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"DE-LEVERAGING" THE LEVERAGED BUYOUTS OF THE 1980s: A PRISONER'S DILEMMA FOR UNSECURED CORPORATE BONDHOLDERS IN THE 1990s

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The 1980s witnessed an unprecedented burgeoning of merger and acquisition (M&A) transactions in American corporations.[1] One transaction in particular, the leveraged buyout (LBO),[2] increased in number from 99 in 1981 to 316 in 1988.[3] The M&A growth resulted from several factors, not the least of which was the development by Drexel, Burnham & Lambert (Drexel) in 1977 of high-yield debt securities (junk bonds).[4] During the 1980s, corporations also began incurring record levels of debt.[5] This increase in both M&A activity and corporate leveraging now threatens the restructuring of newly-merged firms because interest obligations often exceed corporate revenues, leaving pre- and post-merger unsecured bonds teetering on default.

This article explores the "prisoner's dilemma" created for pre-merger unsecured bondholders by failed or failing buyouts of the 1980s. Section I outlines the dilemma. Section II discusses the nature of bonds

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1. *See Top 25 Transactions*, 24 MERGERS & ACQUISITIONS, Mar.-Apr. 1990, at 124, for a listing by name and value of the transaction in millions of dollars of the largest acquisitions in the fourth quarter of 1989. *See also Top 25 Transactions*, 24 MERGERS & ACQUISITIONS, July-Aug. 1989, at 81 (twenty-five largest acquisitions in the first quarter of 1989); *The Top 100*, 23 MERGERS & ACQUISITIONS, May-June 1989, at 47 (one hundred largest acquisitions in 1988); *The Top 100*, 22 MERGERS & ACQUISITIONS, May-June 1988, at 39 (one hundred largest acquisitions of 1987); *The Top 100*, 21 MERGERS & ACQUISITIONS, May-June 1987, at 47 (one hundred largest acquisitions in 1986); *The Top 100*, 20 MERGERS & ACQUISITIONS, May-June 1986, at 33 (one hundred largest acquisitions in 1985).

2. An "LBO" refers to any highly leveraged transaction. Leveraged takeovers fall into two primary categories: (1) buyouts by a company's management in which key executives acquire the firm through borrowed funds and subsequently become the sole or primary equity owners of the company or (2) buyouts by third-party acquirors who purchase target securities through borrowed funds and subsequently become the company's primary equity owners or who participate in equity ownership of the firm with target management who consented to and cooperated in the firm's acquisition. Leveraged transactions may also be a corporate recapitalization in which a firm borrows cash to distribute to equity holders. The result of leveraged recapitalizations is that high levels of debt replace outstanding equity creating a capital structure which resembles that of an LBO.

Recapitalizations, unlike traditional LBOs, do not effect a change in corporate management and, therefore, firm directors often use them as a defensive maneuver.

3. The aggregate value of LBOs alone swelled from $3.1 billion in 1981 to over $42 billion in 1988. *See Quarterly Profile*, 23 MERGERS & ACQUISITIONS, Mar.-Apr. 1989, at 74.

4. *See infra* notes 53-55 and accompanying text.

5. *See infra* note 57 and accompanying text.

and bond financing. Section III examines the conflict inherent in corporate bond financing between stockholders and bondholders. Section IV discusses the consequences of bankruptcy upon pre-merger unsecured bondholders as well as workout and insolvency plans of reorganization. Section V suggests a solution to the dilemma by examining various state and federal remedies.

I. Outlining the Dilemma

M&As increased at a phenomenal rate during the 1980s. This was due to several factors: (1) Drexel's development of a primary market in junk bond financing for acquisitions;[6] (2) the acceptance of commercial lending on the basis of anticipated cash flow and asset dispositions; (3) tender offers for large conglomerate corporations based upon the company's "break-up" value; (4) the practice by institutional investors, pension funds, and savings and loans of acquiring risky investments to generate fees and to maintain performance levels on their customers' behalf; (5) the control of commerce in United States' securities by a few industry professionals and institutional investors; (6) the use of tax incentives for debt financing purposes; and (7) the emergence of specialized takeover firms which located target firms and raiders, assisted in structuring buyouts, provided bridge financing for acquisitions, and often became owners of the acquired entity.[7]

During the 1980s, American businesses also began incurring record levels of debt. In 1989, the New York Times reported that from 1984 to 1987 corporate equity decreased by $313 billion, while new corporate debt increased by almost twice that amount.[8] This unprecedented growth in corporate leverage has several consequences. First, new leveraging imposes a substantial strain upon the cash flow of a firm's ability to service interest commitments. For example, interest, as a percentage of cash flow, increased from approximately 17% in 1977-78 to approximately 25% in 1988.[9] Consequently, larger portions of a firm's

6. Junk bonds were issued in transactions involving the following companies: RJR Holdings ($14.9 billion), Long Island Lighting ($3.8 billion), Owens-Illinois ($2.9 billion), Quantum Chemical ($2.1 billion), Southland ($1.7 billion), SCI Holdings ($1.7 billion), Wickes ($1.6 billion), Safeway Stores ($1.6 billion), Fort Howard ($1.6 billion), Union Carbide ($1.6 billion), Harcourt Brace Jovanovich ($1.6 billion), E.II Holdings ($1.5 billion), R.H. Macy ($1.5 billion), USG ($1.5 billion), Federated Dept. Stores ($1.4 billion), Allied Stores ($1.4 billion), National Gypsum ($1.0 billion), Burlington Holdings ($1.0 billion), American Standard ($1.0 billion), and Interco ($0.8 billion). *See* Kuhn, *Junk: The Weak and the Strong*, FORTUNE, Oct. 23, 1989, at 17.

7. Kohlberg, Kravis, Roberts & Co. is one of the first, and best known, firms developed for the purpose of locating buyers and assisting in mergers and acquisitions activity, particularly LBOs.

8. *See* Reuters, *Buyout Curbs Draw Concern*, N.Y. TIMES, Jan. 20, 1989, at D6, col. 5. *See also* Dowd, *Washington's War Against LBO Debt*, FORTUNE, Feb. 13, 1989, at 91 (corporate equity incurred a net loss of $442 billion whereas debt experienced an $800 billion increase).

9. *See* Dowd, *supra*, note 8, at 92. If companies issuing non-investment grade debt expect cash flow problems following placement of the securities, payment-in-kind (PIK) notes or zero-coupon bonds may be used instead of traditional junk bonds. Zero-coupon bonds provide relief to struggling firms through interest deferrals. PIK notes, on the

cash flow are being directed to debt obligations. Second, the increase in interest payments led Standard & Poor's to downgrade 386 debt issues valued at over $170 billion.[10] For the most part, these debt issues were investment grade when issued and carried low risk of loss to security holders.[11] Finally, since most LBO transactions allowed no leeway for an economic downturn, the effects of a recession on target firms, LBO participants, pre-LBO bond owners, and trade suppliers were largely ignored.[12]

The expansion in volume and aggregate dollar amount of M&As, coupled with the increase in corporate debt, threaten a systematic restructuring of newly-merged firms. Defaults will occur on both pre-merger unsecured corporate bonds, which have suffered material reductions in bond ratings,[13] and junk bonds.[14] A 1989 study reported that

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other hand, pay interest with other debt securities and, therefore, require no cash outlays for extended intervals. PIK notes and zero-coupon bonds allow LBO firms to avoid interest payments at the outset, thus deferring the possibility of default until a later date.

10. Reuters, *Record Debt Downgrading*, N.Y. TIMES, Jan. 16, 1989, at D6, col. 2 (ratings were cut in part because of the impact of huge LBOs and acquisitions).

11. *See id.*

12. *See Corporate Finance, "Leveraged to the Hilt": Will History Repeat Itself?*, WALL ST. J., Oct. 25, 1988, at A26, col. 3.

13. In 1988, Standard & Poor's reported that downgrades of corporate debt securities outranked upgrades by more than 2 to 1, with an adverse effect on $46 billion worth of corporate debt. *See* Committee on Developments in Business Financing, *Sixth Annual Review of Developments in Business Financing*, 45 BUS. LAW. 441, 451 (1989). As a result of this attack on the bond market, bondholders from major corporations have united to form the Institutional Bondholders' Rights Association. The purpose of the Association is, in large part, to aid debt owners during merger and acquisition transactions. *Id.* at 453. *See also* Winkler, *Sore Junk Bond Holders Form Rights Group But Say They Aren't Looking for Free Ride*, WALL ST. J., June 30, 1988, at 61, col. 2. The triggering event for the Association's formation was the fall 1988 LBO of RJR Nabisco which resulted in a fifteen percent drop in RJR bond value. Laderman, *How Megadebt Shakes Up Banks and Bonds*, BUS. WK., Nov. 14, 1988, at 132, 136.

14.

ISSUER	JUNK BONDS in billions	ESTIMATED DEFAULT RISK* 2 yrs.	5 yrs.	RECENT PRICE percent of face value	CHANGE 8/31-9/27
RJR Holdings	$14.9	2	4	103.0	−4.5
Long Island Lighting	3.8	1	3	103.0	−0.5
Owens-Illinois	2.9	1	4	96.0	−4.5
Quantum Chemical	2.1	2	5	96.0	−4.0
Southland	1.7	3	6	52.0	−22.0
SCI Holdings	1.7	2	4	109.0	−1.5
Wickes	1.6	3	6	69.0	+3.0
Safeway Stores	1.6	2	4	101.5	−1.5
Fort Howard	1.6	2	5	99.5	−3.0
Union Carbide	1.6	1	2	86.0	−2.0
Harcourt Brace Jovanovich	1.6	2	5	102.0	−2.0
E.II Holdings	1.5	4	6	67.0	−3.0
R. H. Macy	1.5	2	4	102.5	−1.5
USG	1.5	3	5	66.0	−12.0
Federated Dept. Stores	1.4	6	7	62.0	−21.0
Allied Stores	1.4	6	7	40.0	−11.0
National Gypsum	1.0	3	5	70.0	−4.0
Burlington Holdings	1.0	2	5	104.0	−2.5
American Standard	1.0	2	5	102.0	−2.0
Interco	0.8	5	6	57.0	−4.0

the junk bond default rate averaged 1.5 percent over the period from 1978 to 1986.[15] Another study indicated that junk bonds issued between 1977 and 1978 incurred a default rate in excess of thirty-four percent; those issued between 1979 and 1983 had a default rate from nineteen to twenty-six percent; and those issued between 1984 and 1986 showed a default rate of approximately nine percent.[16] The latter study reflects the concept of bond aging which recognizes minimum default percentages immediately after issue that then rise over the life of the bond and ultimately become diluted by new bond placement accretion.[17] If bond aging proves to be an accurate default progression indicator, the number of bankruptcies or voluntary reorganizations will increase as more junk bonds approach maturity.

Despite the modest default ratios on straight corporate debt and junk bonds in relation to the billions of dollars of outstanding bonds, the 1990s will gauge whether corporate cash flow is sufficient to sustain the 1980s buyout debt. Already two large LBOs have failed because of junk bond commitment defaults: Campeau Corporation (which filed for Chapter 11 bankruptcy protection in January 1990)[18] and Revco R.S. Inc. (which filed under Chapter 11 in July 1988).[19] Market analysts currently are following the Kohlberg, Kravis, Roberts & Co.'s 1989 LBO of RJR Nabisco (RJR) which, at approximately $25 billion in cash and securities, is the largest acquisition in history.[20] At last report, RJR generated sufficient cash to cover its interest costs at the end of 1989. RJR management, however, faces the prospect of adjusting interest rates on two securities at a cost of approximately $7 billion by April 1991.[21]

One significant result of the frenzied 1980s debt financing for M&As is that companies now need greater revenues to service debt obligations. To avoid default, firms must create cash. If further junk bond financing is unavailable and corporate assets cannot be sold for reasonable amounts, target firms will be forced either into liquidation or insolvency reorganizations. Assuming that most firms will initially attempt to continue business operations, reorganization provides the best alternative to forced disposal of firm assets. The probable goal of rehabilitative restructuring in or outside of bankruptcy is the de-leveraging of the

* A default risk of one is considered safe; a default risk of seven represents a 75 percent chance of default. Kuhn, *supra* note 6, at 17.

15. SPIOTTO, HIGH-YIELD BONDS, LEVERAGED BUYOUTS AND TROUBLED DEBT FINANCING, at 76 (1989). *See also* Winkler, *Junk Bonds Are Taking Their Lumps*, WALL ST. J., Apr. 14, 1989, at Cl, col. 3 (the default rate between 1970 and 1985 on junk bonds never exceeded 2.1 percent).

16. *See* Winkler, *Junk Bonds Are Taking Their Lumps*, WALL ST. J., Apr. 14, 1989, at C1, col. 3.

17. *See* SPIOTTO, *supra* note 15, at 76.

18. Barmash, *Campeau Invokes Bankruptcy Code for its Big Stores*, N.Y. TIMES, Jan. 16, 1990, at A1, col. 6.

19. Holusha, *Revco Drugstore Chain in Bankruptcy Filing*, N.Y. TIMES, July 29, 1988, at D1, col. 3.

20. Norris, *Can RJR Nabisco Keep Its Promise?*, N.Y. TIMES, Feb. 1, 1990, at D10, col. 3.

21. *Id.* Although the securities do not pay interest in cash until 1995, as the interest accrues and compounds it becomes an obligation of the company.

debtor corporation. The query for the 1990s is how the restructuring will be effected and who will bear its costs.

The capital structure of a typical LBO consists of three general levels: (1) approximately ten percent equity, or common stock; (2) fifty to sixty percent senior secured debt; and (3) mezzanine financing of the difference between the cost of the LBO company and the equity and senior debt available.[22] When a LBO company is restructured or de-leveraged, management often retires, replaces, or amends outstanding debt interests. To do this, management repurchases existing debt securities at a fraction of their face value, exchanges new securities (either debt or equity) for pre-existing bonds, or modifies indenture covenants to extend or reduce material terms to outstanding bond contracts. Presently, LBO companies are pursuing reorganizations in which equity and debt interests are realigned pursuant to exchanges of securities. For example, assume an LBO firm is unable to meet all of its debt commitments. A common alternative to default or foreclosure is to offer debt owners an equity position in the company. In September 1990, the Trump Organization varied this tactic by offering equity in the Trump Taj Mahal Casino Resort to its bondholders in exchange for delaying a $47.3 million interest payment.[23]

The more common inversion of debt and equity positions is negotiated either on a long-term or permanent basis to effectuate a successful restructuring of the LBO firm. In the latter instance, holders of equity, senior debt, and mezzanine financing compete for priority consideration in the debtor's de-leveraging process. For example, assume that senior debt holders reject a substitution of securities due to the inequality of the exchange (speculative equity for low-risk secured debt). Instead, senior lenders offer to advance additional credit to the LBO company in return for a security interest in unencumbered assets. By this maneuver, secured creditors provide necessary cash to the distressed company, exact collateral as security for the loan, and preserve their status as priority creditors.

Unsecured creditors—including pre-merger bondholders, trade claimants, and junk bond owners—are in a less favorable bargaining position. For the most part, these creditors must compete for cash payments or equity. Trade creditors, comprising a relatively small percentage of the outstanding unsecured debt claims, will negotiate for

22. Mezzanine financing is most often in the form of junk bonds or preferred stock which, together with pre-existing unsecured corporate debt and trade claims, comprise all interests not classified as equity or senior debt. Equity investors in an LBO may include: (1) LBO firm's management; (2) shareholders who sold all but a small portion of their former equity position; (3) venture capitalists or firms that specialize in LBO financing; and (4) owners of senior debt or mezzanine financing who receive an equity "kicker" as part of a financing "package" or "strip." Senior debt owners often consist of banks and insurance companies who require full collateralization of the LBO company's assets for their investment. Mezzanine financing includes third-party financiers, insurance companies, and senior debt holders (as included in their secured loan package).

23. *See* Hylton, *Trump Now Reported Near Bond-Sways Offer*, N.Y. TIMES, Sept. 11, 1990, at D2, col. 5.

cash payments to be made out of ongoing business operations over a twelve-month period. Management will be inclined to permit these payments in order to maintain the flow of goods and services to the distressed firm. Junk bondholders, on the other hand, have no alternative except to accept equity securities since the sheer volume of their claims forecloses possible cash settlements.

Unsecured pre-LBO bondholders' interests lie in an abyss somewhere between those of trade creditors and junk bondholders. As with trade creditors, pre-existing bondholder claims are diminutive in relation to the percentage of LBO debt outstanding and, thus, arguably could be paid in cash. Like junk bondholders, pre-merger debt owners do not provide essential supplies or services to the LBO firm. The LBO firm management, therefore, neither owes nor is encouraged to develop an allegiance to the pre-merger debt owners. Equity investors in the LBO company oppose any stock offering to debt holders which dilutes their ownership posture. From a practical perspective, however, these equity owners must endorse a common stock offering since the alternative is bankruptcy liquidation where they rank last among the debtor's other creditors.

Secured and unsecured creditors who are not willing to wait for partial compensation under a plan of reorganization may assign their rights against the debtor. The assignment of creditor claims arguably will be initiated by insiders to the buyout. These insiders include members of creditors' committee and former LBO participants who have access to the merged entity's proprietary financial information and who hold millions of dollars of the debtor's unsecured bonds or preferred stock. Deleveraging an LBO company, by substituting equity for unsecured debt interests, has the immediate effect of auctioning away corporate control in bankruptcy. As a practical matter, insiders control the auction process. To allow corporate control to be manipulated in a bankruptcy forum effectively circumvents the jurisdiction of the federal securities and state corporate courts—the traditional sentinels of fairness in corporate control transactions.

Currently, the costs and risks of restructuring M&As in bankruptcy are borne by pre-merger unsecured bondholders whose post-LBO interests align neither with trade creditors nor high-yield debt owners. As unsecured creditors, these bondholders rank only above equity investors in priority of payment by a bankrupt debtor and are considered *pari passu* with both junk bond owners and trade creditors. In practical terms, however, these debt holders are hard pressed to secure a cash settlement and are instead compelled to consent to an equity offering by the reorganized entity. If the restructured firm fails to become profitable, the substituted stock becomes worthless. In effect, pre-LBO bondholders must either sell their devalued securities at a substantial loss or await compensation in the form of equity. The question raised by these bondholders is what remedy, if any, is available to protect their debt stake that was solicited years earlier by a financially sound issuer.

