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

ANN E. CONAWAY STILSON*

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	ESTIMATED DEFAULT RISK*		RECENT PRICE	CHANGE
	in billions	2 yrs.	5 yrs.	percent of face value	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 C1, 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,

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[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-

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
				Equity	
			Capital	$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

(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 pre-merger 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-

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]

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]

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-

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. Premerger corporate bonds are trading at sixty percent of their face value. S's management enters negotiations for the purchase and sale of noncrucial 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 premerger 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 com-

pensation 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

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)

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

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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

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 bowtie."[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 uncharted 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.

SHAKESPEARE COMES TO THE LAW SCHOOL CLASSROOM

NANCY COOK*

INTRODUCTION

This is a paper about legal pedagogy. Although content and methodology are often difficult to separate, what I have to say has more to do with process than with substance. It is not complicated, but it is intended to be provocative as well as illustrative. The basic premise is that virtually any subject area can provide fertile ground for teaching the skills, principles, and theories of responsible law practice from which law teachers have to choose in designing their courses. The subject of Shakespeare, for both practical and philosophical reasons, serves here as the example by which this premise is demonstrated.

In putting this piece together, I was guided by two underlying principles. Neither is revolutionary, but together they help explain the conclusions I have drawn and the decisions I make about teaching. The first principle has to do with metaphors and the interrelationships between ideas. Law can be seen as a metaphor for life, and life, I suppose, can be seen as a metaphor for the practice of law.[1] Anything, in fact, can be seen as a metaphor for anything else. Any process can be analogized to any other, and in the final analysis, all things are related to all others. It is simply a matter of seeing the connections. Thus I can say to my students, a good brief is like an award-winning Japanese garden; it must be planned and laid out with excruciating care to insure that the results achieved appear to be the inevitable and untampered-with design of nature. Or, I might postulate, the attorney at the negotiating table is a Babel fish;[2] the attorney's job is to decode both the client's and the

* The author owes thanks to Susan, Bob, Ann, Nancy, and Elliott, who not only tolerate their colleagues' experiments in education, but encourage them; to Mary, Heather, Lori and Michael for all their hard work; and of course to Peter and Jamie, whose brilliant scholarship and stellar courtroom performances were the inspiration.

1. The same idea has been expressed by James De Young, speaking on the subject of experiential learning in the field of theatre arts:

> Since the main goal in theatre practicums is cooperative achievement of the best production possible and since every step along the way in a production involves a new problem or new decision, it would appear that we have in place an ideal model for life training as well as artistic training.

J. De Young, The Practicum Experience, Relic of the Sixties or Hope of the Eighties 3 (1985) (paper prepared for U.S. Department of Education, National Institute of Education, Educational Resources Information Center).

2. "The Babel fish," said the *Hitchhiker's Guide to the Galaxy* quietly,

> is small, yellow and leechlike, and probably the oddest thing in the Universe. It feeds on brainwave energy received not from its own carrier but from those around it. It absorbs all unconscious mental frequencies from this brainwave energy to nourish itself with. It then excretes into the mind of its carrier a telepathic matrix formed by combining the conscious thought frequencies with nerve signals picked up from the speech centers of the brain which has supplied them. The

adversary's language and communicate the thoughts of each to the other. Such analogies, discussed and developed in the classroom, help bridge the perceived chasm between the world of lay experiences and the world of law practice. Students are thus able to learn something about lawyering.

It is no doubt true that not all things are easily related to the practice of law, nor are all analogies equally appropriate. I would not, for example, necessarily teach Japanese gardening as a prelude to teaching about brief writing. Then again, I would not rule out the possibility either. The point is, I *could* use Japanese gardening theory to teach about brief writing, and do it successfully. Sufficient similarities exist in the two activities to make an extended metaphor or analogy workable in the classroom. This is true of a great many processes.

The second point I'd like to make is that we do best what we love. When Bill Moyers asked Joseph Campbell during one of their interviews on the critically-acclaimed *Joseph Campbell and the Power of Myth* (interviews reprinted in J. CAMPBELL, THE POWER OF MYTH (1988)), what advice he would give to one attempting to find meaning in this mythless and ritualless time, Campbell replied, "follow your bliss." Law, teaching, the teaching of law, and the practice of law may be blissful activities in and of themselves, but most of us have broader interests. We like to scale mountains or bake, steep ourselves in political debates or bury ourselves in classical languages. These interests are important to us and there is no reason why we have to leave our interests or those interesting parts of ourselves outside the classroom door. The metaphorical method is one way of making the things we love best an integral part of our teaching.

One thing that makes it possible for law teachers to bring outside interests into the classroom is the fact that the range of things that practicing lawyers need to know and understand is so vast as to be almost overwhelming. We have the luxury—or the impossible task—of picking and choosing among any number of important subject areas and ways of teaching. This gives us broad latitude in discovering ways to fit into the curriculum matters of interest to ourselves without straining to find ways in which these interests are relevant to lawyering.

This is not, however, a call to omit a class on cross-examination in favor of a class on bird watching. Nor do I mean to suggest that law teachers should abandon basic instruction in essential areas. I simply point out that what is "essential" consists of a great many things, and that the number of ways of prioritizing what should be taught and how is infinite. It is possible—perhaps even essential—to incorporate what we

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practical upshot of all this is that if you stick a Babel fish in your ear you can instantly understand anything said to you in any form of language. The speech patterns you actually hear decode the brainwave matrix which has been fed into your mind by your Babel fish.

D. ADAMS, THE HITCHHIKER'S GUIDE TO THE GALAXY 59 (1979). I am indebted to my friends George LaRoche and Edith Blackwell for introducing me to the Babel fish.

teachers, as human beings, have learned and loved outside the classroom into our course syllabi.

There is also, I believe, a sound pedagogical basis for doing this. Imagine a lawyer sitting back after dinner doing the *New York Times* crossword puzzle. She is suddenly struck by the idea that the stories told by plaintiff's and defendant's witnesses in court that day, cross and fit together in the same way as the downs and acrosses of the *Times*' puzzle. That lawyer has the beginnings of a closing argument. Such is the way arguments and theories of a case are born. The ability to idly reflect on processes and things and to make associations with other processes and things is itself a skill, a skill that can be learned through observation and practice. When law teachers practice that skill in the classroom, it enhances, rather than sacrifices, pedagogical objectives.[3]

To demonstrate how these ideas can be put into practice, I have selected two sample classes from an appellate advocacy seminar in which the main theme is the writings of Shakespeare. The classes were inspired by a debate over the question of the true authorship of Shakespeare's works. The format of the debate—an argument before an appellate court—made it easy to see the connections that might be drawn between Shakespearian scholarship and lawyering, and provided some familiar means by which the classes could be taught.

Part I of this Article provides basic historical background to the subject of legal pedagogy, and particularly to the rise of the clinical method. Part II identifies the existing problems law teachers face in deciding on course content for skills-related courses and describes a few of the choices others have made or advocated. Part III discusses my personal approach to course design. Part IV examines the multiple ways in which the subject of Shakespeare *could* be used to accomplish the objectives. The ultimate choices made and justifications for these objectives are detailed in Part V.

I. HISTORICAL BACKGROUND

In the late 19th century, when the scientific method was enjoying its heyday, Christopher Columbus Langdell introduced into the law school curriculum a pedagogical theory which he believed applied principles of scientific analysis to legal thought.[4] The legal system envisioned by Langdell was one in which the ultimate discovery of a "few fundamental principles" would inevitably lead to a legal practice governed by these fundamentals. Legal judgments would be made by applying the few legal principles written into the common law to facts, and legal judgments accordingly would be dictated by "rationally compelling reason."[5] Despite the continuing efforts of legal theorists who have

3. It makes the learning process less painful for the students. "When we our betters see bearing our woes,/ we scarcely think our miseries our foes." W. SHAKESPEARE, *King Lear*, act 3, sc. 6, lines 102-103.

4. Grey, *Langdell's Orthodoxy*, 45 U. PITT. L. REV. 1 (1983).

5. *Id.* at 8.

pointed out the many flaws in Langdell's orthodoxy,[6] Langdell's theories retain much of their vitality in today's law schools. The notion that decisions are made by judges pursuant to some rational ordering of known constructs still predominates, and the belief that such a process of analysis can best be understood by examining the cases in which it is done is still operative through the case book method of teaching law.[7]

Even as the law schools clung (and continue to cling) to the scientific method as adapted by Langdell, the legal profession has continuously registered its complaints about the inability of new lawyers to handle real cases as well as about the failures of the legal education system to prepare students to practice law.[8] Recent years have seen a vast increase in the number of skills training programs for lawyers.[9] This trend must be attributed in part to the profession's concern that lawyers are not acquiring training in law school which is adequate to meet professional practice norms.[10]

Although legal education has been slow to respond to the needs of the profession, some development along these lines has taken place during the last twenty years. Perhaps the most significant development has been in the area of clinical legal education.[11] Without engaging in, and certainly without resolving, any debates about what the definition of

6. This includes the futility of achieving anything like the formalistic utopia he predicted in a system governed by humans preferring to apply their own subjective rules rather than the ostensibly objective ones of Langdell's ideal world. *See, e.g.*, Bok, *A Flawed System of Law Practice and Training*, 33 J. Legal Educ. 570 (1983); Cramton, *Lawyer Competence and the Law Schools*, 4 U. Ark. Little Rock L.J. 1 (1981); Frank, *Why Not a Clinical Lawyer-School?* 81 U. Pa. L. Rev. 907 (1933); Gee & Jackson, *Bridging the Gap: Legal Education and Lawyer Competency*, 4 B.Y.U. L. Rev. 695 (1977); Kennedy, *Legal Education and the Reproduction of Hierarchy*, 32 J. Legal Educ. 591 (1982); N. Redlich, THE COMMON LAW AND THE CASE METHOD IN AMERICAN UNIVERSITY LAW SCHOOLS (1914).

7. GREY, *supra* note 4, at 50.

8. *See e.g.*, Burger, *Isn't There a Better Way?* 68 A.B.A. J. 274 (1982); Devitt & Roland, *Why Don't Law Schools Teach Law Students How to Try Lawsuits?* 13 WM. MITCHELL L. REV. 445 (1987). Macauley, *Law Schools and the World Outside Their Doors II: Some Notes on Two Recent Studies of the Chicago Bar*, 32 J. LEGAL EDUC. 506 (1982); Martineau, *Appellate Litigation Skills Training: The Role of the Law Schools*, 54 CINN. L. REV. 129 (1985); McEachern, *The Trial Process*, 40 THE ADVOCATE 217 (1982).

9. In addition to the training opportunities offered by private firms, state and local bar associations and such organizations as the National Institute for Trial Advocacy, lawyers in some states are now required to participate in some form of practice-oriented continuing legal education. *See, e.g.*, IOWA CODE ANN. §§ 602, app. A (Supp. 1991); OKLA. STAT. ANN. tit. 5, ch. 1, app. 1-B (Supp. 1991); S.D. COD. LAWS §§ 16-8-2 (1987).

10. The American Bar Association's standards on accreditation of law schools have thus far not been interpreted to require law schools to make lawyering skills courses mandatory for their students. *See Standards for Approval of Law Schools*, Standard 302 (1987). Despite increasing pressure from bench and bar, such courses are still offered primarily as electives; indeed, practical skills courses constitute a small percentage of the total number of courses offered at most law schools. *See* Devitt & Roland, *supra* note 8, at 459. Devitt and Roland point out that studies commissioned by federal judges and by the ABA have identified significant advocacy deficiencies, which they attribute in part to the interpretation of Standard 302. *Supra* note 8 at 445, 459.

11. This development is tracked in Meltsner & Shrag, *Report from a CLEPR Colony*, 76 COLUM. L. REV. 581 (1976). *See also* Grossman, *Clinical Legal Education: History and Diagnosis*, 26 J. LEGAL EDUC. 162 (1974); Meltsner & Shrag, *Scenes from a Clinic*, 127 U. PA. L. REV. 1 (1978).

"clinical legal education" is[12] or what the purposes of clinical education are,[13] I think it is safe to say that clinical education is, in part, a response to the perceived failures of the educational system. Clinical teachers are engaged in a search for ways to prepare students for the responsibilities and realities of law practice.[14]

Thus, in clinical circles, the underlying assumption of Langdell orthodoxy—that we need to teach students to *think* like lawyers-has been undermined by identification of a need for students to learn how to *act* like lawyers.[15] Dissatisfaction with the Langdell method and greater emphasis on what lawyers do has led to experimentation and development of new methods and theories.[16]

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12. One definition of clinical legal education that has been proposed is "a curriculum-based learning experience, requiring students in role . . . to take responsibility for the resolution of a potentially dynamic problem." Boon, *A Working Model for Clinical Legal Education: Testing the Definition Against a Range of Examples*, 21 L. Tchr. 172 (1987). Boon goes on to describe five categories of clinical course design: work experience; applications of new (computer) technology; observation exercises; simulation exercises; and gaming. *Id.*

13. It has been asserted that clinical legal education had a "specific political origin" in the late 1960's and was intended to promote two experiential goals: the exposure of middle class professional students to the life of the poor and the exposure of those same students to the hypocrisy of the bar. Kennedy, *The Political Significance of the Structure of the Law School Curriculum*, 14 SETON HALL L. REV. 1, 6 (1983). Another educator has argued that clinical methodology differs from the Langdellian appellate casebook method only insofar as clinical instructors collect directly experienced examples involving third parties as their core teaching materials rather than vicariously or indirectly experienced two-dimensional examples from casebooks. Barnhizer, *The Clinical Method of Legal Instruction: Its Theory and Implementation*, 30 J. LEGAL EDUC. 67 (1979). Barnhizer then suggests that a "unique" potential of clinical programs is in the area of teaching professional responsibility. *Id.* at 68.

The uncertainty about, or lack of consensus on, what the purposes of clinical education are can be gleaned further from articles describing clinical program development at various schools. *E.g.*, Haydock, *Clinical Legal Education: The History and Development of a Law Clinic*, 9 WM. MITCHELL L. REV. 101 (1984) (focusing on clinical education as a "learn-by-doing" method); Oppenheimer, *Boalt Hall's Employment Discrimination Clinic: A Model for Law School/Government Cooperation in Integrating Substance and Practice*, 7 INDUS. REL. L. REV. 245 (1985); *see also* Adams, *Tulane Students Must Undertake Pro Bono Work Before Graduation*, 10 NAT'L L.J. 4 (1988) (illustrative of the view that community service is a primary goal of student practice).

14. It is no small problem that clinical legal education, however it is defined and whatever its purposes are purported to be, is still regarded by many as peripheral to law school education. Among other things, the continued marginality of clinical education has been attributed to its associations with feminine (in the Jungian sense) concerns with people, unstructured situations and feelings. Tushnet, *Scenes from the Metropolitan Underground: A Critical Perspective on the Status of Clinical Education*, 52 GEO. WASH. L. REV. 272 (1984). Tushnet argues that clinicians have themselves contributed to this marginality by taking a defensive posture when clinical education's overall value and cost-effectiveness are brought into question rather than taking the offensive and attacking traditional legal education's methods and values. It is well beyond the scope of this article to examine the reasons for whatever continuing resistance there is to the inclusion of clinical programs in the law schools, but in defense of clinical educators, I think it should be pointed out that many are, and have been, engaged in the process of refining definitions, analyzing programs and making recommendations for development, and are not simply expending efforts justifying the existence of clinical programs. *See, e.g.*, *infra* note 34 and accompanying text.

15. *See, e.g.*, Motley, *A Foolish Consistency: The Law School Exam*, 10 NOVA L.J. 723 (1986). Motley critiques the law school examination tradition, and goes on to make recommendations for change based on experiential learning concepts.

16. *See* Amsterdam, *Clinical Legal Education - a 21st Century Perspective*, 34 J. LEGAL EDUC.

II. Curricular Needs and Options for Law Teachers

As educators have moved from the rationalistic orientation of Langdell orthodoxy to a more practice-focused orientation, considerable attention has been paid to the tasks of lawyering. In this regard, much effort has been expended on teaching students, particularly in clinical programs, how to "do" such tasks.[17] Implicit in this approach to clinical teaching are some underlying assumptions about what lawyers do. From the available literature, it may be widely assumed that what lawyers do is interview and counsel clients, negotiate, develop case theories, engage in case planning, conduct direct and cross examinations of witnesses, write pleadings and do discovery. No doubt many lawyers do engage in these activities, but they engage in many other activities as well. Even these identified tasks can be broken down further or rearranged to create different categories of tasks for teaching purposes. The fairly typical focus of clinical curricula on such skills as interviewing and negotiation is by no means necessarily dictated by the needs of the legal profession or the goals of clinical educators.[18]

Moreover, dissatisfaction with Langdellian orthodoxy has not led to wholesale agreement or immediate satisfaction with the programs created in part as alternatives. Interestingly enough, although the initial creation of skills programs may be intimately related to a growing dissatisfaction with Langdellian orthodoxy, internal program development has suffered from many of the very same problems as those which have consistently plagued the legal education profession and which contributed to the creation of clinical skills programs in the first place. This, perhaps, should come as no surprise. The more clinicians inquire into their own as well as traditionalist pedagogical assumptions, the clearer it

612 (1984); Kreiling, *Clinical Education and Lawyer Competency: The Process of Learning to Learn from Experience Through Properly Structured Clinical Supervision*, 40 Md. L. Rev. 284 (1981).

17. A quick inventory of some of the best known texts in clinical legal education demonstrates the high priority given to the "how to's" of lawyering. *See, e.g.*, A. Amsterdam, Trial Manual for the Defense of Criminal Cases (1978); G. Bellow & B. Moulton, The Lawyering Process: Materials for Clinical Instruction in Advocacy (1978); P. Bergman, Trial Advocacy (1982); D.Binder & S. Price, Legal Interviewing and Counseling: A Client Centered Approach (1977); R. Fisher & W. Ury, Getting to Yes (1981); K. Hegland, Trial and Practice Skills (1978); T. Mauet, Fundamentals of Trial Techniques (1980); J. Tanford, The Trial Process (1983).

> The underlying theory, expressed in another context, is that
>
> Play acting like child's play is a ritualized form of exploration of the world that is both enjoyable and challenging while being structured to move towards a satisfying learning conclusion. Seeing is better than hearing and doing is better than seeing. Or as an old Chinese proverb has it:
>
> I hear; I forget.
> I see; I remember.
> I do; I understand.

J. De Young, *supra* note 1, at 5.

18. *See* Hoffman, *Clinical Course Design and the Supervisory Process*, 1982 Ariz. St. L.J. 277 (1982). Indeed, clinical law teachers have recognized that the structure and focus of their courses may well be the result of historical accident or the demands of funding needs rather than the consequence of planning in response to well thought out pedagogical objectives.

becomes that the number of things that lawyers do, and therefore must learn, is mind boggling.

For example, law can be perceived of as a helping profession. Since lawyers work with people, they must talk with them, understand their needs, and work with them to solve problems.[19] This requires the ability to communicate, and communication requires an understanding of values and language and of the interplay between the two.[20] This, in turn, may require an understanding of political, socio-economic, and historical contexts.[21] To provide a client with adequate information

19. "The beginning and end of a lawyer's professional life is talking with a client about what is to be done." Shaffer, *The Practice of Law as Moral Discourse*, 55 NOTRE DAME L. REV. 231 (1979); "The skills of the successful lawyer lay in mastery of the human interaction and in subtle awareness of the emotions, concerns and anxieties of others as well as in the knowledge of how to utilize that awareness to advance the attorney's professional aims in the interaction." Goodpaster, *The Human Arts of Lawyering: Interviewing and Counseling*, 27 J. LEGAL EDUC. 5 (1975). "This is a practice,/ As full of labour as a wise man's art." W. SHAKESPEARE, *Twelfth Night*, act 3, sc. 1, lines 64-65. The way in which attorney-client discussions are to be carried out has been a subject of some interest. *See, e.g.*, D. BINDER & S. PRICE, LEGAL INTERVIEWING AND COUNSELING: A CLIENT CENTERED APPROACH (1977); M. SCHOENFIELD & B. SCHOENFIELD, LEGAL INTERVIEWING AND COUNSELING (1982); T. SHAFFER & R. REDMOUNT, LEGAL INTERVIEWING AND COUNSELING (1980); A. WATSON, THE LAWYER IN THE INTERVIEWING AND COUNSELING PROCESS (1976).

