] 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 stock and, unless an adjustment is made, in its conversion value. Stock splits, stock dividends and sales of additional common stock below market value by the issuer are examples of this phenomenon. See Bratton, *supra*, note 99 at 681.

[102] Conversion value is destroyed when the issuer disposes of corporate assets for a price below market value. There is a total destruction of the conversion value when the issuer or the underlying common stock or both cease to exist altogether. See Bratton, *supra*, note 99 at 681 – 682.

[103] 716 F. Supp. 1504 (S.D.N.Y. 1989).

[104] *Ibid.*, at 1509.

The view has been expressed that despite the similarity in the default risks in bank, that is private, and public debt arrangements, the typical covenant in public debt protects the debt holder to a much lesser degree than the typical covenant in commercial bank debt.[105]

3.3 Nature of Debt Covenants

A debt covenant is a provision in a debt contract that restricts the firm from engaging in specified actions after the debt has been engaged. These covenants may be found in lending agreements, as between a bank or other institutional lender and a corporate borrower, or in trust deeds or indentures in public issues of debt.

The more important terms of a trust deed, and for that matter any debt agreement are the amount borrowed, the rate of interest and the repayment schedule of interest and capital.[106] The agreement will also refer to any security interest given as collateral, and what that interest is. Additional classes would refer to the insurance of plant and equipment. However, at the heart of the debt agreement are certain observed debt covenants which can conveniently be grouped into four categories, namely production/investment

[105] Triantis & Daniels, *supra*, note 91 at 1088.

[106] See Sappideen, *supra*, note 53 at 377.

covenants, dividend covenants, financing covenants and bonding covenants.[107]

3.3.1 Production/Investment Covenants

Debt covenants may contain restrictions on the type of activity the corporate borrower should, or should not engage in. Debt covenants frequently restrict the extent to which a corporate borrower may invest in other entities such as common stock investments, loans, extension of credits and advances. The extent of such restrictions may vary. There may be a flat prohibition of such investments, or they may be permitted only if certain financial ratios are met. While commending the use of such restrictions, Smith and Warner[108] argue that the investment covenant imposes opportunity costs, because firstly, if there are economies of scale in raising additional capital, they will be lost due to the presence of these restrictions, and secondly, if the corporate borrower is engaged in merger activities, the purchase of equity claims of the target corporation can provide benefits.

Debt covenants may also provide for restrictions on the disposition of corporate assets by way of a prohibition on disposition of those assets, except in the ordinary course of business, or to permit asset disposition up to a certain amount, or only if the proceeds from the disposition are applied to

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[107] See C. W. Smith, Jr. & Jerold Warner, "On Financial Contracting: An Analysis of Bond Covenants" (1979) 7J of Fin. Econ. 117 at 124. The discussion in this section is based primarily on Smith & Warner's paper.

[108] *Ibid.*, at 126.

the purchase of new fixed assets or some fraction of the proceeds is used to retire the corporation's debt. The main purpose of such restrictions is to reduce the incentive for asset substitution by the corporate borrower. Asset substitution is a source of bondholder-stockholder conflict because if a corporation sells bonds for the stated purpose of engaging in low variance projects and the bonds are valued at prices commensurate with that low risk, the value of the stockholders' equity rises and the value of the bondholders' claim is reduced by substituting projects which increase the corporation's variance rates. In situations where the assets of the corporation secure the debt, a prohibition of the sale of such assets ensures that in the event of a default by the borrower, the debtholder's claim is not prejudiced.

There may be debt covenants providing restrictions on mergers, either by a flat prohibition, or by permitting it only if some financial conditions are met. Such restrictions limit the ability of shareholders to use mergers to increase the firm's variance rates or the debt to asset ratio to the detriment of the debtholders.

Certain debt covenants may also restrict the corporation's operating decisions by requiring that it take certain actions, either by investing in certain projects or holding particular assets. A breach of such covenants often serves as early warning signals to debtholders about the condition of the corporation so as to take any requisite remedial measures.

3.3.2 <u>Covenants Regulating Payouts</u>

Debt covenants often restrict the ability of corporate directors to distribute funds to shareholders by way of dividends, share buy-backs, and reductions of capital. Dividend payments are a source of bondholder-stockholder conflict because if the firm issues bonds and the bonds are priced assuming the firm will maintain its dividend policy, the value of the bonds is reduced by raising the dividend rate and financing the increase by reducing investment. These forms of distributions reduce funds that would otherwise be available for investment, and possibly disable to corporation from meeting its debt obligations. Since the aim of a dividend payout prohibition is to prevent the corporation from doing so when the corporation is in difficult financial circumstances, most dividend prohibition clauses prohibit the payment of a dividend unless certain liquidity ratios are met.

3.3.3 <u>Covenants Regulating Subsequent Financial Decision</u>

Debt covenants may contain provisions targeted at preventing or handling the problem of claim dilution. Claim dilution is a source of bondholder-stockholder conflict because if the corporation sells bonds, and the bonds are priced assuming that no additional debt will be issued, the value of the bondholders' claims is reduced by issuing additional debt of the same or higher priority. This is done through a prohibition against issuing new debt claims with a higher priority, or through a restriction on the creation of a claim with higher priority unless the existing debt claims are upgraded to have equal priority. Other provisions may also restrict the issuance of new debt subject to certain aggregate limits. New debt issuance can also be prohibited unless certain minimum prescribed financial ratios are maintained.

These restrictions provided in these covenants do not only apply to money borrowed by the corporation, but may also to other debt-like obligations such as:

1. Assumptions or guarantees of indebtedness of other parties.
2. Other contingent obligations that are analogous to, but may not technically constitute, guarantees.
3. Amounts payable in installments on account of the purchase of property under purchase money mortgages, conditional sales agreements or other long-term contracts.
4. Obligations secured by mortgage on property acquired by the corporation, subject to the mortgage but without assumption of the obligations.[109]

Sappideen[110] makes the point that the main argument against covenants imposing absolute restrictions on corporate borrowings is that it may prevent

[109] *Ibid.* at 137.

[110] Sappideen, *supra*, note 53 at 379.

what could be a last ditch attempt at preventing a bankruptcy situation since those willing to lend and rescue in these circumstances will almost invariably want priority in payout over all existing creditors. Also, such a prohibition may lead to shirking, as management may not persevere in their efforts when the corporation is heading towards crises.