To date, corporate bondholders who have pursued impairment of investment claims against management or acquirors in state corporate or federal securities actions have lacked standing to sue.[24] State courts in particular are unwilling to extend corporate fiduciary principles to pre-LBO bondholders, ostensibly in recognition of the inviolable precept of corporate law that management must maximize shareholder welfare over bondholder gain.[25] State contract actions which seek relief based upon modifications of outstanding debt securities have fared no better.[26] The contractual actions, unlike their fiduciary duty counterparts, implicate questions of coercion, good faith, fair dealing, and informed consent.[27] Since junk bonds issued in the 1980s will continue to mature and press troubled companies to the verge of bankruptcy, the quandry of spiraling devaluation confronting unsecured corporate bondholders in the 1990s apparently will be addressed in bankruptcy proceedings, a forum ill-suited to adjudicate issues of corporate control in publicly-held corporations. The only other alternative for unsecured corporate debt holders is to set aside certain claims by buyout participants under fraudulent transfer provisions of the bankruptcy code or analogous state fraudulent conveyance statutes.

II. The Nature and Characteristics of Bonds and Bond Financing

The financial structure of a corporation is primarily composed of two common investment devices: common stock (equity) and bonds or debentures (debt).[28] Straight corporate debt involves a creditor (the bondholder) lending money to a corporate entity in return for the cor-

24. *See infra* notes 193-220 and accompanying text.

25. *See id.*

26. *See* Katz v. Oak Indus., 508 A.2d 873 (Del. Ch. 1986); Kass v. Eastern Air Lines, C.A. No. 8700, 8701, 8711 (Del. Ch. Nov. 14, 1986). *See also* Simons v. Cogan, 542 A.2d 785 (Del. Ch. 1987).

27. *See infra* notes 193-220 and accompanying text.

28. The fundamental characteristics of common stock include: (1) the right to vote for the election of directors and on other extraordinary corporate matters; (2) the right to receive dividends; (3) free transferability; (4) the ability to be pledged or hypothecated; (5) the ability to increase in value; and (6) the right to share in the net assets of the corporation upon liquidation. *See* United Housing Found. v. Forman, 421 U.S. 837 (1975) (addressing the issue of whether "a share of stock" that entitled the holder to lease an apartment in a housing cooperative was a "security"). Common stock holders are also entitled to inspect books and records, Revised Model Business Corp. Act § 16.02 (1984), to sue derivatively on behalf of the corporation, *Id.* § 7.40, and to receive financial information concerning the corporation, *Id.* § 16.20.

Bonds and debentures are evidences of long-term corporate commitment and indebtedness. Each involves an unconditional promise to pay a certain sum at the maturity date plus interest. The distinction between bonds and debentures is technical and often ignored in short-hand finance practice. Debentures are unsecured corporate obligations, whereas bonds are secured by a lien or mortgage on corporate assets. For purposes of this article, the term "bond" means both types of debt securities.

Additional characteristics of debt securities are (1) interest payments at fixed intervals (this interest is deductible to the corporation for income tax purposes); (2) a redemption feature which allows the corporation to pay off the debt before its maturity date, usually at a premium over the face value of the security; (3) subordination to other corporate obligations; (4) a right of conversion into other classes of stock, generally common stock; and (5) poration's unconditional promise to repay the sum at a future fixed date (the maturity date).[29] The transaction is a debt that must be repaid; it is a loan of capital by the bondholder to the firm which is the debtor. Corporate bonds are generally issued in $1,000 denominations, representing the face or par value of the bond. The face or par value must be paid to the creditor upon maturity. The bond manifests the additional obligation by the debtor to pay a fixed amount of interest at specified intervals, commonly semi-annually. This interest becomes a deductible expense for the corporation. But, in turn, the firm must generate sufficient cash flow to service the debt obligation.

The three basic attributes of a bond—maturity date, interest, and face or par value—are set forth in a bond contract, referred to as a "trust indenture."[30] The trust indenture is a standard form contract that contains numerous covenants to protect bondholders from undesirable management or debtor actions.[31] The purpose of these covenants is to minimize corporate decisions that tend to transfer wealth from bondholders to stockholders. Customary bond covenants include restrictions on future unsecured long-term debt,[32] limitations on the declaration and payment of dividends,[33] and restraints on secured debt (known as a

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a right to vote permitted by statute and created by the indenture upon certain, limited contingencies.

A third common investment device is preferred stock. Preferred shares are "hybrid" securities, involving features of both classic equity and debt. Typical features of preferred stock include: (1) priority in dividend payments over holders of common shares; (2) priority over common stockholders in distributions upon liquidation; (3) the accumulation of dividends in arrears which must be paid before any new dividends are paid to common stockholders; (4) the absence of voting rights unless dividends are in arrears for a specified time; (5) a redemption feature exercisable at the corporation's option; and (6) convertibility at the holder's option if permitted by the articles of incorporation.

29. Straight debt is not convertible into equity. A convertible bond, on the other hand, allows the holder to surrender the bond in exchange for issuer's common stock. Ordinarily, convertible bondholders do not vote for directors since their interest is similar to that of a creditor of the corporation. Likewise, convertible bondholders enforce their respective rights via the bond indenture as opposed to the derivative cause of action which is accorded to equity holders to whom directors owe a fiduciary duty. *See* Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667.

30. The trust indenture is a contract between the corporate bond issuer and a trustee for the benefit of the bondholders. The contract sets forth the rights and obligations of the issuer and the bondholders. *See* A. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 173-74 (5th ed. 1953).

31. Committee on Developments in Business Financing, ABA Section of Corporation, Banking and Business Law, *Model Simplified Indentures*, 38 BUS. LAW. 741-43 (1983).

32. AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURES 369-70 (1971) [hereinafter COMMENTARIES]. *See also* B. MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL 98 (2d ed. 1981).

Issuance of additional debt generates proceeds which correspondingly increase the value of the corporate issuer. The additional debt, however, simultaneously increases the leverage of the firm. With the addition of new debt, the total amount of outstanding equity declines in relation to the total debt issued, thereby raising the risk of insolvency by the issuing corporation. Restrictions on additional debt may include absolute prohibitions or covenants providing for the subordination to existing debt of subsequent bond financing.

33. COMMENTARIES, *supra* note 32, at 402. The declaration and payment of dividends involve judgments within the sound discretion of a board of directors and may be overturned only upon a showing of bad faith and a capital surplus from which the dividends may be paid. *See* Gottfried v. Gottfried, 73 N.Y.S.2d 692 (N.Y. Sup. Ct. 1947). Addition-

negative pledge cause).[34] Covenants which are uncommon to indenture contracts, but which substantially protect bondholder interests, are constraints on the sale or disposition of assets[35] and restrictions on future investments.[36]

In 1984, a survey was conducted of indenture covenants for one-hundred and fifty corporations with outstanding bond issues as reported in the Moody Industrial Manual for 1956-1975.[37] The survey found that ninety percent of the corporate indentures directly restricted dividend payments while the remaining ten percent imposed indirect dividend constraints.[38]

In 1979, Smith and Warner published findings from a random sampling of eighty-seven indenture contracts filed with the Securities and Exchange Commission (SEC) between 1974 and 1975.[39] According to this study, standardized contract covenants as set forth in The Commentaries on Indentures by the American Bar Foundation (Commentaries) were used frequently.[40] In addition, ninety-one percent of the bond contracts restricted additional debt, thirty-six percent limited disposition of assets, and twenty-three percent curtailed payment of dividends.[41]

In a similar survey of America's one hundred largest industrial corporations, as listed in Fortune in 1984, eighty-four companies reported senior public debt issues.[42] Of those corporations, eighty-two disclosed indenture covenants which contained a restriction on secured debt—the negative pledge clause. Ninety-two of the one hundred companies reported one or more outstanding senior debt issues, one or more subordinated debt issues, or both. Approximately twenty-eight percent of the ninety-two reporting companies revealed indenture restrictions on unsecured long-term debt while thirty-five percent identified restrictions on dividends. Of the twenty-eight percent, twenty-two percent restricted unsecured long-term debt of the parent company alone and the

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ally, under state corporate law, payment of dividends is not permitted when the effect is to impair the corporation's capital account or to otherwise render the corporation insolvent. *See, e.g.*, DEL. CODE ANN. tit. 8, § 170 (1983); REVISED MODEL BUS. CORP. ACT, § 6.40 (1984). The term "dividend" includes other corporate transactions which effect a transfer of corporate property from the corporation to its shareholders. The most common example of such a transaction is an issuer's repurchase of its common stock.

34. COMMENTARIES, *supra* note 32, at 350. A negative pledge clause typically limits a company's ability to incur additional mortgage debt. This pledge by the firm promises its unsecured bondholders that no mortgage debt will be created that would obtain priority over the pre-existing unsecured debt. The negative pledge clause, however, relates only to the firm's fixed assets.

35. *Id.* at 423.

36. *Id.* at 458.

37. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 425 (1986).

38. Kalay, *Stockholder-Bondholder Conflict and Dividend Constraints*, 10 J. FIN. ECON. 211, 214-16 (1982).

39. Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

40. *Id.* at 122-23.

41. *Id.*

42. The survey was based on information in Moody's 1984 Industrial Manual.

remaining six percent restricted such debt of only the subsidiary corporation. None of the ninety-two corporations surveyed disclosed an indenture covenant which curtailed the transfer of assets.

These statistics, however, do not reflect representative covenants for new bond issues. For example, of the twenty-six companies with restraints on unsecured debt, eleven dropped the restrictions for new issuances. Consequently, with regards to new offerings alone, only eleven of ninety-two major industrial corporations protected their bondholders against subsequent unsecured debt. Similarly, fourteen of the thirty-two firms which restricted dividends omitted that limitation from initial issues. Again from the perspective of subsequent bond offerings, therefore, only twenty percent of the ninety-two companies surveyed granted bondholder protection from dividend payments.

In view of these statistics, America's largest industrial corporations are not contracting in favor of their bondholders. Evidence instead indicates that indenture covenants concerning unsecured debt and dividends are occurring less frequently, thereby representing the position of a minority of publicly-held American corporations. The plight of unsecured bondholders may be greater than these statistics indicate since small businesses, for which no data is available, often pattern their transactions on Fortune 100 companies. If, therefore, only negative pledge clauses remain inviolate,[43] a threshold question is raised: Are unsecured bondholders of American corporations essentially contract unprotected?

Another preliminary issue concerns the role of long-term unsecured debt in financing corporate America. First, issuance of some debt to third parties is generally warranted due to the concept of leverage. Leverage occurs when the use of borrowed funds generates more revenue than the cost of the borrowing. Second, raising capital through the placement of bonds, as opposed to common stock or other forms of equity, avoids a potential transfer of control of the firm through voting securities or the dilution of existing common stockholder interests. Third, debt financing provides tax advantages to the firm since interest payments on debt are deductible by the borrower whereas dividend payments are double-taxed, once by the corporation and again by the equity holder. Finally, repayment of principal is a non-taxable return of capital unlike a purchase or redemption of stock by an issuer which is a taxable dividend to the investor. In sum, the issuance of unsecured debt with

43. Negative pledge clauses represent a simple business decision by firm management that soliciting public funds for unsecured bonds and then selling mortgage bonds soon thereafter guarantees antagonism by the existing bondholders who become junior debt holders. Negative pledge clauses thus protect a company's reputation as a debtor. In addition, major corporations rarely mortgage their plants to raise additional capital inasmuch as mortgage bonds inflict high administrative costs and limit management's ability to use its fixed assets.

Negative pledge clauses, on the other hand, take from debtors of the firm the option of avoiding insolvency or bankruptcy by mortgaging fixed assets. This threat may not be perceived as great since junior unsecured creditors likely will agree to the creation of new senior debt where the only remaining choice is bankruptcy.

appropriate indenture protections infuses start-up or working capital to the issuer without requiring recourse to banks, existing stockholders, or the pledge of fixed assets, while providing all of the tax advantages of debt financing. Long-term unsecured debt is, therefore, a desirable and necessary aspect of the capitalization and ongoing financial structure of the corporate enterprise.

In order to effect debt financing, firms often issue bonds to the "public."[44] Public debt issuance requires the issuing corporation to register with the SEC.[45] The registration statement contains all material terms of the bond placement, including financial disclosures pertinent to the issuer and the bonds to be sold.[46] Before the registration statement is filed, however, the issuer will likely negotiate the sale of the entire bond offering to an investment banker who, in turn, underwrites or sells portions of the placement to participating brokers and dealers.[47] The impact of underwriting the offering is that basic terms of the debt, such as the maturity date, interest rate, and redemption feature, will be negotiated by the issuer and investment banker. Other terms, such as the manner in which the call feature is exercised, the duties of the trustee under the indenture, and the method for calculating dividend restrictions will tend to follow standardized indenture contracts. Specialized provisions which reflect specific needs of sophisticated creditors will be costly, if not impossible, to draft into indenture contracts. Where unusual circumstances demand the adoption of non-standardized terms, the issuer may propose a private placement, that is, the sale of bonds to a single creditor or small group of creditors. The advantages of a private securities placement are twofold. First, the borrower avoids the cost of an SEC registration since the offering is private in nature. Second, the borrower and lender may freely negotiate contract terms which are beneficial to both and which more accurately reflect the allocation of risks for the bonds as market circumstances change. Although private placements are advantageous to issuers, the benefits are illusory when debt holders in a private offering soon thereafter sell some or all of the obligations to a number of other investors. In the situation of immediate resales, the initial lenders themselves become underwriters to the offering and the placement becomes public.[48]

A second category of corporate bond is the "junk bond." The term "junk bond" refers to all debt instruments issued by any of the 22,000 American corporations whose bonds are not rated "investment grade."[49] "Non-investment grade" bonds are defined as those debt in-

44. In this context, "public" means a discernible number of individuals, mutual funds, savings and loans, pension funds and insurance companies who require material information regarding the offering for their investment of funds.

45. Securities Act of 1933, 15 U.S.C. §§ 77a-77e (1988). Where bonds are sold to the public, the terms of the indenture contract must comply with the requirements of the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1988).

46. Securities Act of 1933, 15 U.S.C. §§ 77g, 77aa (1988).

47. *See generally* JENNINGS & MARSH, SECURITIES REGULATION (1982).

48. *See id.*

49. *See* DREXEL BURNHAM LAMBERT, INC., 1989 ANNUAL HIGH YIELD MARKET REPORT 6

struments rated below Baa by Moody's, below BBB by Standard and Poor's, or unrated. To assign ratings for new bond issuances, these agencies consider the issuer's financial status to determine the issuing company's ability to pay interest when due and to repay principal upon maturity. Bond ratings are also reflective of the issuing firm's future business plans, objectives, strategies, and policies.

Prior to 1977, junk bonds comprised a small market of "fallen angels" (companies whose bonds carried low risk when issued but which had been downgraded to high-risk and high-yield because the issuer experienced financial hardship).[50] In 1977, Lehman Brothers (Lehman) marketed high yield bonds to raise new capital for companies that otherwise could not qualify for investment grade securities.[51] Lehman abandoned this line of financing shortly thereafter.[52] Drexel entered the market upon Lehman's withdrawal and began to expand immediately and underwrite original-issue, high-yield bonds in both public and private placements.[53]

In the early years of use, the Drexel high-yield securities provided alternative capital for newer and smaller businesses unable to secure investment grade debt placements due to an absence of historical financial performance. With the advent of Drexel's junk bonds, these emerging companies were able to substitute their prior source of funding—bank loans and loans from insurance companies (which imposed onerous loan covenants and accelerated repayment schedules)—with a more flexible, high-yield financing source which typically required a longer ten to twenty year repayment feature.[54] In effect, Drexel created alternative "securitized commercial loans" for emerging small businesses.[55] Additional uses for the original Drexel high-yield bonds included negotiated mergers and takeovers, LBOs, and bank loan payoffs.

In 1984, the junk bond market careened into the hostile takeover arena with Drexel's agreement to arrange funding for the attempted takeover of Gulf Oil by T. Boone Pickens. This entry into hostile M&A activity witnessed the increase in volume of new issue junk bonds from $900 million in 1977 to $14.3 billion in 1984.[56] By the close of 1989,

[hereinafter DREXEL REPORT]. As of 1989, approximately 800 American corporations had bonds outstanding which were "investment grade."

50. McGough, *Reaching for Yield*, FORBES, Sept. 16, 1985, at 91.

51. In the 1920s and 1930s, original-issue high-yield bonds were marketed by a variety of United States corporations including General Motors and IBM. This market dried up after a high rate of default on the bonds occurred in the 1930s. *See* Loeys, *Low-Grade Bonds: A Growing Source of Corporate Funding*, FED. RES. BANK OF PHIL., BUS. REV., Nov.-Dec. 1986, at 3-4 (citing W. BRADDOCK HICKMAN, CORPORATE BOND QUALITY AND INVESTOR EXPERIENCE 153 (1958)).

52. Loeys, *Low-Grade Bonds: A Growing Source of Corporate Funding*, FED. RES. BANK OF PHIL., BUS. REV., Nov.-Dec. 1986, at 3, 4 (citing W. BRADDOCK HICKMAN, CORPORATE BOND QUALITY AND INVESTOR EXPERIENCE, at 153 (1958)).

53. *Id.* at 10-12.

54. *Id.*

55. *Id.*

56. Samuelson, *Junk Campaign Against Junk Bonds*, L.A. TIMES, Dec. 18, 1985, at 5, col. 2.

original issue bonds comprised at least twenty-five percent of the total bond market.[57]

Notwithstanding their relative proportion to the outstanding bond market, use of junk bonds for hostile tender offer financing has generated considerable debate and concern by both market professionals and Congress.[58] Of primary concern to junk bond critics is the use of original-issue, high-yield securities to place large, well-managed companies "in play" for purposes of short-term speculation. These critics argue that the resulting profit-taking and inside trading harm target security holders and create confusion in the public securities market. Junk bond proponents emphasize the high rates of return associated with the securities and their eradication of size as an impediment to a successful takeover of inefficient firms.

III. The Bondholder—Stockholder Conflict

Bondholders are creditors of the firm. They neither vote for the board of directors nor share an equity interest in the corporation.[59] Contract law and traditional bond covenants protect bondholder interests.[60] Conversely, shareholders own and indirectly manage the firm through equity securities of common stock.[61] Corporate law protects stockholders by imposing upon directors fiduciary duties of care and loyalty in the management of the firm.[62] The question is whether these concepts of simple debt and equity accurately reflect the rights, interests, or claims of the financial participants of publicly-held corporations which are targeted for an LBO.