There is a considerable amount of non-legal literature dealing with the process of communication in professional or quasi-professional settings that is of use to law teachers as well. The work of Carl Rogers has been of particular interest to clinical law teachers. *E.g.*, C. ROGERS, ON BECOMING A PERSON (1961) excerpted in INTERPERSONAL DYNANMICS 287 (Bennis *et al* eds. 1968). Other articles of note in this volume include Davis, *The Cab Driver and His Fare: Facets of a Fleeting Relationship*, at 556 and Gibb, *Defensive Communication*, at 606. *See also* A. BENJAMIN, THE HELPING INTERVIEW (2d ed. 1974); BERNSTEIN & BERNSTEIN, INTERVIEWING: A GUIDE FOR HEALTH PROFESSIONAL (1976); J. CHILDRESS, WHO SHOULD DECIDE? PATERNALISM IN HEALTH CARE (1982).

20. Jerome Bruner, in his work on the importance of language to the development of what he terms the "transactional self" (a self that is both "personal" and part of a culture), addresses this idea in depth. *See, e.g.*, J.S. Bruner, Development of a Transactional Self (Apr. 29-30, 1983) (paper presented at the conference of the Erikson Institute, Chicago, Ill.) *See also* A.M. Quinton, *Contemporary British Philosophy* reprinted in WITTGENSTEIN, THE PHILOSOPHICAL INVESTIGATIONS 8-21 (G. Pitcher ed. 1966.) One attempt to deal with the problems of interpersonal communications has been made by developing an attorney-client communications model which takes into account the varied sensory-based ways in which people experience the world. Barkai, *A New Model for Legal Communications: Sensory Experience and Representational Systems*, 29 CLEV. ST. L. REV. 575 (1980). *See also* W. SHAKESPEARE, *The Tempest*, act II, scene 1 ("You cram these words into mine ears against the stomach of my sense."). Another approach is suggested by Clark Cunningham, who encourages attorneys to translate client language into jury language. For further understanding of the philosophical bases of the interplay between language and values, see Cornell, *Institutionalization of Meaning, Recollective Imagination and the Potential for Transformative Legal Interpretation*, 136 U. PA. L. REV. 1135 (1988).

21. Many would see this as a need for political action, not just as a need for recognition or understanding. "We must not make a scarecrow of the law,/ Setting it up to fear the birds of prey,/ And let it keep one shape till custom make it/ Their perch, and not their terror." W. SHAKESPEARE, *Measure For Measure*, act 2, sc. 1, lines 1-6; Freeman, *Racism, Rights and the Quest for Equality of Opportunity, A Critical Legal Essay*, 23 HARV. C. R.- C. L. L. REV. 295 (1988) (taking the view that law is ideology); Pellar, *The Metaphysics of American Law*, 73 CALIF. L. REV. 1151 (1985) (asserting that legal discourse is political or mythical). *See also* Menkel-Meadow, *Portia in a Different Voice: Speculations on a Women's Lawyering Process*, 1 BERKELEY WOMEN'S L. J. 39 (1985) (examining the impact of the increased presence of women in the legal profession on the practice of the law). The title of Menkel-Meadow's article is, of course, derived from the character Portia in W. SHAKESPEARE, *Merchant of Venice*; Folsom & Roberts, *The Warwick Story: Being Led Down the Contextual Path of the Law*, 30 J.

to make decisions, a lawyer may need to know basic psychiatry, be proficient in math, or understand the inner workings of large bureaucracies.[22]

Another view of the law focuses on the nature of the legal system. If the system is primarily perceived as an adversarial one, particular attention must be paid to its philosophical underpinnings, especially insofar as they have been adopted or institutionalized by the profession.[23] As advocates in an adversarial system, lawyers take on a certain role. An understanding of that role and its implications is necessary to competent performance in that role.[24] Adequate performance in this role may also entail competency in dramatic arts, public speaking skills, the ability to strategize and compete, and persuasive writing.

The trend toward specialization in law practice suggests another approach to teaching. To the extent that students enter law school or the profession with the expectation of practicing in a particularized area, there is a tendency to gravitate toward courses and clinics which relate

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LEGAL EDUC. 166 (1979). These contexts affect the lawyer as much as the law and legal problems. *See* J. KATZ, POOR PEOPLE'S LAWYERS IN TRANSITION (1982); A. SCHEINGOLD, THE POLITICS OF RIGHTS: LAWYERS, PUBLIC POLICY AND POLITICAL CHANGE (1974). *See generally* C. GEERTZ, THE INTERPRETATION OF CULTURES: SELECTED ESSAYS (1973).

22. This need has been identified by supporters of the Langdellian scientific orthodoxy. R. Clark, *The Return of Langdell*, 8 HARV. J. L. & PUB. POL'Y 299 (1985). Clark asserts that first year students require some grounding in statistics, model building and cognitive psychology to enable them as lawyers to ferret out errors in legal reasoning. *Id.* at 307. *See also* T. C. SCHELLING, STRATEGY OF CONFLICT (1960) (mathematical principles applied to negotiation); Llewellyn, *The Modern Approach to Counseling and Advocacy - Especially in Commercial Transactions*, 46 COLUM. L. REV. 167 (1946) (identifying a need to understand "operational" systems); Monahan & Walker, *Teaching Social Science in Law: An Alternative to "Law and Society,"* 35 J. LEGAL EDUC. 478 (1985).

There is no lack of material intended to acquaint lawyers with the basic precepts of other disciplines relevant to law practice. *E.g.* W. CURTIS, MICROECONOMIC CONCEPTS FOR ATTORNEYS: A REFERENCE GUIDE (1984); D. HERWITZ, MATERIALS ON ACCOUNTING FOR LAWYERS (1980); M. HOOTS, LAWYERS GUIDE TO MEDICAL PROOF (1966); A. MOENSSES, F. INBAU & J. STARRS, SCIENTIFIC EVIDENCE IN CRIMINAL CASES (3rd ed. 1986); J. RUBIN, ECONOMICS, MENTAL HEALTH AND THE LAW (1978); T. SANNITO & P. MCGOVERN, COURTROOM PSYCHOLOGY FOR TRIAL LAWYERS (1985); A. WATSON, PSYCHIATRY FOR LAWYERS (1978).

23. The norms of the profession are perhaps best gleaned from the ABA Standards relating to professional conduct: "Toward the client the lawyer is a counselor and an advocate; toward the prosecutor the lawyer is a professional adversary; toward the court the lawyer is both advocate for the client and counselor to the court." ABA STANDARDS FOR CRIMINAL JUSTICE 4-8 (1980). Because "[a]dvocacy is not for the timid, the meek, or the retiring," and because "[o]ur system of justice is inherently contentious . . . it demands that the lawyer be inclined toward vigorous advocacy." *Id.* Voices have been raised against too-strict adherence to these principles. *See, e.g.*, Simon, *The Ideology of Advocacy: Procedural Justice and Professional Ethics*, 1 WIS. L. REV. 30 (1978)(discussing the implications of widespread unquestioning acceptance of certain professional norms, including the belief in the legitimacy of the system). *See also* Wasserstrom, *Lawyers as Professionals: Some Moral Issues*, 5 HUM. RTS. 1 (1975) (raising questions about whether "it is a good thing for lawyers to be so professional—for them to embrace so completely this role-differentiated way of approaching matters"). *Id.* at 8.

24. There are many writings from the lawyer's perspective on their professional role and its implications. A number of them have been collected in DVORKIN, HIMMELSTEIN & LESNICK, BECOMING A LAWYER (1981), and can be also found in BELLOW & MOULTON, THE LAWYERING PROCESS (1978). Some interesting implications of role assumption are also addressed in Weinstein, *The Integration of Intellect and Feeling in the Study of Law*, 32 J. LEGAL EDUC. 87, 89-93 (1982); and Elkins, *The Legal Persona: An Essay on the Professional Mask*, 64 VA. L. REV. 735 (1978).

to those particular substantive interests. In-depth knowledge of substantive areas of law is considered both desirable and necessary by many law teachers as well as students. Because clinics in most instances serve a disempowered minority or class, there may be an increased danger that clients will be exploited in the name of education and will be disserved by student representatives lacking basic understanding of the law in the field in which they are operating. Thus intense inculcation in substantive law is considered a necessary prerequisite to the rendering of services by students.

Process as well as substantive law can be viewed as essential content to clinical law courses. Whereas traditional law courses stress analytical thinking and demonstrable inferential logic as necessary components to the process of "thinking like a lawyer," clinical courses may concentrate more on creative problem solving and intuition as critical to legal thought processes.[25] In addition, process as content can take the form of deliberate observation, reflection, and self-analysis.[26] This suggests a process-oriented and experientially-based approach to teaching, or perhaps more accurately, to developing ethical standards.[27]

The acme of the process orientation may be the theory that the real

25. "Clinical legal education, while attending to cognitive changes, has emphasized learning in the affective and active dimensions." Harbaugh, *Simulation and Gaming: A Teaching/Learning Strategy for Clinical Legal Education*, REPORT OF THE ASSOCIATION OF AMERICAN LAW SCHOOLS-A.B.A. COMMITTEE ON GUIDELINES FOR CLINICAL LEGAL EDUCATION 191, 198 (1980). It may be that the exposure to the real world of practice is what leads to this approach to developing thought processes. As Emily Calhoun notes, "The genius of a trial lawyer lies in knowing when to appeal to logic and when to appeal to values or unprovable intuition." Calhoun, *Thinking Like a Lawyer*, 34 J. LEGAL EDUC. 507, 512 (1984). Good litigators, in other words, can sometimes ". . . see that most noble and most sovereign reason,/ Like sweet bells jangled, out of tune and harsh." W. SHAKESPEARE, *Hamlet* act 3, sc. 1, lines 157-158.

26. *See* SCHON, THE REFLECTIVE PRACTIONER (1988) for a full development of this notion. Of a student successfully taught by such a method, it might be said: "He is a great observer, and he looks/ Quite through the deeds of men." W. SHAKESPEARE, *Julius Caesar* act 1, sc. 2, lines 202-203. Clinical law teachers normally incorporate constructive critique methods, including self-critique methods, into their supervisory sessions and thus tend to be conscious of the process. Motley, *supra* note 15, at 749-50. In doing so, they certainly can emphasize the same analytical skills that are central to Langdell's orthodoxy, especially in the classroom. Some, perhaps many, clinical teachers are prone to utilize teaching methodologies such as the Socratic method generally associated with more traditional law courses. There is a belief that the clinical methodology merely adds a new dimension to or is only marginally different from more conventional methodologies, Bloch, *The Andragogical Basis of Clinical Legal Education*, 35 VAND. L. REV. 321 (1982); Barnhizer, *supra* note 13, and that it is in danger of becoming even more like the system from which it rebelled. Kennedy, *supra*, note 13, at 7. *See also* Tushnet, *supra* note 14 (suggesting that the leanings toward acceptance or integration of traditional methods should be resisted).

27. Thus, it has been advocated that professional conduct in the mental health provider field be taught, tested and modified through "active experimentation and concrete experience," even if the risk is that, by working through the decision making process themselves, students will reject professional codes of conduct. Pelsma & Borgers, *Experience-Based Ethics: A Developmental Model of Learning Ethical Reasoning*, 64 J. COUNSELING & DEV. 311, 313 (1986). Although the teaching of ethics has long been a concern of clinical law teachers, *see* COUNCIL ON LEGAL EDUCATION FOR PROFESSIONAL RESPONSIBILITY, THIRD BIENIAL REPORT, 1973-1974 (1974), there has been some resistance to entrusting this task to clinical education. *See* Burger, *The Role of the Law School in the Teaching of Legal Ethics and Professional Responsibility*, 29 CLEV. ST. L. REV. 377, 392-93 (1980).

goal of the educational system, or at least that part designated as "clinical," ought to be one of empowering students to teach themselves. The thrust of most self-directed learning proposals is that teachers should facilitate a process by which students are ultimately transformed into their teachers' equals.[28] Among the advantages cited for adopting a self-directed learning approach are: (1) such learning coincides with normal psychological development toward a more independent and mature self,[29] and (2) learners can be expected to continue to assimilate ever-increasing amounts of needed new knowledge over time.[30]

Regardless of what substantive approach to legal education is favored, law teachers cannot teach everything.[31] The choices with respect to content are difficult and frustrating. If students are plied with substantive law, how will they learn what to do with it? If they are not, do the clients suffer? Is it reasonable to expect that students will grapple with professional responsibility issues in their ethics classes and will have been provided adequate foundations in research and writing skills in their first year legal methods classes? Are clinical law teachers qualified to teach about matters having psychological components?

Even the goal of teaching students to teach themselves, however valid, is rife with complications. For one thing, students raised in educational environments notable for using external reinforcements such as grades as learning incentives may resist or have difficulty adjusting to the demands of self-education. The learning quotient in such situations may decrease in the short term.[32] This has obvious implications for clinical programs in which clients are dependent on the students' ability to assimilate a significant amount of information quickly and which, because of their intensity and the time demands made on students, are likely to suffer from student frustration and attendant decreased motiva-

28. M. KNOWLES, SELF DIRECTED LEARNING 14, 29 (1975). Knowles' theories are applied to the clinical legal education context in Bloch, *supra* note 26. Actually, Shakespeare may have forecasted this trend when he wrote, "[b]e governed by your knowledge and proceed/ I' the sway of your own will." W. SHAKESPEARE, *King Lear*, act 4, sc. 7, lines 19-20.

29. KNOWLES, *supra* note 28, at 14. It has been asserted that with self-directed learning, "the self-actualized person experiences an integration of self and an integration of experience into a meaningful whole" during which the person "feels more whole, more alive, more at one with the world, more self-sufficient." M. Kersh, Integrative Curriculum for Gifted Learners 2 (April, 1987) (paper presented at the annual meeting of the American Education Research Association, Wash., D.C., April 20-24, 1987).

30. KNOWLES, *supra* note 28, at 16; P. Beare, The Contract-An Individualized Approach to Competency-Based Learning and Evaluation 1 (Oct., 1986) (paper presented at 15th annual conference of Internat'l Soc. for Individualized Instruction, Atlanta, Ga., Oct. 9-11, 1986). Other possible advantages may be reduction of stress, which has been attributed in part to the one-exam system, *see* Archer & Peters, *Law Student Stress*, 23 NAT'L A. STUDENT PERSONNEL ADMINS. J. 48 (1986), and the greater development of talent. A. Astin, *Assessment, Value-Added and Educational Excellence*, 15 NEW DIRECTIONS FOR HIGHER EDUC. 89 (1987).

31. As it is, "[m]ore to know/ Did never meddle with my thoughts." W. SHAKESPEARE, *The Tempest*, act I, sc. 2, lines 22-23.

32. K. Duckworth, Intelligence, Motivation, and Academic Work: An Operations Perspective (March 25, 1983) (paper commissioned by the National Commission on Excellence in Education, Mar. 25, 1983).

tion. In addition, the recognition of different styles and paces of learning makes the task of teaching self-directed learning a particularly difficult one.[33]

Given that every legal educator cannot teach everything, choices about what to teach have to be made. One way of looking at the choices is to see them as mutually exclusive. In deciding what to teach and how to go about it, it is certainly possible to restrict one's self to a very limited number of topics and methodologies. For example, one could decide to focus exclusively on interpersonal skills taught through lecture and discussion, or one could choose to teach substantive bankruptcy law by means of role playing. It is, however, also possible to avoid the conclusion of mutual exclusivity and recognize both the importance of all the learning areas and the individual teacher's inability to teach everything there is to know in all these important areas. The choices can be seen as providing a wide range of interesting and relevant topics and methods from which individual educators and institutions can select in ways that best serve their purposes.[34] This calls for selective incorporation of learning areas and methodologies.[35]

III. ONE APPROACH TO COURSE DESIGN

There are, no doubt, as many ways to design a syllabus as there are law teachers to do it. In this section, I describe only one of the ways of conceptualizing a clinical seminar, that being my own. It is an illustration of how a selective incorporation approach to course design can work when non-legal subject areas are included in the learning areas to be incorporated.

I should point out that in putting together my class syllabus, I am guided by several principles. First, I believe that students do learn in different ways and that it is important to attend to their different needs

33. Much work has been done in the development of learning models from a number of different perspectives. Chief among the various theories seem to be those which identify stages of development. *See, e.g.*, A. CHICKERING, EDUCATION AND IDENTITY (1969); Kohlberg, *Stage and Sequence: The Cognitive-Developmental Approach to Socialization*, in HANDBOOK OF SOCIALIZATION THEORY AND RESEARCH 347-480 (1969); Kolb & Fry, *Toward an Applied Theory of Experiential Learning*, in THEORIES OF GROUP PROCESSES (G. Cooper, ed. 1975); the "whole brain" theories developed by Abraham Maslow among others, *see, e.g.*, A. MASLOW, TOWARD A PSYCHOLOGY OF BEING (1969); K. Bruch, *Bridging Curriculum with Creative Development*, 30 GIFTED CHILD Q. No. 4 (Fall 1986); and studies collected in INTEGRATIVE PRINCIPLES OF MODERN THOUGHT (H. Morgenau, ed. 1972); and those which concern themselves with the impact of environmental factors and dynamics to explain intellectual growth patterns, *e.g.*, A. ASTIN, ACHIEVING EDUCATIONAL EXCELLENCE (1985); K.A. Feldman, *Some Theoretical Approaches to the Study of Change and Stability of College Students*, 42 REV. OF EDUC. RES. 1 (1972); G. STERN, PEOPLE IN CONTEXT: MEASURING PERSON-ENVIRONMENT CONGRUENCE IN EDUCATION AND INDUSTRY (1970).

34. This seems almost too obvious to state. A number of law teachers have made recommendations regarding how to go about identifying priorities and begin the process of selection. *See, e.g.*, Bloch, *supra* note 26; Hoffman, *supra* note 18.

35. I have no doubt that most law teachers do engage in a process of selective incorporation in designing their courses. If my method of course design differs from my colleagues in any notable way, I believe it is more a matter of degree than anything else, and is based on the belief that the range of learning areas and teaching methodologies from which it is possible to draw is endless.

as much as is reasonably possible. I also lean to the view that my job is to give students the push they need to get started in their chosen profession, so that they can carry on confidently without my assistance a few months or years down the road.[36] Finally, I believe that contributing to my own growth and maintaining an interest in my work are important goals that should not be overlooked in deciding what and how to teach.

With those precepts always in mind, I move to designing the class syllabus. In keeping with the general goal of empowering students to learn on their own, I attempt to identify subject areas and teaching methods that can serve as the source for learning something outside and beyond the classroom. I think of these learning areas in simple (if trite) metaphorical terms as "seeds." For example, a focal point of a class nominally dealing with counseling might be the process of decision making. Decision making is clearly not an activity that is limited to the context of counseling. In fact it is not limited to lawyering activities at all. An individual who understands the process of decision making can apply that understanding to other life decisions. It is, therefore, a skill that aids in learning and self development. The subject area of decision making, taught in the context of a counseling class, has the potential to "blossom" later in other situations and thus helps insure the individual's continued growth.[37]

Consistent with the belief that people learn in different ways, I have found it works best to select seeds from several different categories for each class or series of classes. These categories include skills, substantive law, values issues, and overlapping interdisciplinary theory. I likewise try to utilize several different teaching methods in each class, such as non-legal role plays, problem solving, simulation, non-legal games, and lecture with discussion.

As important as it is for the subject matter and learning method to have intrinsic interest for me, it is equally important that the subject matter and learning method have some intrinsic interest for the students.[38] There are many ways in which student interest can be piqued. Some measure of familiarity with the subject area may do the trick. For example, they studied this subject in college or played this game in kindergarten. Non-threatening novelty, especially combined with humor, can likewise be appealing. Predictably, student interest is affected by the degree to which it is apparent that what they learn in the classroom has a direct relationship to what they are doing in their field work or will be doing in practice. It also helps if students are able to see the relationship of any given class to other classes or to the course as a whole.

36. The students "must be taught, and trained, and bid go forth." The hope is that they will not thereafter be "barren spirited," feeding on "abjects, orts, and imitations." W. SHAKESPEARE, *Julius Caesar*, act 4, sc. 1, lines 35-37.

37. "Their understanding/ Begins to swell; and the approaching tide/ will shortly fill the reasonable shore/ That now lies foul and muddy." W. SHAKESPEARE, *The Tempest*, act 5, sc. 1, lines 79-82.

38. Motivational theories of particular significance to clinical law teachers are discussed in Harbaugh, *supra* note 25, at 199-205.