3.3.4 Bonding Covenants

Such covenants are employed to lower the cost of monitoring the corporate borrower to ensure that the debt covenants have not been breached. The value of the corporation at the time the debt is issued is influenced by anticipated monitoring costs.[111] Thus bonding covenants may require the submission of certain periodic financial reports to debtholders.

Bonding covenants may also require the corporate borrower to provide an annual certificate as to whether there has been any default under the indenture or debt agreement. This is referred to as the "Certificate of Compliance".

3.4 Corporate Debt Types and Governance Issues

The discussion in the preceding sub-paragraphs shows that there are different types of debt arrangements with some having a combination of both debt and equity features. This latter feature presents some complexity in

[111] Smith & Warner, *supra*, note 107 at 143.

determining whether debtholders should be accorded the benefits of directors' fiduciary duties in the same manner as equityholders have, and consequently whether debtholders influence corporate governance. This complexity arises from the fact that if it is argued that conventional debtholders are contractual claimants and therefore derive their protection from terms of their contracts, as compared to equityholders who are residual claimants and have no fixed claim on the corporation, then the issue arises as to what protections should be offered to holders of hybrid corporate financial products having characteristics of both equity and debt, such as convertible bonds.

I provide some reflections on this issue in the next chapter.

3.5 Interpretation of Covenants in Debt Contracts

Contracts governing debt relationships – trust indentures in the case of bonds and debentures, and loan agreements in the case of privately placed notes and bank loans – are generally viewed as the main source of the rights and duties in corporate debtor-creditor relationships.[112] Thus in determining what rights and protections debtholders have against adverse corporate actions, courts have looked to contract law by objectively determining the plain meaning of a contract term from the words the contracting parties chose to express themselves and from other indications of meaning found within the four corners of the contract. This approach, the classical view of contract

[112] See Bratton, *supra*, note 96 at 371.

interpretation, promotes certainty and efficiency in the drafting of debt contracts. This traditional view is adopted even when there is little indication that the debtor corporation and the debtholder intended that meaning. This view of contract interpretation tends to allocate the burden of drafting an explicit provision to the party seeking to enforce the right and the courts refuse to make contracts for the parties as they hold the view that this approach effectuates the parties' expectations.[113]

The effectiveness and fairness of the use of the traditional view of debt contract interpretation can be viewed from two different perspectives, namely from private debt and from public debt. In private a debt issue, the corporate borrower and lender have a face-to-face negotiation of the specific terms of the debt contract. Thus, the terms of the contract are largely a reflection of the intention of the parties to the contract. Given this situation, applying the traditional view of debt contract interpretation would seem to meet the expectations of the parties, absent any vitiating factors.

The real bone of contention with the employment of the traditional view comes up when it is viewed from the perspective of public debt issues. In public debt issues, such as bond issues, the prospective bondholders do not negotiate the terms of the trust indentures. The issuers and the lead

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[113] See Bratton, *supra*, note 99 at 683.

underwriters usually do the negotiations.[114] Given this situation, it has been argued that the trust indenture cannot be said to be an expression of the intent of the parties to the contract since the underwriter is not a party to the contract, neither is he chosen by the prospective bondholder, but rather by the issuer.

It has been argued that the traditional approach creates opportunities for strategic corporate behaviour by allowing debtor corporations to take advantage of ambiguities of language and gaps in contractual terms by taking certain actions that harm bondholders yet are within the literal meaning of bond contract language and that were not foreseen by bond investors at the time of contracting.[115] It is difficult even for the most skilled draftsman to foresee every contingency that may arise in the debtor-creditor relationship. This critique that the traditional contract rule does not protect bondholders against opportunistic behaviour is validated by the existence of court decisions that apply the traditional contract approach in disputes over the meaning of bond contract terms and in so doing reach results that are demonstrably unfair in failing to protect legitimate expectations of bond-holders.

[114] See *Metropolitan Life, supra*, note 103 at 1509.

[115] See *Tauke, supra*, note 1 at 68.

Harris v. *Union Electric Co.*[116] concerned a provision in the supplemental indenture governing an issue of bonds. The provision prohibited any redemption effectuated with the proceeds of a debt issue bearing a lower coupon rate, or preferred stock having a lower dividend payment rate, than that of the issue governed by the indenture. A parenthetical in the provision made an exception to redemptions from a "maintenance fund." This maintenance fund had been set up in earlier supplemental indentures and was intended to force a partial redemption to the extent the issuer had failed to devote fifteen percent of any year's earnings to property maintenance. The issuer had always satisfied the requirement with actual investment in property. Unfortunately for the bondholders, the earlier supplemental indentures limited neither the source of money nor the occasion for use of the maintenance fund. Taking advantage of these loopholes, the issuer floated a new issue of bonds at a lower coupon rate, put the proceeds in the maintenance fund and redeemed the original bonds at face value out of the maintenance fund. It thereby avoided the redemption prohibition (along with a redemption premium also provided for in the supplemental indenture).

A literal reading of the indentures supported the issuer's right of redemption. But all contextual evidence, including the subjective understanding of officers of the issuer, pointed to the opposite result – that the bonds had redemption protection.

[116] 622 S.W.2d 239 (Mo. Ct. App. 1981) as discussed in Bratton, *supra*, note 96 at 390 – 392 (hereafter *Harris*).

Harris does not involve facially vague or ambiguous language. The *Harris* debt contract is clear when read within its four corners. The interpretation problem becomes apparent only when the context is considered. The choice between classical and neoclassical alternatives could not be clearer. Strict classicism permits the court to remove the discordant contextual elements from its field of vision. Neoclassicism permits it to intervene in the relationship, in effect to rewrite the contract to accord with the context. The *Harris* court chose the classical alternative. It found the language "unambiguous on its face," and permitted the force of the "unambiguous" language to outweigh the contextual evidence.

There has been a resort to what has come to be known as the neoclassical or modern approach to contract interpretation. This approach supports the expansion of the interpretative process to include all relevant circumstances surrounding the transaction, and recognizes the danger of variances between the literal meaning of contract terms and understanding of one or more of the parties.[117] The modern approach also applies to situations where the parties may have conflicting intentions in different provisions of a contract or may have had no actual intentions whatsoever as to particular contract language. Further, if the parties fail to provide in their contract for a matter that later becomes important in their relationship, it is appropriate for a reviewing court

[117] See Tauke, *supra*, note 1 at 78 – 79.

in certain circumstances to imply a reasonable term into the contract to provide for allocation of risks and returns with respect to the omitted matter.