A. *The Bondholder—Stockholder Dichotomy in Corporate Finance*

Corporate management may take actions that maximize shareholder interests at the bondholders' expense. The three most obvious examples of such shareholder maximization are dividend payments, investment choices, and surplus capital investment.[63] In each of these circumstances, issuers face unavoidable potential conflicts of interest between equity investors and debt holders.

(1) Dividend Payments

The classic conflict between debt and equity relates to dividend pay-

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57. *See* DREXEL REPORT *supra* note 49, at 6.

58. *See* Congressional Research Service Report, Report for the House Subcommittee on Telecommunications, Consumer Protection and Finance, *The Role of High Yield Bonds (Junk Bonds) in Capital Markets and Corporate Takeovers: Public Policy Implications* (Dec. 1985); H. SHERMAN & R. SCHRAGER, JUNK BONDS AND TENDER OFFER FINANCING (1987).

59. R. HAMILTON, CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS, 321-22 (1990).

60. L. RIBSTEIN, BUSINESS ASSOCIATIONS § 11.07 (1990).

61. H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 188 (1983).

62. *Id.* §§ 234-235.

63. *See* Malitz, *On Financial Contracting: The Determinants of Bond Covenants*, FIN. MGMT., Summer 1986, at 18.

ments. For example, the greater the distribution of stock dividends, the smaller the value of the issuer's assets, the greater the likelihood of default on bonds and the decrease in value of debt securities. Retention of earnings and capital conversely results in increased assets, an increase in the firm's equity cushion, a decrease in the risk of default on the debt, and a rise in the value of bonds. If management is able to pay a substantial dividend and is governed by shareholder maximization decisions, asset distributions will be effected and other potential investments lost. The result is a transfer of assets to shareholders at the expense of reducing the current value of outstanding bonds. The wealth of the firm is thus shifted from the bondholders to the equity investors.

(2) Choice of Investments

Another way in which the firm's value may be transferred from bondholders to common stockholders is for management to supplant risky assets for existing ones. For example, assume a firm has additional capital for investment. Further assume that the firm has two choices. Option A bears slight volatility of risk and a moderate monetary return. Option B represents a less conservative investment strategy but promises substantial potential yield. From the bondholder's perspective, Option B transfers the benefit of increased monetary yield to common stockholders because of the higher probability of default on existing debt and the resulting lower return rate on outstanding bonds. To bondholders, any management decision which substitutes investments in a manner that increases default risk shifts firm wealth from bondholders to stockholders. The likelihood of this wealth transfer is increased when common stockholders exercise control over the enterprise and act in a way to serve their interests at the bondholders' expense.

(3) Investment of Surplus Capital

The firm directors' decision to invest additional capital presents another shareholder-bondholder conflict. Consider the following balance sheet of a firm which has been in operation for five years:

Balance Sheet A

	Assets			Liabilities	
	Book	Mkt.		Book	Mkt.
Investments	$1,000	$500	Debt	$800	$400
				Equity	
			Capital	$200	$100

Corporate management receives an opportunity to invest in a new enterprise for a cost of $500 and a present value of $750. Assume the project is a certain winner and that the cost must be funded with new equity. Further assume that all management decisions must benefit shareholder interests. If corporate directors pursue a new stock issuance with preemptive rights to existing stockholders (and all stockholders are forced to contribute for fear of losing wealth), the book value of the firm's investments increase by $500 and the market value of the assets increase by the $750 value of the project. The market value of the debt increases by $400 due to the absence of any risk of default resulting from the total value added by the new opportunity. The parallel increase in shareholder equity, however, is only $350. Balance Sheet B reflects the post-offering results:

Balance Sheet B

	Assets			Liabilities	
	Book	Mkt.		Book	Mkt.
Investments	$1,500	$1,250	Debt	$800	$800
			Capital	Equity $700	$450

The total value of the new corporate enterprise is $250, the difference between the acquisition cost of the opportunity ($500) and the present value to the firm ($750). The project will be rejected, however, because pursuit of the opportunity decreases shareholder wealth by $150 (the post-opportunity value of the common stock ($450) minus the cost of acquisition to equity holders ($500) and the pre-opportunity value of the common shares ($100)). As a practical matter, the project increases firm value by $250, but the additional contribution of equity by existing stockholders transfers $400 of firm wealth to the bondholders. Thus, directors governed exclusively by shareholder maximization are forced to abandon the opportunity to the detriment of bondholders.

It may be suggested that, as to dividend payments, choice of investments, and investment of surplus capital, appropriate bond covenants would enable firm management to choose those options which maximize firm value and which neither focus exclusively on stockholders nor bondholders. Due in part to the continuing adherence to a bright line creditor-owner rule, however, particularized drafting is not feasible because it tends to be costly, subjective, and otherwise non-responsive to unforeseen circumstances.

(4) The Option-Pricing Model

In order to value risky bonds in relationship to stockholder equity, financial experts developed an "option-pricing model."[64] Consider a firm with common stock and long-term bonds outstanding. According to the concept of option-pricing, issuance of both types of securities creates an option in common shareholders relative to bondholder interests. For example, stockholder liability in the event of a corporate liquidation is limited to the amount of each shareholder's investment in the firm. Consequently, shareholders have the option to default on outstanding bonds, which is equivalent to a put of the firm's assets to the bondholders. The value of the put is the present value of the obligations due to

64. *See* R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 294, 429, 432, 436-38, 480-84 (2d ed. 1984).

the corporate debt owners. If the value of this option is $100 and present firm value is $50, shareholders will exercise the put. As a result, shareholders are relieved of their commitment to pay on the bonds.

From another perspective, bondholders in effect own the firm's assets while stockholders own only an option to repurchase the assets by buying out the bondholders' interests. Such an option is equivalent to a call upon corporate assets. The exercise price of the call feature is the present value of commitments due to the bondholders. Thus, if the value of the call is $100 and firm value is $150, shareholders will exercise the call and become sole owners of the firm.

Recent financial research indicates that the value of a call increases according to fluctuations in the potential value of the assets subject to the option. Consequently, potential gains to common stockholders are unlimited by volatility in the value of underlying assets. Losses, on the other hand, cannot exceed a shareholder's equity investment—the price paid for the option. The relationship of these puts and calls thus bear directly on the bond value by way of shareholder decisions which pursue corporate investments or uses of surplus capital that reduce or otherwise place at risk present firm value.

B. *Bondholders and Stockholders and Leveraged Tender Offers*

Since the 1960s, corporations have announced "tender offers" for other corporations' common stock by soliciting target security holders to "tender" their shares to the bidding entity.[65] These bids were highly successful in wrestling shares from common stockholders since the offering price typically reflected a sizeable premium (often fifty percent or more) over current or historic stock market value. From the standpoint of the bidder, tender offers provided a fast and efficient vehicle for securing control of the target company because (1) the "offer" was to the "market"—that is, the decision of whether or not to sell control of the subject company remained with each individual stockholder rather than management (who often tend to resist changes in control) or controlling shareholders (who often align with management in decisions affecting corporate policy and control); (2) the offer commenced upon the advertisement or public announcement of the bid thereby guaranteeing a "surprise attack" on the target firm; (3) the terms of the offer were fixed rather than negotiable; and (4) the offer remained open for a limited period of time.[66] The motivation for early takeover bids was primarily

65. In 1968, Congress amended the Securities Exchange Act of 1934 to provide a statutory construct for the regulation of cash tender offers. This framework, commonly known as the Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (codified at 15 U.S.C. §§ 78m-78n (1988)) is embodied in five sections: § 13(d), § 13(e), § 14(d), § 14(e), and § 14(f).

66. The term "tender offer" is not defined in the Williams Act. In Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd on other grounds*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983), the court proposed an "eight-factor test" for determining the existence of a tender offer. The eight factors are:

(1) active and widespread solicitation of public shareholders for the shares of an issuer;

either to increase the bidder's market power through a "horizontal merger" or to achieve gains through a "synergistic" blending of the combined firms. This latter motivation was often effectuated through a "vertical" combination of the bidder and a supplier in order to assure the acquiror a supply source and to reduce the cost of competitive behavior.

In the 1980s, takeover activity changed its hue. Although target companies of the 1960s and 1970s were unwieldy conglomerates with entrenched management, targets of the 1980s were often well-known, well-managed firms worth millions and, sometimes, billions of dollars. The explanation for the up-scaling of acquisition targets rests, in large part, with the development by Drexel of the new original issue market for high-yield junk bonds.[67] With the advent of the Drexel junk bond, bidders were able to announce cash tender offers that were financed with borrowings of ninety percent or more. Until this time, takeovers were funded almost exclusively with bank borrowings and equity contributions by the bidder corporation. The availability of subordinated high-yield bonds served to eliminate size as a barrier to a takeover bid and created a new offeror—the corporate "raider."

The 1980s raider was commonly cast as a predator that targeted companies for liquidation or restructuring by reducing acquisition debt and paying a large, one-time cash dividend to stockholders. These raiders were motivated by a perceived disparity between the present value of a firm, as evidenced in stock prices, and the firm's breakup value if various assets could be sold. "Corporate control" thus became an asset that was subject to short-term speculation as unlimited debt financing became available. Changes of control for assimilation and management purposes were left for smaller businesses.

Leveraged tender offers of the 1980s presented yet another conflict of interest for stockholders and bondholders of the constituent corporations to a successful takeover. For example, consider X, a corporate raider who desires to initiate an any and all cash tender offer to corporation T's common stockholders. X forms corporation A solely for the purpose of making the bid for and purchasing shares. X incorporates A in Delaware as a shell corporation with minimum capitalization. The offering price for T's stock is $20 per share. The market value for T's shares at the time of the announcement of the bid is $12. T has outstanding long-term unsecured bonds with a face value of $1,000 and a

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(2) solicitation made for a substantial percentage of the issuer's stock;
(3) offer to purchase made at a premium over the prevailing market price;
(4) terms of the offer are firm rather than negotiable;
(5) offer contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased;
(6) offer open only a limited period of time;
(7) offeree subjected to pressure to sell the stock;
(8) public announcements of a purchasing program concerning the target company preceding or accompanying rapid accumulation of large amounts of the target company's securities.

Id. at 823-24.

67. DREXEL REPORT, *supra* note 49.

current market value of $1,150. Interest on the bonds is six percent, payable annually.

In order to pursue its bid, X, on A's behalf, negotiates commercial bank financing for fifty percent of the total acquisition cost. X is unable to secure further bank commitments due to federal margin regulations. To raise the remaining capital necessary to complete the acquisition, X contacts I, an investment banking firm. I issues A a letter stating that I is "highly confident" that funds may be raised at a future time by I's placement of subordinated, high-yield, high-risk bonds of A. Based upon its bank financing, its "highly confidential" letter, and an approximately one percent equity contribution, A proceeds with its offer.

Upon receipt of the bid, target management announces to T's stockholders their opinion concerning the inadequacy of A's offer. T's directors cite their long-range plan for recapitalizing T, A's lack of funding for forty-nine percent of the offer, and X's reputation as a takeover artist and greenmailer. Despite management perceptions, eighty-five percent of T's stockholders tender to A. Management thereafter effectuates a financial restructuring.

Pursuant to its restructuring, T borrows substantial sums from L to be used to repurchase T's common stock. The intended effect of the restructuring is to increase current share value by the reduction of equity. The immediate effect, however, is T's excessive debt-to-equity ratio. Upon announcement of the defensive restructuring, T's unsecured long-term bonds are downgraded to non-investment grade by both Standard & Poor's and Moody's.

Notwithstanding T's management efforts, A closes its tender offer and successfully purchases voting control of T by utilizing its fifty percent bank funding as well as its one percent equity contribution. Immediately thereafter, A's management proposes a merger with T wherein T's remaining minority shareholders are to be cashed out for the $20 per share tender offer price. The merger cost is financed by funds raised from I's sale of junk bonds of A company which is now the owner of T company. Junk bond purchasers include pension funds, savings and loans, institutional investors, mutual funds, and insurance companies.

Upon completion of the follow-up merger, A begins to sell T's assets in order to pay acquisition costs and expenses and to service premerger debt and post-merger junk bond obligations. When the cost of carrying all outstanding debt exceeds the cash generated from the remaining assets, newly-merged A is forced to declare bankruptcy.

The question becomes: What is the status of A's and T's stockholders and bondholders? All of T's former equity investors have sold or been cashed out for at least $20 per share (an $8 per share premium over pre-tender offer stock value). X, A's stockholder, is the owner of the merged entity as well as the beneficiary of all profits derived from T's systematic breakup. Since the present value of payments due to all bondholders exceeds the present value of the merged firm, X, operating through A, exercises its option to put the firm's remaining assets to T's and A's bondholders. The consequence of this default is the disposition in bankruptcy of pre-merger corporate bondholder interests.

IV. Consequences of Default in Bankruptcy

A. *The Bankruptcy Code*

If a firm's value is less than the present value of all obligations due on outstanding debt, stockholders likely will exercise their option to put the firm's assets to the bondholders. By pursuing this option, stockholders default on existing bonds and concurrently violate non-default provisions of the trust indenture. If the debt is secured by a mortgage or lien on corporate assets, the trustee may seek to enforce the bondholder's security interest; that is, he may enforce the lien. Execution on the lien involves the sale of the subject asset with the proceeds to be used to pay down the bondholders' claims.

Bondholder rights and remedies, as set forth in the indenture contract, are limited by the rules and procedures of federal bankruptcy law. The Bankruptcy Reform Act of 1978[68] offers two basic approaches for debtors suffering severe financial hardship: "straight" bankruptcy, commonly known as "liquidation" in Chapter 7 or Chapter 11, and insolvency reorganization, commonly called "rehabilitation" or "reorganization." In a liquidation proceeding, a trustee for the debtor sells appropriate assets and distributes the proceeds to various creditors.[69] Once the liquidation procedure is completed, the debtor is discharged and further claims on outstanding debts are terminated.[70]

In the context of the stockholders and bondholders of a debtor corporation, the cash-fund generated by the sale of corporate property is distributed in accordance with a schedule of priorities among claimants.[71] The order of priorities is (1) secured creditors, (2) certain priority creditors, (3) unsecured creditors, and (4) equity investors.[72] Secured creditors include bondholders whose interests are protected by mortgages or liens on specific corporate property. The amount of a secured creditor's claim is the face amount of the debt plus accrued interest and attorney's fees if the value of the collateral exceeds the value of the debt.[73]

After secured creditors are priority creditors. These claimants at-

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68. 11 U.S.C. § 101-1330 (1988). The Bankruptcy Code was amended in 1984. *See* Pub. L. No. 95-598, § 402, 92 Stat. 2682 (1978) (as amended by Pub. L. No. 98-249, § 1(a), 98 Stat. 116 (1984)); Pub. L. No. 98-271, § 1(a), 98 Stat. 163 (1984); Pub. L. No. 98-299, § 1(a), 98 Stat. 214 (1984); Pub. L. No. 98-325, § 1(a), 98 Stat. 268 (1984); Pub. L. No. 98-353, §§ 113, 121(a), 98 Stat. 343, 345 (1984); and Pub. L. No. 98-454, § 1001, 98 Stat. 1745 (1984).

69. 11 U.S.C. § 323 (1988) (defining the role and capacity of a trustee in bankruptcy); 11 U.S.C. § 541 (1988) (defining the property of the debtor's estate).

70. *See* 11 U.S.C. § 524 (1988) (describing the effect of discharge in bankruptcy).

71. B. Manning, Legal Capital 162-63 (1981).

72. 11 U.S.C. § 507 (1988).

73. 11 U.S.C. § 506(b) (1988); G. Treister, J. Trost, L. Forman, K. Klee & R. Levin, Fundamentals of Bankruptcy Law, § 6.03 at 277 (1988) [hereinafter Fundamentals].

tack assets that are not subject to mortgages and liens and include attorneys and other persons who provide services to the debtor firm, individuals with wage claims, and the Internal Revenue Service.[74] Assuming the cash-fund produced by the liquidation sale is sufficient to satisfy these priority claimants, any excess amount passes to unsecured creditors who share pro rata according to the debt owed.

Unsecured creditors include long-term bondholders and junk bond owners whose claim is for the face value of their security plus accrued interest. Other such claimants are trade creditors who have supplied goods and services to the debtor but who remain unpaid when the bankruptcy petition is filed. After the unsecured creditors are paid, the remaining funds are shared among preferred stockholders according to provisions in the firm's articles of incorporation. Common stockholders then divide the remaining proceeds in accordance with their equity interest.

If the debtor instead proceeds with a plan of reorganization, the rules and procedures become more complex. In an insolvency reorganization, the debtor desires to maintain the corporate enterprise and attempts, through an agreement with its creditors, to meet its financial obligations. As a result, secured creditors are restrained from executing upon their security interests through seizure and forced sale of assets. In the absence of fraud, firm management remains in the hands of the board of directors.[75] State corporate law regulates the day-to-day affairs of the firm pursuing reorganization and imposes upon directors fiduciary duties of care and loyalty.

In most circumstances, management subject to an insolvency reorganization seeks to issue a new set of securities to distribute to claimants in some relation to their priorities. As top priority claimants, secured creditors will not accept a speculative equity position in the debtor nor substitute an inferior note for an existing secured interest. Secured creditors may instead negotiate the extension of additional post-petition credit to the debtor in exchange for a security interest in unencumbered assets. Unsecured creditors, who lack the bargaining position of a senior secured lender, may be compelled to accept a substitute note in order to forestall liquidation of the debtor's assets.

Debt substitution is generally accomplished through an exchange offer. Under the Trust Indenture Act,[76] modification of material terms to publicly issued debt can only be made with the consent of the holders affected by the alteration. As a practical matter, an exchange offer always alters the core terms of existing debt (the maturity date, rate of interest, and face value) in favor of a lower principal amount, a lower interest rate, and a longer period for repayment. To be effective, approximately ninety-five percent of the unsecured bondholders must subscribe to the exchange offer. Since amendments are binding only to the

74. 11 U.S.C. § 507 (1988).
75. 11 U.S.C. § 1104 (1988).
76. 15 U.S.C. §§ 77aaa-77bbbb (1988).

extent debt holders consent to accept new bonds, ninety-five percent of pre-offer bondholders must tender into the offer. If bondholders refuse to substitute notes, the issuer will file for a Chapter 7 liquidation and the value of bonds likely will decrease to an amount below the face value of the debt securities offered in the exchange.