Learning cannot take place in an environment in which students are forever in fear that they will be criticized or embarrassed. Many students embark upon their law school experience with intrepidation and nearly all enter clinical programs intimidated by the responsibility of client representation. For most students, it is no easy task to perform for courts and clients (even simulated ones) in the role of a lawyer. The need to create a non-threatening environment in which the first frightening steps toward being a professional can take place is of particular importance in skills-oriented teaching.[39] It is important to earn the students' trust by expressing over and over again, in the first few classes especially, support and confidence in their abilities. It is equally important to reinforce students' support of each other and to impress upon them both the need to work cooperatively rather than competitively (as many learned to do in their first semester or two of law school, if not before) and the responsibility each person bears towards the others in the learning process. In this way, a foundation can be laid upon which students individually and as a group can build. The idea is to create a relatively safe environment in which planted seeds can develop.

The overall methodological strategy for all this is to demystify the giant of lawyering by breaking it down into recognizable parts that can be analyzed, mastered, put into a legal context, and finally incorporated into an increasingly larger whole. Each of my classes has a goal of its own and provides some measure of closure. At the same time, each class fits into a series (usually a series of three), with each class relating to the others in the series and each successive class building on the class before it. There are recurring themes in many of the classes which help the students see their work as part of a much bigger picture as well.

IV. The Process of Incorporating Shakespeare

Shakespeare fits into this teaching framework very well. Fortuitously, in 1987 The American University hosted a debate in which the origins of Shakespeare's works was at issue. The debate, the brainchild of Shakespeare enthusiast David Lloyd Kreeger,[40] took the form of an appellate argument before three justices of the United States Supreme Court: Harry Blackmun, William Brennan, and John Paul Stevens. Representing the appellant in the case, Edward deVere, who claimed to be the true author of the works historically attributed to Shakespeare, was Peter Jaszi, a professor of law at the American University's Washington College of Law. Representing William Shakespeare before the Court was Professor Jaszi's colleague at the Washington College of Law, Professor James Boyle.[41] The debate proved to be a rich source of class

39. I agree with Gary Goodpaster when he says "It is difficult to overemphasize the need for openness in class atmosphere, in the instructor and in the students." Goodpaster, *supra* note 19, at 7.

40. Mr. Kreeger, himself a lawyer among other things, also serves as chairman of the Board of the Corcoran Gallery of Art and the Washington Opera.

41. A full description of the debate, the briefs of the parties, the opinions of the justices, and Professors Jaszi's and Boyle's reflective comments on the project are contained

material for an appellate seminar.

The question of *whether* to use the debate as a teaching tool was an easy one; the possibilities seemed endless. The process of deciding *how* to use it was more problematical and required some brainstorming on the possibilities. What follows is an abbreviated and considerably better organized version of the brainstorming process by which specific potential subject areas for teaching were identified, considered, and either adopted or rejected. The choice of substantive content took precedence over decisions as to methodology. Teaching methodologies such as moot court-type arguments, edited tape review, and directed class discussions mentioned here in passing are specifically identified only because they are methodologies that seemed to jump out given the appellate argument structure of the Shakespeare debate already in place. Although decisions regarding methodology could be made in advance of decisions regarding class topics, here, because the starting point was a non-legal subject of interest, it seemed to make sense to first ascertain in what ways that subject matter related to topics associated with the practice of law before deciding on the specific method for incorporating an as yet undetermined topic into the curriculum.[42] The advantages and disadvantages of particular methodologies available for each topic or class do have to be weighed,[43] a process which I believe is most effectively illustrated by the description in Part V of the choices ultimately made in this instance.[44]

The first broad subject area considered was written advocacy. At a very basic writing skills level, students could be given one or both briefs or portions of the briefs and could be required to write responsive arguments or summaries of arguments. The purpose of such an exercise would be to get students to work on such elements of their writing as organization, clarity, emphasis, and accuracy. The same things could be addressed by having the students critique the briefs written by the participants in the debate and compare and contrast the writing styles and

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in *In Re Shakespeare: The Question of Authorship*, 27 AM. U.L. REV. 609 (1988). The debate before the justices was also filmed and broadcast on public television.

42. This, then, is certainly not to make light of the decision as to methodology. "As teachers we must first collect, understand, and organize our material. But we must, in the end, pass on that material to students in a way that insures that meaningful learning occurs." Harbaugh, *supra* note 25, at 222.

43. Some of these advantages and disadvantages have been analyzed with reference to particular teaching methodologies. As the title of his report indicates, Dean Harbaugh has advocated the integration of gaming and simulation methods into clinical law teaching. *Id.* Simulation and gaming exercises are two of five clinical methods examined in the article by Boon, *supra* note 12 (the others being work experience, computer technology, and observation exercises). Role playing as an effective teaching methodology is addressed in Cabral, *Role Playing as a Group Intervention*, 18 SMALL GROUP BEHAV. 470 (1982). A communication and psychological interaction model specifically geared to law teaching is the subject of Gary Goodpaster's article, *supra* note 20. The use of non-legal role plays as an effective teaching method is discussed in Bergman, Sherr & Burridge, *Learning From Experience: Non Legally-Specific Role Plays*, 37 J. LEGAL EDUC. 535 (1987). Peter Hoffman looks at five methodologies—role assumption, evaluation, demonstration, expository teaching, and dialectic teaching, *supra* note 18.

44. "Though this be madness, yet there is method in 't." W. SHAKESPEARE, *Hamlet*, act 2, sc. 2, lines 203-04.

techniques used by the authors of the briefs.[45]

A slightly more sophisticated approach to analyzing writing techniques and styles would be to construct a class around the role of truth in brief writing and how that "truth" is presented.[46] Discussions could also center around questions of perspective or point of view.[47] A closer look at specific word choices and language makes for yet a different kind of class discussion.[48]

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45. Countless books have been written on the subject of legal writing. *E.g.*, M. FONTHAM, WRITTEN AND ORAL ADVOCACY (1985); A. HORNSTEIN, APPELLATE ADVOCACY (1984); R. MARTINEAU, MODERN APPELLATE PRACTICE - FEDERAL AND STATE CIVIL APPEALS (1983); M. MOSKOWITZ, WINNING AN APPEAL (1983); E. RE, BRIEF WRITING & ORAL ARGUMENT (5th ed. 1983); R. STERN, APPELLATE PRACTICE IN THE UNITED STATES (1982); F. WIENER, BRIEFING AND ARGUING FEDERAL APPEALS (1967). This list is by no means exhaustive.

46. Discussions about the relationship between the "facts" of a case and "truth" always seem to pique considerable student interest. The notion that there is an objective truth to be known is prevalent. It often takes some time for students to realize that lawyers, also, must grapple with the idea that "[t]he truth or falsity of statements is affected by what they leave out or put in or by their being misleading and so on," and that " 'true' and 'false', like 'free' and 'unfree,' do not stand for anything simple at all, but only for a general dimension of being a right or proper thing to say as opposed to a wrong thing, in these circumstances, to this audience, for these purposes and with these intentions." J. AUSTIN, HOW TO DO THINGS WITH WORDS 143-44 (1962). In litigation, "[b]ecause one cannot usually return in a time machine to show a trier of fact 'what really happened,' investigations do not produce 'facts.' They produce evidence from which the trier of fact will resolve the parties' dispute(s) by deciding the *probable facts*." D. BINDER & P. BERGMAN, FACT INVESTIGATION: FROM HYPOTHESIS TO PROOF 6 (1984). The difficulty with ascertaining truth in the adversary system is effectively demonstrated in Susan Glaspell's play *Trifles* (copyright 1920 by Dodd, Mead & Co., Inc., renewed by S. Glaspell, 1948). (The movie version of Glaspell's play, *A Jury of Her Peers*, may be familiar to some.)

47. Perspective and point of view are closely aligned to the concept of truth. In weaving a story and bringing characters to life, the narrator necessarily begins somewhere and makes decisions that will be reflective of a particular point of view. Disciplined writers (and speakers) are conscious of this approach.

As Professor Jaszi points out, the question of who wrote Shakespeare's works will be determined to some extent on the basis of how Shakespeare himself is portrayed. Critics, he notes, have thus described Shakespeare as, *inter alia*, gardener, lawyer, doctor and sailor. Jaszi, *Who Cares Who Wrote "Shakespeare"?*, 37 AM. U.L. REV. 617, 619; *See also* Jaszi, *Brief of Appellant Edward De Vere, Seventeenth Earl of Oxford*, 37 AM. U.L. REV. 645, 673-74. Just as the sailor may be perceived as less likely to be the author of *Hamlet* than some other candidate for authorship of Shakespeare's works, a client, party or witness portrayed as a poet will be perceived differently from the person identified as a politician or pauper.

48. Language and literary style may be presumed to have limited definitions in the law.

> If it were only teachers who insisted that. . .writers stay close to literary styles of the past, we might reasonably ignore them. But readers insist on the very same thing. They want our pages to look very much like pages they have seen before. Why? It is because they themselves have a tough job to do, and they need all the help they can get from us. . . . They have to *read*, an art so difficult that most people do not really master it. . . .
>
> So. . . our stylistic options as writers are neither numerous nor glamorous, since our readers are bound to be such imperfect artists.

K. VONNEGUT, PALM SUNDAY 80 (1981). Vonnegut was not speaking about legal writing, although he could have been.

Notwithstanding the limits within which lawyers operate, much work can be done to increase awareness of the impact of word choices and phrasing and to alleviate the problems resulting from what George Orwell called "pretentious diction," "verbal false limbs," and "meaningless words," *see* G. Orwell, *Politics and the English Language* 337 in 4 THE COLLECTED ESSAYS, JOURNALISM, AND LETTERS OF GEORGE ORWELL 127, 130-32 (S. Orwell & I. Angus eds. 1968), and to improve the lucidity of what is written. Such efforts can mean the difference between verbal products consisting primarily of "dead carcasses

The topic of oral persuasion is at least as obvious a choice as that of writing skills. Students could themselves do oral arguments based on the briefs, either in class or in out-of-class taped sessions. The effectiveness of various techniques could be analyzed by means of in-class critiques, self critiques, or class discussion of edited tapes. As with the possible writing skills options, here, because the actual arguments are available on tape, students could review and critique those instead of engaging in the oral advocacy themselves. Some fairly typical goals of this critiquing process would be to alert students to the proper and effective use of humor and sympathy in oral argument, to help them develop ways of simplifying their arguments and making them more memorable, and to work on the concept of anticipatory rebuttal.[49]

On a slightly different plane, the tapes and student presentations could be used to analyze performance issues, as opposed to content issues. Dramatic techniques involving body language, memory and delivery, listening, and audience bonding would be appropriate subjects to develop.[50] Also of particular importance for discussion in the legal context would be questions relating to the effects of role expectations, ego threats, and other underlying needs or inhibitions.[51]

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of words," Y. OUOLOGUEM, BOUND TO VIOLENCE 137 (1968), and those constituted of the kind of words describable as "damned sparks of syllables that set fire to the blood. . . ." C. FUENTES, THE DEATH OF ARTEMIO CRUZ 41 (1964). For further readings, *see* D. Allison, *Translator's Introduction* to J. DERRIDA, SPEECH AND PHENOMENA AND OTHER ESSAYS ON HUSSERL'S THEORY OF SIGNS (1983); TRUTH AND MEANING: ESSAYS IN SEMANTICS (G. Evans & J. McDowell eds. 1976).

49. As in the area of legal writing, there is no dearth of material on the skill of oral advocacy. Indeed, the vast majority of books dealing with the subject of written advocacy also include chapters on oral advocacy. For a listing of some of these works, see *supra* note 45.

50. Unlike many others who have tackled the subject of oral advocacy, Bea Moulton and Gary Bellow devote substantial space to the arts of rhetoric and drama in their book. Bellow and Moulton, *supra* note 17, at 914-23, 937-56, 638-45. For additional information, see B. BATES, THE WAY OF THE ACTOR: A PATH TO KNOWLEDGE & POWER (1987); V. SPOLIN, IMPROVISATION FOR THE THEATRE (1983); J.L. HANNA, THE PERFORMER-AUDIENCE CONNECTION (1983). Theatrical interpretation—by producers and audiences alike—is a subject of interest to Shakespeare scholars. As a result, a number of texts deal with the subject of interpretation specifically in the context of Shakespeare's plays. *See* Jaszi, *supra* note 47, at 620-21, and *supra* notes 6-8.

51. Motivating and inhibiting factors, frequently discussed in the context of counseling, deserve attention when attorneys and judges engage in a dialogue, if the advocate does not wish to be told, "your words/and performance are no kin together." W. SHAKESPEARE, *Othello*, act 4, sc. 2, lines 185-86. Legal argument must be more than an entertaining performance; it is intended to be persuasive. Similarly, argument that is substantively persuasive (i.e. good rhetoric) fails if the arguments are not heard or understood by the audience. This suggests that a focus on the communicative and persuasive aspects of oral discourse is desirable. Literature dealing with these subjects abounds. *E.g.*, H. ABELSON AND M. KARLINS, PERSUASION: HOW OPINIONS AND ATTITUDES ARE CHANGED (1959); K. ANDERSON, PERSUASION: THEORY AND PRACTICE (1971); HOVLAND & JANIS, COMMUNICATION AND PERSUASION (1972); W. MINNICK, THE ART OF PERSUASION (1957). For some thoughtful insights on the psychology and ethics of persuasion, see F. Haiman, *Democratic Ethics and The Hidden Persuaders*, 44 Q. J. SPEECH 385 (1958) and White, *Persuasion and Community in Sophocles Philoctetes*, in HERACLES BOW: ESSAYS ON THE RHETORIC AND POETICS OF THE LAW (1985).

At another level, an understanding of differences in communication patterns is worth studying, particularly if attorneys and clients are representative of minority cultures. Perspectives on issues of difference that might be worth exploring include the gender-associ-

Moving from the performance skills orientation to the analytical, one could use the briefs and oral arguments to focus on the logical connections between factual premises and conclusions. What inferences are drawn? What authorities are used to support the inferences? What predictions are made and what role do the predictions play in the choice of arguments?[52] Students could be asked to work through their ideas in advance of class or the process could be initiated in class, with a full development of logical constructs following.

With regard to substantive areas, it would be possible to have the students review the opinions of the justices on their merits and analyze the reasons for the decision as they might in any other class. Several aspects of this case deserve particular attention; for one thing, the parties are dead. In addition, there is no lower court record nor any precedent to guide the court. The absence of these elements could be the basis for a discussion about their ordinarily presumed importance or necessity. The justices who heard the case, in making their decision, relied heavily on the fact that deVere bore the burden of persuasion. This might prompt an inquiry into the standard of review and the deference to be given lower courts.[53] In their briefs, the parties examined at length historical and sociological factors,[54] which might suggest as a

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ated view proposed by C. GILLIGAN, IN A DIFFERENT VOICE (1982), the cross-cultural approach to body language addressed in LaBarre, *The Language of Gestures and Emotions*, reprinted in INTERPERSONAL DYNAMICS, *supra* note 14, at 197, and the call to listen to the "voices at the bottom" in Matsuda, *Looking to the Bottom: Critical Legal Studies and Reparations*, 22 HARV. C.R.- C.L. L. REV. 323 (1987). *See also, Julius Caesar* W. SHAKESPEARE, act I, sc. 2, line 284: "But for my own part, it was Greek to me."

52. Although logical reasoning or deduction may be the heritage of western philosophical thought and the foundation of the Socratic method widely used in American law schools, it is a method with which many students "being young, till now ripe not to reason," W. SHAKESPEARE, *A Midsummer Night's Dream*, act 2, sc. 2, line 128, in fact seem to have little or no familiarity. Were they more familiar with Shakespeare's works, they might come to a greater appreciation of these skills. *See, e.g.*, W. SHAKESPEARE, *A Midsummer Night's Dream*, act 2, sc. 2, lines 129-30 "And touching now the point of human skill,/ Reason becomes the marshal to my will."; W. SHAKESPEARE, *Hamlet*, act 4, sc. 4, lines 36-39 "He that made us with such large discourse,/Looking before and after, gave us not/That capability and godlike reason/To fust in us unused."; W. SHAKESPEARE, *The Tempest*, act 4, sc. 1, lines 66-68 "rising senses/Begin to chase the ignorant fumes that mantle/Their clearer reason." A useful source for a full understanding of the practical applications of deductive reasoning to law practice is D. BINDER & P. BERGMAN, FACT INVESTIGATION: FROM HYPOTHESIS TO PROOF (1984).

53. *See* Martineau, *supra* note 8; J. PURVER & L. TAYLOR, HANDLING CRIMINAL APPEALS (1980); *see also* Note, *Ponduit Corp. v. Dennison Manufacturing Co.: De Novo Review and the Federal Circuit's Application of the Clearly Erroneous Standard*, 36 AM. U.L. REV. 963 (1987); Case Note, *Federal Rule of Civil Procedure 52(a): Applicability of the "Clearly Erroneous" Test to Findings of Fact in All Nonjury Cases*, 29 How. L.J. 639 (1986); Chapman v. California, 386 U.S. 18 (1967); Erie Railroad Co. v. Tompkins, 304 U.S. 64 (1938).

54. Indeed, a substantial portion of the Appellant's brief is devoted to untangling the historical events which led to the conclusion that Shakspeare of Stratford wrote the works attributed to him and to setting forth historical facts supporting the claim that someone other than Shakspeare of Stratford (allegedly Edward deVere), was the true author. The appellee, for his part, argues that the appellant "ignores the historical, social and artistic context in which the plays were written." *Brief of Appellant Edward De Vere, Seventeenth Earl of Oxford*, 37 AM. U.L. REV. 725, 733. Appellee also counters with a few historical facts of his own, including the fact that deVere was dead before all the plays were published. *Id.* at 745.

topic for discussion the appropriate reliance on non-legal authority and use of "Brandeis briefs."[55]

The case against Shakespeare presents special problems of issue development. Much relevant information is unknown or unknowable or, if known, suspect.[56] Although most cases handled by the students do not suffer from the same extreme dearth of information, there are often problems of incomplete records, problems which may be exacerbated when there is access to information (from a client, for example) that will never be part of the record. Posing a question like "did Shakespeare write Shakespeare?" provides opportunities for brainstorming, discovering creative theories, and developing ways of testing the strength and validity of theories.[57] The brainstorming process leads into the process of classification and organization, which in turn provides fodder for discussion of how to frame issues.[58] Role issues abound in this context as in any other. Who is the client? How does one relate to an absent client?[59] What is the importance of the client to the case? Must others' interests be taken into account? What are the attorneys' obligations to

55. A Brandeis brief, named after the noted jurist Louis Brandeis, is "[a]n appellate brief in which economic and social studies are included along with legal principles." WEST'S LEGAL THESAURUS/DICTIONARY (1985).

56. This is what Professor Jaszi calls "[t]he informational void surrounding the historical Shakespeare." Jaszi, *Who Cares Who Wrote "Shakespeare"?*, 27 AM. U.L. REV. 617, 623 (1988). According to Professor Boyle, "the whole imposing edifice of Shakespearian biography rests on a set of facts which one could fit onto-if not a postcard-then at least three medium sized sheets of paper." Boyle, *Brief of Appellee William Shakespeare of Stratford-Upon-Avon*, 37 AM. U.L. REV. 725, 729 (1988).

57. Thus, "imagination bodies forth/the forms of things unknown. . ." W. SHAKESPEARE, *A Midsummer Night's Dream*, act 5, sc. 1, lines 14-15, and "All difficulties are but easy when they are known." W. SHAKESPEARE, *Measure for Measure*, act 4, sc. 2, line 172. Creative problem solving is a not-entirely-new, though perhaps underused, approach to the legal issues. *See, e.g.*, Hegland, *supra* note 17, at 180-85. The initial stages of creative thought are developed in J. GUILFORD, WAY BEYOND THE IQ 160-80 (1977) and in A. OSBORN, APPLIED IMAGINATION 125-36 (1963). For an understanding of how creativity can be blocked, read B. UELAND, IF YOU WANT TO WRITE 28-39 (1987); R. PIRSIG, ZEN AND THE ART OF MOTORCYCLE MAINTENANCE 270-94 (1974). Pirsig also provides a brief, readable description of theory development. *Id.* at 62-67, 252-59. The same ideas are explicated somewhat less colorfully in Osborn, *supra*, at 86-109. Those wishing to explore concepts of creativity further may find it useful to consult S. PARNES, A SOURCE BOOK FOR CREATIVE THINKING (Parnes & Harding, eds. 1962).

58. A simple checklist for evaluating theories which includes recognizing underlying assumptions, evaluating authority and understanding problems of language is contained in the NEW YORK TIMES: GUIDE TO REFERENCE MATERIALS 185-86 (rev. ed. 1985). The process of systematizing ideas and of organizing them is clearly explained by Guilford, *supra* note 57, at 34-37. The relevance and application of the skill of idea association to the process of classification is described by Osborn, *supra* note 57, at 111-21. Lawyers, in developing case theories and framing issues, of course go through this process, even if not consciously. One lawyer's attempt to simplify and clarify the process of issue classification by creating a full taxonomy of cases appears in A. HORNSTEIN, APPELLATE ADVOCACY 74-127 (1984).