CHAPTER FOUR

CORPORATE GOVERNANCE, FIDUCIARY RELATIONS AND DEBT FINANCING: WHAT INTERACTION?

The issue as to what influence debt financing has on corporate governance may be discussed from the point of view of directors' fiduciary duties, and statutory interventions.

4.1 Do or Should Corporate Directors Owe Fiduciary Duties to Debtholders?

The debate as to whether corporate directors do or should owe fiduciary duties to debtholders has been taken from two major perspectives, that is whether the debtor corporation is solvent or not.

4.1.1 Post Insolvency

Most commentators on corporate law problems and the courts, particularly in Australia, England and New Zealand are unanimous on the view that directors of insolvent companies[118] owe fiduciary duties to their debtholders.

[118] Insolvency is a financial condition. Our working definition of insolvency will be that found in the Bankruptcy and Insolvency Act of Canada, R.S.C. 1985, C.B-3, as amended ("BIA") which provides that a corporation may be found to be insolvent if for any reason, the corporation is unable to meet its obligations as they become due or has ceased paying its current obligations in the ordinary course of business as they generally become due or the aggregate of the company's property is not, at a fair valuation or if disposed of at a fairly conducted sale under legal process, would not be sufficient to pay the company's due and accruing obligations. This definition is a useful codification of the relevant common law tests of insolvency. See M. P. Richardson, ed., *Directors' and Officers' Duties and Liabilities in Canada* (Toronto and Vancouver: Butterworths, 1997) at 237. However, it is important to note that different jurisdictions may have slight variations in the formulation of the insolvency test. Insolvency manifests itself in all aspects of commercial transactions in which lending or credit plays a part. Credit forms a very important aspect of the operations of corporations, particularly for those that operate in countries where the stock market is poorly developed or where the stock market is limited to equity financing. Considerations of potential insolvency

The often-cited case in support of this proposition is *Kinsella* v. *Russell Kinsella Property Ltd. (in liq.).*[119] The theory upon which directors of insolvent corporations are found to owe fiduciaries to debtholders is aptly summed up in the following passage from *Kinsella*:

> *In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If as a general body, they authorize or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.*[120]

Thus, in principle, once the corporation becomes in insolvent, directors owe a fiduciary duty to its debtholders. The above comment in *Kinsella* establishes the point that directors duties are owed to the corporation and in determining the content of the corporate interest, and hence what the board may

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problems guide and often dictate business decisions and the structuring of business transactions. The test of insolvency is an objective one which can be verified from a company's financial statements, with particular emphasis on cash flows. However, gradually, the courts are approaching insolvency with a commercial sense of reality. As a result, there is a distinction between merely temporary cash flow problems and endemic shortfalls of working capital, the latter indicating insolvency. The philosophy of commercial reality may mean that in certain industries which have traditional practices of slow or late payment, such as building or clothing industries, the failure to pay debts on time may not necessarily be evidence of insolvency. See Anker Sorensen, ed., *Directors' Liabilities in Case of Insolvency* (The Hague-London-Boston: Kluwer Law International, 1999) at 70 – 71.

[119] (1986) 4 N.S.W.L.R. 722 [hereinafter *Kinsella*].

[120] *Ibid* at 730 .

conceivably do in its furtherance, the court will no longer select the shareholders as the group of natural persons whose interests may be ascribed to the company, but will instead equate the corporate interest with the interests of that group which is, for the time being, affected by the action complained of.[121] Thus, if as a result of the corporation's state of insolvency, the effect of its actions are borne by its debtholders, then the interests of the debtholders should determine the corporate interests, and subsequently, managerial actions should be with the view to further these interests.

4.1.2 Prior to Insolvency

The real point of contention in the debate as to whether corporate directors do or should owe fiduciary duties to debtholders is with respect to when the debtor corporation is solvent. Whiles one school of thought postulates that directors do or should not owe any fiduciary duties to its debtholders prior to insolvency, another school holds the opposite view and oppose any attempt to deprive debtholders of the benefits of directors' fiduciary duties.

4.1.2.1 Proponents of "No Fiduciary Duties" School

For several years, most common law jurisdictions have held the view, in describing directors' duties, that directors must act honestly and in good faith with a view to the best interests of the corporation, and the best interests of

[121] See Ross Grantham, "The Judicial Extension of Directors' Duties to Creditors" (1991) J. Bus. L. 1 at 14.

the corporation has been held to be the interests of directors.[122] Thus, when a corporation is financially healthy, directors owe fiduciary duties of care and loyalty to the corporation and its shareholders. Creditors rights are limited by the terms of their contracts with the corporation.

4.1.2.2 Proponents of "Fiduciary Duties" School

A number of commentators have made propositions to the effect that corporate directors should owe fiduciary duties to creditors even when the corporation is solvent. Sappideen argues[123] that reliance on the debt contract to protect the interests of debtholders is inadequate because although all investors have access to information concerning residual risks, different individual investors possess different amounts of information. Thus, debentureholders lack a unitary set of expectations and this justifies the invocation of good faith principles to protect debentureholders from residual risks. Sappideen argues further that the exclusive reliance on express covenanting may prove inadequate because a trust deed cannot and will not contain a complete set of protective covenants because a debt contract, like any contingent contract, can never be complete because it is impossible to write a detailed contract that covers every contingency, and the trust deed will be incomplete because managers will resist covenants that limit their ability to take value increasing actions.

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[122] See Jacobs Ziegel, "Creditors as Corporate Stakeholders: The Quiet Revolution – An Anglo-Canadian Perspective" (1993) 43 U. T. L. J. 511 at 517.

[123] Sappideen, *supra*, note 53 at 376 – 377.