Bond investors thus face a "prisoner's dilemma." Assuming that most bondholders refuse to accept the proposed exchange, bankruptcy follows and all parties lose. Ironically, under bankruptcy law, these "holdouts" place the debtor corporation in a position to negotiate a reduced debt claim. As a practical matter, once bankruptcy ensues, the debtor is encouraged to negotiate and compromise prior claims. A majority vote of debt holders binds all others. In the event of a privately placed debt issue, the bond indenture must grant to bondholders the legal power to force all interests under the indenture to accept a substitute security.

B. *Unsecured Bondholders in Bankruptcy*

(1) Creditors' Committees in Chapter 11 Reorganizations

Bondholders confronting a debtor reorganization are granted procedural representation in bankruptcy proceedings. Representation is effected through the formation and operation of creditors' committees which serve as conduits for bondholder interests.

Creditors' committees lessen the administrative burden on bankruptcy courts. These committees are granted broad ranging powers and duties. In addition, the Bankruptcy Code grants standing to creditors who wish to appear and be heard on issues involved in the bankruptcy action.

In Chapter 11 reorganizations[77] the United States trustee[78] appoints a committee of unsecured creditors.[79] These creditors generally hold the seven largest unsecured claims.[80] The trustee may appoint additional committees of creditors or equity security holders as deemed appropriate or if necessary to assure adequate claimants' representation of other unsecured creditors. In the alternative, the United States trustee may appoint a creditors' committee consisting of pre-petition committee members if those members were fairly selected and are representative of the different claimants.[81]

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77. 11 U.S.C. §§ 1101-1174 (1988).

78. The United States trustee is empowered to raise, appear and be heard on any issue in any case or proceeding under the Bankruptcy Act but may not file a plan pursuant to § 1121(c). 11 U.S.C. § 307 (1988).

79. 11 U.S.C. § 1102(a)(1) (1988).

80. *Id.* § 1102(b)(1).

81. 11 U.S.C. § 1102(b)(1) (1988). Bankruptcy Rule 2007(b) sets forth the criteria for determining the representative nature of a pre-petition committee:

> (1) it was selected by a majority in number and amount of claims of unsecured creditors who may vote under § 702(a) of the [Bankruptcy] Code and were present in person or represented at a meeting of which all creditors having claims of over $1,000 or the 100 unsecured creditors having the largest claims had at least five days notice in writing, and of which meeting written

The Code empowers the committees to consult with the trustee or debtor-in-possession concerning administration of the case; to investigate the debtor's business and financial condition; to participate in the formulation, acceptance, and rejection of a plan; to request the appointment of a trustee or examiner; and to perform other services in the unsecured creditors' interest.[82] The committee may also select and employ attorneys, accountants or other agents.[83] The trustee or debtor-in-possession must meet with the committee as soon as practicable after the committee is appointed to transact all necessary and proper business.[84] In conducting business, members of the committee are subject to a fiduciary duty to represent all interests of their class.[85]

If the debtor and its creditors attempt an out-of-court workout, the debtor may appoint creditors with relatively small claims to the creditors' committees. Like their Chapter 11 counterparts, workout committees include hostile creditors. Dissident claimants are vital to a bankruptcy workout because out-of-court workout plans are binding on these claimants only to the extent these claimants accept a plan's terms.[86] Individual workout committees may be selected to represent secured creditors, banks, senior and junior bondholders, general unsecured creditors, and equity investors.

Although workout committees operate in a manner substantially similar to the Chapter 11 committees, considerable differences exist. First, no specific rules regulate the operation of workout committees.[87] As a consequence, no guidelines delineate the scope of the members' duties and powers. This lack of regulation raises questions such as whether committee participants owe fiduciary duties to those whom they represent. In addition, unlike in a Chapter 11 proceeding, there are no established procedures protecting creditors who allege discrimination or acts of self-interest by committee members. Further, workout committee members are subject to federal securities laws—including prohibitions on insider trading[88]—yet no specific forum is empowered to impose sanctions on committee members in the event of insider trad-

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minutes reporting the names of the creditors present or represented and voting and the amounts of their claims were kept and are available for inspection;

(2) all proxies voted at the meeting for the elected committee were solicited pursuant to [Bankruptcy] Rule 2006 and the lists and statements required by subdivision (e) thereof have been filed with the court; and

(3) the organization of the committee was in all other respects fair and proper.

11 U.S.C. § 702(a) (1988).

82. 11 U.S.C. § 1103(c)(1)-(5) (1988).

83. *Id.* § 1103(a). In addition, persons employed to represent a committee may not, during their agency, represent any other entity having an adverse interest in connection with the reorganization. *Id.* § 1103(b).

84. *Id.* § 1103(d).

85. *See In re* First Republic Bank Corp., 95 Bankr. 58 (Bankr. N.D. Tex. 1988); *In re* Johns-Manville Corp., 26 Bankr. 919, 925 (Bankr. S.D.N.Y. 1983).

86. CAMPBELL, LYNN & YOUNGERMAN, CREDITOR'S RIGHTS HANDBOOK, § 902, at 250j (1990) [hereinafter CREDITOR'S RIGHTS].

87. *Id.* § 902, at 253.

88. *Id.* § 905, at 261.

ing or other breaches of implied fiduciary duties. Finally, no "cram down" provision is applicable in an out-of-court workout;[89] creditors who do not accept the workout plan are not bound by its contract terms.[90] Notwithstanding these differences, debtors who are able to work out their financial obligations with creditors avoid substantial administrative costs associated with bankruptcy. Workout committees, therefore, allow savings for creditors as well as debtors-in-possession.

(2) Purchase and Sale of Claims in Bankruptcy

A creditor or an indenture trustee may file a "proof of claim" against the debtor's estate.[91] The claim is deemed allowed unless objected to by a party in interest.[92] Creditors holding unsecured claims may be appointed to a creditors' committee by the trustee or the debtor pursuing a workout plan.[93] Members of the creditors' committees are empowered to negotiate with the debtor over a plan of reorganization or may seek liquidation of the estate or a trustee's appointment.[94]

The Rules of Bankruptcy Procedure recognize the practice of purchase and sale of creditors' claims. Bankruptcy Rule 3001(e) governs the transfer of claims other than those based on a bond or debenture. The rule is organized into four operative parts: (1) unconditional transfer before the filing of a proof of claim; (2) unconditional transfer after the filing of a proof of claim; (3) transfer of a claim for security prior to a proof of claim being filed; and (4) transfer of a claim for security after a proof of claim is filed.[95]

Rule 3001(e)(1) provides that if a claim, other than one based on a bond or debenture, is unconditionally transferred before a proof of claim is filed, only the transferee may file a proof of claim.[96] If the claim is transferred subsequent to the filing date, the proof of claim must be supported by a statement of the transferor acknowledging the transfer and stating the consideration therefor or setting forth the consideration for the transfer and the reason the transferee is unable to obtain the statement from a transferor.[97]

Rule 3001(e)(2) governs claims unconditionally transferred after the proof of claim has been filed. Evidence of the transfer terms must be filed by the transferee.[98] The clerk of court gives immediate notification

89. Section 1129(b)(1) allows the court, on request of the proponent to the plan, to "cram down" the plan on dissident creditors; that is, to confirm the plan notwithstanding opposition by these creditors if the plan "does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1) (1988).

90. CREDITOR'S RIGHTS, *supra* note 90, § 902, at 251.

91. 11 U.S.C. § 501(a) (1988).

92. *Id.* at § 502.

93. *Id.* at § 1102.

94. *Id.* at § 1103.

95. FED. R. BANKR. P. 3001(e) (1988).

96. *Id.* at 3001(e)(1).

97. *Id.*

98. *Id.* at 3001(e)(2).

to the original claimant of the evidence of transfer filing.[99] The claimant must file an objection to the transfer generally within twenty days.[100] If the court finds that the claim has been unconditionally transferred, the transferee is substituted for the original claimant.[101]

Rule 3001(e)(3) provides that if a claim, other than one based on a bond or debenture, is filed for security before a proof of claim is filed and if either the transferor or the transferee files a proof of claim, the clerk must immediately notify the other of the right to join in the filed interest.[102] If the transferor and transferee each file a proof upon the same claim, the proofs are consolidated.[103] The court then determines the allowance and voting of the claim, payment of dividends thereon, and appropriate participation in the administration of the estate.[104]

Proposed bankruptcy rule amendments include an extensive revision of Bankruptcy Rule 3001(e) which would limit the court's role in connection with the transfer of claims to the adjudication of disputes arising in connection with transfers.[105] Authors of the proposed amendments indicate that revised rule 3001(e) is not intended to encourage or discourage post-petition transfers of claims.[106] The revisions also are not intended to affect any remedies otherwise available to the parties under nonbankruptcy law.[107]

It is suggested that the proposed revision to rule 3001(e) recognizes the emergence of an auction market for bankruptcy claims and treats the purchase and sale of transferred interests in a manner analogous to existing rules governing bonds and debentures. The apparent intent of the revision is to limit the power of bankruptcy judges to curtail the transferability of bankruptcy claims. The Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States (Rules Committee), therefore, supports a free market in trade claims whereby passive creditors may liquidate their position in a bankruptcy case rather than await distribution under liquidation or a plan of reorganization.

The question raised by an auction market in bankruptcy claims is the legality and potential conflicts of interest inherent in the trading of securities by members of the creditors' committee in large insolvency reorganization cases. In general, committee members are fiduciaries to the class of creditors represented.[108] Pre-Bankruptcy Code cases limited claims purchased by fiduciaries to the amount paid for the claim.[109]

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99. *Id.*
100. *Id.*
101. *Id.*
102. *Id.* at 3001(e)(3).
103. *Id.*
104. *Id.*
105. Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, Preliminary Draft of Proposed Amendments to the Bankruptcy Rules 76-80 (Aug. 1989).
106. *Id.* at 80-81.
107. *Id.*
108. CREDITOR'S RIGHTS, *supra* note 90, § 905, at 259.
109. *In re* Moulded Products, 474 F.2d 220 (8th Cir. 1973), *cert. denied*, 412 U.S. 940 (1973); *In re* Franklin Bldg. Co., 178 F.2d 805 (7th Cir. 1949), *cert. denied*, 339 U.S. 978

Section 328(c) of the Bankruptcy Code denies compensation to "professional persons" if they are post-petition investors.[110] The section, however, does not reach indenture trustees, creditors' committee members, or the debtor's officers and directors.[111] Yet Bankruptcy Rule 2019 authorizes the court to examine any claim or interest acquired by an entity or committee in the course of a case under the Code and to grant appropriate relief.[112] The court's Rule 2019 power is not applicable, however, to committees under section 1102.[113] In light of these gaps in statutory application to committee members and indenture trustees, the issue of whether the bankruptcy court has the power to curtail or otherwise limit the enforceability of claims purchased by insiders after bankruptcy remains to be decided. Presently, committee members are being requested to adopt a confidentiality agreement which addresses issues of use of inside information and trading activities. Execution of such an agreement is discretionary by committee members and indenture trustees and binds only those with notice or who otherwise accept its terms.

C. *Impact of the Securities Laws on Workouts and Insolvency Reorganizations*

(1) The Securities Act of 1933

The Securities Act of 1933 (Securities Act)[114] requires that investors be provided material information concerning new issues of securities offered for sale to the public. The Securities Act prohibits fraudulent or deceptive practices in primary and secondary distributions. Its objectives are primarily satisfied through three code provisions: section 5—which prohibits any person from offering or selling securities without an effective registration statement or an exemption[115] and sections 17 and 12(2)—which prohibit fraud or misrepresentation in interstate sales of securities.[116]

Registration requires that an issuing corporation file a registration statement with the SEC.[117] Information contained in the statement includes financial data concerning the issuer and the securities to be sold.[118] Sales effected pursuant to a public distribution must be accompanied or preceded by a registration statement or the prospectus contained therein.[119] Failure to comply with registration and delivery requirements results in substantial potential liability for issuers, under-

(1950); *In re* Lorraine Castle Apartments Bldg. Corp., 149 F.2d 55 (7th Cir. 1945), *cert. denied*, 326 U.S. 728 (1945); *In re* Philadelphia and Western Ry. Co., 64 F. Supp. 738 (E.D. Pa. 1946); *In re* Indiana Central Telephone, 24 F. Supp. 342 (D. Del. 1938).

110. 11 U.S.C. § 328(c) (1988).

111. *Id.*

112. FED. R. BANKR. P. 2019 (1988).

113. *Id.*

114. 15 U.S.C. §§ 77o-77aa (1988).

115. *Id.* at § 77e.

116. *Id.* at §§ 77q, 77L(2).

117. *Id.* at § 77e(c).

118. *Id.* at § 77aa.

119. *Id.* at § 77h.

writers, and other participants to the distribution.[120]

The Securities Act also sets forth transaction and securities exemptions from registration guidelines.[121] Securities which are exempt may be freely resold without registration.[122] Securities issued under a transaction exemption are "restricted" and may not be resold without registration or an independent exemption.[123]

(2) Issuance of Securities Under a Plan of Reorganization

The Bankruptcy Code significantly alters the application of the Securities Act. In particular, under specified circumstances, securities may be issued under a plan of reorganization without registration. Section 1145 of the Bankruptcy Code sets forth the governing rules for exemption from state and federal registration requirements.[124] Despite poor drafting,[125] section 1145(a)(1)[126] permits a debtor, its affiliates,[127] and successors[128] to issue securities without registration if the plan allows for such a distribution and the securities are issued principally in exchange for a claim or interest against the debtor.[129] The section does

120. *Id.* at §§ 77k, 77L(1), (2).

121. *Id.* at §§ 77c, 77d.

122. *Id.* at § 77c.

123. *Id.* at § 77d. The five securities transaction exemptions under the Securities Act of 1933 most likely to be used in a workout or Chapter 11 reorganization are section 4(1) (15 U.S.C. § 77d(1) (1988)) (exempts from registration "transactions by any person other than an issuer, underwriter, or dealer"); section 4(2) (15 U.S.C. § 77d(2) (1988)) and Regulation D (17 C.F.R. §§ 230.501-508 (1990)) (exempts from registration "transactions by an issuer not involving any public offering," and Rule 506 of Regulation D provides a safe harbor for compliance); section 3(a)(9) (15 U.S.C. § 77c(9) (1988)) (provides: "[e]xcept with respect to a security exchanged in a case under title 11 of the United States Code, any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange"); Rule 144 (17 C.F.R. § 230.144 (1990)) (sets forth circumstances under which resale of restricted securities or securities held by control persons will not be deemed to be transactions by an underwriter); and section 4(1 1/2) (provides an exemption from registration for private resales of restricted or controlled securities).

124. 11 U.S.C. § 1145 (1988) (exemption from securities laws). Section 1145 permits issuance of securities without registration under applicable state blue sky laws as well as section 5 of the Securities Act of 1933.

125. *See In re* Frontier Airlines, Inc., 93 Bankr. 1014, 1018 (Bankr. D. Colo. 1988) (lawyers at confirmation hearing cannot provide "cogent and logical explanation for the seemingly incomprehensible statutory provisions").

126. 11 U.S.C. § 1145(a)(1) (1988).

127. "Affiliate" is defined as an:

> (A) entity that directly or indirectly owns, controls, or holds with the power to vote, twenty percent or more of the outstanding voting securities of the debtor . . .
>
> (B) corporation twenty percent or more of whose outstanding securities are directly or indirectly owned, controlled or held by the debtor or by an entity that controls twenty percent or more of the voting securities of the debtor . . .
>
> (D) entity that operates the business or substantially all the property of the debtor.

11 U.S.C. § 101(2) (1988).

128. "Successor" is not defined in the Bankruptcy Code. In general, however, a successor is any entity that assumes the rights and liabilities of another corporation. *See In re* Stanley Hotel, Inc., 13 Bankr. 926, 933 (Bankr. D. Colo. 1981). *See also In re* Amarex, Inc., 53 Bankr. 12 (Bankr. W.D. Okla. 1985) (parent corporation of acquiring subsidiary may be deemed "successor" to debtor).

129. Securities are issued principally in exchange for a claim or interest against a

not contemplate a sale of securities by the debtor corporation to raise new capital. The rationale underlying section 1145(a)(1) is that registration affords no additional protection to creditors due to the bankruptcy requirement of court approval for a plan of reorganization and a disclosure statement attendant to the distribution of new securities.

Section 1145(a)(2) exempts from registration the offer and sale of a security through a warrant, option, right to subscribe, or conversion privilege that was sold in a manner specified in section 1145(a)(1).[130] Convertible securities usually are exchanged without registration. Such convertible securities do not require registration upon conversion since no investment decision is implicated. Section 1145(a)(2) also permits the exercise of warrants, options, and conversion privileges for cash without registration.

Debt securities also may be issued under a plan of reorganization without registration. In general, the Bankruptcy Code allows the trustee to incur unsecured debt as an administrative expense in the ordinary course of business.[131] Subject to court approval, debt issued outside the debtor's ordinary business is permitted.[132] Section 364(f) exempts from registration the issuance of debt securities by the trustee pursuant to sections 364(a) to (d).[133] Although it is possible to use sections 364 and 1145 together for the placement of non-equity securities, the SEC objects to this practice after a plan of reorganization is confirmed.[134]

The issue of resales of securities under a plan of reorganization is also addressed in section 1145.[135] For example, assume a person or entity purchases certain securities with the intent to resell them immediately or soon thereafter. Conduct which implicates immediate resales raises the question of underwriter status under the Securities Act and subjects the issuer and selling security holders to potential federal securities violations. Section 1145(b) of the Bankruptcy Code attempts to delimit the securities definition of "underwriter" for insolvency reorganizations.[136]

Section 1145(b) sets forth four instances in which entities may be considered underwriters pursuant to the Securities Act:[137]

> (1) persons that purchase a claim against or interest in the debtor if such purchase is with a view to distribution of any

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debtor where the value of the claim or interest exceeds the value of the consideration transferred with the claim or interest in exchange for the securities.

130. 11 U.S.C. § 1145(a)(2) (1988).

131. *Id.* at § 364(a). The Trust Indenture Act, 15 U.S.C. §§ 77aaa-77bbbb (1988), requires that an offering of debt securities in excess of $5 million be issued pursuant to a qualified indenture.

132. *Id.* at § 364(d).

133. *Id.* at § 364(f).

134. *See In re* Cordyne Corp., SEC Corporate Reorganization Release No. 369 (Dec. 7, 1987); *In re* Custom Laboratories, SEC Corporate Reorganization Release No. 367 (July 13, 1987).