59. This is an issue that students in an appellate practice clinic face rather frequently. Clients are likely to be federal prisoners to whom access is often frequently restricted. The absent client problem can occur in trial work as well for a number of reasons, including the fact that some clients simply never communicate with their attorneys before trial. In other cases, such as class actions, the clients are many and geographically widely distributed, and some clients, such as very young children or the severely mentally disabled, may be literally present but incapable of communicating.

the Court in this case? Does the role of the attorney change depending on what is at stake and whose interests are involved?[60]

Viewing any event, decision, or belief in its historical or political context is likely to affect perception. Analyzing the question of the authorship of Shakespeare's works in the context of 16th or early 17th century societal and political norms as compared to current societal and political norms is revealing.[61] An inquiry into the effects of culture and class in the Shakespeare case is illuminating as to similar effects in legal disputes. Recognition of the significance of context raises questions about how and whether to address value-laden issues in any given case and what to do when conflicts between values are apparent.[62] These are just a few examples of ways in which Shakespearian scholarship, as already encapsulated in briefs and oral argument, might work its way into a Clinic classroom. Once Shakespeare became the focal point of a class, it was more difficult to curtail the ideas for incorporating the theme than it was to come up with ways in which to make Shakespeare relevant to the practice of law. In fact, in the end, Shakespeare dominated two classes.

V. THE ULTIMATE CHOICES

Shakespeare originally made his appearance in the appellate seminar of a year-long clinical course.[63] By this time, most students in the appellate clinic had made an argument before a real court, and all of them had filed at least one brief of their own composition. Classroom coverage in the first semester included system analysis, interviewing, fact writing, and theory development. The beginning of the second semester introduced the students to counseling and to different aspects of written and oral persuasion, including logic and rhetoric, dramatic per-

60. These are issues that frequently arise in the cases clinic students handle. A student may feel very differently about what role to assume in a divorce case in which the issue is jurisdiction than about what the proper role is in the representation of a guilty murderer whose speedy trial claim, if successful, will result in the client's release from prison.

61. As Shakespeare wrote, "men may construe things after their fashion,/Clean from the purpose of the things themselves." W. SHAKESPEARE, *Julius Caesar*, act 1, sc. 3, lines 31-32. Professor Jaszi examines some of the ways in which Shakespeare's works have been interpreted at different points in history and by different people. Jaszi, *Who Cares Who Wrote "Shakespeare"?*, 37 AM. U.L. REV. 617 (1988). In his essay, Professor Boyle looks at "the strange subtext that lies under the Shakespeare story and [links] it to current philosophical and literary concerns about the reading of texts." Boyle, *supra* note 56, at 626. Professor Boyle analogizes the desire to understand Shakespeare's writings by reference to the "real" author to the drive to determine the "intent of the framers" in constitutional analysis. Among other things, he concludes that still prevailing 18th Century romantic notions about authors are what have led critics to reject Shakespeare of Stratford, who does not fit the romantic conception, as author of Shakespeare's plays.

For additional reading on the subject of the relationship between social, political and cultural norms and decision making, see R. BENDIX, CLASS, STATUS AND POWER: A READER IN SOCIAL STRATIFICATION IN COMPARATIVE PERSPECTIVE (R. Bendix & S. M. Lipset eds. 1966).

62. *See supra*, notes 22, 24, 28.

63. In addition to using these two classes in a clinical setting, I have included variations of them in a one-semester, non-clinical seminar on appellate advocacy.

formance, and communication problems. The classes I am about to describe were docketed as classes on the art of responding.

In the first of these two classes, the primary emphasis is on skills. The skills I seek to focus on are recognition of crucial points of argument, fluff elimination, argument reduction, and labeling. The primary focal points of the second class are interpersonal relations, role assumptions and underlying values. In both classes I make use of some interdisciplinary theories that have surfaced in prior classes. In addition, an attempt is made to bring in substantive law on the appropriate use of reply briefs and practical advice on maximizing the effectiveness of responses.

Prior to the first class, students are required to read the statement of facts and summary of argument from Appellant Edward deVere's brief. They are told to reduce deVere's argument to 50 words or less. They are then given Appellee William Shakespeare's summary of argument and instructed to reduce *it* to 50 words or less.[64]

In class, samples of the reduced appellant's arguments are distributed and the discussion is focused on the decisions different people have made with respect to emphasis, in particular on the process by which choices were made and the difficulties encountered in trying to reduce a lengthy argument to bite-size pieces. The goal is to identify the skill of "argument reduction" and provide some information about the process and about possible resolutions of problems associated with it. We also talk about why this skill is important in the context of appellate advocacy.

The second segment of the class is devoted to a variation on the children's game of "telephone." Two students are provided with a one-page essay or argument of some sort. I have used several different things for this exercise, but my current favorite is a short portrayal of the life of Shakespeare's imaginary sister by Virginia Woolf.[65] The two students are asked to read the essay and then they are paired up with two other students. The readers have three minutes - or up to five minutes, depending on the length and complexity of the essay - to relay to their partners all the essential information contained in the essay. The two listeners are then paired up with two other students and instructed to convey what they have just heard. They have a reduced amount of time in which to do this, perhaps two or three minutes. The process continues, with the last two students receiving all essential information in a period of about thirty seconds. These last two students then relate to the group as a whole the substance of what they have heard. The results of the two lines of communication are invariably different.

What follows is a deconstruction of the process. How did the stu-

64. "Brevity is the soul of wit." W. SHAKESPEARE, *Hamlet*, act 2, sc. 2, line 90.

65. V. WOOLF, A ROOM OF ONE'S OWN 8-50 (1929). Woolf poses the hypothetical of William's "sister," Judith, a woman whose literary genius is equal to that of her brother's, attempting to find an outlet for that genius. Woolf concludes that had such a person lived, she may well have ended up committing suicide.

dents choose what to tell? How did they decide what to eliminate? Did they use any shortcuts—words, labels or themes—that got picked up by the next listener and passed on? Flowing from this is a discussion about the problem of time in the court room. Because time is scarce, and because an opponent's argument can take unexpected turns, it is important to be able to sift through a lot of information quickly and eliminate the non-essential. Of course, what constitutes "essential" information and what constitutes "fluff" are questions that provoke a fair amount of debate.

To build on the concept of labeling or themes-and the use of shortcuts-the students are given a list of quotes from Shakespeare and asked which they find best describe the Appellant's position, the Appellee's position, or maybe the class. The following selected quotations are illustrative:

"Things without all remedy
Should be without regard; what's done is done."[66]

"Good wombs have borne bad sons."[67]

"Thus the native hue of resolution
Is sicklied o'er with the pale cast of thought."[68]

"Reputation is an idle and most false imposition;
oft got without merit and lost without deserving."[69]

"[T]hy head is as full of quarrels as an egg
is full of meat."[70]

"Our doubts are traitors."[71]

"Have we eaten on the insane root,
That takes the reason prisoner?"[72]

"I shall the effect of this good lesson keep."[73]

The students' choices are compared and the question is posed whether any of the ideas expressed in the quotations could be used as a centralizing theme for an argument. Ideas about the benefits of themetizing or labeling get aired and ways of putting such notions into practice are discussed, often with reference to the students' own cases.

Each of these exercises stresses the importance of identifying the heart of an argument. The first highlights the desirability of brevity; the second, the situational necessity for speed; the third, the advantages of having an easily remembered central theme. The final segment of the class is devoted to conceptualization of a framework for responding that can aid in preparation of rebuttal arguments.

It is not uncommon for a student to believe that a rebuttal argument is primarily a matter of making spontaneous declarations. The last

66. W. SHAKESPEARE, *Macbeth*, act 3, sc. 2, lines 11-12.
67. W. SHAKESPEARE, *The Tempest*, act 1, sc. 2, line 22.
68. W. SHAKESPEARE, *Hamlet*, act 3, sc. 3, lines 84-85.
69. W. SHAKESPEARE, *Othello*, act 2, sc. 3, lines 263-65.
70. W. SHAKESPEARE, *Romeo and Juliet*, act 3, sc. 1, line 22.
71. W. SHAKESPEARE, *Measure for Measure*, act 1, sc. 4, line 79.
72. W. SHAKESPEARE, *Macbeth*, act 1, sc. 3, lines 85-86.
73. W. SHAKESPEARE, *Hamlet*, act 1, sc. 3, line 45.

part of class is thus dedicated to analyzing the accuracy of this proposition and attempting to demonstrate that spontaneity can spring from a well-ordered framework—indeed, often works best when that framework is solidly in place in advance.

At this point, the students look at some of the 50 word reductions of the Appellee's argument and begin to categorize them. Generally, this categorization process breaks the possible arguments down to something like this: (1) The premises are false, incomplete or unsupported; (2) What the party is trying to achieve (the goal) is undesirable, creates havoc or is inconsistent with other desirable ends; (3) The points made lack relevancy or consistency, or the inferential leap between facts and conclusions is too great; (4) The writer is stupid, insincere, insensitive, etc.

These four categories all focus on the opponent's position. Other argument reductions usually fall within a set of categories building on the strength of the appellee's position, most frequently either: (1) there is direct support for the Appellee's position, or (2) there is indirect (consistent) authority supporting the appellee's position.

Once the arguments are categorized, it becomes clear that the categories cover a great many of the arguments that could be made by a respondent. Mastery of the categories, therefore, makes preparation for *any* rebuttal an easier task. Although the strengths and weaknesses of any given approach still must be balanced, rebuttal need no longer be viewed as a "gut reaction," but can be seen as a measured response.

The second class brings in the human dimension. Prior to class, the students engage in non-legal role plays with partners and write-up their reactions to the experience. The role plays are designed to require the students to confront persons having some measure of power or authority. So, for example, one situation might involve a street encounter with a police officer; another will place the student in a tax assessor's office. Other students might be required to confront the principal at a daughter's school, or a nurse at a hospital. These role plays become the focus of a discussion midway through the class.

Class begins with a review of taped excerpts of the appellant's argument in the Shakespeare case. A brief discussion follows on the difference between the appellant's written argument and his oral presentation. The students then put into practice what they learned the previous week. They discuss what has been identified by the appellant's counsel as crucial and what points of argument have been eliminated. The question of whether the argument as presented has a logo or central theme is raised, and the students are asked to develop memorable themes from what they have seen and heard on the tape. The themes that get developed may run the gamut from the simple "the facts don't fit" to the accusatory "their's is a classist plot" to the more mystical "Shakespeare is a figment of the collective imagination." What is important about this exercise is that students are able to see that they are

quite adept at breaking down an argument and reframing it in simple, memorable terms.

At this point, the students are broken into groups and asked to take a few minutes to construct a responsive argument. Volunteers from each group are then asked to stand up and make the responsive argument before me as judge. Following the first group's presentation, the class discusses the advantages and disadvantages of the choices made. Alternative choices might be brought up and the advantages and disadvantages of these other options discussed.

The second and third arguments are then heard without any intervening discussion. The second advocate's argument is interrupted by inappropriate, irrelevant, or confusing questions and comments from the judge. The third volunteer faces a judge who stares without making any response at all. At the end of the oral presentations, the students are asked what is different about the last two arguments, and the discussion shifts from a focus on the decisions about content of the arguments to the effects of the listener's conduct on both the substance of the arguments and the speaker's ability to present arguments.

This is the time at which the role play assignments are brought into focus. We talk about the difference between perceiving oral argument as a performance, as many students initially assume it is, and perceiving it as a confrontation with authority, which is what many really believe. Students begin to reassess their assumptions about the nature of courtroom presentations and begin to think about how they deal with persons with apparent power or authority (police officers, car mechanics, and administrators) and what about their manner of dealing with such figures is likely to carry over to the courtroom and cause problems.

This discussion is followed by a review of taped segments of the responsive arguments actually made in the Shakespeare case. The appellee's choices are compared to and contrasted with the choices made by the students. Also at this point, questions are raised about different styles of argument—manipulation versus conciliation, for example—and how these styles may be influenced by the attorneys' views of the nature of oral argument and any underlying authority issues. If there is time, volunteers are permitted to rebut the appellee's arguments and then excerpts of the rebuttal made by Professor Jaszi before the Justices are shown.

These two classes are, I believe, rather moderate examples of the principle that lawyering skills can be taught from any topical base. The inspiration of Mr. Kreeger to have a debate on the origins of Shakespeare's works and to have it presented as an appellate argument minimized the amount of imaginative work it took to bring Shakespeare into the classroom. Perhaps for that reason, it seemed an opportunity not to be passed up. In some ways, because the groundwork for introducing Shakespeare into a clinic seminar was already done, the classes built from that groundwork may not be the best choices for testing or demonstrating the hypothesis. In another way, I think the debate makes it eas-

ier to see the association between things non-legal and legal, and thus makes the point clearer. Even without the good fortune of having the briefs and arguments at hand, it is possible to draw on Shakespearian scholarship, or anything else, to make law classes both interesting and instructive. Obviously, a law teacher could fashion a debate on the origins of Shakespeare's works without the fanfare attached to Mr. Kreeger's spectacle and derive from that debate the same lessons as can be derived from the jazzed-up version.

Despite the fact that the two classes described here are what I view to be rather moderate extensions of fairly typical seminar classroom scenes, I feel it advisable to anticipate and respond to criticisms. I hear voices saying that the attempt to teach lawyering skills by drawing on outside interests is inefficient, clouds the issues, and trivializes the role lawyers must assume. There are those who would say that the best way to learn is to do, and "doing" means doing the thing itself, or the closest thing to it, and not some facsimile of tortuous relevance.

If the premise of such criticisms is that "person as lawyer" is somehow fundamentally different from "person as person," then I find myself in disagreement with the premise. It is only when we see our lawyer selves as independent of our non-lawyer selves that we see what we do in one context as separate from what we do in another. This notion of separate selves has, I think, been resoundingly refuted.[74] To the extent that it still curries favor within the profession, it seems to me to be wise to make attempts to eradicate its influence. Thus, the role of the lawyer is trivialized in non-legal contexts only if there is a preconceived notion of the lawyer's role.

The method is inefficient only if efficiency is defined in terms of what students learn in the immediate environs of the classroom, what they can regurgitate outside the classroom, or the amount of preparation time required of the teacher. It is not inefficient if looked at from the perspective of learning yielded per class. Admittedly, a lot of preparation goes into these classes, but the long term benefits go far beyond producing student lawyers who are capable of not humiliating themselves in court.

Similarly, the method clouds the issues only if the "issues" are artificially limited to well delineated legal issues. In fact, the introduction of non-legal subjects into the classroom helps identify and clarify important issues in the legal realm that might otherwise remain clouded. For example, when students read and transmit the essential thoughts in Virginia Woolf's essay about Shakespeare's sister, they learn not only about the skill of argument reduction, but about historical sexism and how individual values dictate decisions. It is a little bit like the poetry of Robert Frost or Emily Dickinson; everyday occurrences and familiar objects

74. "Our tendancy to treat the law as a separate, unique human activity has been harmful; we need to tie law into the whole social fabric." Bergman, Sherr & Burridge, *supra* note 43, at 540 (footnotes omitted). I would add that we need to tie person-as-lawyer into the concept of the whole person.

are the means by which the student is safely and uncombattingly brought into other contexts.[75] New ideas sink into consciousness without the learner even necessarily realizing that the process is occurring or knowing to what to attribute changes in thinking patterns and attitudes. It is learning by osmosis.

CONCLUSION

Experimentation in law teaching methodologies has opened up the range of options for those engaged in law teaching. The resulting proliferation of possible subject areas is forcing legal educators to look closely at their curricular offerings. It is also forcing educators to make difficult decisions both about what is most essential substantively and about what is the best and most efficient way to transfer knowledge and to prepare students to utilize their knowledge, skills, and perceptions in the practice of law. To the already overbrimming pot of subject matter covered in the classroom, I propose to add non-legal subject areas. Rather than flood the classroom with trivial or irrelevant ideas, I believe the introduction of non-legal subject areas into class helps to bridge the gap between students' life experiences and their legal careers. The integration of the non-legal with the legal enables students—and teachers—to see connections between different aspects of their lives, discloses new perspectives and meanings, clarifies and simplifies the mysteries of law practice through the device of analogy, and provides a measure of entertainment that enhances living as well as learning.

75. Like "Lovers and madmen," they "apprehend/More than cool reason ever comprehends." W. SHAKESPEARE, *A Midsummer Night's Dream*, act 4, sc. 1, lines 4-6.

THE REUSE RIGHT IN COLORADO WATER LAW: A THEORY OF DOMINION

ALISON MAYNARD*

The Colorado law governing the right to reuse or make successive use of return flows after a first use of water has been made is relatively strict compared to that in other western states. In other states, the right of a first user of tributary water to recapture seepage or return flows of that water is often permitted; in Colorado, "when the use has been completed the right of the user terminates."[1] The Colorado courts have taken the view that such return flow or seepage water is also tributary to the stream, and interception of it thus constitutes an interference with vested water rights.[2] Therefore, if a Colorado appropriator wishes to "recapture" tributary water return flows, he or she must make a separate appropriation for each successive use.[3] Each successive appropriation is thus subject to the test of availability of water and takes its place at the bottom of the priority system.

There is obviously a strong economic motivation in claiming water to be "reusable" in a prior appropriation state, therefore, since reusability circumvents entirely the priority system by which tributary water is allocated. Reusable water may be "taken off the top," and the owner does not have to stand in line for it.[4] Thus, in Colorado, the right of reuse is limited to return flows from waters which are not tributary, and so not initially subject to the priority system: developed,[5] foreign,[6]

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1. Pulaski Irrigation Ditch Co. v. City of Trinidad, 70 Colo. 565, 568, 203 P. 681, 683 (1922); Water Supply and Storage Co. v. Curtis, 733 P.2d 680 (Colo. 1987); Ft. Morgan Reservoir & Irrigation Co. v. McCune, 71 Colo. 256, 206 P. 393 (1922); A. TARLOCK, LAW OF WATER RIGHTS AND RESOURCES § 5.05[3][b] (1989). Some cases suggest, however, there may be a right to recapture escaped surface water (running wastewater) before it has left the user's control and percolated into the ground, *see* McKelvey v. North Sterling Irrigation Dist., 66 Colo. 11, 179 P. 872 (1919) (*explained in McCune*, 71 Colo. at 260-61, 206 P. at 395), and Burkart v. Meiberg, 37 Colo. 187, 86 P. 98 (1906). The distinction between irrigation wastewater and return flow is explained in City of Boulder v. Boulder & Left Hand Ditch Co., 192 Colo. 219, 557 P.2d 1182 (1976). Wastewater is never deemed "used" in the first instance. *Id.* at 220, 557 P.2d at 1185.

2. Comstock v. Ramsay, 55 Colo. 144, 133 P. 1107 (1913); Ft. Morgan Reservoir & Irrigation Co. v. McCune, 71 Colo. 256, 206 P. 393 (1922). *See also* discussion in note 1, *supra*.

3. *See Curtis*, 733 P.2d 680; *McCune*, 206 P. 393.

4. *See, e.g.*, Rio Grande Reservoir & Ditch Co. v. Wagon Wheel Gap Improvement Co., 68 Colo. 437, 191 P. 129 (1919) (Garrigues, J., dissenting) and cases cited therein.

5. "Developed water, also described as artificial or salvaged water, is that water which has been added to the supply of a natural stream and which never would have come into the stream had it not been for the efforts of the party producing it." Note, *A Survey of Colorado Water Law*, 47 DEN. L.J. 226, at 356 (1970). *See also* Southeastern Colo. Water

and nontributary ground waters[7] only[8] (henceforth referred to as "developed water"), and even here there are certain threshold requirements governing the ability to reuse.

THE LEGAL REQUIREMENTS OF REUSE

The right of a developer to reuse developed water, which "is that water which has been added to the supply of a natural stream and which never would have come into the stream had it not been for the efforts of the party producing it,"[9] exists in the common law and is also codified in different statutes.[10] The most particularized of these Colorado statutes states:

> RIGHT TO REUSE OF IMPORTED WATER. (1) Whenever an appropriator has lawfully introduced foreign water into a stream system from an unconnected stream system, such appropriator may make a succession of uses of such water by exchange or otherwise to the extent that its volume can be distinguished from the volume of the streams into which it is introduced. Nothing in this section shall be construed to impair or diminish any water right which has become vested.
>
> (2) To the extent that there exists a right to make a succession of uses of foreign, nontributary, or other developed water, such right is personal to the developer or his successors, lessees, contractees, or assigns. Such water, when released from the dominion of the user, becomes a part of the natural surface

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Conservancy Dist. v. Shelton Farms, 187 Colo. 181, 529 P.2d 1321 (1974); Pikes Peak Golf Club Inc. v. Kuiper, 169 Colo. 309, 455 P.2d 882 (1969); and Ripley v. Park Center Land and Water, 40 Colo. 129, 90 P. 75 (1907).