Another point that supports the invocation of fiduciary duties for the protection of debtholders, particularly public bondholders, is the fact that the issuers and the prospective bondholders do not directly negotiate the trust indenture. It is negotiated on behalf of the latter by an underwriter who is appointed, not by the bondholders, but by the issuer. Several factors question the underwriter's effectiveness and loyalty in protecting the interests of the future bondholders.[124] Firstly, because the underwriter only holds the issuer's bonds with the view to disposing of them to the investing public, the underwriter has no incentive to negotiate terms that will best protect public purchasers against any residual risks, given the short period within which the underwriter is the owner of the bonds. Secondly, being dependant on the issuer for selection as the underwriter in a particular debt issuance and in future debt issuances, the underwriter has an incentive to be less than diligent in negotiating protective terms for future bond investors if the issuer objects to the terms. Thirdly, because they are interested in selling financial services other than underwriting skills to corporate bond issuers, that presents a further disincentive to be diligent in negotiating with the issuer if the issuer would object to certain terms in the trust indenture. Fourthly, because bond investors usually lack the expertise to determine what constitutes appropriate protective bond contract terms, and because the evaluation of the terms of the bond contract may entail substantial investment in relation to the amount of a bond issue purchased, bond investors may be unable to price the bonds

[124] Tauke, *supra*, note 1 at 23. The discussion following is based on this article.

properly in relation to the scope of the contract's protective terms. Thus, the pricing structure of bond issues is unable to serve as an effective control in the underwriter's laxity in self-interest in the negotiation of bond contract terms. Fifthly, there are limits on the ability of the underwriter to foresee all possible corporate actions that may be harmful to the interests of the prospective bond investor.

In further support for the invocation of directors' fiduciary duties to debtholders, Mitchell[125] argues that classification of the relationship between a corporate borrower or issuer and a debtholder as a contractual one is the result of a misconception. He makes the point that in classifying the relationship as contractual, the focus is on the nature of the debt instrument at issue rather than the nature of the relationship between the holder of the debt instrument and management. This misconception has virtually ensured that no fiduciary relationship will be found because, as he puts it, "fiduciary duties are owed to persons, not financial instruments".

Mitchell argues further, in support of the invocation of directors' fiduciary duties to debtholders, that bond contracts are long, detailed, and technical, and thus difficult to read and appreciate the effect of their provisions.[126] Even

[125] L. E. Mitchell, "The Fairness Rights of Corporate Bondholders" (1990) 65 N.Y.U. L. Rev. 1165 at 1175 – 1176.

[126] *Ibid.* at 1181.

if their effect is appreciated, potential investors must take the contract as it is written because they do not have the opportunity to negotiate new terms.
The arguments discussed above aim at exposing the inadequacy of the contractual protections available to debtholders, and to support the invocation of the fiduciary duties of due care and loyalty of directors to debtholders, irrespective of whether the corporate debtor is solvent or not.

It is also worth noting that almost all of the arguments proffered seem to support the invocation of directors' fiduciary duties to public debtholders, rather than private debtholders.

4.1.3 Fiduciary Duty To Public Debtholders?

One alternative to the inadequacy of the contracting process and market forces in the protection of the interests of public debtholders is the resort to the concept of fiduciary duties in the same manner as stockholder rights are protected.[127] It is argued that the recognition of a fiduciary duty in favour of public debtholders would overcome the defects of the traditional contract approach to the protection of public debtholder rights by empowering the courts to police the relationship between public debtholders and the corporation through the evaluation of the fairness of particular corporate actions in particular circumstances without regard to the presence or absence of contract terms protecting public debtholders. Fiduciary duties to

[127] See Tauke, *supra*, note 1at 52. The discussion following is based substantially on this article.

bondholders might be construed to mean that the corporation is to be prohibited from taking any action that might harm the interests of the bondholders, that is, a duty to exercise due care and in pursuing the best interests of the bondholders.

The adoption of such broad notions of fiduciary rights of bondholders is set to be fraught with some problems.

First, the reasons for questioning the traditional contract approach to determining bondholder rights do not go so far as to say that the contracting process and market forces are highly ineffective in protecting the interests of bondholders. The criticisms of the traditional rule establish only that there are some circumstances in which the traditional rule's presumption of the adequacy of the contracting process and market forces are so ineffectual in protecting the interests of bondholders that sweeping judicial policing in the form of enforcement of fiduciary duties to bondholders is necessary. A broad grant of fiduciary rights to bondholders would completely undermine the allocation of rights under bond contracts even though there is little reason to believe bondholders have been extensively victimized by the opportunistic behaviour of debtor corporations.

Second, creating a corporate fiduciary duty to bondholders would raise fundamental problems of impairing the efficiency of the capital structure of the corporation. Because bondholders have only a fixed claim on the income of the corporation, and do not share in corporate profits, maximization of profits is not in the best interests of the bondholders. Their best interest is to have the corporation engage in the least risky activities that are consistent with earning sufficient income to cover the payments due the bondholders under the bond contract. Risk taking is essential to business transactions,[128] thus the recognition of corporate fiduciary duties to bondholders could impair the corporations ability to take risks in its business, even if taking such risks would produce a higher expected return for the corporation. Such a notion of fiduciary duty would impart an undue conservatism to corporate decision-making and to the detriment of wealth maximization and social welfare. The problem of opportunistic behaviour by corporate debtors is not of so great magnitude as to warrant any solution that will impair the risk-taking activities of the corporation.

A narrower concept of directors' fiduciary duties to bondholders has been suggested, that directors of a corporation should be deemed to be fiduciaries of bondholders, not with an obligation to favour the best interests of bondholders at all times, but rather with an obligation to exercise independent judgment in the best interests of the corporation as a whole.[129] Under this standard, corporate directors would not be allowed to favour stockholders

[128] Schwarcz, *supra*, note 64 at 656.

[129] See Morey W. McDaniel, "Bondholders and Corporate Governance" (1986) 41 Bus. Law. 413 at 422 – 450.

over bondholders or bondholders over stockholders. A number of problems arise with this narrow concept of fiduciary duties as well.

First, such a standard of duty provides no alternative to analyzing the bondholder-corporation contractual relationship. Any attempt to mandate the corporate management to act only in the best interests of all corporate investors must take account of what rights the various investors have bargained for. If bondholders have contracted to allow the corporation to retain certain powers and have received appropriate compensation, in the form of higher rates of interest, for allowing the corporation to retain those powers, determining what is in the best interests of the corporation "as a whole" must take account of how the relationship of various corporate investors has been structured. Thus, this narrow concept of corporate fiduciary duty is nothing more than requiring management to honour the terms of the bond contract by interpreting the bond contract in the proper fashion.

Second, the narrow fiduciary concept of mandating that corporate managers act for the benefit of all investors rests of the false premise that the concept will overcome the inherent tension between investor groups. For example, one of the most basic of corporate decisions, whether or not to pay dividends, raises a fundamental conflict of interests between bondholders and stockholders. Whiles stockholders would prefer the payment of dividends if there are funds available for that, bondholders would rather prefer to have the funds retained for eventual payment of bondholder claims. It is not clear what the best interest of the corporation as a whole are, in such circumstances. A corporation cannot be viewed simply as a separate entity whose value is to be maximized separately and apart from the interests of its discrete groups of investors.