135. 11 U.S.C. § 1145 (1988).

136. *Id.*

137. 15 U.S.C. § 77b(11) (1988).

security received or to be received in exchange for such a claim or interest;
(2) persons that offer to sell securities offered or sold under the plan for the holders of such securities;
(3) persons that offer to buy securities offered or sold under a plan from the holders of such securities if such offer to buy is made with a view to distribution of such securities and under an agreement made in connection with the plan, with the consummation of the plan or with the offer or sale of securities under the plan; or
(4) issuers, as used in section 2(11) of the Securities Act, with respect to such securities.[138]

If the persons who receive securities in a Chapter 11 reorganization are not underwriters as defined in section 1145(b), the securities are not subject to the usual resale restrictions. Persons who come within the underwriter definition in categories (1) through (3) may avoid underwriter status and, therefore, they resell in ordinary trading transactions.[139]

(3) Civil and Criminal Liability for Fraudulent Securities Distributions in Reorganizations

The Securities Act prohibits fraud and misrepresentation in interstate sale of securities. The primary sections proscribing fraudulent sales are section 12(2), which provides civil sanctions for securities fraud or misrepresentation,[140] and section 17, which imposes criminal sanctions for illegal transactions and grants to the SEC a basis for disciplinary proceedings or injunction.[141] The Securities Act also allows civil liability for offers or sales that violate section 5 (section 12(1))[142] and civil penalties for issuers, directors, officers, underwriters, and certain other parties who sign the registration statement (section 11).[143] Notwithstanding these provisions, section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) imposes a further prohibition on fraud in the purchase or sale of securities.[144]

Section 1145 of the Bankruptcy Code provides a registration exemption to the Securities Act. The exemption creates a safe harbor from civil and criminal penalties imposed when an issuer, underwriter, or dealer fails to satisfy registration and prospectus delivery guidelines. Section 1125(e) of the Bankruptcy Code reflects this intent by holding

138. 11 U.S.C. § 1145b(1)(A)-(D) (1988).

139. 15 U.S.C. § 77b(11) (1988). The "ordinary trading transaction" exemption is not available to affiliates who must register resales under the Securities Act, resell pursuant to Rule 144, or find an independent exemption from the federal securities registration requirements.

140. *Id.* § 77L(2).

141. *Id.* § 77t. It remains an open question whether a private cause of action will be implied under § 17(a). *See* JENNINGS & MARSH, SECURITIES REGULATION 890-92 (6th ed. 1987).

142. 15 U.S.C. § 77L(1) (1988).

143. *Id.* § 77k.

144. *Id.* § 78j(b).

unaccountable persons who comply with applicable Chapter 11 provisions. In particular, section 1125(e) states that a person who, in good faith and in compliance with the applicable provisions of the Bankruptcy Code, offers, issues, sells or purchases a security offered or sold under a plan of the debtor, its affiliates or successors, is not liable for violation "of any applicable law" governing the offer, issuance, sale or purchase of securities.[145] In order to lose the safe harbor protection of section 1125(e), a person must act with scienter[146] or otherwise engage in activities which extend beyond those enumerated in the section.[147]

Despite the apparent blanket application of section 1125(e), certain questions remain. For example, is section 1125(e) only applicable to offers and sales effected pursuant to section 1145(a)? Does section 1125(e) apply to trades or tipping of inside information by committee members or indenture trustees? If a debtor pursues a private placement of debt securities in connection with a plan of reorganization, does section 1125(e) exempt all participants from the liability provisions of the Securities Act? Did Congress in 1978 intend that recent auctions of creditors' claims by insiders fall outside the parameters of section 10(b) and rule 10b-5 of the Exchange Act?

(4) Fraudulent Conveyances and Insolvency Reorganizations

Individual debtors facing severe financial hardship frequently conveyed property to family or friends to avoid losing the assets to creditors. It was often understood between the parties to the conveyance that the debtor would continue to use the property and would obtain its return after the creditor threat passed. This problem of secreting assets was addressed in the sixteenth century in the Statute of 13 Elizabeth (Statute of Elizabeth).[148] The Statute of Elizabeth allowed a transferor's creditor to reach the transferred assets upon proof of an "intent to delay, hinder or defraud"[149] a creditor. To satisfy the requirement of scienter, the creditor could set forth the circumstances and timing of the conveyance and thereby permit the inference to be drawn of the requisite mental state.[150]

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145. 11 U.S.C. § 1125(e) (1988).

146. In enacting section 1125(e) of the Bankruptcy Code, Congress intended the standard of culpability to be that announced by the Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). H.R. REP. No. 595, 95th Cong., 1st Sess. at 229-31 (1977).

147. 11 U.S.C. § 1125(e) (1988).

148. Statute of 13 Eliz., ch. 5 (1570).

149. *Id.*

150. An early case, Twyne's Case, 76 Eng. Rep. 809 (Star Chamber 1601), addressed the circumstances evidencing an intent to defraud. In *Twyne's*, a creditor who was owed four hundred pounds had his debtor convey to him all the debtor's property, which was worth three hundred pounds. The creditor allowed the debtor to retain possession of the property. At the time of the conveyance, the debtor had been sued by another creditor for a claim of two hundred pounds. The transfer to the first creditor was found to be fraudulent based on certain indications of fraud. The signs of fraud included:

(1) the gift included all the debtor's property;

(2) the debtor remained in possession of the goods and therefore deceived others who traded with him;

In 1918 the National Conference of Commissioners on Uniform State Laws (ULC) proposed the Uniform Fraudulent Conveyance Act (UFCA) to promote "uniformity in the law of fraudulent conveyances" and to eliminate the "existing confusion in the law."[151] The UFCA Prefatory Note indicated the ULC's concern regarding uncertainty in the existing law.[152] The first concern was the attempt under the common law of fraudulent conveyances to make the Statute of Elizabeth embrace all conveyances which harmed creditors even though an actual intent to defraud was not present. The ULC noted that many conveyances were avoided by judicial presumptions of law as to intent and in equity by presumptions as to fact.[153] The rulings of these cases were fair, but for unsound reasons. As a result, the ULC undertook to draft a uniform act in which all presumptions of law as to intent were avoided.[154] The product of the ULC was the UFCA which condemns all conveyances made with an intent to defraud, with the express statement that the intent must be "actual intent, as distinguished from intent presumed as a matter of law."[155]

Today, three statutory schemes may govern an allegedly fraudulent conveyance: section 548 of the Bankruptcy Code,[156] the UFCA,[157] and the Uniform Fraudulent Transfer Act (UFTA).[158] With minor variations in language and interpretative case law, each statute allows a person to disavow two general categories of fraudulent transfers: (1) transactions undertaken with an actual intent to hinder, delay or defraud the transferor's creditors and (2) constructively fraudulent transfers that are undertaken in exchange for inadequate consideration and occur when a

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(3) the transfer was secret;

(4) the transfer was made pending an outstanding claim against the debtor;

(5) trust was created and intended between the parties to the transfer; and

(6) the deed of conveyance stated that the transfer was made honestly and in good faith.

Id. at 812-14.

151. *See* UNIFORM FRAUDULENT CONVEYANCE ACT, Historical and Prefatory Notes, 7A U.L.A. 427-29 (1985).

152. *Id.*

153. *Id.* at 428.

154. *Id.*

155. *Id.*

156. 11 U.S.C. § 548 (1988).

157. As of March 1990, the UFCA remained in effect in Arizona, Delaware, Maryland, Massachusetts, Michigan, Montana, New York, Ohio, Pennsylvania, Tennessee, the Virgin Islands, and Wyoming. *See* UNIFORM FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 107 (Supp. 1990).

158. The UFTA was approved by the National Conference of Commissioners on Uniform State Laws in 1984 and has replaced the UFCA in many jurisdictions. *See* UNIFORM FRAUDULENT TRANSFER ACT, Prefatory Note, 7A U.L.A. 639 (1985). As of March 1990, the UFTA had been adopted in Alabama, Arkansas, California, Florida, Hawaii, Idaho, Illinois, Maine, Minnesota, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Dakota, Oklahoma, Oregon, Rhode Island, South Dakota, Texas, Utah, Washington, West Virginia and Wisconsin. UFTA, 7A U.L.A. 120 (Supp. 1990).

Section 548 of the Bankruptcy Code reflects in large part the elements of a fraudulent conveyance under the UFCA. Cases decided under one statute generally have precedential value under the other. The UFTA likewise is patterned after the UFCA and section 548 of the Bankruptcy Code. *See* UFTA, Prefatory Notes, 7A U.L.A. 639-42 (1985).

company is insolvent, is rendered insolvent, or otherwise too thinly capitalized to continue in business.

The basic elements of fraudulent transfers are substantially similar under the Bankruptcy Code, the UFCA, and the UFTA. For example, each statute allows the avoidance of transfers or obligations made or entered into with an "actual intent to hinder, delay or defraud" creditors of the transferor.[159] Further, culpability does not rest exclusively upon direct evidence of "actual intent"; objective evidence of circumstances surrounding the conveyance is admissible to prove state of mind.[160]

The UFTA enumerates eleven factors which may be considered by courts in determining the actual intent by a transferor.[161] These "badges of fraud" include: (1) whether the conveyance was of substantially all of the debtor's assets; (2) whether the conveyance occurred shortly before or after a substantial debt was incurred; (3) whether the consideration received by the debtor was reasonably equivalent to the value of the property transferred; and (4) whether the debtor became insolvent at the time or shortly after the transfer was made.[162] In large part, the objective "badges of fraud" factors reflect "constructive fraud" analysis under the Bankruptcy Code and the UFCA. Consequently, fraudulent conveyance claims may arise and be upheld more frequently in jurisdictions adopting the UFTA.

Asset transfers may also be avoided under traditional constructive fraud theories. The test for constructive fraud is twofold: (1) whether the debtor receives "fair consideration"[163] or "reasonably equivalent value"[164] for the transferred asset or obligation and (2) whether the debtor is either rendered insolvent at the time or shortly after the transfer or engaged in business and as a result of the conveyance has "unreasonably small capital" to maintain its business.[165]

The requirement of "fair consideration" or "reasonably equivalent value" likely is not satisfied by a third-party benefit. For example, assume a firm is in the throes of a hostile takeover bid. Target management obtains loan proceeds which are secured by the firm's assets. The proceeds are used to repurchase the target stockholders' equity securities. The result of the transaction is a one-time cash payment to com-

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159. 11 U.S.C. § 548(a)(1) (1988).

160. *See* United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1304 (3d Cir. 1986) (actual intent may be inferred from surrounding circumstances); *In re* Roco Corp., 701 F.2d 978, 984 (1st Cir. 1983) (circumstantial evidence permitted to prove actual intent).

161. UFTA § 4(b)(1)-(11), 7A U.L.A. 653 (1985).

162. UFTA § 4(b), 7A U.L.A. 653 (1985).

163. UFCA § 4, 7A U.L.A. 474 (1985).

164. 11 U.S.C. § 548(a)(2)(A) (1988); UFTA §§ 4, 5, 7A U.L.A. 652-53 (1985). The "reasonably equivalent value" test in section 548 of the Bankruptcy Code is a re-statement of the "fair consideration" test embodied in the UFCA. Apparently no substantive change was intended upon the drafting of the Bankruptcy Code. *See* S. REP. No. 989, 95th Cong., 2d Sess. 89 (1978) and H.R. REP. No. 595, 95th Cong., 1st Sess. 375 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5963.

165. 11 U.S.C. § 548(a)(2) (1988); UFCA §§ 4, 5, 6, 7A U.L.A. 474, 504, 507 (1985); UFTA § 4, 7A U.L.A. 652-53, 657 (1985).

mon shareholders, an increase in the debt-to-equity ratio of the firm, and an increase in the probability of default on pre- and post-obligation debt. Claims seeking to avoid the cash transfer to target stockholders emphasize the absence of fair consideration (the loan proceeds) to the debtor firm. Consideration received by the target shareholders is a third-party benefit and not, therefore, "fair consideration" received by the debtor. Courts applying constructive fraud provisions generally focus only upon the consideration received by the transferor, not the value transferred by the lender or selling shareholder.[166] Although this interpretation is not mandated by the language of the fraudulent conveyance statutes, a broad application frequently protects creditors.[167]

In addition to proving "fair consideration" or "reasonably equivalent value," a claimant for avoidance of fraudulent transfers must show either that the transferor was insolvent at the time or as a result of the conveyance or obligation incurred, or, as a consequence of the transfer, the firm possessed too little capital to continue business. "Insolvency" under the UFCA occurs when the "present fair saleable value" of a company's assets is less than the amount required to be paid on "probable liability on existing debts as they become absolute and matured."[168] Insolvency also may be determined under an "equity" (cash-flow) test[169] or a "balance-sheet" test.[170]

The Bankruptcy Code defines insolvency to mean that the sum of the debtor's liabilities is greater than the debtor's property "at a fair valuation," excluding property transferred, concealed or removed with the intent to hinder, delay or defraud creditors as well as certain property that is exempt from the debtor's estate.[171] Although the Bankruptcy Code definition appears to adopt a "balance-sheet" test of insolvency, courts have not always interpreted the Code language so narrowly.[172]

The UFTA, on the other hand, defines insolvency to include a bal-

166. *See In re* Roco Corp., 701 F.2d 978, 982 (1st Cir. 1983) (In addressing a stock repurchase under § 548(a)(2) of the Bankruptcy Code, the court found that "the value to be considered is that received by the debtor and not that forfeited by the transferee."); *In re* Vadnais Lumber Supply, Inc., 100 Bankr. 127, 136 (Bankr. Mass. 1989) (In applying the "reasonably equivalent value" test of § 548(a)(2), the court stated, "The debtor must receive the required value, not some third party."); *In re* Ohio Corrugating Co., 70 Bankr. 920, 927 (Bankr. N.D. Ohio 1987) (Focus of constructive fraud is "what the [d]ebtor surrendered and what the [d]ebtor received, irrespective of what any third party may have gained or lost.").

167. Cases approving indirect benefits as fair consideration have involved "consideration with definite value" rather than benefits which were "merely conjectural and indeterminate." *See* Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491, 1501 (1987). *See also* Credit Managers Ass'n v. Federal Co., 629 F. Supp. 175, 182 (C.D. Cal. 1986) ("As a matter of law, management services do not constitute fair consideration when they have no identifiable monetary value.").

168. UFCA § 2(1), 7A U.L.A. 442 (1985).

169. *See* Cellar Lumber Co. v. Holley, 9 Ohio App. 2d 288, 290, 224 N.E.2d 360, 363 (1967).

170. *Id.*

171. 11 U.S.C. § 101(31) (1988).

172. *See In re* Ohio Corrugating Co., 91 Bankr. 430, 439 (Bankr. N.D. Ohio 1988) (The Bankruptcy Code test for insolvency may include the "equity" or cash flow standard.).

ance-sheet as well as equity or cash-flow standard.[173] Section 2(a) of the UFTA states that a debtor is insolvent if "the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation."[174] A presumption of insolvency is raised if the debtor "is generally not paying his debts as they come due."[175] Although the definitional language of insolvency varies among the Bankruptcy Code, UFCA, and UFTA, each statute demands a "balancing of present assets against present and future liability of existing debts."[176] The value of a firm's assets, for purposes of an insolvency determination, includes all relevant financial data and is not limited to the book value of present assets.[177]

Each of the three fraudulent conveyance statutes contains a "savings clause" that protects bona fide initial transferees if they give value to the debtor.[178] Subsequent transferees are also exempt where value is given in good faith and without the transferor's knowledge of a voidable conveyance.[179] Section 548(c) of the Bankruptcy Code is a typical savings clause:

> [A] transferee or obligee . . . that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.[180]

"Good faith" by the transferee requires a showing of no actual knowledge of the insolvency or inadequate capitalization of the transferor and a lack of constructive knowledge that the debtor is failing financially.[181]

V. COMMENTARY

To examine fully the repercussions of M&As which are funded in large part by non-investment grade corporate debt, consider the following scenario. I, a large investment banking firm, forms a $1 billion "Leveraged Buyout Bridge Fund" to provide short-term funding for corporate acquisitions. I approaches the management of A corporation with a plan for the acquisition of B company. A's directors meet with I's senior executives to consider the possibility of a takeover bid for B. In the discussion, I's representatives procure non-proprietary information regarding A's financial condition, including income statements and projected cash flow reports. After unsuccessful negotiations (due to the reluctance of A's directors to incur inordinate amounts of debt), I seeks an investor elsewhere. Several weeks later, I contacts B's directors with a

173. UFTA §§ 2(a)-(b), 7A U.L.A. 648 (1985).
174. *Id.* § 2(a).
175. *Id.* § 2(b).
176. *See* Heiman, *Fraudulent Conveyances*, 2 ASSET-BASED FINANCING (MB) § 21.03[2][a] at 21-15 (1987).
177. *Id.*
178. 11 U.S.C. §§ 548(c), 550(b) (1988); UFCA § 9, 7A U.L.A. 577-78 (1985); UFTA § 8, 7A U.L.A. 662-63 (1985).
179. *Id.*
180. 11 U.S.C. § 548(c) (1988).
181. *See* 4 COLLIER ON BANKRUPTCY ¶ 548.07 at 548-70-71 (King ed. 1988).

proposition: the acquisition of A with partial funding to be supplied by I. Negotiations with B are successful and a cash tender offer for A's common stock is planned.

To implement its bid, B organizes a shell corporation, S, in Delaware for the sole purpose of acquiring A's shares. Thereafter, B initiates its tender offer at a price of $60 per share. The total purchase price of A is approximately $23 billion. Funding for the acquisition includes a fifty percent secured bank commitment from a syndicate of approximately two hundred banks, a one percent equity contribution by B (which represents the approximate cost of filing the offer), and a forty-nine percent bridge loan to be advanced by I on a short-term basis and supplemented by the sale by I of S's subordinated, high yield bonds. I is to receive for its services over $386 million in fees as well as a six percent ownership interest in A.[182] The syndicate of banks providing the senior debt shares a $325 million fee.[183] B, as owner of S, anticipates an investment return of almost $3 billion in five years.