6. Foreign water is water which is imported into a stream system from an unconnected stream system. COLO. REV. STAT. § 37-82-106(1) (1990). *See* Benson v. Burgess, 192 Colo. 556, 561 P.2d 11 (1977); City and County of Denver v. Fulton Irrigation Ditch Co., 179 Colo. 47, 506 P.2d 144 (1972); and Martz, *Seepage Rights in Foreign Waters*, 22 ROCKY MTN. L. REV. 407 (1950). The term includes transmountain and transbasin waters.

7. Nontributary ground water is defined in pertinent part as "that ground water . . . the withdrawal of which will not, within one hundred years, deplete the flow of a natural stream . . . at an annual rate greater than one-tenth of one percent of the annual rate of withdrawal." COLO. REV. STAT. § 37-90-103(10.5) (1990). Because of the negligible hydraulic connection with tributary water, nontributary ground water is allocated based upon ownership of the overlying land, *see* COLO. REV. STAT. § 37-90-102(1) (1990), and is consequently private property. The reusability of nontributary water is established or assumed in COLO. REV. STAT. §§ 37-82-101, -82-106(2), -90-137(9)(b) (1990).

8. *See* City and County of Denver v. Fulton Irrigation Ditch Co., 179 Colo. 47, 53, 506 P.2d 144, 147 (1972) and cases cited therein. It has also become common to claim the right to reuse to extinction consumptive use (CU) water following a change of point of diversion or type or place of use. The writer knows of no reported decisions holding that such a right does in fact attach to CU water, however, and regards it as unlikely to withstand the scrutiny of the supreme court. Because CU water is still tributary water, it cannot lawfully, by the mere fact of being once quantified, be immunized from subsequent requantification in a later change proceeding, nor from a finding of abandonment. What is claimed to be "reusable to extinction," therefore, is in fact tributary return flow in which the appropriator has no property right. *See, e.g.*, Green v. Chaffee Ditch, 150 Colo. 91, 371 P.2d 775 (1962).

9. *Fulton Ditch*, 179 Colo. at 53, 506 P.2d at 147.

10. *See Fulton Ditch*, 179 Colo. 47, 506 P.2d 144 and COLO. REV. STAT. § 37-82-106(1) (1990).

> stream where released, subject to water rights on such stream in the order of their priority, but nothing in this subsection (2) shall affect the rights of the developer or his successors or assigns with respect to such foreign, nontributary, or developed water, nor shall dominion over such water be lost to the owner or user thereof by reason of use of a natural watercourse in the process of carrying such water to the place of its use or successive use.[11]

Subsection (1) of section 106 delimits the right to reuse in two respects: first, by allowing reuse of the water only "to the extent that its volume can be distinguished from the volume of the streams into which it is introduced"; and second, by requiring that no other vested water right be impaired or diminished by such reuse.[12] The two requirements of this subsection thus set up an injury analysis which must be satisfied before the right to reuse is recognized.

Subsection (2) of section 106, added in 1979,[13] articulates a third limitation on the right to reuse: the user must maintain the personal property right in the water. The impetus for the bill was the "Huston filings" for 444 c.f.s., whereby Mr. Huston sought to recapture, independent of the priority system, return flows from nontributary waters developed by others' deep wells, which had escaped to the South Platte River.[14] Discussions in both the Colorado Senate and House Committees, which considered this amendment, emphasized that it was enacted for the purpose of clarifying by statute what the legislators felt had always been historically a part of the law. They stated that the bill was intended neither to expand upon nor diminish the right of a developer or his assigns to reuse foreign water. Rather, it was to make clear that a complete stranger to the water, such as Mr. Huston, had no such right.

The difficulty raised by the language in subsection (2), however, is that the right to reuse is not merely dependent upon a showing of the personal property right as determined by contractual privity, but is also coextensive with the prospective reuser's retention of "dominion" over the water. Whether that mystical term adds or ought to add any new conditions on reuse which must be satisfied in addition to privity, and in addition to the injury analysis required in subsection (1), requires examination.

THE MEANING OF "DOMINION"

No definition of "dominion" is provided in subsection (2)[15] or anywhere in the water statutes, even though it is used at least three

11. COLO. REV. STAT. § 37-82-106 (1990).

12. *Id.* at § 37-82-106(1).

13. S.B. 481, 52d Leg., 1st Reg. Sess., 1979 Colo. Laws 1366 (codified at COLO. REV. STAT. § 37-82-106(2) (1990)).

14. Characterization by Mr. Ward Fischer, during testimony on S.B. 481 before Senate Agricultural Committee, March 15, 1979, at approximately 1:37 p.m. *See also* State Dept. of Natural Resources v. Southwestern Colo. Water Conservancy Dist., 671 P.2d 1294 (Colo. 1983) ("*Huston II*").

15. COLO. REV. STAT. § 37-82-106(2) (1990).

times.[16] Nevertheless, "dominion is a word of distinctive legal meaning,"[17] and consequently lawyers might feel they instinctively understand it. For example, a definition of "dominion" which has been frequently used by courts[18] comports with the general understanding of the concept. "Dominion" is "[p]erfect control in right of ownership. The word implies both title and possession and appears to require a complete retention of control over disposition. Title to an article of property which arises from the power of disposition and the right of claiming it."[19]

The problem with relying on this definition too much, however, is that it, and the concept it defines, arose not in the context of water law, but was probably borrowed from the law of immutable discrete chattels and fixed real property. The idea of dominion over *water*, which is migratory, fluid, and mixable in character, confounds the intuition. Words like "possession" and "control," easily enough understood when applied to a chattel, become problematic when applied to water.

Yet the definition is helpful in one respect, which is that of title: clarifying that dominion is exactly the "right of claiming" the water and the "right of ownership."[20] Dominion thus *is* the right to recapture the water for reuse and *is* the personal property right. From the outset, then, it can be easily remarked that the separate statutory requirement of contractual privity is comprehended within the term "dominion" and is, therefore, redundant. But it also follows that if there are authorities, for example, in other states, which have found the satisfaction of certain external conditions to be prerequisite to retention of the personal property right or of the right of claiming the water from others, these conditions also constitute components of "dominion," and could by the use of that word in the Colorado statute properly be considered incorporated into Colorado law.

Thus, although the right to recapture and reuse water in other western states applies often even to appropriative waters, and so is qualitatively different from the Colorado law, the guidelines courts have used in those states in finding or not finding the right to reuse should be useful. Similarly, those Colorado cases which have denied the right of reuse of tributary water provide insight into the problem, as whether or not dominion is retained is a question which can be addressed independently from that of the initial character of the water sought to be reused.

As could be expected, then, the cut-off point in these cases (the point where the personal property right in the water terminates and the right to reuse is consequently extinguished) often will not be labeled "loss of dominion" per se. The word "dominion" may never appear at all. Rather, the right of reuse will be denied due to some other condi-

16. *See* COLO. REV. STAT. §§ 37-82-101(1), -82-106(2), -90-137(9)(b) (1990).
17. Whelan v. Henderson, 137 S.W.2d 150, 153 (Tex. Civ. App. 1939).
18. Eastex Aviation v. Sperry and Hutchinson Co., 522 F.2d 1299, 1305 (5th Cir. 1975) (citing Black's Law Dictionary) and cases cited therein.
19. BLACK'S LAW DICTIONARY 486 (6th ed. 1990).
20. *Id.*

tion or conditions, which, as will be seen, appear always to be variants of the following: abandonment, failure to identify, and loss of possession (or control) of the water.

Specific cases will be discussed where relevant in this article. Before leaving the task of circumscribing the concept of "dominion" as far as possible at the outset, however, it is instructive to examine one more source: the understanding the legislators may have had of the term, as reflected in the testimony and questions asked of expert witnesses at the time subsection (2) was added to section 106 in 1979,[21] for "[w]ords and phrases which have acquired a technical or particular meaning, whether by legislative definition *or otherwise*, shall be construed accordingly."[22] For example, the testimony of Mr. Ward Fischer, a Colorado water lawyer, on the bill during committee hearings in the senate, equated loss of dominion with abandonment:

> [W]hile a person who is a developer of water can use that water until it is totally consumed, by a succession of uses or reuse or otherwise, once he abandons that water and it goes back to the stream, it belongs to the other appropriators on the stream, and that is the existing law.[23]

In the course of discussions of the Huston filings during the committee hearing in the house, Mr. Fischer was also asked, "Would you differentiate between after the waters get into the South Platte, or just prior to that? Would there be a difference there?"

His answer to that question revealed a somewhat different aspect of his understanding of "dominion" as applied to water:

> I think the difference is, as long as the developer *controls* the developed waters . . . he could totally consume them. *Once they have left his control*, they became part of the waters of the stream, because they became part of the groundwaters which are tributary to that stream . . . . *As soon as he loses control of them, they're gone.*[24]

Mr. Glenn Saunders, another prominent Colorado water lawyer, testified that the right of reuse was dependent not only on dominion, but on the ability to identify the water:

> We have made it clear now by both statute and judicial decision that [the] appropriator of [developed] water may make a succession of uses of that water *so long as he maintains it within his dominion and can identify it quantitatively.*[25]

Thus, as a first attempt at defining "dominion," the ability to claim the water from others and subsequently dispose of it, evidenced by

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21. COLO. REV. STAT. § 37-82-106 (1990).

22. COLO. REV. STAT. § 2-4-101 (1973) (emphasis added).

23. Testimony on S.B. 481, *supra* note 13, before Senate Agriculture Committee, March 15, 1979, at approximately 1:35 p.m.

24. Testimony of Mr. Ward Fischer before House Agriculture, Livestock, and Natural Resources Committee hearings on S.B. 481, *supra* note 13, May 7, 1979, at approximately 4:06 p.m. (emphasis added).

25. Senate Agriculture Commitee hearings, *supra* note 14, at approximately 3:00 p.m. (emphasis added).

"nonabandonment" or intent to reuse, identification,[26] and control, would appear to have been its meaning in the legislators' eyes.

In fact, those three terms which the legislators understood to be the hallmarks of "dominion" are the same which keep reappearing in the case law from other states,[27] like beacons in the mist: intent, identification, and control. As will be seen, any particular element of these three may be emphasized with or without the others, in different proportions, any one assuming paramountcy depending on the aspect of reuse which is important in the case at hand. It is reasonable, therefore, to regard these three elements as the primary components of "dominion."

INTENT AS AN ELEMENT OF DOMINION

The intent to reuse is at this point in Colorado law primarily an implicit, common-law requirement on the prospective reuser, and perhaps so obvious as to appear simplistic. The user of developed water must intend to reuse, at the very least, or the statute compels that the water discharged after first use will belong to the stream.[28] Intent to reuse probably can be presumed if the developed water remains always in the continuous actual possession of the owner, meaning inside a confining structure within the boundaries of his or her property. When the water either leaves the owner's property or leaves confinement, however, intent would seem to be critical as the "first cut" to distinguish the prospective reuser from the abandoner, who discharges water to the stream merely to get rid of it.

That the legislature thought it necessary to insert express language permitting the use of a natural watercourse as a conduit to take reusable water downstream to the place of successive use reinforces this view.[29] Only if the placing of the water in the watercourse is purposeful (done with a specific type and place of successive use in mind) does this language have effect, as the reason for it is to protect the reuser from the interpretation of abandonment of the water that would normally attach to such a practice. As a Colorado Supreme Court Chief Justice once stated, "[I]f it was put in with the intention of taking it out and using it, it belongs to the person causing the increase."[30]

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26. Although concededly redundant with the "volumetric distinction" requirement in COLO. REV. STAT. § 37-82-106 (1) (1990) that "identification" is also understood by many to be comprehended within "dominion" is explored more fully in the "Identification and the Burden of Proof" section of this article.

27. *See also* Annotation, *Right of Appropriator of Water to Recapture Water which has Escaped or is Otherwise No Longer Within the Immediate Possession*, 89 A.L.R. 210 (1934), for more cases.

28. COLO. REV. STAT. § 37-82-106(2) (1990) ("Such water, when released from the dominion of the user, becomes a part of the natural surface stream where released, subject to water rights on such stream in the order of their priority . . . .").

29. *See* Annotation, *supra* note 27, at § II(a), *and* Ramshorn Ditch Co. v. United States, 269 F. 80 (8th Cir. 1920), *aff'g* United States v. Ramshorn Ditch Co., 254 F. 842 (D.C. 1918) (dealing with appropriative water).

30. Rio Grande Reservoir & Ditch Co. v. Wagon Wheel Gap Improvement Co., 68 Colo. 437, 451, 191 P. 129, 134 (1919) (Garrigues, C.J., dissenting). Although Justice Garrigues was outvoted on his characterization of the water in this case as "developed water,"

The difficult question to answer is when, if ever, in Colorado intent must manifest itself to ensure the right of reuse. For example, may the developer who has been heedlessly discharging return flows from developed water for many years suddenly form the intent to reuse, change her or his practice, and begin capturing that water to use over? Section 106[31] cannot readily be interpreted as providing an answer to this question. The Colorado Supreme Court has also avoided addressing this issue, the equitable "flip side" of which is reliance on the developed water return flows by downstream juniors who made their appropriations in the expectation that the waters they saw available at the time were waters of the state, rather than waters which were privately owned.

The question may perhaps be answered if some confusion in the labeling is unraveled. In the cases where intent is discussed, it is sometimes characterized as the intent to recapture and reuse,[32] and sometimes as merely the intent not to abandon.[33] These are in fact two distinct problems. As the doctrine of abandonment comes into play only if there is a delay between the commencement of first use and the implementation of recapture/reuse plans, "intent not to abandon" should need to be proved, if at all, not in lieu of intent to reuse, but rather regarded as an additional hurdle which may need to be overcome by the nondiligent reuser.

The most positive proof that there exists intent to reuse, other than the continuous possession/confinement scenario already mentioned, would be a comprehensive plan for reuse to be implemented concurrently with the initial use of the developed water.[34] This level of proof thus is similar to that required for the intent to appropriate in the conditional water rights context, constituting a "fixed purpose to pursue . . . a certain course of action."[35] Intent to reuse should be regarded as a question of fact, proved by concrete plans which indicate the place and type of each successive use to be made of the water, and also logically requiring evidence of the developer's ability accurately to identify, as well as to control (if necessary), the water sought to be reused.[36]

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the principles he reviewed as governing the right to reuse provide a helpful summary of the development of the law to that time.

31. COLO. REV. STAT. § 37-82-106 (1990).

32. *See, e.g.*, Ide v. United States, 263 U.S. 497, 507 (1924) (the government's intent to use all the water for project purposes was "stated and restated in various official reports, . . . and was well understood by the project officers."); and *Rio Grande Reservoir*, 68 Colo. 437, 451, 191 P. 129, 134 (Justice Garrigues's dissent discussing cases where intent to recapture was present).

33. Southeastern Colo. Water Conservation Dist. v. City of Florence, 688 P.2d 715 (Colo. 1984) and City and County of Denver v. Fulton Irrigation Ditch Co., 179 Colo. 47, 506 P.2d 144 (1972) (both discussing the evidence of no intent to abandon).

34. *See* Wiel, *Mingling of Waters*, 29 HARV. L. REV. 137 (1915) and Fischer, *Re-Use of Foreign Waters*, 7 COLO. LAW. 523 (1978) (discussing concepts Wiel developed in his article); *see also*, Martz, *Seepage Rights in Foreign Waters*, 22 ROCKY MTN. L. REV. 407 (1950).

35. Water Supply Storage Co. v. Curtis, 733 P.2d 680, 683-84 (Colo. 1987) (quoting City and County of Denver v. Colorado River Water Conservation Dist., 696 P.2d 730, 745 (Colo. 1985)).

36. *See, e.g.*, Ramshorn Ditch Co. v. United States, 269 F. 80 (8th Cir. 1920) ("The existence or nonexistence of an intention to abandon is a question of fact," 269 F. at 84);

The argument for requiring an equivalent demonstration of intent in the reuse case to that in the conditional rights context is a sensible one. While proof of intent to appropriate in the conditional rights context does determine the extent of a property right,[37] not an issue when the subject is a quantity of water already privately owned, the type of proof required that no injury occur to vested water rights from the taking may be identical. In the conditional rights case, the injury question must be addressed in determining whether water is available for appropriation;[38] in the reuse case, the question must be addressed before recapture is allowed and the right to reuse recognized.[39] Proof of how much water will be taken out, at what locations and at what times, including in what quantities depletions will occur to the stream, should be fundamental to answering the injury question in both cases. Also, owners of vested water rights deserve the opportunity to discover the extent of a prospective reuser's plans for recapture and reuse in detail, and to be heard on the injury issue, as much as they do in the tributary conditional rights case.[40]

If the most positive proof of the intent to reuse is not present (meaning the plan for reuse is either not sufficiently detailed or is not implemented concurrently with initial use), the question of abandonment of the reuse right then could potentially arise. For example, in *Fulton Ditch Co.*, Denver thought it prudent to make "a good record" at trial that it never intended to abandon its return flows,[41] and the City of Pueblo did likewise in the most recent pronouncement of the supreme court on the reuse issue.[42] Proof of intent not to abandon might be adequately made by a reservation of the right to reuse expressed in the original decree for the water. Resume notice at the time of application would also have the salutary effect of putting later appropriators on notice that the enhanced flows they observe are in fact private property

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Southeastern Colo. Water Conservation Dist. v. City of Florence, 688 P.2d 715 (Colo. 1984); *Curtis*, 733 P.2d 680; COLO. REV. STAT. § 37-92-305(9)(b) (1990); and discussion in note 37 *infra*. Also see the "Control" section of this article.

37. A water right is established by an appropriation. COLO. REV. STAT. § 37-92-103(12) (1990). The definition of "appropriation" states that it means "the application of a *specified portion* of the waters of the state to a beneficial use . . . but no appropriation of water, either absolute or conditional, shall be held to occur when . . . [t]he purported appropriator of record does not have a *specific plan and intent* to divert, store, or otherwise capture, possess, and control a *specific quantity of water* for specific beneficial uses." COLO. REV. STAT. § 37-92-103(3)(a)(II) (1990) (emphasis added).

38. Cache la Poudre Water Users Ass'n v. Glacier View Meadows, 191 Colo. 53, 61, 550 P.2d 288, 294 (1976) ("water is available for appropriation when the diversion thereof does not injure holders of vested rights").

39. COLO. REV. STAT. § 37-82-106(1) (1990) ("Nothing in this section shall be construed to impair or diminish any water right which has become vested.").

40. *See* Bunger v. Uncompahgre Valley Water Users Ass'n, 192 Colo. 159, 557 P.2d 389 (1976).

41. City and County of Denver v. Fulton Irrigation Ditch, 179 Colo. 47, 58, 506 P.2d 144, 150 (1972) (The trial court did not, however, pass upon the issue).

42. City of Florence v. Board of Waterworks, 793 P.2d 148 (Colo. 1990). The supreme court quoted from the trial court's ruling: "Transmountain waters have unique properties, most importantly, the right to use, reuse, and successively use to extinction, free from the call of the river, *unless those reuse rights are somehow abandoned or otherwise surrendered. The evidence showed that such a loss has not in fact occurred.*" *Id.* at 153 (emphasis added).

subject to discontinuance at any time.[43] Other evidence should also be admissible to the extent it is in the tributary water rights context.

But as mentioned, whether as a question of law the reuse right may be abandoned is dubious, and has not been addressed by the Colorado Supreme Court.[44] There is in fact some indication to the contrary in *City of Florence*. The supreme court stated there that "importers of foreign water are accorded wide latitude as to the use and disposal of the [imported] water" in finding that the general change of water right criteria did not apply to the imported water.[45] It also quoted with approval the principle set forth in a treatise on Colorado water law that "the appropriator of such waters may reduce or eliminate the amount of foreign water available to junior appropriators, by changing the time, place or manner in which these waters are used, even if junior appropriators are adversely affected."[46] Also, as Colorado law does not permit the reuse right to attach to tributary water, there is less motivation to apply abandonment principles to the reuse right here than there would be, say, in California. Adding to these statements the fact that there is no statutory diligence requirement on the right to reuse, unlike the conditional water right situation, it seems unlikely that the supreme court will find abandonment of the right to reuse even after many years of non-reuse. As it held for Pueblo against downstream juniors who complained of that city's decision to change the place of use of its imported water after years of heedless discharge,[47] the Court would probably also hold for the developer who finally formulates and implements a plan for recapture and reuse under the same circumstances.[48] For the part of the downstream junior, however, let it be also remarked that even if the reuse right may not be lost through abandonment, it potentially could be adversely possessed against the nondiligent reuser.[49]

43. "[A]ppropriators on a stream have no vested right to a continuance of importation of foreign water which another has brought to the watershed." Brighton Ditch v. City of Englewood, 124 Colo. 366, 377, 237 P.2d 116, 122 (1951).