Third, is a problem with respect to the expectation, under the fiduciary duty notion of acting in the best interests of the corporation as a whole, that corporate management exercise independent judgment when faced with conflicts between bondholder and stockholder interests? A number of factors militate against this expectation, namely; (1) corporate management is elected by stockholders, not bondholders (2) corporate management may have significant stock ownership (3) management compensation levels may be tied to stock prices and (4) management is constrained by the market for control to maximize the price of corporate stock or else face the danger of a hostile takeover.

Fourth, is the problem of how such a standard of fiduciary obligation could ever be enforced? Given that boards of directors will rarely state an intention to favour one group over another, and absent any self-dealing, any complaint of a breach of these duties by directors by one group of investors could almost always be justified by the directors as being in the interests of the other group of investors. Thus, for example, if the board determines that distributing assets to stockholders will benefit the corporation by increasing stock investor goodwill, is there any way in which bondholders could refute the directors' judgment? Or if a debtor corporation decides not to redeem bonds at a time when redemption could benefit stockholders, could stockholders challenge the directors' justification that not redeeming promoted bond investor goodwill? Thus, the question of what is best for the corporation in the long run tends to be subjective and difficult to decide.

4.1.4 The Solution

It is this author's view that given the catalogue of problems inherent in the imposition of directors' fiduciary duties to debtholders, the rights of debtholders in their relationships with corporate debtors should remain within the domain of contract law. With respect to private lending arrangements between financial institutions and corporations, the parties on both sides are sophisticated and therefore neither can be presumed to be a weaker party.[130] It is therefore not difficult to come to the conclusion here, that contract law should regulate the relationship between private debtholders and corporations.

With respect to public debtholders, I am of the view that fiduciary duties should not arise here. Despite the fact that they do not negotiate the terms of the indentures themselves, and do not even chose the underwriter who negotiates the terms, the bondholders have no basis to trust or rely upon the

[130] See Schwarcz, *supra* note 64 at 658

corporate debtor and the corporate debtor does not accept the bondholders' confidence. Infact, bond investors, most of whom are corporations, cannot seek to avoid the terms of the trust indentures just because the indentures are long and their terms are technical. Whilst conceding that covenants in public bond loan agreements are usually weaker than in a privately negotiated loan agreement, the reasons for this state of affairs is not far fetched. Although large corporations with good reputation rely less on bank lending for short and medium term capital, but rather issue public debt instruments, they, however, still rely on banks for cash management and transaction services. Corporate issuers often need to back their publicly issued debts with lines of credit from banks. Bank lines of credit also provide liquidity insurance to the issuer in the event it cannot roll over its short-term public debt upon maturity because, for instance, of a credit–rating downgrade. As a result of informational advantages, banks are usually lower-cost monitors than indenture trustees. Given that borrowers bear the aggregate costs of monitoring incurred by their debtholders, debt issuers ensure that the bank does the monitoring and not the trustee on behalf of public debtholders, by limiting the covenants and trustee obligations in public debt indentures. To the extent it deters borrower misbehavior, the banks' monitoring and reaction to correct managerial slack inures to the benefit of debtholders as well. The existence of a bank lender is an assurance to public debt investors that restrictive covenants are in place and that the firms activities are being monitored. Public debtholders, therefore, make a voluntary and fully informed decision to purchase debt instruments with limited covenant protection. The reliance on banks by other debtholders to monitor and react appropriately to developments in the operations of the corporate borrower accounts partially for the higher interest received by banks than other debt holders.[131]

Moreover, securities laws in most jurisdictions now require bond issuers to disclose all material risks pertaining to the bonds in prospectuses pursuant to which bonds are publicly issued.[132] Thus, bondholders cannot pretend to be unaware of the risks inherent in the investments they purchase.

While acknowledging the problems posed by the reliance on classical contract interpretations to the protection of bondholders' rights, it is my submission that resort to the modern or neoclassical approach to debt contract interpretation should be able to deal with most of the problems raised in favour of bondholders fiduciary rights. The resort to this modern approach was emphasized in *Canadian Deposit Insurance Corp.* v. *Canadian Commercial Bank,*[133] where the court, in characterizing a number of support agreements as constituting a loan rather than equity participation in the respondent corporation, stated that:

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[131] See Triantis & Daniels, *supra* note 91 at 1088 – 1092.

[132] See for example, s. 56 (1) of the *Ontario Securities Act*, R.S.O. 1990 c. S-5.

[133] (1992) 97 D. L. R. (4th) 385.

> *[A]ny case involving contractual interpretation ...... must be decided by determining the intention of the parties from the ...... agreements. This ..... depends primarily on the meaning of the words chosen by the parties to reflect their intention. When the words alone are insufficient to reach a conclusion as to the true nature of the agreement, or when outside support .... is required, a consideration of admissible surrounding circumstances may be appropriate.*[134]

With respect to the hybrid situation of convertible bonds, it has been suggested that corporate fiduciary duties should be extended to convertible bondholders only in cases where the wrongs alleged impinge upon the equity aspects of the bond.[135] I am unable to accept this suggestion. Bonds retain their usual characteristics upon being made convertible into other securities, the conversion right being an optional and alternative right of the holder in addition to and separate from the usual rights of the bondholder under the terms of the trust indenture.[136] The convertible bondholder is not a stockholder in equity or at law nor is he a subscriber to shares of the issuer. He cannot acquire any of the rights of a stockholder unless he complies with all of the terms and conditions of his contract. Given this situation, a convertible bondholder cannot be endowed with fiduciary rights even in respect of matters affecting the equity aspects of the bond, and until the conversion privilege is exercised, he has no right to question corporate actions affecting stockholder interests.

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[134] *Ibid.*, at 405.

[135] Bratton, *supra*, note 99 at 734.

[136] Hills, "Convertible Securities – Legal aspects and Draftsmanship" (1930) 19 Calif. L. Rev. 1 at 2 – 4, in Buckley, *supra*, note 79, at 916.

4.2 Statutory Protections

There are some statutory provisions that compel corporations to consider the interests of debtholders in managerial decision-making even when the debtor corporation is solvent. This provides a measure of protection for the interests of debtholders. The main statutory provisions concerned here are those dealing with the oppression remedy and legal capital protection rules.