At the announcement of the offer, A's common stock is trading at $50 per share. A also has outstanding senior secured debt which includes bank loans and long-term notes, long-term unsecured bonds (which were investment grade when issued eight years earlier), preferred stock, and convertible bonds. In addition, A has accounts with twenty large trade creditors which have supplied goods and services to A since its incorporation in 1954. A's board of directors is composed of five inside and six outside directors, all of whom enjoy lucrative stock option plans and severance contracts. A employs 100,000 workers at sites located throughout the southeast. A's balance sheet reflects a conservative, but prudent, management: sixty-five percent equity to thirty-five percent debt. Of the thirty-five percent debt outstanding, only ten percent represents secured obligations. Consequently, A's assets are relatively unencumbered. A also possesses a $400 million cash reserve which management anticipates using for additional investments. At the time of the offer, A has no acquisition plans.

A's directors, believing A to be better served by remaining independent, announce to A's shareholders their opinion concerning the inadequacy of S's bid. Immediately thereafter, A's management announces the repurchase of eighty-five percent of A's common stock. To complete the purchase, A must obtain bank loans, liquidate its $400 million cash reserve, and issue new subordinated debt. Announcement of the repurchase program results in the placement of A's unsecured bonds on Standard & Poor's Credit Watch list. As a result, A's outstanding unsecured bonds plunge almost fifteen percent in price.

Fearing the impact of a defensive restructuring, eighty percent of A's stockholders tender to S. At the close of the bid, S takes down ten-

182. These figures are based upon the LBO of RJR by KKR in 1989, White, *KKR Sells Its Partners RJR as a Bargain But Gives Them Few Numbers to Prove It*, WALL ST. J., Dec. 5, 1988, at A4, col. 2.

183. *Id.*

dered securities and pursues its announced cash-out merger in which the remaining stockholders of A will receive $60 per share in cash. The proposed merger is successfully completed within several months. At the end of this time, newly-merged A has senior debt to the extent of the fair market value of all the company's assets, approximately ten to fifteen percent equity (including common stock, warrants, and preferred stock), and unsecured debt equivalent to the difference between the cost of acquiring A and the amount of equity and senior debt available. The $400 million cash reserve has been depleted by S in order to remit acquisition and financing fees to banks, underwriters, and attorneys. Pre-merger corporate bonds are trading at sixty percent of their face value. S's management enters negotiations for the purchase and sale of non-crucial assets, and terminates or lays off approximately 50,000 employees.

Notwithstanding these post-merger cost-cutting decisions, eighteen months later, B, as owner of the post-merger A entity, is unable to pay obligations on the new secured and unsecured debt. B's alternatives are to file for a Chapter 11 reorganization in an attempt to restructure debt commitments or to file for a Chapter 7 liquidation. Secured creditors of post-merger A are reluctant to negotiate any restructuring terms which would result in a reduction of their debt interests. Extensions of payment periods or adjustments in interest rates are, however, negotiable terms to these lenders. A's unsecured bondholders are in a less favorable position. If these creditors "holdout" against a restructuring, bankruptcy relief will be pursued and their interests will suffer greater depreciation due to the costs and delays inherent in bankruptcy liquidation proceedings. If these unsecured creditors agree to a restructuring, their debt interests will certainly experience a substantial dilution in value. A "game of chicken" now exists between besieged management and bondholders. The choice is whether to pursue a negotiated reorganization (in which all parties compromise their claims) or liquidation in bankruptcy (in which all parties suffer a substantial dilution in the value of their investments). In either of these options, the parties who bear the direct financial impact of the LBO are the unsecured pre-merger corporate bondholders.

A brief explanation reveals their dilemma. The keystone of a leveraged acquisition is the transfer of wealth from the target company's bondholders to the firm's common stockholders. For instance, at the close of the leveraged tender offer for A, A's shareholders have received a $10 premium for their common stock. The cash paid to A's stockholders originated from bank loans provided to B as well as bridge loans from I and the sale of S's subordinated, high yield debt. Since the cash payments were generated almost exclusively from borrowed funds, B, through S, is obligated to repay the loans, plus accrued interest. The bank loans are to be repaid over a period of years and the bridge loans from I must be paid down within a few months of the buyout and then replaced by the sale of subordinated debt. In order to satisfy interest obligations and to remit fees to I and other participants to the transaction, B must gain immediate access to cash or other assets. The primary asset available to B is the $400 million cash fund which presumably will be used to reimburse fees. Next, B will attempt to sell A's severable divisions. The remaining assets will be used to generate cash to service all outstanding debt.

The result of these maneuvers is that A's cash fund has, in effect, bought out the equity interest of A's common stockholders. Further, A's assets, which were previously unencumbered, have furnished the leverage with which B secured buyout financing. From the perspective of common stockholders, the resulting leverage of A is of no moment since they received a one-time cash payment for their equity and, therefore, retain no economic interest in the newly-merged A. From the standpoint of secured bondholders, their security interest remains (albeit further encumbered by subsequent debt financing)—they are priority creditors with a right to execute upon assets in the event of default.

Unsecured bondholders, on the other hand, are in a precarious position. First, pre-merger bonds suffered a substantial loss of value upon the announcement of the leveraged tender offer and defensive restructuring. This decrease in value (the "event risk" of the bond) reflected the concern by market analysts that the credit quality of A's outstanding debt could not survive a takeover or LBO. Upon the cuts in the value of bonds, pre-merger bondholders face an immediate dilemma: sell into a falling market after the bonds are downgraded or "wait and see" what subsequent developments occur. Assuming that pre-merger bondholders will not sell into the market, a second dilemma is presented: whether remaining assets are adequate to create the revenues necessary to carry all outstanding debt. Added to the bondholder's second dilemma is the question of their rank in priority if bankruptcy ensues. In other words, if bankruptcy is the result of the leveraged acquisition, pre-merger bondholders can either be paid in cash like trade creditors or can be equated to owners of "junk" bonds and, therefore, be entitled only to a rank above that of equity investors who, for the most part, have been cashed out.

At this point, pre-existing debt holders may attempt to negotiate with S's management. The bondholders' probability of success is severely limited, if not prohibited, by the fiduciary duties owed by management to stockholders and by indenture provisions which curtail amendments absent bondholder consent. If the indenture terms permit and the bondholders acquiesce to an amendment forcing acceleration of debt payments, firm directors probably will file for Chapter 11 protection. Consequently, pre-merger bondholders must address the ultimate prisoner's choice: hold out against a management attempt to restructure debt on terms less favorable than existing debt (thereby risking the bankruptcy of the target firm) or accept an out-of-court restructuring plan which dilutes their debt interests, but which provides more compensation than in bankruptcy because of the fees, expenses, and delay associated with an in-court reorganization.

In sum, the outcome of the LBO is the shifting of A's former wealth from legitimate unsecured bondholders to A's common stockholders. A's assets likewise were transferred to B, as owner of A, and B's investment advisors and attorneys. Since straight unsecured corporate debt is a bona fide and necessary aspect of corporate financing, safeguards must be available to long-term unsecured bondholders of firms subject to successful buyouts.

VI. Proposing a Solution

A. *Remedies Pursuant to Trust Indenture Covenants*

It may first be suggested that indenture covenants provide appropriate bondholder protection. For example, indentures may contain prohibitions or limitations upon mergers with the intended goal of curtailing subsequent leveraging and its adverse effect on pre-existing debt. Corporations adopting merger prohibitions or limitations must, in order to pursue a business combination, redeem outstanding debt according to the terms of the bond's call feature (generally at a premium). In the alternative, indenture contracts may allow a merger to proceed only if the surviving corporation assumes all prior liabilities, and on terms satisfactory to the indenture trustee and which impose no financial hardship upon existing bondholders.

Another contract-protective alternative is for management to draft a bondholders' right to put the bonds to the target corporation in the event of a merger or the downgrading of the debt subsequent to a merger or other change of control. These "poison puts" safeguard against the effects of further leverage.

Poison puts, however, often serve to prevent acquisitions, entrench incumbent management, and otherwise raise the specter of favorable bondholder treatment at the expense of equity owners. In addition, indenture covenants which restrict mergers are difficult to value, costly to draft, and burdensome to management decision-making. Consequently, creditor protection in the form of enforcement of existing indenture terms is not an optimal alternative for bondholders.

Bondholders are increasingly pursuing contractual remedies for management-proposed modifications of outstanding debt securities. In particular, solicitation of indenture amendments comprise modifications to debt and capital expenditure limitations and often include inducements to bondholders to consent to proposed changes. Consent solicitations implicate certain contractual issues including coercion, fair dealing, good faith, and informed consent. These issues are particularly relevant where inducements are available only to consenting bond owners and thus, are perceived by non-consenting bondholders as a means of vote-purchasing.

These issues were presented to, and rejected by, the Delaware

Court of Chancery in *Katz v. Oak Industries, Inc.*[184] Most recently, this type of claim was raised by RJR Nabisco's bondholders in *Metropolitan Life Insurance Co. v. RJR Nabisco Inc.*[185] who charged that management misappropriated the value of their bonds to help finance the LBO of the company.[186] Although the court in *Metropolitan Life* rejected the debt owners' claim that management's misappropriation constituted a breach of the implied covenant of good faith and fair dealing,[187] such suits invite an expanded use of good faith terminology to cloud the distinction between corporate fiduciary duties owed to stockholders and duties of good faith in the performance of indenture covenants.

B. *State Corporate Remedies*

Another option for unsecured bondholders is to pursue relief under state corporate law. Currently two choices are available to these debt holders. First, bondholders may rely upon a bondholder protection argument premised on a contractual duty of good faith in the performance and execution of indenture contracts. This remedy proceeds from the black-letter rule that bondholders are creditors of the firm and therefore must provide their own creditor self-protection remedies. If indenture terms are silent or otherwise prohibit a bondholder-protective construction, debt holders may raise contract avoidance doctrines to set aside indenture language that results in unfairness or oppression.

The second option seeks to impose upon issuers and controlling shareholders a fiduciary duty to bondholders when debt holder interests conflict with stockholder interests.[188] This approach abandons the traditional characteristic of bonds as being wholly debt and consequently being governed exclusively by express contractual language.[189] For instance, convertible bonds combine features of both equity and debt.[190] The issue is raised whether convertibles and other hybrid se-

184. 508 A.2d 873 (Del. Ch. 1986).

185. 716 F. Supp. 1504, 1506 (S.D.N.Y. 1989).

186. *Id.* at 1506.

187. *Id.* at 1519.

188. Bondholder suits under state corporate law may receive additional support from stakeholder constituency statutes recently adopted in twenty-four jurisdictions. *See generally* Hart & Degener, *Non-Stockholder Constituency Statutes*, N.Y.L.J., Apr. 12, 1990, at 1, col. 2. These statutes generally allow directors to consider interests of employees, suppliers, creditors, consumers, and the local economy in making business decisions for the firm. The statutes vary according to mandatory consideration of non-stockholder interests, *see* CONN. GEN. STAT. § 33-313(e) (1989); permissive consideration of other constituencies, *see* IND. CODE ANN. §§ 23-1-35-1(d), (f), (g) (Burns. Supp. 1990); and opt-in charter provisions for debt holder approval of takeovers or replacement of specified percentages of directors, *see* WYO. STAT. § 17-18-201 (1990). How these statutes will be interpreted in light of directors' traditional duties owed to stockholders is unknown. It may be suggested that such stakeholder legislation increases confusion concerning director accountability and should, therefore, not provide the primary impetus for bondholder suits in the absence of searching legislative examination of the impact of such anti-takeover statutes on the efficiency and predictability of traditional corporate precepts.

189. *See id.*

190. *Id.*

curities require departure from a conclusory "equity" or "debt" analysis for bond interests when they conflict with stockholder interests.

Recently, state courts have revisited the black-letter demarcation of equity and debt and the doctrinal regimes of corporate and contract law as applied to securities.[191] Once again, judicial response to the imposition of a corporate fiduciary duty to bondholders has been a resounding negative.[192] Justification for this lack of intervention by state courts rests upon the unresolvable conflict between the financial interests of stockholders and bondholders.[193] On the contract side, requests for bondholder protection have met with no greater success.[194]

Consider the alternatives of a pre-merger unsecured bondholder of A corporation who seeks relief in Delaware's Court of Chancery. The issue is whether the debt holder has a cause of action to enjoin the defensive restructuring which caused an immediate downgrading of the holder's security. If the bondholder casts her claim in the form of a derivative cause of action alleging breaches of fiduciary duties by A's management, the short answer is clearly no. In *Wolfensohn v. Madison Fund, Inc.*,[195] plaintiffs sought to enjoin an exchange offer by a holding company for ninety-seven percent of the target company's stock. According to plaintiffs, the exchange offer effected a reorganization which transferred corporate income from bondholders to stockholders in the event of a liquidation and otherwise placed plaintiff bondholders in an inferior position.[196] Plaintiffs were denied relief because debt holders were deemed creditors of the corporation to whom no fiduciary duty was owed and the exchange offer impaired no contractual rights owed to the plaintiff bondholders.[197]

A similar result was obtained in *Harff v. Kerkorian*.[198] In *Harff*, plaintiffs brought a combined derivative and class action suit challenging the declaration and payment of a dividend for the controlling shareholder's benefit.[199] Plaintiffs were the holders of five percent convertible debentures due in 1993.[200] They alleged the classic conflict of interest between stockholders and bondholders in the declaration of a cash dividend that impairs the value of conversion features and causes a decline in the market value of the underlying bonds.[201] The Delaware Court of Chancery dismissed the derivative cause of action for lack of standing.[202] Citing the *Wolfensohn* decision, the court found that convertible bondholders do not gain stockholder status until exercise of the

191. *See* Katz v. Oak Indus., 508 A.2d 873 (Del. Ch. 1986).
192. *Id.*
193. *Id.*
194. *Id.*
195. 253 A.2d 72 (Del. 1969).
196. *Id.* at 75.
197. *Id.*
198. 324 A.2d 215 (Del. Ch. 1974).
199. *Id.* at 215.
200. *Id.* at 217.
201. *Id.*
202. *Id.* at 215.

option.[203] As to the class action, plaintiffs claimed that defendant directors breached the indenture agreement by violating fiduciary duties to refrain from acting in their own self interest.[204] The court dismissed the class action for failure to show any fiduciary duty existing between the defendants and bondholders.[205]

A second alternative for A corporation's unsecured bondholders is to bring a class action charging a breach of contract. For example, assume that management, at the time of drafting the indenture contract, included a condition which prevented future corporate borrowings without the bondholders' consent. Assume further that a restrictive covenant was adopted which would require consent by a bondholder majority to amend the indenture. If management thereafter proposed an exchange offer wherein existing bondholders would tender their debentures for a combination of notes, common stock, and warrants and the offer was contingent upon an amendment to the indenture and thus to the consent of the bondholders, what decision would the debt holders make? If the company is in sound financial condition, the situation likely will not arise. If a bondholder seeks relief at this juncture, her claim is breach of contract by "coercive" actions of management—that is, a coercive restructuring effected for the stockholders' benefit (reduction of income obligations by the issuer) at the bondholders' expense (forced consent to exchange existing debt instrument at an unfair price).

In *Katz v. Oak Industries Inc.*,[206] Chancellor Allen addressed an analogous situation. The plaintiff in *Katz* was the owner of long-term debt securities issued by Oak Industries, Inc. (Oak).[207] Oak announced an exchange offer and consent solicitation that would effect a reorganization of the firm.[208] The plaintiffs asserted that the offer was coercive and forced bondholders to tender and consent.[209] They argued that by conditioning the offer on consent, management breached their contractual obligation to act in good faith.[210]

Chancellor Allen denied plaintiffs' application for a preliminary injunction on two grounds—one direct and one indirect.[211] As to the latter, he found plaintiffs to have presented no issue of a fiduciary duty owed by corporate management to the holders of debt securities and therefore "[n]o cognizable legal wrong" by directorial action that

203. *Id.* at 219.
204. *Id.* at 221.
205. *Id.* at 221-22. Chancellor Quillen also found that plaintiffs failed to raise the exception that creditors can maintain an action against management upon proof of fraud, insolvency, or a violation of an independent statute. *Id.* On appeal, the Delaware Supreme Court affirmed the dismissal of the derivative claim and reversed on the dismissal of the class action. The court found error in the Chancellor's ruling that plaintiffs alleged no fraud in their complaint. The case was then remanded for trial on the fraud issue. *Id.* at 220-22.
206. 508 A.2d 873 (Del. Ch. 1986).
207. *Id.* at 875.
208. *Id.*
209. *Id.* at 878.
210. *Id.*
211. *Id.* at 878-82.

benefitted shareholder interests at the bondholders' expense.[212] The Chancellor's conclusion was based upon existing Delaware law—and the law generally—which defines the relationship between a corporation and its bondholders (including owners of convertible debentures) to be contractual in nature. The Chancellor further explained a bondholder's rights and interests:

> Arrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the contractual relationship agreed to and *not broad concepts such as fairness* define the corporation's obligation to its bondholders.[213]

Notwithstanding the existing Delaware law, Chancellor Allen acknowledged the impact of the proposed restructuring—that is, the transfer of risk of economic loss to bondholders and thus, in effect, a removal of wealth from owners of debt to equity investors.[214] The court declined to intervene, however, in the absence of either legislative directives safeguarding bondholder interests or indenture terms granting creditor self-protection.[215]

Troubling to this writer is the court's apparent suggestion that lenders do negotiate and adequately document bondholder-protective provisions when recent statistics indicate a lack of negotiated terms in indenture contracts. Is it reasonable to assume, therefore, that corporate management will draft pro-bondholder terms in light of their corporate fiduciary duty to maximize shareholder interests? Arguably, by relegating debt owners to relief on their contracts, the Chancellor conceded the inviolable conflict between bondholder and stockholder interests. Although each is a "stakeholder" in the firm, decisions which advantage one, disadvantage the other. Corporate directors, therefore, cannot simultaneously fulfill fiduciary obligations to both parties since each has conflicting economic concerns.

On the contract side, Chancellor Allen outlined the modern contract principle that a party to an indenture owes a duty of good faith and fair dealing in the performance and execution of a contract.[216] The Chancellor found the contract obligation not to be synonymous with the duty of loyalty required by a director in the exercise of his duties to the corporation and its shareholders.[217] The Chancellor stated the legal

212. *Id.* at 879.

213. *Id.* at 879 (emphasis added) (footnote omitted). Chancellor Allen noted, however, the application of concepts of implied covenants of good faith and fair dealing as a matter of contract law. Further noted by the court was the impact of the challenged transaction—that is, the transfer of wealth from stockholders to bondholders.

214. *Id.* at 876.

215. *Id.* at 879.