44. Fischer, *Re-Use of Foreign Waters*, 7 COLO. LAW. 523 (1978), distinguishes the abandonment of the "corpus of the water" from the abandonment of the reuse right. Certainly, physical abandonment of the water itself, as occurs when a gap exists between the initial use of the water and later implementation of plans for reuse, might serve as an indicator of intent to abandon the reuse right altogether.

45. *Florence*, 793 P.2d at 154.

46. *Id.*

47. *Florence*, 793 P.2d 148.

48. Nevertheless, a stipulated decree containing an effective diligence requirement was quoted with approval by the supreme court in *Fulton Ditch*, although not because of any equitable balancing of the reuser's versus the downstream users' rights. Rather, the reuse itself, as required in that decree, was seen as a way of furthering the goal of minimizing transbasin diversions from the Western slope. City and County of Denver v. Fulton Irrigation Ditch, 179 Colo. 47, 54-55, 506 P.2d 144, 148 (1972); *accord* City of Florence v. Board of Waterworks, 793 P.2d 148 (Colo. 1990). The implication, thus, is that there is a duty to reuse before more transmountain diversions should be allowed.

49. *See, e.g.*, Lomas v. Webster, 109 Colo. 107, 122 P.2d 248 (1942) (dealing with adverse possession of nontributary seepage water arising on the lands of another). *But see* Martz, *supra* note 6.

IDENTIFICATION AND THE BURDEN OF PROOF

A requirement that the reuser "identify" reusable water in the course of establishing the right to reuse is separately embodied in the statutory requirement of volumetric distinction.[50] Requiring that the reuser is in fact using her or his own water, and not water owned by others, also furthers the separate statutory requirement of no injury to vested water rights set forth in the same paragraph.[51] As the Montana Supreme Court has succinctly put it, "Whoso asserts that he is entitled to the exclusive use of water by reason of its development by him must assure the court by satisfactory proof that he is not intercepting the supply to which his neighbor is rightly entitled."[52] Other cases agree that the burden of proof as to identification is on the developer:

> The burden of proof rests with the party causing the mixture. He must show clearly to what portion he is entitled. He can claim only such portion as is established by decisive proof. The enforcement of his right must leave the opposite party in the use of the full quantity to which he was originally entitled.[53]

As these quotations reflect a concern with injury, again, by analogy to the level of proof required to prove no injury in a change of water rights case it can be said that the reuser makes "satisfactory"[54] or "decisive" proof,[55] once specific injury to a vested right is asserted, by a preponderance of the evidence.[56]

As to the elements of identification, one Colorado water lawyer writing on the subject has characterized them as follows: "A prospective reuser must prove that it can maintain "dominion" of the water *by quantifying the amount, timing, and location of the return flows* in order to establish that it will be reusing its own water rather than water properly claimed by senior water rights."[57] Thus, each of these three elements, amount, timing, and location, should be proven by a preponderance of the evidence.

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50. COLO. REV. STAT. § 37-82-106(1) (1990) ("[S]uch appropriator may make a succession of uses of such water . . . to the extent that its volume can be distinguished from the volume of the streams into which it is introduced.").

51. *Id.*

52. Smith v. Duff, 39 Mont. 382, 391, 102 P. 984, 986-87 (1909).

53. Butte Canal & Ditch Co. v. Vaughn, 11 Cal. 143, 153 (1858). *See also, e.g.*, United States v. Haga, 276 F. 41, 43-44 (S.D. Id. Cir. 1921) ("Nor is it essential to his control that the appropriator maintain continuous, actual possession of [water sought to be recaptured] . . . . *It is requisite, of course, that he be able to identify it; but, subject to that limitation,* he may conduct it through natural channels and may even commingle it or suffer it to commingle with other waters.") (emphasis added); Comrie v. Sweet, 75 Colo. 199, 201, 225 P. 214, 214-15 (1924); and Herriman Irrigation Co. v. Keel, 25 Utah 96, 115, 69 P. 719, 726 (1902) ("The burden . . . is upon him who turns water into a natural stream to show that he has not taken more out of it than belonged to him.").

54. *Smith*, 39 Mont. at 391, 102 P. at 986.

55. *Butte Canal*, 11 Cal. at 153.

56. Danielson v. Jones, 698 P.2d 240, 249 (Colo. 1985). *See also* Hallenbeck v. Granby Ditch & Reservoir, 160 Colo. 555, 568, 420 P.2d 419, 426-27 (1966); COLO. REV. STAT. § 13-25-127(1) (1987).

57. Hallford, *Water Reuse and Exchange Plans*, 17 COLO. LAW. 1083 (June 1988) (emphasis added) (footnote omitted).

Identification of the return flows contributed by the developer is the major stumbling block in plans for reuse. The statutory exception that dominion will not be lost merely by use of a "natural watercourse" to carry developed water to its place of use or successive use[58] raises the question of whether a tributary underground aquifer can constitute such a "natural watercourse." Developed water return flows which have traveled underground and intermingled with other waters of the state, after irrigation, for instance, if sufficiently identified therefore might be recoverable through wells, or even from the surface stream itself at a point down-gradient.

But in such a case, the problem of identification is considerably more complicated than it is in the simple surface water situation. For instance, the early cases involved developed water produced from a mine and turned into the watercourse via a flume, where it could be measured. Hence, such water was easily identifiable when taken out again downstream: there was effectively no time delay, and the water's physical presence in the stream was observed. The right of recapture for reuse was later established for wastewater discharges from municipal systems, where essentially the same circumstances are present.

The most important Colorado case to date dealing with the subject of reuse is a municipal wastewater case, *City and County of Denver v. Fulton Ditch*.[59] The court did not directly take up the issue of identification, since that issue was determined on the basis of stipulated facts. But the supreme court noted with approval that stipulation, which specified that "[t]he amounts of water put into the potable water distribution system by Denver, delivered into sanitary sewer systems, and discharged into the South Platte River *are measured to the extent traceable* or determined by calculations, interpolations, interpretations or estimates, *based on measurements.*"[60]

These sorts of engineering or accounting procedures were important again in *City of Florence*,[61] which also concerned recapture and reuse of municipal wastewater discharges. In that case, the supreme court was content to rely on the trial court's findings of the adequacy of accounting methods employed, subject to approval by the division engineer, in determining the volume of water which could be exchanged while protecting against injury to other vested rights. The accounting procedures considered "the ratio of native to transmountain water in [Pueblo's water delivery and sanitary sewer system]; the infiltration of groundwater into the Pueblo system; and certain transit and stream losses."[62] It was remarked by the court in *City of Florence* that Pueblo's exchange of foreign water was similar to the plan of Denver's approved in *Fulton*

58. COLO. REV. STAT. § 37-82-106(2) (1990).

59. City and County of Denver v. Fulton Irrigation Ditch Co., 179 Colo. 47, 506 P.2d 144 (1972).

60. *Id.* at 57, 506 P.2d at 149-50 (emphasis added).

61. City of Florence v. Board of Waterworks, 793 P.2d 148 (Colo. 1990).

62. *Id.* at 150, note 5.

Ditch.[63] In both, the proportion of developed water was known at all times: either measured directly, or determined by calculations based on prior measurement.

Indeed, the right of recapture and reuse in the municipal wastewater case is well established probably because identification is easy when the water is always effectively in a pipe (meaning always confined, as it goes from pipe to dishwasher, bathtub, toilet, or the like, and thence to a pipe again). It is similar to water produced from a mine, which, coming from confinement, is also effectively channelized, and so easily measurable before its discharge to the stream. A much different situation arises, however, in the irrigation context, when the water sought to be reused has percolated underground and mingled with other waters of the state. Whether the contributed water is in fact physically present at the time and point of recapture, and in the quantities expected, is an important question which cannot be answered by mere visual observation. "Accurate differentiation" of the waters is difficult to make,[64] and to date there are no reported Colorado cases which have authorized reuse of irrigation return flows.

There do exist cases involving irrigation or water conservancy districts, where the right to reuse irrigation return flows has been granted, and recapture of such waters has, at least on paper, been allowed to occur within the boundaries of the district.[65] But as all water rights in these cases apparently belonged exclusively to the district in question, the problem of differentiating the reusable developed water from waters subject to the priority system did not arise.[66] The applicability of such cases to the general situation (where not all waters are owned by the prospective reuser, who seeks to withdraw groundwater within the boundaries of her own property) is thus undecided. It seems clear, however, that dominion over real property should not be confused with dominion over return flows of water. Identification of waters sought to be

63. *Id.* at 154.

64. *See* Water Supply and Storage Co. v. Curtis, 722 P.2d 680 (Colo. 1987); Ft. Morgan Reservoir & Irrigation Co. v. McCune, 71 Colo. 256, 206 P. 393 (1922).

65. *See, e.g.*, Estes Park v. N. Colo. Water Conservancy Dist., 677 P.2d 320 (Colo. 1984); Stevens v. Oakdale Irrigation Dist., 90 P.2d 58 (Cal. 1939); and *Concerning the Application for Water Rights of James L. Orr* ("the Cottonwood case"), 81CW142, Water Division 1 (March 21, 1986) (when appealed to the supreme court, the issue of dominion over the return flows was not contested). In *Curtis*, 733 P.2d 680, there was no express requirement the recapture be done within the district's boundaries. The supreme court remanded the case to the trial court, however, to make an "accurate differentiation" of the foreign water from waters of the state. After remand, a settlement was reached; the stipulated decree then requires the applicant to "install such measuring and recording devices and institute such accounting practices as are acceptable to and required by the State and Division Engineers." Amendment to Decree in Case No. 82CW289, Water Division 1, April 19, 1988. Identification was thus required to be made here.

66. *See* discussion in note 65 *supra*. It is important to note that the "reuse" reserved by the District for its irrigation return flows in *Estes Park*, 677 P.2d 320, in fact appears to be merely a concession of abandonment of such flows to the stream. There is no indication that the District's downstream ratepayers could take the return flows independent of the priority system. It appears, to the contrary, those flows merely augment the supply available to them, which users take pursuant to their respective decrees or shares.

recaptured must still be made, in spite of the developer's ownership of the property.

Yet the problem would appear at this point in the development of the law to be one of proof, not of principle. Although there is no right under Colorado law to recapture seepage water, that stricture applies to tributary waters, not waters which are "paid for" and have been transformed into private property. Thus, if the prospective reuser develops the technical wherewithal to tag the individual water molecules belonging to him or to measure or otherwise deduce with adequate precision the proportion of that privately-owned water to other waters of the state, it may be possible to meet the burden of proof as to identification of developed water return flows.[67] Logically, however, as a general rule identification should be easy. Whatever "dominion" over water really is, it is indisputably present if that water, after first use, is in confinement, and so capable of measurement prior to its commingling with other waters of the state. The more complex the proof of identification of the water becomes, however (meaning the further removed from actual physical measurement of the return flows themselves, and the more dependent on measurements of other factors or on estimates and mathematical proofs in lieu of measurement), the more suspect that the water is physically present at all, that it may be recaptured without injury, and thus that it may be reused.

THE REQUIREMENT OF CONTROL

In other legal contexts, where the term "dominion" is apparently well understood, it is defined as including "control."[68] Even though the terms are often used together in legal parlance ("dominion and control") as well as in section 137(9),[69] a more reasonable interpretation for this use than that the words have different substantive meanings is the fondness of lawyers for coupled synonyms (like "cease and desist" and "null and void").[70] Thus, "control" could easily be considered an all-

67. The applicant in case no. 88CW246 in Water Division 1, the Clear Creek Skiing Corporation, for example, sought the right to recapture and reuse for augmentation foreign water applied to the Loveland ski areas as artificial snow, when those flows melted and returned to the stream the following spring. The initial plan to reuse this water was denied by the court (decree of Feb. 1, 1990), as the applicant proposed no accurate method to distinguish its contribution from natural snowmelt. Although on a seasonal basis, the quantity of reusable water was sufficiently known, the actual timing and location of the return flows were not.

Pursuant to its statutory right to propose additional terms and conditions to prevent injury (COLO. REV. STAT. § 37-92-305(3) (1990)), however, the applicant made a new proposal to install a "Snotel" instrument, which would measure natural precipitation as well as the reduction in snow-water equivalent when melting occurred. As the ratio of applicant's water to the natural snow was known then, as were the times of actual melting and return to the stream, the court subsequently decreed (January 14, 1991) that the applicant had met its burden of proof as to no injury resulting from the recapture and reuse. The legal right to reuse was thus established.

68. *See* definition of "dominion" in BLACK'S LAW DICTIONARY, *supra*, note 19, and Fischer, *supra*, note 24.

69. COLO. REV. STAT. § 37-90-137(9) (1990).

70. R. MELLINKOFF, LEGAL WRITING: SENSE AND NONSENSE 4-5 (1982).

purpose synonym for dominion; however, for purposes of this discussion it will not be. Rather, as "intent" and "identification" have been employed as separate elements of dominion, "control" as the missing included component will also be restricted to a specific meaning which does not overlap those terms, and so can be analyzed separately. Here, "control" will mean the ability to regulate the flow of water, an ability which presupposes physical confinement. Assigning such a meaning to "control" is useful precisely because it permits identification then to be analyzed separately, and at least theoretically accomplished without the necessity for physical confinement.

That the right of reuse, or the concept of dominion, is not completely described without the added parameter of control is apparent first by analogy to appropriative water law, where control is fundamental. Sections 305(9)(a) and (b)[71] provide that a decree for absolute and conditional water rights may be granted only to the extent it is established that the waters have been (or can and will be) *diverted, stored, or otherwise captured, possessed, and controlled.*[72] The separate statutory definitions of "divert" and "store"[73] also comprehend control of the water, which as a practical matter requires it to be within some confining structure.

In appropriative water law, the point at which control is no longer required is generally that point at which the water is applied to beneficial use. It is readily apparent that water cannot be used for most purposes if it remains always in the structure used for its diversion or storage. The requirement of control, then, while a practical as well as a legal prerequisite to the beneficial use of water, is often antithetical to it. This irony is much more serious in the reuse situation, as if the right to reuse is held to depend on continuous control of the water, as in a pipe, the ability to apply it to first use is severely restricted. The municipal water/wastewater reuse precedent set by *Fulton Ditch* may be unique in meeting the requirement of continuous, or near-continuous, control of the water.[74] And, as the municipal example is the only one to date addressed by the Colorado Supreme Court, it is not known whether "reusable water" is by definition restricted to only that which is continuously controlled.

Yet it seems unduly harsh to require continuous control, in light of the separate and stringent requirement of identification. If it is determined that identification of the developed water after first use is adequate, so that recapture can proceed without injury, by analogy to appropriative water law "control" should become important, if at all, only in the course of applying the recaptured water to its next use. The inquiry is thus reduced to whether recapture must in fact be physically

71. COLO. REV. STAT. §§ 37-92-305(9)(a), (b) (1990).

72. *Id.*

73. *Id.* at §§ 37-92-103(7), (10.5).

74. City and County of Denver v. Fulton Irrigation Ditch Co., 179 Colo. 47, 506 P.2d 144 (1972).

effected in a particular situation for reuse to proceed without injury, or whether recapture can be forgone. The answer to that inquiry is that the level of control required should be entirely determined by an injury analysis made with reference to the nature of the successive use.

One method of achieving control, the type utilized in the municipal cases, would be an exchange into storage. *City of Florence*[75] and *Fulton Ditch*[76] involved exchanges into storage of native water for the foreign contribution in municipal wastewater. The amount taken in at the reservoir in these cases (ignoring losses) was equivalent to the amount of foreign wastewater released. The rate of entry into storage could also easily be tied to the rate of discharge. Thus, in any such exchange case the water which is ultimately "reused" after the exchange is in fact not the water discharged from the treatment plant, but the water which has entered into storage upstream. "Recapture" thus actually occurs at the reservoir, while simultaneous identification occurs at the point of discharge. Control of the discharge is consequently unimportant; and controlled releases of reservoir water can easily be made, so that reuse can proceed whenever desired. It would seem that *wherever* the identification hurdle is overcome, whatever the source of developed water, and an exchange allowed to proceed as described (or similarly, when the identified water itself is directly placed into storage), the prospective reuser is "home free" on the control issue. The level of control achievable by releases from storage is sufficient for any successive use.[77]

In a second scenario, where the water is identified at the actual point of discharge, thence to be applied directly to the successive use without the benefit of storage, the ability to regulate the flow of water at the point of discharge may or may not be important. For instance, if the purpose of reuse is augmentation, whereby water must be supplied to seniors by the out-of-priority diverter at the time and place of the seniors' need, a high level of control of the augmentation sourcewater could be required.[78] Although many of these types of plans have been approved at the trial court level, it would seem that simply relying on a general, seasonal credit for return flows seeping back to the stream at their own rate might not suffice as sources for augmentation, as these flows cannot be turned on and off to satisfy the call. But if the second use is subirrigation of adjacent lands, or recharge of underground aquifers, control should then be unimportant.

CONCLUSION

The concept of dominion in water law is best regarded as flexible, assuming almost different forms depending on which aspect of the prob-

75. City of Florence v. Board of Waterworks, 793 P.2d 148 (Colo. 1990).

76. 179 Colo. 47, 506 P.2d 144 (1972).

77. Exchanges themselves are subject to legal requirements, an examination of which is beyond the scope of this article. *See* COLO. REV. STAT. § 37-83-101 (1990), and Hallford, *supra* note 57.

78. COLO. REV. STAT. § 37-92-305(8) (1990). Augmentation plans also require their own injury analysis.

lem of reuse is being examined. It might be useful to think of "reuse" as a three-stage process. At the first stage, the time of original use, it is intent which is most important in satisfying the requirement of dominion: the prospective reuser ideally should demonstrate a comprehensive plan which evidences the physical and legal ability to reuse. At the second stage, the time of recapture of return flows, it is identification which is primarily important: the developer must accurately differentiate the reusable water from other waters of the state, so that more is not taken out from the stream than has been contributed. At the third stage, the time of successive use, control may be particularly important, as the nature of the reuse may or may not require a high degree of control of the water in order adequately to forestall injury to vested water rights.

The ultimate conclusion arrived at here is that, since in Colorado the right of reuse can attach in the first instance only to waters not initially subject to the priority system, the corners of "dominion" are adequately pinned down by an injury analysis. That injury analysis is consistent with the reuse statute, but is not completely described without addressing all three criteria suggested here: intent, identification, and control. If the burden of proof as to each of these criteria is met, and the subsequent user has a statutorily permitted relationship to the original developer, the right of reuse then should be established.

ALLSTATE INS. CO. V. TROELSTRUP: APPLICATION OF THE INTENTIONAL ACTS EXCLUSION UNDER HOMEOWNER'S INSURANCE POLICIES TO ACTS OF CHILD MOLESTATION

I. INTRODUCTION

In the United States, and in Colorado, the tragedy of sexual abuse becomes a reality for children. In 1989, a national study found two million reported incidents of child abuse of all types,[1] of which over 900,000 were confirmed.[2] Colorado recorded 7,224 confirmed reports of child abuse or neglect in 1989,[3] classifying 1,969 as sexual abuse.[4] Of these, 1,208 were incest and 761 third party sexual abuse.[5]

Colorado makes sexual abuse of a child a criminal offense.[6] But

1. REPORT OF THE U.S. ADVISORY BOARD ON CHILD ABUSE AND NEGLECT, CHILD ABUSE AND NEGLECT: CRITICAL FIRST STEPS IN RESPONSE TO A NATIONAL EMERGENCY (1990).

2. *Id.*

3. CONFIRMED REPORTS TO THE CENTRAL REGISTY (sic), (unpublished report) (1990) (hereinafter REPORT).

4. Sexual abuse of children is defined as "the involvement of dependant, developmentally immature children in sexual activities that they do not fully comprehend and therefore to which they are unable to give informed consent and/or which violate the taboos of society." R. HELFER & R. KEMPE, THE BATTERED CHILD 286 (4th ed. 1987).