4.2.1 Debtholders and the Oppression Remedy

Although the statutory oppression remedy was initially conceived of as a remedy for minority shareholders, it is obvious from recent statutes and reported cases in some jurisdictions that it is now possible for certain categories of debtholders to avail themselves of the remedy. The remedy seeks to protect the eligible complainants from unfair and prejudicial treatment from other constituents of a corporation, even if the prejudicial or unfair actions are not illegal. This means that it is possible for a complainant to use the remedy to thwart any actions of corporate directors if the complainant deems any of those actions to be prejudicial or unfair to his interests. This in turn, means that corporate directors have an obligation to consider the interest of eligible complainants in corporate decision-making, thus giving the eligible complainants some measure of influence over corporate decision-making.

In Canada, debtholders of certain categories are eligible complainants under the remedy of oppression. Section 238 of the CBCA defines "complainant", *inter alia,* as "registered holder or beneficial owner, and former registered holder or beneficial owner, of a security of a corporation or any of its affiliates", or "any other person who, in the discretion of a court, is a proper person to make an application."

4.2.1.1 Registered Holder Or Beneficial Owner Of Security

A "security" is defined in s. 2(1) of the CBCA as "a share of any class or series of shares or a debt obligation of a corporation and includes a certificate evidencing such a share or debt obligation." A "debt obligation", in turn, is defined as a "bond, debenture, note or other evidence of indebtedness or guarantee of a corporation, whether secured or unsecured".

It is clear from these definitions that bondholders are eligible to bring an action for the remedy of oppression. The definition of "debt obligation" above also includes "other evidence of indebtedness or guarantee of a corporation". This would seem to include debt obligations other than bonds, debentures and notes. However, one commentator has suggested that reference to "registered holders" in sectors 238 (a) suggests a legislative intension to limit claims by debtholders to those holding registered obligations or obligations which are susceptible to registration, like bonds and debentures, to the exclusion of other types of debts which are not registrable.[137] This view can be supported given the fact that most registrable debt obligations are publicly issued, and publicly issued debtholders are more susceptible to abuse as a result of the nature of these debt obligations which have been discussed previously. Thus, it would seem that the intention of the legislator was to curb the abuses peculiar to public debtholders given the fact that they often have weaker protective covenants than in privately negotiated debt agreements. The view that section 238(a) was intended to exclude holders of non-registrable debt obligations is supported by the case of *First Edmonton Place Ltd. Vrs. 315888 Alberta Ltd.,*[138] where the court held that "a creditor can be a 'complainant' under s. 231(b)(i) [now s. 238 (a)] only if it holds or is the beneficial owner of a security of the corporation and if the security is of a type *which is capable of being registered*..............." [emphasis added].[139] The court pointed out that this meaning of s.238(a) was consistent with the meaning of "bonds, debentures and notes" in the world of corporate financing.

In deciding what is unfair prejudice or unfair disregard, the history and nature of the corporation, the essential nature of the relationship between the corporation and the creditor (including the protection of the underlying expectation of a creditor in its arrangement with the corporation), the types of

[137] J. A. VanDuzer, "Who may claim Relief From Oppression: The Complainant in Canadian Corporate Law" (1993) 25 Ottawa L. Rev. 463 at 472.

[138] (1988) 60 Alta. L. R. (2d) 122.

[139] *Ibid*, at 149.

rights affected, the extent to which the acts complained of were unforeseeable, the detriment to the interests of the creditor and general commercial practice should all be material.[140] It is clear from the foregoing discussions that creditors holding registrable debt obligations such as bonds, debentures and notes can influence the course of corporate decision making by resorting to the use of the oppression remedy to resist any corporate actions that are unfairly prejudicial to or that unfairly disregards their interests if the substantive basis for the remedy are satisfied.

4.2.1.2 Proper Person in Court's Discretion

It is possible for other categories of debtholders excluded from s.238 (a) to resort to the oppression remedy to influence the governance mechanisms of the debtor corporation. This is by way of bringing an application for leave under s.238 (d). The section gives the courts discretion here in deciding whether the applicant is a proper person to make the application.

The court in *First Edmonton Place* stated two circumstances in which justice and equity would entitle a creditor to be regarded as a "proper person" (although it admitted that there could be other circumstances), that is, if the act or conduct of the directors or management complained of constitutes (1) using the corporation as a vehicle for committing a fraud upon the creditor or (2) a breach of the underlying objectively reasonable expectation of the

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[140] *Ibid.*, at 146.

creditor arising from the circumstances in which the creditor's relationship with the corporation arose.[141]

Thus, it is possible for debtholders such as banks granting term loans and other non-registrable debt financing facilities to corporations to intervene in the managerial processes of those corporations using s.238(d), given that the substantive standard is satisfied.

4.2.1.3 Other Jurisdictions

England

In England, the provision dealing with the oppression remedy is s.459 of the Companies Act of 1985. This section provides that:

> *"[A] member of a company may apply to the Court by petition for an order under this part on the ground that the company's affairs are being, or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including any act or omission on its behalf) is or would be so prejudicial."*

It seems, from this provision that the remedy anticipated here is not open to debtholders. It is not clear whether a member whose interests are affected in the capacity as a debtholder is eligible to obtain this remedy.

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[141] *Ibid.*, at 152.

However, when an administration order[142] is in force, section 27 of the Insolvency Act of 1986 permits *a creditor* (emphasis mine) or member of the company to apply to petition the court on the ground:

> *(a) that the company's affairs, business and property are being, or have been managed by the administrator in a manner which is unfairly prejudicial to the interests of its creditors or members generally, or some part of its creditors or members (including at least himself), or*
>
> *(b) that any actual or proposed act or omission of the administrator is or would be so prejudicial.*

It follows, therefore, that it is only when the company becomes insolvent that its debtholders can avail themselves of the oppression remedy in England.

Ghana

In Ghana, the oppression remedy is created under s.218 (1) of the Companies Code, 1963 (Act 179) which provides that any member or debentureholder of a company may apply to the court for an order for the remedy of oppression on the ground:

> (a) *that the affairs of the company are being conducted or the powers of the directors are being exercised in a manner oppressive to one or more of the embers or debentureholders or in disregard of his or her proper interests as members, shareholders, officers, or debentureholders of the company; or*
>
> *(b) that some act of the company has been done or is threatened or that some resolution of the members, debentureholders or any*

[142] An administrative order is made under s.8 (1) of the Insolvency Act of 1986 when the court is satisfied that the company is unable to pay its debt (or is likely to become so).

class of them has been passed or is proposed which unfairly discriminates against, or is otherwise unfairly prejudicial to, one or more of the members or debentureholders.