216. Katz v. Oak Indus., 508 A.2d 873, 878 (Del. Ch. 1986).

217. *Id.* at 878 n.7.

test in Delaware for a breach of contract based upon a claim of "coercion" in the structure of a corporate transaction:

> [I]s it clear from what was *expressly agreed upon that the parties who negotiated the express terms* of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter. If the answer to this question is yes, then, in my opinion, a court is justified in concluding that such act constitutes a breach of the implied covenant of good faith.[218]

Two questions arise from the Chancellor's formulation of "coercion" as a matter of contract law. First, is the concept of coercion different in a contract, as opposed to a corporate, regime? If not, is the appropriate legal test then one of "fairness" as effectuated through the equitable powers of the court of chancery? If so, then do not the same equitable principles require fair treatment to all who seek relief in a court of chancery? Second, if the test of contractual good faith is what the parties "would have agreed to," what bondholder protections will ever be implied when to do so is to breach a corporate duty owed by directors to their shareholders? In other words, the duty of good faith in contract law does not attach to the negotiation process which is the precise juncture at which stockholder and bondholder interests will unalterably diverge and leave a debt owner's contract unprotected. If the covenant of good faith does not reach the bargaining process, therefore, how will a bondholder sustain proof of a breach of good faith in the performance of the indenture?

Where, then, is the bondholder of A who sought relief in the Delaware Court of Chancery? First, the bondholder is without a remedy if the claim is one for a breach of a corporate fiduciary duty. This result is both necessary and reasonable. Directors cannot simultaneously serve two masters who seek opposite results concerning the use and retention of capital assets. In addition, if a court should grant equity status to a bondholder by imposing such a duty on corporate directors, that bondholder likely will be deemed a "stockholder" and thus placed in the lowest priority rank in the event of bankruptcy. Consequently, a derivative cause of action poses a remedy for unsecured bondholders only in a pre-merger, non-bankruptcy circumstance. If the claim is one for breach of contract based upon coercion by management or the acquiror, it is questionable whether the claim is co-extensive with a charge of a breach of fiduciary duty and therefore likely to suffer the same outcome as the latter allegation.

C. *Remedies Under the Federal Securities Laws*

Corporate bondholders in tender offer transactions may pursue a private action for damages against an issuing or acquiring corporation for violations of sections 10(b)[219] and 14(e)[220] of the Exchange Act.

218. *Id.* at 880.
219. 15 U.S.C. § 78j(b) (1988).

Both section 10(b) and section 14(e) proscribe fraud or other deceptive acts or practices made in regards to a "security."[221] A "security" is defined in the Exchange Act to include any "bond" or "debenture."[222] To secure standing under these provisions, however, a corporate bondholder must first establish the elements of a cause of action for securities fraud.

To date, corporate bondholders have largely rejected the federal avenue of relief in favor of unsuccessful state law remedies.[223] The paucity of bondholder protection in the federal arena rests in large part upon judicial characterization of bonds as "debt" and, therefore, security holders to whom no duty is owed by an issuing or acquiring corporation. Stated another way, bondholders, as creditors, lack standing under federal antifraud provisions. Shareholders, on the other hand, are permitted access to federal securities remedies.[224] This distinction between stockholders and bondholders in the context of federal securities laws ignores the economic realities of debt transactions and investments and appears to rely instead upon subtle state corporate concepts of "duty" and the nature of the instrument held.

To understand the application of federal securities remedies, assume that a pre-merger bondholder of A company initiates a federal suit against S and A corporations alleging violations of sections 10(b) and 14(e). The claim by A's bondholders is that debt instruments were

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220. *Id.* § 78n(e).

221. *Id.* §§ 78j(b), 78n(e).

222. *Id.* § 78c(a)(10).

223. In articles appearing in The Wall Street Journal at the close of 1988, it was noted that federal suits were pending against RJR Nabisco by two RJR noteholders in which bondholders alleged violations of the securities laws and sought rescission of their debt instruments. *See* White, *ITT Sues RJR, Saying Buy-Out Devalues Bonds*, WALL ST. J., Nov. 17, 1988, at C1, col. 3; Heylar, *KKR Hiring Firm to Fund an RJR Chief; Though Purchase is Far From Complete*, WALL ST. J., Dec. 7, 1988, at A5, col. 1. *See also* Winkler, *Sore Junk Bond Holders Form Rights Group but Say They Aren't Looking for a Free Ride*, WALL ST. J., June 30, 1988, at 61, col. 2; Piontek, *Met Sued RJR to Protect Its Bondholdings*, NAT'L UNDERWRITER, Nov. 28, 1988, at 1; Franklin, *Metlife Looks for Help*, N.Y.L.J., May 11, 1989, at 5, col. 2. For state law actions *see* Simones v. Cogan, 549 A.2d 300 (Del. 1988); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989).

In addition, debt holders increasingly are demanding disclosure obligations to debt owners at least as extensive as those provided to equity investors. In a recent renewal of this charge, bondholders are "banding together in the most concerted effort yet to change Securities and Exchange Commission policy" by amending the 300 Rule. Schultz, *Bondholders Mobilizing to Change 300 Rule: Financial Information More Difficult to Get Post-LBO*, INVESTMENT DEALERS' DIG., July 30, 1990. The 300 Rule, as enacted under section 15(d) of the Securities Exchange Act of 1934, allows companies with less than 300 security holders to forego all disclosure of financial information relevant to the issuer.

224. *See* Metropolitan Securities v. Occidental Petroleum Corp., 705 F. Supp. 134, 138 (S.D.N.Y. 1989); Plessey Co. PLC v. General Electric Co. PLC, 628 F. Supp. 477, 488 (D. Del. 1986); Werfel v. Kramarsky, 61 F.R.D. 674, 678 (S.D.N.Y. 1974); Sargent v. Genesco, Inc., 352 F. Supp. 66, 80 (N.D. Fla. 1972), *aff'd in part and rev'd in part*, 492 F.2d 750 (5th Cir. 1974). *Cf.* McMahan & Co. v. Wherehouse Entertainment, Inc., 900 F.2d 576 (2d Cir. 1990) (In public offering of debentures, issuer disclosed right of holders to tender the debentures to the issuer in the event of a merger, consolidation or other triggering event, unless such event was approved by a majority of independent directors; court held that jury could find such disclosure misleading under § 10(b) because the independent directors were required by state law to protect the shareholders' interests above those of debt owners.).

purchased by the plaintiffs many years earlier based upon representations by the issuer and other public information concerning the issuer's credit worthiness. Plaintiffs will contend that, when purchased, the bonds were investment grade and carried little or no chance of default. Further, indenture covenants to the bond contract represented the market circumstances of the debt transaction, including the company's conservative debt-to-equity ratio and its $400 million cash reserve. Plaintiffs will allege that upon the announcement of S's leveraged tender offer and A's defensive restructuring, A's bondholders suffered a substantial loss in the value of bonds as well as a downgrading of their debt instrument. A's bondholders will then seek damages and/or rescission of their debt investments based upon the fraudulent and deceptive practices of A's and S's management in the initiation and defense of the LBO.

Each antifraud provision implicated in the bondholders' complaint prohibits the commission of fraud during the course of a tender offer.[225] Under the federal securities laws, fraud includes misrepresentations or omissions of material facts and the use of deceptive, fraudulent, or manipulative devices.[226] To determine whether a plaintiff has established a cause of action for securities fraud, the courts have considered five factors: misrepresentation or omission of a material fact, scienter, reliance, causation, and damages. Bondholder suits are preempted by the following elements: a "duty" to speak (where a claim is one of omission of fact) and reliance.

1. The Duty Requirement

In *Chiarella v. United States*,[227] the Supreme Court held that a failure to disclose material information constitutes fraud under section 10(b)

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225. Section 14(e) of the Securities Exchange Act of 1934 provides:

> It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C. § 78n(e) (1988). Rule 10b-5 (as promulgated under § 10(b) of the Securities Exchange Act of 1934) states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) to employ any device, scheme, or artifice to defraud,
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1990).

226. *Id.*

227. 445 U.S. 222 (1980).

and rule 10b-5 when the person who remained silent had a "duty" to speak. The petitioner was a printer employed as a "mark-up man" on various documents concerning announcements of corporate takeover bids.[228] Petitioner used these documents to determine the name of the target firm in order to purchase target securities before the tender offer announcement.[229] After initiation of the bid, petitioner sold the securities to the acquiring corporation at a substantial profit.[230]

The issue before the Supreme Court was whether a person who learns material information from the confidential documents of a would-be acquiror violates section 10(b) if he fails to disclose the information (the impending takeover bid) before trading in the target company's securities.[231] The Court framed the issue in terms of whether the printer had a "duty" to speak to the selling shareholders. Absent such a duty, the Court reasoned, there could be no violation, and therefore no liability, under section 10(b) and rule 10b-5.[232] In finding no duty in *Chiarella*, the Court stated "[w]hen an allegation of fraud is based upon nondisclosure . . . [t]here can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."[233] To establish a duty, the Court reasoned, there must exist a fiduciary relationship between the parties or a similar relation of trust or confidence.[234]

For the purpose of standing for the bondholders of A corporation, the question is whether a target or acquiring company owes a duty to A bondholders under the antifraud provisions and, if so, what information satisfies the obligation to speak. In terms of the target corporation, it seems fair and consistent with the federal securities laws to impose a duty to disclose in light of the trust and confidence the bondholders placed in the firm which solicited their investment in the issuer's debt securities. On the other hand, if the test of "duty" is a fiduciary relationship imposed by state corporate law, target management owes no such obligation to the creditors of the firm—that is, its bondholders. An immediate conflict arises, therefore, concerning the substantive test for "duty" under the federal antifraud provisions.

In a recent decision, the District Court for the Southern District of New York reaffirmed the distinction between stockholders and bondholders, holding that an issuer owed no duty to convertible debenture owners to disclose the effect of a third-party tender offer on the bondholders' contractual rights.[235] In *Metropolitan Securities v. Occidental Petro-*

228. *Id.* at 224.
229. *Id.*
230. *Id.*
231. *Id.*
232. *Id.* at 230.
233. *Id.* at 235.
234. 445 U.S. at 228.
235. Hartford Fire Ins. Co. v. Federated Dept. Stores, Inc., 723 F. Supp. 976 (S.D.N.Y. 1990).

leum Corp.,[236] a holder of convertible debentures claimed that target management violated federal securities laws by failing to disclose the impact of a premium provision in the indenture contract on an outstanding third-party tender offer. According to the debt holder, had management disclosed the effect of the offer on relevant premium provisions, the debt holder would not have exercised its conversion privilege and, thus, realized a greater gain from the takeover bid. The court rejected plaintiff's argument, holding that the tender offer was directed to the issuer's stockholders and that the issuer, therefore, owed no disclosure duty to owners of its other classes of securities.[237]

As to the acquiring entity, an argument can be made that a duty should be implied under federal law. Consider the impact of a successful leveraged tender offer on a pre-merger corporate bondholder. First, pre-existing bonds will suffer reductions in bond ratings and severe devaluation in face value at the announcement of a takeover bid. Second, if the bondholders choose not to sell in a weak bond market, upon the successful completion of the offer, the acquiror will systematically dismantle the target firm's capital structure in order to service the junk bond debt and other acquisition costs. Once the assets have been stripped to finance the takeover, the value of the once-investment grade bonds will decrease further. If an out-of-court work-out is effected, pre-merger bondholders will receive substitute notes, cash, and/or equity in the reorganized firm which represent only a fraction of the face value of the prior bonds. If the acquiror pursues a Chapter 11 reorganization, the bondholders must battle for partial payment with priority secured creditors, trade creditors, other unsecured debt holders, and junk bond owners. Whether and in what form A's bondholders ever receive compensation is unknown. The economic realities of the tender offer transaction therefore compel the acquiring corporation to acknowledge a duty to target bondholders—an outcome which reflects a broad remedial construction of the federal securities laws.[238] Unfortunately, adherence to state corporate principles—which recognize no fiduciary duty or relation of trust and confidence between an acquiror and target security holders—prevents this extension of the antifraud provisions to takeover bidders by bondholders.

2. The Reliance Requirement

Under the antifraud provisions, a plaintiff may recover only if she can demonstrate that deception caused the injury. Proof of reliance provides the causal nexus between the defendant's conduct and the plain-

236. 705 F. Supp. 134 (S.D.N.Y. 1989). *See also* Hartford Fire Ins., 723 F. Supp. 976 (S.D.N.Y. 1989).

237. Metropolitan Securities v. Occidental Petroleum Corp., 705 F. Supp. 134 (S.D.N.Y. 1989).

238. For authorities advocating the existence of a duty under the securities laws based upon principles of trust and fairness, *see* Dirks v. S.E.C., 463 U.S. 646 (1983); S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795 (1983).

tiff's injury. In *List v. Fashion Park, Inc.*,[239] the Second Circuit stated that proof of reliance was necessary to prevent rule 10b-5 from becoming an insurance policy for the investor:

> Resistance to "investor's insurance" may be analytically restated as a refusal to transfer certain economic risk from investors to those who must make disclosures under the securities laws. There are, of course, legitimate risks inherent in a firm's enterprise that investors bear in exchange for the opportunity to profit.[240]

The court in *List* held, however, that "actual" reliance was unnecessary and instead articulated the test as "whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact."[241]

This relaxed standard for proof of reliance is commonly known as the "fraud on the market" theory.[242] Acceptance of the fraud on the market theory requires the assumption that market prices respond to information available in the marketplace regarding the securities being traded. This theory treats reliance on market price as identical to reliance upon representations made directly to an individual investor:

> [T]he market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus, the market is performing a substantial part of the devaluation process performed by the investor in the face-to-face transaction. The market is acting as the unpaid agent of the investor . . . .[243]

An investor, therefore, can rely upon the integrity and efficiency of the market. He is also entitled to recover where injury results from the defrauder's action or inaction.

In the context of A's bondholders, adoption of a fraud on the market theory enhances an argument for an emendatory construction of federal antifraud language. The target firm's bondholders are investors who rely upon the integrity of the market to decide the investment quality of their debt instrument.[244] If the relaxed standard of reliance applies throughout the life of the bond, bondholders, like stockholders, can establish the element of reliance under antifraud provisions. If, however, reliance occurs only at the time the bond was purchased, bondholders will not have standing for allegation of fraud.

3. The "In Connection with the Purchase or Sale" Requirement

Section 10(b) and rule 10b-5 require that the fraud be committed

239. 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).
240. *Id.* at 463.
241. *Id.*
242. *See* 3 A. BROMBERG, SECURITIES LAW § 8.6 (1981).
243. *In re* LTV Securities Litigation, 88 F.R.D. 134, 143 (N.D. Tex. 1980).
244. For cases, referring to the Williams Act, *supra* note 77, and applying the "fraud on the market" theory, *see* Berman v. Gerber Products Co., 454 F. Supp. 1310 (W.D. Mich. 1978); Bertozzi v. King Louie Int'l, Inc., 420 F. Supp. 1166 (D.R.I. 1976).

"in connection with the purchase or sale of a security."[245] This is the final bondholder obstacle in tender offer transaction suits.

Consider a pre-merger bondholder who wishes to pursue a federal antifraud claim. As a pre-existing debt owner, the bondholder is unable to show a purchase or sale of a security at the time of the alleged wrongdoing—that is, the announcement of an LBO or a defensive recapitalization. If the bondholder proceeds on the basis of a purchase or sale by the defendant, which is a recognized theory for satisfying the "in connection with" element of rule 10b-5,[246] the bondholder has no standing. For example, a would-be acquiror cannot purchase securities during the pendency of the offer. Likewise, non-investment grade securities will not be sold by the offeror until the bid closes or is within days of closing. These latter sales do not comport with the acts or practices (the announcement of the offer) which caused the devaluation of the pre-existing bonds.

Target management will not purchase or sell securities at the time the leveraged recapitalization is announced and the bond ratings are cut since directors probably cannot effect a repurchase program until after the event which caused the decrease in bond value. Consequently, despite the remedial purpose underlying the Exchange Act and the definition of "security," pre-merger bondholders lack a federal remedy for harm emanating from leveraged tender offers.[247] Ironically, owners of junk securities who provided the key portion of leverage for the buyout receive antifraud protection more easily because of the timing of the bonds' issuance—that is, junk bond owners are purchasers of debt securities when the alleged harm occurs. As a consequence, non-investment grade debt holders have a greater chance of succeeding on the merits of a section 10(b) cause of action.

D. *Relief Under the Bankruptcy Code*

In the event a buyout firm is unable to meet interest obligations and fails to secure a voluntary restructuring of corporate indebtedness, firm management may seek protection under the bankruptcy laws. The alternatives available to financially beset corporations are liquidation under Chapter 7 or a Chapter 11 reorganization.[248] Most companies initially

245. Securities Exchange Act of 1934, 15 U.S.C. § 10(b) (1988); 17 C.F.R. § 204.10b-5 (1990); Rule 10b-5, 15 U.S.C. § 78n(e) (1988).

246. *See* Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).

247. *But see* McMahan & Co. v. Wherehouse Entertainment, Inc., 900 F.2d 576 (2d Cir. 1990) (holding that a jury could find misleading certain disclosures by an issuing corporation of rights of debenture holders to tender debt securities to the issuer upon specified triggering events unless such events were approved by a majority of directors).

248. Another alternative to a bankruptcy petition is a reorganization under § 1126(b) of the Bankruptcy Code. 11 U.S.C. § 1126(b) (1988). Section 1126(b) allows a debtor to propose and solicit acceptance of a plan for restructuring outstanding indebtedness prior to the filing of a petition. Pre-petition reorganizations are uncommon, however, due in substantial part to the restriction on indenture trustees to negotiate and compromise the interests of owners of public debt issuances where the outstanding bonds are subject to an

will pursue reorganization in Chapter 11 in order to continue in business and to restructure existing debt. Equity investors and unsecured debt owners probably will consent to reorganization since a forced liquidation in Chapter 7 or Chapter 11 will unlikely bring prices which approximate the market value of the property if it is sold as an ongoing business.