5. REPORT *supra* note 3. COLORADO CENTRAL REGISTRY, REPORTING OF CHILD ABUSE TO COLORADO CENTRAL REGISTRY FOR CHILD PROTECTION at 6 (1986). This report defines incest as "inappropriate sexual activity where the victim to perpetrator relationship was as natural parent, stepparent, adoptive parent, foster parent, [or] sibling (natural, adoptive or stepsibling)" and third party sexual abuse as "inappropriate sexual activity with a child where the perpetrator is unrelated to the victim."

6. *See* COLO. REV. STAT. § 18-3-405 (Supp. 1990) Sexual Assault on a Child.
(1) Any actor who knowingly subjects another not his or her spouse to any sexual contact commits sexual assault on a child if the victim is less than fifteen years of age and the actor is at least four years older than the victim.
(2) Sexual assault on a child is a class 4 felony, but it is a class 3 felony if:
(a) The actor commits the offense on a victim by means of such force, intimidation, or threat as specified in section 18-3-402 (1) (a), (1) (b), or (1) (c); or
(b) Repealed, L. 90, p. 1033, § 25, effective July 1, 1990.
(c) The actor commits the offense as a part of a pattern of sexual abuse. No specific date or time must be alleged for the pattern of sexual abuse; except that the acts constituting the pattern of sexual abuse must have been committed within ten years of the offense charged in the information or indictment. The offense charged in the offense or indictment shall constitute one of the incidents of sexual contact involving a child necessary to form a pattern of sexual abuse as defined in § 18-3-401 (2.5).
(3) If a defendant is convicted of a class 3 felony of sexual assault on a child pursuant to paragraph (a) or (c) of subsection (2) of this section, the court shall sentence the defendant in accordance with the provisions of section 16-11-309, C.R.S.
Sexual contact within the meaning of section 18-3-405 is defined as:
the knowing touching of the victim's intimate parts by the actor, or of the actor's intimate parts by the victim, or the knowing touching of the clothing covering the immediate area of the victim's or actor's intimate parts if that sexual contact can reasonably be construed as being for the purposes of sexual arousal, gratification, or abuse.
§ 18-3-401 (4) C.R.S. (1986).

prosecution and incarceration of the abuser does little to help the victim, who may suffer psychological effects from the molestation.[7] Often such effects are long-term and require extensive medical assistance and psychological therapy.[8] Abused children have sought compensation for these damages through civil suits,[9] often recovering from an abuser's insurance policy. Recently, several jurisdictions have limited recovery under an intentional act exclusion provision of an abuser's homeowner's insurance policy. In *Allstate Insurance Company v. Troelstrup*,[10] the Colorado Supreme Court joined this trend.

Section II of this Comment provides background of such suits and the trend towards limitation of recovery. Section III reviews pre-*Troelstrup* Colorado case law concerning the nature of intentional acts within the meaning of an intentional act exclusion clause of a homeowner's insurance policy. Section IV examines the *Troelstrup* decisions. Section V reviews the cases from other jurisdictions cited in support by the *Troelstrup* court. Finally, section VI discusses the implications of *Troelstrup* and reviews alternative sources of recovery for child sexual abuse victims.

II. BACKGROUND

Victims of child sexual abuse have sought recovery from their abusers for costs of past, present and future counseling, therapy and medical expenses.[11] They have also pursued damages for pain and suffering, emotional trauma, diminished childhood, hedonic damages (economic measurements of reduced enjoyment of life) and punitive damages,[12] often under differing theories of recovery.[13] Such suits have produced impressive results. *Laurie M. v. Jeffery M.*[14] granted an abused stepdaughter $100,000 in compensatory and $100,000 in punitive damages.[15] Thirteen alter boys who sued a Catholic priest for alleged sexual abuse settled for $400,000 to $600,000 per child.[16] In *Wilson v. Tobias-*

See also COLO. REV. STAT. § 18-3-405.3 (1986) Sexual assault on a child by one in a position of trust.

7. *See generally* C. WALKER, THE PHYSICALLY AND SEXUALLY ABUSED CHILD, (1988); R. HELFER & R. KEMPE, THE BATTERED CHILD, (4th. ed. 1987); Comment, *Insurance Coverage for Child Sexual Abuse Under California Law*, 18 SW.U.L. REV. 171 (1988).

8. *See* Comment *supra* note 7 at 172; HELFER *supra* note 7 at 294.

9. Moss, *Fighting Child Abuse*, A.B.A.J. Oct. 1, 1987 at 36. *See* Comment, *Civil Remedies for Victims of Childhood Sexual Abuse*, 13 OHIO N.U.L. REV. 223 (1986) (identifying and suggesting reforms of obstacles barring suit by incest victims against their abusers and outlining theories of recovery).

10. 789 P.2d 415 (Colo. 1990).

11. For a lengthy discussion of the long term psychological effects of incest and resultant need for therapy, see Jones v. Jones, 242 N.J. Super. 195, 576 A.2d 316 (1990).

12. Pimpinelli, *Incest: The Secret Tort; Toward a Civil Cause of Action*, N.J.L.J. Jan. 17, 1991, at 12.

13. *See* Comment, *supra* note 9, (discussing tort theories including intentional infliction of emotional distress, assault and bodily harm).

14. 159 A.D.2d 52, 559 N.Y.S.2d 336 (1990).

15. *See id.* at 56, 559 N.Y.S.2d at 339, for a discussion of punitive damage awards in sexual abuse cases. The court reduced the amounts from the $200,000 actual and $275,000 punitive damages awarded by the trial court.

16. Moss, *supra* note 9.

sen,[17] the plaintiff, sexually abused by a Boy Scout leader, was awarded $4.2 million. Such verdicts only benefit the victim if a source exists to satisfy the judgment. Often the most likely source is the abuser's homeowner's insurance policy.

Most homeowner's policies contain an "intentional acts" exclusion provision, allowing the insurer to deny coverage for injury or harm that results from acts intended or expected by the insured.[18] Abuse involves intentional behavior by the molester that, at first glance, appears to fall squarely within the exclusion. Plaintiffs have avoided these exclusions and obtained recovery by alleging that abusers, while intending the act of molestation, did not have the subjective intent to *injure*. Although suggesting that an act of sexual abuse is not intended to harm the victim seems ludicrous, evidence suggests that in some cases it may be true.[19] Defendants have introduced expert testimony, often uncontroverted, supporting this distinction.[20] Insurers, however, have sought to deny coverage in these cases by arguing that courts should decline to make an act/harm distinction and instead find that molesters intended the resultant psychological injury.[21] Finding such an intent to injure brings the acts within the intentional act exclusion provisions and allows insurers

17. On appeal the punitive damages were vacated; the actual damages were affirmed. 97 Or. Ct. App. 536, 777 P.2d 1379 (1989).

18. The policy in the *Troelstrup* case excluded coverage for "bodily injury or property damage intentionally caused by an insured person." *Troelstrup*, 789 P.2d at 417. *See generally* Annotation, *Construction and Application of Provision of Liability Insurance Policy Expressly Excluding Injuries Intended or Expected by Insured*, 31 A.L.R.4th 957 (1990).

19. "Because the sexual victimization of children is so reprehensible, the offender is perceived to be some sort of depraved monster. [W]e have . . . not found this to be the case. His offense has been more the product of immaturity than malicious intent . . . ." NATIONAL CONFERENCE ON SENTENCING ADVOCACY, THE CHILD MOLESTER: CLINICAL OBSERVATIONS (1989).

See also D. FINKELHOR, CHILD SEXUAL ABUSE: NEW THEORY & RESEARCH 33-44 (1984). Child sexual abuse in many cases is motivated by emotional rather than sexual needs. Finkelhor summarizes theories about why a molester commits child sexual abuse into four research models. Some theorists believe that child sexual abusers have an arrested psychological development and thus have a need to relate to "other" children because of their low sense of self-esteem. Some evidence suggests that molesters actually have a sexual orientation for children. A third model holds that the abuser is unable to get his or her sexual and emotional needs met in an adult relationship. This model is often seen in cases of incest in dysfunctional families. The fourth factor is that some social conditioning, including role models set by the abuser's own childhood, may make molestation more acceptable because some social norms have been altered or never learned. *See generally* M. BRASSARD, PSYCHOLOGICAL MALTREATMENT OF CHILDREN AND YOUTH, 81-82 (1987); K. FALLER, CHILD SEXUAL ABUSE, 89-115 (1988).

20. [Accused molester] Troelstrup presented deposition testimony from several involved professionals, as well as from the investigating officer, all of whom, in essence, expressed the opinion that Troelstrup had no subjective intention to injure or harm the child. He also submitted a psychologist's affidavit in which the opinion was expressed that Troelstrup had formulated no conscious intent to harm the child.

Allstate Ins. Co. v. Troelstrup, 768 P.2d 731, 732 (Colo. Ct. App. 1988). *See also* Foremost Ins. Co. v. Weetman, 726 F. Supp. 618, 620 (W.D. Pa. 1989); Twin City Fire Ins. Co. v. Doe, 788 P.2d 121, 122 (Ariz. Ct. App. 1989); Fire Ins. Exch. v. Abbott, 204 Cal. App. 3d 1012, 1016-17, 251 Cal. Rptr. 620, 623-24 (1988).

21. *See* Grady & McKee, *INSURANCE COVERAGE FOR SEXUAL MOLESTATION OF A MINOR: There should be no coverage for or duty to defend cases involving admitted acts of sexual molestation by an insured*, 56 DEF. COUNS. J. 170 (1989). This article reviews the trend of

to deny any duty to defend the insured or satisfy a judgement assessed against the insured.

Since 1982, eighteen states have decided, generally in declaratory judgment actions brought by insurers, that the intent to injure will be inferred as a matter of law from the intent to commit the molestation, thus allowing insurers to deny liability under homeowner's insurance policies.[22] In its decision in *Troelstrup*, the Colorado Supreme Court joined the jurisdictions accepting this view.

III. COLORADO CASE LAW ON THE MEANING OF AN INTENTIONAL ACT EXCLUSION OF A HOMEOWNER'S INSURANCE POLICY PRIOR TO *TROELSTRUP*

Butler v. Behaeghe[23] established the general approach in Colorado to defining intentional acts within the meaning of an intentional act exclusion in a homeowner's insurance policy. Behaeghe struck Butler in the head with a steel pipe, causing serious injury. Behaeghe claimed he intended to strike the plaintiff in the abdomen but not to injure him. After a favorable jury verdict, Butler sought recovery against the third-party defendant Safeco, the defendant's homeowner's insurance carrier. Safeco denied liability, claiming the defendant's actions were intentional within the meaning of the intentional acts exclusion.

Behaeghe, seeking to secure coverage, argued that for the exclusion to apply, Safeco must show not only that he intended to strike the plaintiff but also intended to cause the specific resulting injury.[24] The court of appeals held that, within the meaning of an intentional act exclusion, coverage is excluded if the insured acted with the intent to cause *any* bodily injury, even if the resultant injury differed in character or magnitude from that expected.[25] The court found that in general such an ex-

decisional law in the area and concludes by noting the trend "favors insurers. We applaud that trend." *Id.* at 178.

22. The first supreme court case to infer intent as a matter of law in a sexual assault on a minor was Fireman's Fund Ins. Co. v. Hill, 314 N.W.2d 834 (Minn. 1982). *Hill* is widely cited as precedent, however, the *Hill* court did not create a new rule inferring intent in all situations. Instead the court found the defendant had received actual notice as to the harmful effects of his actions by prior warnings of the state health department and inferred intent. *See, e.g.*, Foremost Ins. Co. v. Weetman, 726 F. Supp. 618 (W.D. Pa. 1989); Allstate Ins. Co. v. Thomas, 684 F. Supp. 1056 (W.D. Okla. 1988); Allstate Ins. Co. v. Roelfs, 698 F. Supp. 815 (D. Alaska 1987); Twin City Fire Ins. Co. v. Doe, 163 Ariz. 388, 788 P.2d 121 (Ct. App. 1989); CNA Ins. Co. v. McGinnis, 282 Ark. 90, 666 S.W.2d 689 (1984); J.C. Penny Cas. Ins. Co. v. M.K., 278 Cal. Rptr. 64, 804 P.2d 689 (1991); Landis v. Allstate Ins. Co., 546 So.2d 1051 (Fla. 1989); Roe v. State Farm Fire & Cas. Co., 259 Ga. 42, 376 S.E.2d 876 (1989); Altena v. United Fire & Cas. Co., 422 N.W.2d 485 (Iowa 1988); Harpy v. Nationwide Mut. Fire Ins. Co., 76 Md. App. 474, 545 A.2d 718 (1988); Worchester Ins. v. Fells Acres Day School, 408 Mass. 393, 558 N.E.2d 958 (1990); Auto-Owners Ins. Co. v. Gardipey, 173 Mich. App. 711, 434 N.W.2d 220 (1988); Lehmann v. Metzger, 355 N.W.2d 425 (Minn. 1984); MacKinnon v. Hanover Ins. Co., 124 N.H. 456, 471 A.2d 1166 (1984); Rodriguez v. Williams, 107 Wash. 2d 381, 729 P.2d 627 (1986) (*en banc*); N.N. v. Moraine Mut. Ins. Co., 153 Wis. 2d 84, 450 N.W.2d 445 (1990); Horace Mann Ins. Co. v. Leeber, 376 S.E.2d 581 (W. Va. 1988).

23. 37 Colo. App. 282, 548 P.2d 934 (1976).

24. *Id.* at 286, 548 P.2d at 938.

25. *Id.* at 287-88, 548 P.2d at 938-39 (emphasis added).

clusion would apply unless the insured acted "without *any* intent or *any* expectation of causing *any* injury, however slight."[26]

The Colorado Supreme Court extended the scope of an exclusionary provision in *Chacon v. American Family Mutual Insurance Company.*[27] In *Chacon*, an insured sought recovery from his own insurance company for damages he paid after his son vandalized a public school. The policy provided coverage for the named insured and other residents of the insured's household, and excluded coverage for acts intended by any insured.[28] The insurer denied coverage, arguing that this language excluded coverage to all those insured for property damage which was intended or expected by any individual insured.[29] The insured brought the instant suit for breach of contract. The supreme court affirmed a decision for the insurer.

Such an exclusion was held not to apply in *American Family Mutual Insurance Company v. Johnson*,[30] which involved a mistaken assault on an innocent party. Johnson, after a domestic dispute, kicked a person whom he thought was his wife but turned out to be Brown, an uninvolved third party; Brown was subsequently successful in a personal injury action. American, the plaintiff, from whom Johnson held a homeowner's insurance policy, brought a declaratory judgment action alleging that Johnson's actions were within the scope of the provision.[31] The court held that an act intended to accomplish a certain result which accomplishes a result not expected or intended does not fall within an intentional acts exclusion.[32] Since Johnson neither intended nor expected to kick Brown, the exclusion did not apply.[33] In *Mangus v. Western Casualty Surety Company*,[34] Miller was tried for assault to commit murder after shooting Mangus, and found not guilty by reason of insanity. In a subsequent settlement, Miller assigned all rights under his homeowner's policy to Mangus. Western Casualty brought a declaratory judgment action alleging that Miller's acts were intentional and it was thus not liable for coverage under the intentional acts exclusion clause.[35] The court held that as the insured was insane at the time of the assault, the insured's insanity, as a matter of law, precluded application of the exclusion.[36]

Thus, prior to the *Troelstrup* decision, an intentional act exclusion in a homeowner's insurance policy had been held to apply where any in-

26. *Id.* (emphasis added).
27. 788 P.2d 748 (Colo. 1990).
28. *Id.* at 750. The policy defined the insured as "you and your relatives if residents of your household." The intentional act exclusion provided that coverage would not apply for injury "expected or intended by any insured."
29. *Id.*
30. 796 P.2d 43 (Colo. Ct. App. 1990).
31. *Id.* at 44. The provision excluded coverage for "bodily injury . . . which is expected or intended by any insured."
32. *Id.* at 45.
33. *Id.*
34. 41 Colo. App. 217, 585 P.2d 304 (1978).
35. *Id.* at 218, 585 P.2d at 305.
36. *Id.* at 219-20, 585 P.2d at 306.

sured intended or expected to cause property damage or injury. Coverage was not excluded where the insured simply had no intent to injure, injured the wrong person by mistake or was legally insane at the time of the act and could not form the requisite intent.

IV. THE *TROELSTRUP* SERIES OF DECISIONS

A. *Troelstrup v. District Court*[37]

In December 1983, W.M.L., a minor, filed a suit by and through his mother in Denver district court against the defendant, Glenn Troelstrup, alleging sexual assault and seeking money damages for negligence and outrageous, willful and wanton conduct.[38] Troelstrup tendered his defense to Allstate, his homeowner's insurance carrier. Allstate accepted under reservation of rights and sought a declaratory judgment that Troelstrup's actions fell within the intentional act exclusion in his homeowner's policy.[39] The district court refused Troelstrup's request to delay the action and allowed the declaratory action to proceed before the underlying civil trial. Troelstrup sought review of the denial of his request to delay through a petition of prohibition and mandamus. The Colorado Supreme Court affirmed, additionally noting its belief that Allstate had a reasonable likelihood of success in the declaratory judgment action.[40] Justice Erickson, joined by Justice Neighbors, specially concurred in the result but stated that he believed the court had "unnecessarily" stated that Allstate had a reasonable likelihood of success.[41] On remand, the district court entered summary judgment for Allstate.

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37. 712 P.2d 1010 (Colo. 1986).

38. *Id.* at 1010. W.M.L. was a 12 year old patient at Fort Logan Mental Health Center, a state mental health facility. Troelstrup, age 53, was a volunteer member of the Mental Health Advisory Committee of the center. The alleged molestation occurred at the facility. W.M.L. alleged that Troelstrup had committed homosexual acts, committed the crime of sexual assault on a child, slept nude with W.M.L. and had photographed and developed nude and erotic photographs of W.M.L.

39. *Id.* at 1010. The homeowner's insurance policy had an exclusionary clause that provided: "We do not cover bodily injury or property damage intentionally caused by the insured person."

40. *Id.* at 1012-13. "Hence . . . the nature and character of the alleged facts giving rise to W.M.L.'s personal injury case establish a reasonable likelihood that the tortious conduct of Troelstrup is excluded from coverage under his homeowner's policy." The court went on to cite three other cases, *Allstate Ins. Co. v. Kim W.*, 160 Cal. App. 3d 326, 206 Cal. Rptr. 609 (1984); *Horace Mann Ins. Co. v. Independent School Dist.*, 355 N.W.2d 413 (Minn. 1984); *State Farm Fire & Cas. Co. v. Williams*, 355 N.W.2d 421 (Minn. 1984). All three cases involved sexual assault, the first two on a minor and the last on a physically disabled adult. The court found that all three supported the idea that "an intentional injury exclusion clause may be invoked to negate the insurer's duty to defend where the nature and character of the act is such that the intent to inflict injury may be inferred as a matter of law."

41. *Troelstrup*, at 1014. "[In so deciding], the majority virtually decides the merits of Allstate's summary judgment claim, stating that Troelstrup's conduct is likely not covered by the Allstate policy. Such a factual determination is properly made by the trial court." (Erickson, J., concurring).

B. *Allstate Insurance Company v. Troelstrup*[42]

The court of appeals reversed in *Allstate Insurance Company v. Troelstrup*. The court initially determined that the sole issue before it was whether, as a matter of law, Allstate would be excused from satisfying any judgment W.M.L. might obtain against Troelstrup.[43] The determination of that issue rested on whether Troelstrup had the subjective intent to harm W.M.L.[44]

Allstate argued that Troelstrup's previous *nolo contendere* plea[45] and his deposition admissions in the civil suit were sufficient, as a matter of law, to bring his actions within the intentional act exclusion.[46] Troelstrup argued that, although he admitted the acts, he had provided uncontroverted deposition testimony from psychologists and the arresting officer expressing opinions that he had no subjective intent to harm W.M.L.[47] Troelstrup claimed this constituted a genuine controversy as to his intent to injure, raising a sufficient factual issue to preclude summary judgment.[48]

The court of appeals found *Butler v. Behaeghe*[49] to be controlling precedent. The court also cited *Allstate Insurance Company v. Steinemer*[50] for the "majority rule" that an exclusion did not apply to a policyholder not intending that his act cause bodily injury, even given that harm was a reasonably foreseeable consequence of the act.[51] The court held that Troelstrup's subjective intent to harm was thus integral to the application of the exclusion, and the determination of that intent was a factual issue to be decided by the trier of fact.[52]

C. *Allstate Insurance Company v. Troelstrup*[53]

The Colorado Supreme Court reversed in *Allstate Insurance Company v. Troelstrup*. After reviewing *Butler*, the court noted that other jurisdictions, while accepting this rule, had declined to apply it in cases of child

42. 768 P.2d 731 (Colo. Ct. App. 1988), *rev'd*, 789 P.2d 415 (Colo. 1990).