It is clear on the face of the provision that debentureholders are eligible to obtain the oppression remedy. If a debentureholder satisfies the substantive grounds for obtaining the remedy, the court, *inter alia*, has the power to direct or prohibit any act or cancel or vary any transaction or resolution or regulate the conduct of the company's affairs in future.[143]

It follows, therefore, that in Ghana, debentureholders should be able to intervene in corporate managerial decisions through the use of the oppression remedy if they satisfy the substantive standard required.

4.2.1.4 Issues Arising From the Oppression Remedy

The above discussion on the availability and use of the oppression remedy shows that whiles it is impossible for debtholders in England to avail themselves of the remedy if the corporation is solvent, it is possible for bondholders to obtain the remedy in both Canada and Ghana. Subject to judicial discretion, it is also possible for other types of debtholders in Canada to obtain the protections offered by the remedy.

It falls to be considered, whether the English position is to be preferred to the Canadian and Ghanaian positions or vice versa. It is without doubt, that as a

[143] Act 179 s. 218(2).

result of ingenious financial engineering, the traditional distinction between debt and equity is becoming a fine one. There are numerous hybrid financial products that possess the characteristics of both debt and equity. It therefore sounds unreasonable, in designing legal protective measures for these corporate finance models, to apply a strict debt – equity characterization and on that basis deny one party the legal protection that is accorded the other. Given this problem, it might appear that the Canadian and Ghanaian positions that offer protection under the oppression remedy to both equityholders and some categories of debtholders will be preferred to the English position. However, in applying the oppression remedy to debtholders, even those that possess characteristics of equity such as convertible bondholders, the courts should bear in mind that the crucial factor in offering equityholders this extra-contractual and far reaching remedy is the fact that equityholders are only residual claimants and do not have any fixed claim on the company and the fact that in a lot of corporations, a lot of the equityholders are far removed from the managerial process. That puts equityholders at a certain range of risk that debtholders do not face. Despite the hybrid nature of emerging corporate financial products, it is possible to trace the foundation of each particular product either in debt or equity. Thus, whiles it is my opinion the Canadian and the Ghanaian positions are to be preferred, the courts, in the application of the oppression remedy to debtholders, should be careful not to displace the contractual expectations of the parties to the debt arrangement.

The application of the oppression remedy to debtholders other than holders of bonds, debentures and notes as permitted by law in Canadian poses problems in the exercise of judicial discretion. In a situation where parties to a private debt arrangement have set out the terms of rights and obligations in a contract, it is difficult to determine what amounts to "the underlying objectively reasonable expectation of the creditor" in view of the fact that the expectations of both parties are summarized in the debt contract. The application of the oppression remedy in these circumstances may defeat the intendment of the contract and give a leeway for an undue judicial intervention in debt contracts. It is my opinion that in the application of s. 238 (d) of the CBCA, the courts should be miserly in giving protection under the oppression to holders of privately negotiated debt contracts.

4.2.2 Legal Capital Protection Rules

These are rules governing the declaration and payment of dividends, reduction of stated capital and financial assistance. The purpose of these rules is to protect the assets of the corporation from being distributed to shareholders to the detriment of debtholders. The rules, as provided in the CBCA, are discussed below.

4.2.2.1 Dividends

The mode by which the profits of corporations are distributed to shareholders is the declaration and payment of dividends. The directors of the corporation in their own discretion make a declaration of dividend. There is no legal obligation on directors to declare dividends. Different corporations have different dividend policies. These are not legal requirements but a matter of practice. There are certain statutory limitations on the power of directors to declare and pay dividends. Section 42 of the CBCA prohibits the declaration and payment of dividends if there are reasonable grounds for believing that:

a. The corporation is, or would after the payment be, unable to pay its liabilities as they become due; or

b. The realizable value of the corporation's assets would, after the payment, be less than the aggregate of its liabilities and stated capital of all classes.

Preference share dividend rights are subject to the limitations placed by section 42. However, a corporation with retained earnings can pay dividends up to the value of the retained earnings without being bothered about the restrictions in section 42.

4.2.2.2 <u>Reduction of Stated Capital</u>

<u>Acquisition of Corporation's Own Shares</u>

Section 34 of the CBCA prohibits the corporation from making any payment to purchase or otherwise acquire shares issued by it if there are reasonable grounds for believing that:

a. The corporation is, or would after the payment be, unable to pay its liabilities as they become due; or

b. The realizable value of the corporation's assets would, after the payment, be less than the aggregate of its liabilities and stated capital of all classes.

Redemption of Shares

Section 36 of the CBCA prohibits a corporation from making any payment to purchase or redeem any redeemable shares issued by the corporation if there are reasonable grounds to believe that:

a. The corporation is, or would after the payment be, unable to pay its liabilities as they become due; or

b. The realizable value of the corporation's assets would, after the payment, be less than the aggregate of its liabilities and the amount that would be required to pay the holders of the shares that have a right to be paid, on a redemption or in a liquidation, rateably with or prior to the holders of the shares to be purchased or redeemed.

It should be noted the test required in this case is higher in the case of redemption of shares because acquisitions are not with notice to the public as they are not provided for in the constituent documents of the corporation.

Gift of Shares

Under section 37 of the CBCA, while it is permissible for a corporation to accept a gift of its own shares from the holder by way of surrender, this may not operate to extinguish or reduce any liability on the share.

4.2.2.3 Financial Assistance

Subject to some permitted transactions, section 44 of the CBCA generally prohibits a corporation by offering financial assistance by way of a loan, guarantee or otherwise to any shareholder, director, officer or employee of the corporation or its affiliate or to an associate of any such person for any purpose, or to any person for the purpose of or in connection with a purchase of a share issued or to be issued by the corporation or its affiliate, if there are reasonable grounds for believing that:

a. The corporation is or, after giving the financial assistance, would be unable to pay its debt as they become due, or

b. The realizable value of the corporation's assets, excluding the amount of any financial assistance in the form of a loan and in the form of assets pledged or encumbered to secure a guarantee, after giving the financial assistance, would be less than the aggregate of the corporation's liabilities and stated capital of all classes.

4.3 Market Forces

Although this author does not subscribe to the view that debtholders are entitled to corporate fiduciary obligations, there is support for the view that the employment of debt financing by a corporation influences the actions of corporate management and, therefore, go to influence corporate decision making.[144]

First, the existence of fixed debt obligations force managers to utilize their free cash flows towards the satisfaction of those fixed debt obligations rather than accumulating those cash and liquid resources for other corporate purposes, some of which may only go to serve the interests of the corporate managers.