If firm management pursues reorganization protection under Chapter 11, the filing of the bankruptcy petition temporarily suspends its obligations for servicing debt and prevents secured creditors from foreclosing upon corporate property. In particular, the automatic stay of section 362 of the Bankruptcy Code freezes actions against the debtor and prevents enforcement of claims against the debtor company.[249] Owners of the firm's outstanding debt may not execute upon the debtor's property and may not declare the debtor in default due to the suspension of interest payments.[250]

Filing a bankruptcy petition also suspends the debtor firm's obligation to pay pre-petition claims. In addition, interest charges on unsecured debt commitments are frozen during the pendency of the bankruptcy proceeding.[251] Interest payments on secured debt during bankruptcy are dependent upon whether the trustee can provide adequate protection for the secured creditor's interest.[252]

Firms subject to a Chapter 11 reorganization likely will seek credit advances in order to continue business operations. Unsecured credit is available to struggling companies, without bankruptcy court approval, if the credit is obtained in the debtor's ordinary course of business.[253] Creditors which supply such unsecured credit are provided the priority of an administrative expense and thus will be paid before pre-petition suppliers and creditors.[254] Post-petition secured credit or not-in-the-ordinary-course-of-business unsecured credit is available to debtor firms

indenture and bondholder consents must be obtained. *See* § 316(b) of the Trust Indenture Act of 1939, 15 U.S.C. § 77ppp (1988).

249. 11 U.S.C. § 362 (1988).

250. *Id.* Holders of claims against a debtor corporation may seek relief from the automatic stay of section 362 upon a showing of cause (including the lack of adequate protection of an interest in the creditor's property) or, with respect to a stay of an act against the debtor's property, if the debtor does not have equity in the property and the property is not necessary to the reorganization. 11 U.S.C. § 362(d) (1988). If relief from the stay is granted, holders of claims against the debtor may pursue their rights in the bankruptcy proceeding or in a separate proceeding.

251. Post-petition interest on unsecured debt is paid under a Chapter 7 liquidation after all other claims are paid. 11 U.S.C. § 726(a) (1988). In a Chapter 11 case, post-petition interest is not payable where the debtor is insolvent. *Id.* § 1129(b).

252. Secured creditors are paid accumulation of interest after the petition is filed only where the value of their collateral exceeds the value of their claim. 11 U.S.C. § 506(b) (1988).

253. 11 U.S.C. § 364(a) (1988).

254. *Id.* Secured or super-priority credit may be authorized, upon a debtor's request, after notice and hearing. If the court authorizes such borrowing, the creditor extending the loan receives either a super-priority over administrative expenses or a security interest in the debtor's assets. *Id.* § 364(c). A super-priority position will be granted to the debtor only if unsecured credit is not available or is insufficient to meet business needs and the interests of prior secured creditors are not adversely affected. *Id.*

only after notice and a bankruptcy court hearing.[255] Since most post-petition credit obtains priority over pre-petition claims, pre-existing unsecured creditors are considered parties in interest entitled to notice of a debtor's intent to secure super-priority credit.[256]

Consider the position of a pre-petition bondholder of A corporation, which pursues a Chapter 11 reorganization. Once a Chapter 11 petition is filed, secured creditors are unable to levy upon the company's assets. Further, the A/S corporation receives, by virtue of the automatic stay of section 362, the right to temporarily suspend obligations to service debt, to pay pre-petition claims, and to remit interest accumulations on unsecured debt. With the stay in effect, A/S management will attempt to negotiate with major creditors and members of creditors' committees for a plan of reorganization. If the proposed plan is confirmed, consent by a majority of creditors will bind all others so long as all creditors receive at least as much as they would have received in a Chapter 7 liquidation.

One risk to A's bondholders in a Chapter 11 proceeding is that firm management may be removed and replaced by a trustee.[257] In addition to possible removal of management, reorganization in bankruptcy imposes the scrutiny of the bankruptcy court and creditors' committees upon the firm's daily operation. Any negative effect of outside intervention is lessened, however, by the creation in bankruptcy of a fiduciary relationship between the debtor-in-possession and its creditors; that is, the petition creates an estate consisting of all assets of the company for the benefit of its creditors. To a large extent, therefore, bankruptcy establishes an obligation by representatives of the debtor's estate to maximize returns to all claimants. One result of this fiduciary duty is that the estate may be required to pursue lawsuits against former managers (who may hold equity positions in the LBO company), former shareholders (who cashed out of an arguably insolvent corporation), and buyout lenders (who provided the critical acquisition leverage which ultimately caused the insolvency of the firm).[258] If bankruptcy management is under a fiduciary commitment to charge these participants to the buyout, confirmation of the plan of reorganization may be jeopardized.

Notwithstanding these risks of Chapter 11 filings, A's bondholders

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255. 11 U.S.C. § 364 (1988).

256. 11 U.S.C. § 1104(a) (1988).

257. To the extent that management or former shareholders held secured or unsecured debt claims, those claims may be subordinated under equitable principles to claims of other creditors. *See* Pepper v. Litton, 308 U.S. 295, 306 (1939) (Bankruptcy court is empowered to subordinate claims of insiders who hold judgment liens in an insolvent company; the dealings of directors and dominant shareholders "are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation are challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness . . . .").

258. In a recent development in the Chapter 11 reorganization of Campeau, a committee representing bondholders of Allied Stores Corp. asked a bankruptcy judge in Ohio for permission to sue Allied's owners and banks, alleging they fraudulently conveyed money out of the company to buy worthless stock or to pay off bank debt. NEWS J., D6, col. 1, Sept. 28, 1990.

face the additional uncertainty of the priority they obtain as pre-existing unsecured creditors. Arguably these claimants should be considered *pari passu* with trade suppliers since these persons provided legitimate working capital at a critical juncture in the debtor's life cycle. Moreover, like trade creditors, the unsecured bondholders did not intentionally embark on a risky investment relationship with the issuing corporation. Indeed, all evidence indicates that trade creditors and unsecured bondholders sought investment of capital, services, or goods in return for guaranteed repayment plus interest or profits. Junk bondholders, on the other hand, purchased high risk debt securities in an over-leveraged company with the intent of obtaining interest returns in excess of investment grade debt. The economic motivation for the latter bondholders, although representing a claim for unsecured debt of the bankrupt firm, is altogether different from that of pre-merger bondholders. Consequently, an argument is presented that trade suppliers and "legitimate" unsecured bondholders should gain priority in bankruptcy over subsequent owners of high risk, high yield debt.

This argument is further supported by the fact that junk bond owners increasingly receive an equity position in the reorganized company as a substitute for their unsecured debt claims. The reversal of debt for an equity position in the LBO firm is dictated, in large part, by the enormous volume of junk bond debt. In light of the magnitude of mezzanine financing, junk bond owners do not, in most circumstances, have the cash payment option. The resulting phenomenon of substituting equity for non-investment grade debt has led some commentators to characterize bond financing of highly distressed companies as "equity with a bow-tie."[259] As a consequence, if junk bonds are actually stocks in disguise, these debt securities should be paid in bankruptcy like other equity interests: at the base of the priority scheme.

Debt-equity issues arguably also arise in bankruptcy where a pre-existing bondholder initially seeks relief in a state corporate breach of fiduciary duty action due to the hybrid nature of current corporate bonds. In this circumstance, if the bondholder is successful in imposing a corporate fiduciary duty and its attendant remedies under state corporate law, the same bondholder must take that "equity" characterization into a bankruptcy proceeding if the target firm is forced to restructure or liquidate in Chapter 11. As a result, it appears that A's bondholders are prejudiced in a bankruptcy forum if the debt owners attempt to forestall the over-leveraging of the firm by first seeking an injunction against the leveraged acquisition in a state corporate court. Likewise, if bankruptcy follows, prior corporate debt owners may be forced to share in priorities with holders of junk securities.

In addition to these risks, A's bondholders must await the delays inherent in bankruptcy proceedings before any compensation is forthcoming. During this period, holders of claims against the debtor may

259. *Are Junk Bonds Really Stocks in Disguise?*, WALL ST. J., C1, col. 4, June 4, 1990.

assign their interests to other parties pursuant to Bankruptcy Rule 3001(e).[260] While this process allows creditors to liquidate their claims rather than await a bankruptcy determination, A's bondholders are penalized once again by the ability of indenture trustees and members of creditors' committees to trade their interests on the basis of information garnered in their capacity as LBO participants. As previously noted, claims assigned by these insiders are apparently outside the power of bankruptcy and federal securities courts to regulate. Unless A's bondholders are considered *pari passu* with trade creditors, these unsecured bondholders are substantially handicapped in the event of a Chapter 11 proceeding.

E. *Remedies Under Fraudulent Conveyance Statutes*

Increasingly, the best alternative for pre-merger bondholders is to seek avoidance of pre- and post-LBO conveyances which resulted in the insolvency of the LBO firm. Avoidance of these transactions or security interests creates a larger asset pool from which unsecured bond claims may be paid. The obvious targets of fraudulent conveyance actions are former shareholders, professional advisors, secured lenders, and new subordinated creditors. Actions based upon fraudulent transfers are not, however, without difficulty.

Consider again the plight of A's bondholders. To maintain a fraudulent conveyance suit, A's bondholders allege "constructive" fraud by buyout participants.[261] Under this approach, transfers of property or commitments incurred by the debtor are considered constructively fraudulent if the debtor does not receive "fair consideration" or "reasonably equivalent value" and the debtor is "insolvent" or rendered insolvent by the transfer or is engaged in business and as a result of the conveyance has "unreasonably small capital" to continue in business.

Initially it appears that A's bondholders cannot satisfy the "fair consideration" or "reasonably equivalent value" test for fraudulent transfers. For example, in the buyout of A, A's assets were indirectly encumbered to secure loan proceeds which were paid to A's former shareholders rather than to the target firm itself. The third-party nature of the leveraged acquisition may thus prevent the LBO from satisfying the "adequacy of consideration" standard necessary for the debtor. The difficulty of successfully avoiding LBO conveyances under these circumstances is that the acquisition funds were transferred directly to S, a shell corporation, and not the target firm. Under this scenario, S pledged the A stock which was purchased with the loan proceeds as security for the funding. Structuring the buyout in this manner may, therefore, avoid a fraudulent conveyance claim.

As a practical matter, however, third-party financing is detrimental to the lender who, as a result, has no direct action against target assets.

260. FED. R. BANKR. P. 3001(e) (1988).

261. Due to the difficulty of proving "intentional" fraud, most claimants will attack leveraged transactions on the basis of constructive fraud.

If, therefore, the acquisition under attack is a leveraged recapitalization by A's management which was financed by funding provided directly to A corporation, A's bondholders may maintain a fraudulent conveyance claim. On the other hand, pursuit of an LBO by a third-party via a shell corporation prevents avoidance claims by pre-merger bondholders and insulates the acquiror (and other parties acting in concert with the acquiror) from liability. This result occurs because of the independent existence of S corporation as the acquiring entity.

As a consequence, it seems that A's bondholders are faced with a paucity of remedies against LBOs initiated by outsiders. One response to this dilemma by bondholders is that courts can "collapse" the various stages of an LBO into a single transaction wherein an acquiror leveraged target assets to secure buyout funds which passed to former shareholders rather than the target corporation. The flaw to this approach is that the acquiror and its lenders are not direct creditors of the target firm; their interests are tantamount to a claim by an existing shareholder. Nevertheless, courts have invoked their powers of equity to break down the discernible steps to a leveraged tender offer notwithstanding the use of a direct loan structure.

In the landmark decision of *United States v. Gleneagles Investment Co.*[262] the court ruled that mortgages executed in favor of an LBO lender were fraudulent conveyances voidable under the Pennsylvania Uniform Fraudulent Conveyance Act.[263] In *Gleneagles*, the LBO lender (the transferee) structured the loan arrangement as a two-part process. The loan proceeds first passed directly to the transferor (the LBO company). The proceeds were then immediately turned over to a holding company which used the funds to complete the LBO. In applying the "fair consideration" element of Pennsylvania's UFCA, the court "collapsed" the two separate loans into one transaction in order to find that the transferor did not receive the benefits of the loan.[264] Instead, the court said that the transferor functioned as a mere conduit through which the funds passed to the selling shareholders.[265] As a result of "collapsing" the dual steps to the buyout, the court found the secured LBO lender liable for constructive fraud.[266]

The second obstacle to fraudulent transfer claims is the difficulty in determining if and when insolvency of a target firm occurs. For instance, assume that evidence of constructive fraud scienter is found. Participants to the LBO may escape avoidance of transfers or obligations incurred by the debtor by conducting pre-lending reviews of the

262. 565 F. Supp. 556 (M.D. Pa. 1983), *modified*, United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987) [hereinafter *Gleneagles*].

263. *Id.* at 573-83.

264. *Id.*

265. *Id.* at 575.

266. Although *Gleneagles* is often cited for its broad application of state fraudulent conveyance statutes to LBO transactions, the court also found the LBO lender liable for intentional fraud. 565 F. Supp. 556, 586.

financial status of the target firm or the acquiror (if a "collapse" theory is being used).[267] If the product of that review is a good faith belief concerning the firm's sound financial position, fraudulent conveyance liability may be precluded. If, on the other hand, undercapitalization or insolvency of the firm should have been discovered, fraudulent transfer avoidance likely will attach.

Where courts "collapse" LBO transactions and resulting insolvency is proven, pre-existing bondholders may seek to avoid cash payments to former shareholders. Stockholders to LBOs are prime targets for avoidance claims since selling shareholders, arguably, never convey value to the debtor firm upon the sale of their stock. Likewise, LBO lenders are susceptible to fraudulent transfer claims under these circumstances because loan proceeds pass to selling stockholders rather than the subject corporation. Stockholders and LBO creditors may attack this theory where the buyout is effected by a third-party acquiror to whom the buyout proceeds are directly transferred. If a court "collapses" the leveraged transaction, prior secured lenders, former creditors, and new subordinated lenders may find their claims avoided or otherwise subordinated to existing unsecured claims.[268]

In light of these theories, fraudulent conveyance statutes under state law provide the most optimistic course of recovery for pre-merger bondholders. In addition, if bondholders seek relief from fraudulent transfers under section 548 of the Bankruptcy Code,[269] two additional factors must be considered: (1) that bankruptcy creates a fiduciary relationship between the debtor-in-possession or trustee with the firm's creditors, not simply those who suffer the greatest harm, and (2) section 548 sets forth a one year statute of limitations for avoiding fraudulent transfers and obligations in a bankruptcy proceeding.[270] Section 544(b) of the Bankruptcy Code[271] allows unsecured creditors to extend the section 548 one-year limitations period by initiating claims of fraudulent transfers under other "applicable law," in particular, state fraudulent conveyance statutes. Due in part to the concept of bond aging and the delayed impact of failed or failing LBOs, section 544(b), as applied to

267. *Id.*

268. Section 510(c) of the Bankruptcy Code provides for the equitable subordination of claims pursuant to the bankruptcy court's general powers of equity to alter creditor claim priority in order to rectify a perceived injustice to one or more claimants. 11 U.S.C. § 510(c) (1988). Equitable subordination is applied only in those circumstances where one claimant participated in unfair conduct which resulted in detriment to other creditors. Claimants most often subject to charges of subordination are corporate insiders. The leading case on equitable subordination is Pepper v. Litton, 308 U.S. 295 (1939), in which the Supreme Court upheld the subordination of a claim by a director/sole stockholder in favor of outsider creditor claims. *See also* Estes v. N & D Properties, Inc., 799 F.2d 726, 733 (11th Cir. 1986) (secured interest of insider subordinated to the extent of harm caused to other creditors). *See generally*, Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83 (1961).

269. 11 U.S.C. § 548 (1988).

270. *Id.* Section 548 in particular provides that the trustee may avoid transfers of interests in the debtor that were incurred on, or within one year before, the date of the filing of the bankruptcy petition.

271. *Id.* § 544(b).

state uniform acts, may provide the most fruitful source of recovery for unsecured corporate bondholders.

VII. Conclusion

Unsecured corporate bondholders in the 1990s face an ultimate "prisoner's dilemma" as a result of failed or failing LBOs. The dilemma focuses upon the ineffectiveness of legal remedies and rights for public debt owners in connection with the de-leveraging phenomenon of major U.S. corporations. Currently, unsecured corporate bondholders must decide whether to pursue impairment of investment claims against LBO management or acquirors in state corporate or federal securities actions. They must also decide whether to pursue these actions on the grounds of breach of fiduciary duties or duties of disclosure, or to accept partial payment in cash or equity securities of the insolvent corporation in out-of-court workouts or bankruptcy reorganizations or liquidations. Pursuit of state and federal remedies alleging breach of duties by directors or acquirors have been all but universally rejected due to a lack of standing by bondholders/creditors. State corporate courts are particularly reluctant to intervene on behalf of debt investors, apparently in recognition of the irresolvable conflict between the economic interests of equity and debt investors.

An expanding avenue of relief is the state corporate action which seeks recovery for consent solicitations undertaken by LBO management to retire, replace, or amend outstanding debt securities in connection with firm restructurings. These state contract claims attack "coerced" modifications to indenture covenants, especially where fees, increases in interest rates, or rights to put the securities to the issuer or acquiror are offered as inducements to those bondholders who consent to indenture amendments. Consent solicitation actions provide an unchartered avenue for creative counsel if requirements of good faith and fair dealing in contract enforcement are considered co-extensive with fiduciary duties owed to stockholders. It is suggested, however, that state contract claims needlessly obfuscate the efficient and predictable precept of corporate law that directors owe fiduciary obligations to stockholders and not bondholders.

If bond owners await payment by the debtor during an LBO restructuring, their choices include receipt of equity in the newly-organized entity (which bears the risk of a failed reorganization) or a partial cash payment. If bondholders holdout for a non-reduced claim, LBO management likely will pursue liquidation in Chapters 7 or 11. In the event of a forced disposal of firm assets, unsecured bondholders will receive less than the face value of their bonds and may be compelled to compete with thousands of other unsecured claimants for whatever cash is available to pay claims upon liquidation of the debtor. A possible equitable argument for bondholders confronting this bankruptcy alternative is to seek compensation as trade creditors and, therefore, recover ahead of junk bond owners.

An increasing possibility of recovery for unsecured bondholders is to set aside claims of former shareholders, LBO participants, senior lenders, or LBO management pursuant to state and federal fraudulent conveyance statutes. Due to the third-party nature of most LBOs, however, relief may be dependent upon a court's application of equitable principles which "collapse" the discernible steps to LBOs. In light of the auction process for corporate control which has resulted from the de-leveraging process, as well as the insiders who are effecting the unsupervised transfer of control, courts should exercise the full complement of their equitable powers to avoid fraudulent claims by insiders and LBO participants where detriment is visited upon pre-existing creditors. If courts are unwilling to interpret fraudulent transfer statutes in this manner, the only remaining alternative for unsecured bondholders is to await an unregulated market correction of the harms currently confronting legitimate unsecured lenders.