Second, the existence of periodic repayment obligations, and the threat of acceleration of the debt and liquidation of the corporation upon default of these repayment obligations, sets challenging goals for corporate management and these goals provide direction for managerial action and promote effort and persistence in the pursuit of the goal. This is because (1) specific goals are more effective in motivating higher performance than general goals, such as to do one's best (2) proximal goals have a greater positive effect on performance than distal goals and (3) more difficult goals tend to motivate higher levels of effort and performance than easier goals.

[144] See George G. Triantis, "Debt Financing, Corporate Decision Making, and Security Design" (1995 – 96) 26 Can. Bus. L. J. 93.

Third, debt serves as a powerful agent for change, particularly, an increase in a firm's debt-equity ratio caused by a leveraged buyout forces managers to rethink their strategies and induces directors to reconsider the reorganization and composition of their management teams.

An examination of debt covenants also reveal that these covenants serve as a mechanism for reducing the opportunistic behaviour of corporate management, thus affecting managerial decision making.

In private debt arrangements, lenders may call for an acceleration of the debt and may exit or threaten to exit the relationship if the debt covenants are breached. An exit of a corporation's major creditor is a material fact taken into consideration by investors in deciding to invest in a corporation. In public debt issues, prices of bonds are likely to fall if the bond issuer defaults on the debt covenants. It is, therefore, submitted that debtholders have a certain amount of leverage over the decisions of corporate managers.

CONCLUSION

The importance of corporate governance in both domestic and international economies cannot be over-emphasized as corporations continue to play vital roles in the creation of wealth and in the promotion of economic development and social progress. Corporate governance has become a powerful micro-economic policy tool for supporting macro-economic policy and an effective lever for change at the business enterprise level. There is, therefore, the need for corporate players and governments to ensure that credible corporate governance measures are put in place and observed in order to engender market confidence and encourage stable long-term domestic and international investment flows.

The above discussion has sought to identify the appropriate role of the director as the central issue in corporate governance, and particularly, when the corporation employs debt financing. Of importance to explaining the role of the director in corporate governance is an understanding of corporate fiduciary relationships. The modern corporation is seen as a web of agency relationships, and the economic function of fiduciary duties is to regulate the complex web of agency relationships that comprise the structure of the corporate enterprise. Given the divergence of interests between directors, as agents, and their principals, there is the need to monitor the activities of directors. The fiduciary principle serves as a low-cost alternative, substituting deterrence, for costly and ineffective direct monitoring. The fiduciary concept also helps define the factors directors should take into account in corporate decision-making. Thus, an inquiry into the issue whether the use of corporate debt financing has an impact on corporate governance largely depends on whether directors owe fiduciary duties to debtholders.

While it is not difficult for one to understand the need for corporate directors to owe fiduciary duties to shareholders, the position is not the same with respect to debtholders. This situation becomes even more complicated with the upsurge of numerous hybrid corporate finance instruments, as a result of dynamic financial engineering, whose characteristics defy a strict debt or equity characterization. The corporate law principle of limited liability creates tension between stockholders and debtholders as result of opportunistic behaviour of directors that tend to divert wealth from debtholders to stockholders. There is, thus, the need for debtholders to be accorded adequate protection against such tendencies.

Whiles acknowledging the view that debt covenants are unable to provide adequate protection for debtholders against directors' opportunistic actions in all situations, I am of the view that creating corporate fiduciary obligations in favour of debtholders will be fraught with problems that outweigh the insignificant number of situations in which debtholders become vulnerable to corporate debtors. Thus, I make the point that the rights and obligations of parties to a corporate debt relationship should remain in the domain of contract law rather than the creation of fiduciary relationships. I have argued that given the limitations of the classical approach to contract interpretation and the potential problems it poses for debtholders, courts should resort to the modern or neoclassical approach according to which all the surrounding circumstances are taken into consideration in the interpretation of a contract in order to offer more adequate protection for debtholders. I also noted that securities laws of most jurisdictions offer some measure of protection for public bondholders as a result of disclosure requirements mandating issuer corporations to disclose all material risks inherent in the bonds being offered to the public.

It is important to note, however, that managerial decision making is influenced by pressures from various directions and in the absence of a fiduciary relationship between corporate directors and debtholders, the existence of certain statutory provisions and market forces constrain managerial decision making in favour of the interests of debtholders. The relevant statutory provisions give rise to the oppression remedy and capital protection rules. Market forces explain those factors that compel corporate debtors to consider the interests of debtholders in corporate decision-making without the compulsion of any regulations or laws. On the basis of these constraints, I come to the conclusion that employment of corporate debt financing has an impact on corporate decision-making, and thus, on corporate governance.

This conclusion has some implications for managerial decision-making when corporations resort to debt financing. Despite the absence of corporate fiduciary obligations to debtholders, their impact on corporate affairs and business efficacy demands that corporate managers have regard to their interests. Given the importance of debt financing to corporate affairs, corporate managers will have to engender the confidence of lenders and bondholders in order to maximize investments through the issue of debt obligations. This confidence can be secured if corporate debtors demonstrate their readiness to abandon opportunistic behaviour that prejudices the interests of debtholders. It is also worth mentioning that the cost of debt to corporations increases whenever the divergence and conflict between the interests of debtholders and those of shareholders widens as a result of the opportunistic behaviour of directors. This is so as debtholders take measures to monitor corporate actions in order to protect their interests. The cost of monitoring can be reduced substantially if debtholders have the confidence that corporate management will not take actions that divert wealth from debtholders to shareholders.

The unlimited ability of corporations to design various financial models to derive maximum returns will continue to present governance issues, particularly with respect to corporate fiduciary obligations, as corporate financial products are designed to retain characteristics of both debt and equity. However, given that there are other forces that influence the direction of managerial decision making, it is my opinion that the issue as to whether debtholders should be made beneficiaries of corporate fiduciary obligations, with the attendant issue as to whether particular corporate finance models should be characterized as debt or equity, ought not to dominate the discussion on the role of debt financing on corporate governance. There is the need to give attention to a host of other ways of exercising leverage on corporate governance resulting from a corporation's resort to debt financing. Future work might focus on the informal influence of debtholders whose threat to "exit" and exercise secured rights itself becomes a part of corporate governance.

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