43. *Id.*

44. *Id.*

45. In a criminal trial held before the civil case was brought, Troelstrup pled *nolo contendere* to a charge of felony sexual assault upon a child under Colo. Rev. Stat. § 18-3-405 (1986) and received a three year prison sentence.

46. *Id.* at 732.

47. *Id.*

48. *Id.*

49. 37 Colo. App. 282, 548 P.2d 934 (1976). For a discussion of *Butler* see *supra* notes 23-26 and accompanying text.

50. 723 F.2d 873 (11th Cir. 1984).

51. 768 P.2d at 732. *Steinemer* involved an injury suffered when a minor injured his friend by shooting him with a BB gun. The Eleventh Circuit followed what it termed the "majority rule" which, within the meaning of an intentional act exclusion, separated an intent to do an act from the intent to injure or cause harm by doing the act.

"Under the majority rule . . . an 'intentional injury' exclusion will not apply if the insured intentionally does an act, *but* has no intent to commit harm, even if the act involves the foreseeable consequences of great harm or even amounts to gross or culpable negligence." *Id.* (quoting *Steinemer*, 723 F.2d at 875) (emphasis in *Allstate*).

52. *Allstate*, 768 P.2d at 732.

53. 789 P.2d 415 (Colo. 1990).

molestation.[54] The other courts expressed several theories in support of such holdings. Some used an objective test.[55] This test permitted an inference of intent, since a reasonable person would expect injury to result from molestation. This approach, however, had been criticized as being overly broad.[56] Moreover, most jurisdictions that had considered the issue had decided to infer an intent to injure as a matter of law.[57]

The court found that jurisdictions which inferred intent as a matter of law had taken judicial notice that sexual assault on a child will inevitably produce some harm.[58] The court quoted from *Allstate Insurance Company v. Kim W.*,[59] declaring that injury is inherent in acts of child molestation.[60] It also noted that both the Colorado legislature[61] and court of appeals[62] had found harm present in cases of molestation. The court also found the criminal statutes concerning child abuse implicitly contained the idea that harm is present in and flows from the forbidden behavior.[63]

In its decision, the court held that an intent to injure would be inferred as a matter of law from an intentional act of child molestation.[64] As a result, the subjective intent of the insured would not be relevant in the determination of whether an intentional injury exclusion precluded coverage.[65] The court rejected Troelstrup's claim that the rule should

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54. *Id.* at 418.

55. Such a test "considers what a 'plain ordinary person would expect and intend to result [from the offender's sexual misconduct].' " *Id.* at 419 (quoting CNA Ins. Co. v. McGinnis, 282 Ark. 90, 94, 666 S.W.2d 689, 691 (1984)).

56. "[T]he policy specifically states that the insured must expect or intend harm . . . . [I]f an objective standard is used, virtually no intentional act would ever be covered." Rodriguez v. Williams, 107 Wash. 2d 381, 385, 729 P.2d 627, 630 (1986).

57. 789 P.2d at 419.

58. *Id.*

59. 160 Cal. App. 3d 326, 334, 206 Cal. Rptr. 609, 613 (1984).

60. [I]mplicit in the determination that children must be protected from such acts is a determination that at least some harm is inherent in and inevitably results from those acts . . . . "The harm may be manifested in many different mental, emotional and physical ways, leaving a child with possible lasting and debilitating fears."

Id. (quoting People v. Austin, 111 Cal. App. 3d 110, 114-115, 168 Cal. Rptr. 401, 407 (1980)).

61. The legislature has declared that "the sexual exploitation of children constitutes a wrongful invasion of the child's right of privacy and results in social, developmental and emotional injury to the child . . . ." (quoting COLO. REV. STAT. § 18-6-403 8B (1986)). This section refers to sexual exploitation of a child, a different offense than Troelstrup was charged with. The quoted language appears in section one of the statute and is a statement of legislative intent only. The court has held that social, developmental and emotional injury to the child is specifically *not* an element of this crime. *Id.* People v. Enea, 665 P.2d 1026 (Colo. 1983).

62. *Kim W.*, 160 Cal. App. 3d at 334, 206 Cal. Rptr. at 613. Child molestation "is indeed a heinous crime that causes devastating results whenever it is committed, particularly when the perpetrator is in a position of trust." (quoting People v. Garciadealba, 736 P.2d 1240, 1243 (Colo. Ct. App. 1986)).

63. *Id.*

64. *Id.* Troelstrup had admitted the intentional nature of the acts. Troelstrup had pled *nolo contendere* to the charge of sexual assault on a minor and the trial judge had determined that Troelstrup's actions were taken "to satisfy his own gratification." *Id.* at 417. The court cited as support the cases discussed *infra* in section V.

65. *Kim W.*, 160 Cal. App. 3d at 419, 206 Cal. Rptr. at 613. The court said this decision does not "completely reject the [insured's] subjective intent; rather [it] overrule[s] the

not preclude coverage for his actions as they were not "extreme," citing *Horace Mann Insurance Company v. Leeber,*[66] which found that the majority rule inferring intent was not limited to cases involving "violence," "penetration" or an abuse over a "lengthy period of time."[67]

Troelstrup did not contend that the count of negligence in the complaint was relevant to the resolution of the issue.[68] The court mentioned in a footnote that a Michigan court of appeals case had denied coverage for a "negligent" molestation claim, calling it a "transparent attempt to trigger insurance coverage" by recharacterizing intentional child molestation as negligence.[69] Finally, Troelstrup's claims that Allstate had not zealously pursued his defense in the civil case during the pendency of the declaratory judgment were rejected, the court noting that because Allstate had accepted under reservation of rights, its only obligation was to prevent a default judgment or other prejudicial action.[70]

V. Decisions of Other Jurisdictions Cited as Support in *Troelstrup*

Troelstrup cited decisions from California, Iowa, Minnesota and Washington in support of the holding.[71] *Fire Insurance Exchange v. Abbott*[72] was a consolidated action involving two separate defendants accused of unrelated acts of sexual misconduct with a minor. Both defendants admitted their acts but denied subjective intent to injure.[73] The court decided the question of intent in light of a statute excluding coverage for "wilful" acts of an insured.[74] The statute is construed as a part of all policies written in California; Colorado has no analogous statutory language. *Abbott* adopted the holding of a previous California case[75] inferring intent to injure as a matter of law from an intentional act of molestation within the meaning of the "wilful" statute.[76] Unlike *Troelstrup, Abbott* did not involve an underlying criminal prosecution.[77]

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insured's actual intent in limited circumstances." (quoting Rodriguez v. Williams, 107 Wash. 2d 381, 385, 729 P.2d 627, 630 (1986)).

Of note is Landis v. Allstate Ins. Co., 546 So. 2d 1051, 1053 (Fla. 1989). The *Landis* court excluded coverage based on the insured's intentional act of molestation itself, not reaching the question of specific intent. "[W]e believe that specific intent to commit harm is not required by the intentional acts exclusion. Rather, all intentional acts are properly excluded by the express language of the homeowner's policy."

66. 376 S.E.2d 581, 585-86 (W. Va. 1988).

67. *Troelstrup,* 789 P.2d at 420.

68. *Id.* at 418.

69. *Id.* at 418 n.7 (*citing* Linebaugh v. Berdish, 144 Mich. App. 750, 757, 376 N.W.2d 400, 406 (1985)).

70. *Id.* at 420.

71. *Troelstrup,* 789 P.2d at 419.

72. 204 Cal. App. 3d 1012, 251 Cal. Rptr. 620 (1988).

73. *Id.* at 1016, 251 Cal. Rptr. at 622.

74. "An insurer is not liable for a loss caused by the wilful act of the insured . . . ." Cal. Ins. Code § 533 (West Ann. 1990).

75. Allstate Ins. Co. v. Kim W., 160 Cal. App. 3d 326, 206 Cal. Rptr. 609 (1984).

76. In J.C. Penny Cas. Ins. Co. v. M.K., 804 P.2d 689, 278 Cal. Rptr. 64 (1991), the California Supreme Court upheld the holdings in both these cases.

77. The result in *Abbott* was upheld in J.C. Penny Cas. Ins. Co. v. M.K., 804 P.2d 689,

Altena v. United Fire and Casulty Company[78] involved an adult victim of sexual abuse by a relative. The *Altena* court, although noting that the victim was an adult potentially distinguished the case from others involving abuse of a minor, adopted the holding in *State Farm Fire and Casulty Company v. Williams*[79] which refused to make that distinction.[80] Thus, *Troelstrup*'s reliance on *Altena* for support may indicate that Colorado would extend the rule to cases involving sexual assault on an adult, despite the court's express limitation of its holding to situations involving minors.[81] *Altena*, like *Abbott*, did not involve an underlying criminal prosecution.

In *Lehman v. Metzger*,[82] an uncle was alleged to have sexually abused his minor niece. It is not clear from the reported decision if Metzger admitted his acts. The *Lehman* court, in a perhaps overly broad holding, inferred intent to injure as a matter of law where the underlying *claim* was that the insured intentionally sexually assaulted a *victim* (not limited to an adult).[83] The court provided no analysis, merely citing previous state decisions.[84]

In *Rodriguez v. Williams*,[85] after Williams was convicted of committing incest with his minor stepdaughter, the stepdaughter filed a civil suit.[86] In the declaratory judgment action brought by his insurer, Williams in deposition admitted the incest but denied the subjective intent to injure.[87] He introduced an affidavit from his psychologist in support.[88] The Washington Supreme Court rejected the reasonable person standard applied by the court of appeals, finding the exclusion must be interpreted from the insured's standpoint.[89] Nonetheless, the court concluded that in cases involving incest it would infer intent to injure as a matter of law and thus declined to allow coverage.[90]

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278 Cal. Rptr. 64 (1991). The California Supreme Court also decided the issue in light of section 533 of the California Insurance Code. Of note is that the court found the language of the statute sufficient to infer intent: "Because we agree . . . that child molestation is wilful as a matter of law under section 553, we do not base our decision on the insured's admissions of wrongdoing. *Neither an admission nor a criminal conviction is necessary* to give rise to the exclusion under section 533." *Id.* at 840 P.2d at 698 n.13, 278 Cal. Rptr. at 73 (emphasis added). Thus the California line of cases in this area, based on a state statute, provides questionable support for Colorado's common law decision.

78. 422 N.W.2d 485 (Iowa 1988).

79. 355 N.W.2d 421 (Minn. 1984).

80. *Altena*, at 422 N.W.2d at 489.

81. "We conclude that an intent to injure may be inferred as a matter of law *where child molestation* is involved." *Troelstrup*, 789 P.2d 415, 419 (emphasis added).

82. 355 N.W.2d 425 (Minn. 1984).

83. *Id.* (emphasis added).

84. *Id.* at 426.

85. 107 Wash. 2d 381, 729 P.2d 627 (1986).

86. *Id.* at 382, 729 P.2d at 628.

87. *Id.* The court did not address the effect of the criminal conviction in the instant case.

88. *Id.*

89. *Id.*

90. *Id.* at 388, 729 P.2d at 630. The court cited Linebaugh v. Berdish, 144 Mich. App. 750, 376 N.W.2d 400 (1985) and State Farm Fire & Cas. Co. v. Williams, 355 N.W.2d 421 (Minn. 1984), both reaching similar results in sexual abuse cases.

VI. IMPLICATIONS OF *TROELSTRUP* FOR VICTIMS OF CHILD SEXUAL ABUSE

It is not yet clear what effect the *Troelstrup* decision will have in Colorado. No commentators have yet analyzed the implications in those jurisdictions which preceded Colorado in finding intent as a matter of law in abuse cases. One California justice has offered a cautionary dissent on the effects of a similar decision in that state. *J.C. Penney Casulty Insurance Company v. M.K.*,[91] settling a split in California appellate courts,[92] reached the same holding as the *Troelstrup* court. Writing in dissent, Justice Broussard identified two areas of concern with the majority opinion. Justice Broussard accused the majority of "practicing psychiatry without a license and doing a terrible job of it."[93] He pointed out that all the expert testimony in the case showed that the abuser had no subjective intent to harm the victim, even though the majority held the testimony "irrelevant" and quoted from other cases to the effect that such testimony "flies in the face of all reason, common sense and experience."[94] In strong language, Justice Broussard rebuked the majority for discarding the expert testimony.[95] He also noted that liability insurance serves a two-fold function in society. Such insurance provides not only funds for the wrongdoer to use to pay his debts but is a source of compensation, often the only source, for victims.[96]

Of note is that *Troelstrup* does not give guidance to what result the court would have reached had the defendant denied the allegations in the civil suit. Of the cases cited as support, the alleged molesters in *Abbott*, *Altena* and *Rodriguez* admitted their actions. In *Lehman* the act was established at a trial on coverage with no reference to an admission. In a similar declaratory judgment action brought in Colorado by an insurer subsequent to *Troelstrup*, a plaintiff's lawyer has successfully avoided the application of the *Troelstrup* decision where the defendant in that case denied committing the alleged acts.[97]

The court in *Troelstrup* found it unnecessary to address the effect of the *nolo contendere* plea, finding that the admissions in the deposition provided sufficient basis for its holding.[98] Even if it had reached that issue,

91. 52 Cal. 3d 1009, 804 P.2d 689, 278 Cal. Rptr. 64 (1991).

92. The difference centered on inferring intent to injure as a matter of law in child molestation cases within the meaning of § 533 of the California Insurance Code, applying a "wilful acts" exclusion to all policies in the state.

93. 804 P.2d at 701, 278 Cal. Rptr. at 76 (Broussard, J., dissenting).

94. *Id.* at 704, 278 Cal. Rptr. at 79.

95. There is nothing in our record to justify this shocking attack on the science of psychiatry. Neither the majority opinion nor the cited authorities provide any empirical evidence for such an attack, and the experience involved is that of child molesters and those who work with child molesters, not judges. In the absence of experience, judges should not undertake to practice psychiatry. *Id.*

96. "Often the wrongdoer's insurance is the only way the innocent victims of crime, including child molestation, may recover compensation for medical expenses, their disabilities and their injuries." *Id.* at 703, 278 Cal. Rptr. at 78.

97. Conversation with Tim Devereux, Esq. (Feb. 18, 1991).

98. *Troelstrup*, 789 P.2d 415, 417 n.6.

a *nolo contendere* plea has been held not relevant to prove intent.[99] Thus, if Troelstrup had denied the charges in the civil action, the court would have had nothing on which to base its newly created mandatory inference of intent. Additionally, the court has long held that a guilty verdict may be introduced only as prima facie evidence in a civil case.[100] Had Troelstrup been convicted in the criminal case and denied the charge in the civil suit, the verdict could have been introduced only as prima facie evidence. Trial courts are now apparently in the position of either upsetting precedent and inferring intent as a matter of law from the previously prima facie evidence of a conviction, or not granting summary judgment to an insurer and charging it with the duty to defend the suit. Of the cases cited as support in *Troelstrup*, only *Rodriguez v. Williams*[101] involved a criminal prosecution. Williams was convicted of incest and subsequently admitted his acts in deposition in the declaratory judgment action.[102] As in *Troelstrup*, the *Rodriguez* court accepted the deposition testimony, not considering (or even discussing) the criminal conviction.[103] Other states which have considered the use of criminal convictions in similar declaratory judgment actions have reached differing results.[104]

Also unresolved is the potential extent of the decision's application. Given the plain language of the holding,[105] it is unclear if the decision covers any case in which child molestation is initially *alleged*, even if denied by the defendant. *Lehman v. Metzger*, cited as support, appears to exclude coverage where the *claim* alleges sexual assault.[106] If the doctrine does so extend, it is not obvious what occurs after an insurer is released from any obligation to defend in a pre-trial declaratory judgment action over the denials of the insured and a jury subsequently finds that indeed no molestation occurred, or that the claim itself was spurious. It is possible that an insured may then seek reimbursement for his costs. Also, as noted above, the *Troelstrup* holding is specifically limited to cases involving *child* molestation,[107] yet it cites *Altena*, involving an adult victim, for support. As the case does not define what it considers child molestation, nor limit any such definition by reference to the statute, it is possible that the age of the molester is not determinative.[108]

99. *See* People v. Goodwin, 197 Colo. 47, 593 P.2d 326 (1979).

100. Approximately Fifty-Nine Gambling Devices v. People, 110 Colo. 82, 130 P.2d 920 (1942).

101. 107 Wash. 2d 381, 729 P.2d 627 (Wash. 1986).

102. *Id.* at 383, 729 P.2d at 628.

103. *Id.* at 388, 729 P.2d at 631.

104. *See* Annotation, *Criminal Conviction as Rendering Conduct for Insured Convicted Within Provision of Liability Insurance Policy Expressly Excluding Coverage for Damage or Injury Intended or Expected by Insured*, 35 A.L.R.4th 1063 (1990). This annotation discusses the use of convictions on either a jury verdict or a guilty plea. There are no cases concerning use of a plea of *nolo contendere*.

105. "We conclude that an intent to injure may be inferred as a matter of law where child molestation is *involved*." *Troelstrup*, 789 P.2d 415, 419 (emphasis added).

106. 355 N.W.2d 425 (Minn. 1984), *see also supra* note 82 and accompanying text.

107. 789 P.2d at 419.

108. Colorado makes sexual assault on a child a crime only where "the victim is less than fifteen years of age *and* the actor is at least four years older than the victim." COLO.

Troelstrup may thus apply to alleged molesters who are themselves minors. The ruling could in theory apply to a molester less than ten years old, even though such a defendant can not be criminally charged.[109]

Troelstrup should not affect a victim's initial ability to receive compensation, if needed, for therapy and medical expenses. Funds are usually available from the local county Victim's Assistance program.[110] Recognizing the importance of such programs, a Presidential panel has recommended an increase in funding for state and local programs that assist minor victims of abuse, including sexual abuse.[111] If a criminal case is successfully prosecuted, the court may order restitution from the defendant in addition to other penalties.[112] There remains, however, the difference between an order for, and payment of, restitution.[113]

Troelstrup's effects will primarily be felt by the victim seeking recovery for long-term or late-discovered psychological injuries[114] or for non-economic damages. Where will this compensation come from after *Troelstrup*? A victim may search for an alternate insurance policy providing coverage.[115] A plaintiff may always seek recovery from a defend-

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REV. STAT. § 18-3-405 (1986) (emphasis added). It is unclear if *Troelstrup* applies to a molester who can not be criminally charged.

Two decisions provide conflicting guidance in this matter. *Compare Illinois Farmers Ins. Co. v. Judith G.*, 379 N.W.2d 638 (Minn. Ct. App. 1986) (finding no coverage for a minor who was between the ages of 13 and 16 when he sexually assaulted two minors) *with Allstate Ins. Co. v. Jack S.*, 709 F. Supp. 963 (D. Nev. 1989) (refusing to infer intent and thus allowing coverage for a 14 year old alleged abuser).

109. A person under ten years old can not be found guilty of a criminal offense in Colorado. *See* COLO. REV. STAT. § 18-1-801 (1986).

110. Victim's Assistance offices are divisions of the District Attorney's offices in the Denver metro area. Compensation is usually subject to approval by a review board before disbursement.

Compensation varies in the Denver metro area: Adams County pays for a maximum of ten therapy sessions at a maximum of $60 per session and will pay some medical expenses if the victim has no primary insurance. Arapahoe County has no set maximum dollar amount or number of visits. It seeks a treatment plan from a therapist and will generally follow the recommendations in that plan. Arapahoe also pays reasonable medical expenses.

Denver provides a maximum of $2,500 for therapy plus will pay for hospitalization and miscellaneous medical expenses. Jefferson County will pay for one therapy session per week at a maximum of $60 per session for a reasonable number of sessions. It will also pay medical expenses, with a total maximum therapy and medical expenditure of $10,000 per victim.

111. PRESIDENT'S CHILD SAFETY PARTNERSHIP, FINAL REPORT 128-35 (1987). The panel urged states to reduce or eliminate factors which may prevent minors from receiving compensation from assistance programs offered by state and local governments, such as the victim's age, the nature of the crime and the victim's unique reactions. It also suggested that state and local governments develop "alternative funding mechanisms," such as surcharges on wedding licenses or birth certificates, asset forfeiture of individuals convicted of child exploitation and mandatory fines or penalties in addition to existing criminal sanctions, to generate revenue to fund such compensation programs.

112. Such restitution is usually ordered paid as reimbursement to a Victim's Assistance program if the victim has received such aid.

113. *See infra* note 117.

114. *See* Comment, *Civil Remedies for Victims of Childhood Sexual Abuse*, 13 OHIO N.U.L. REV. 223, 229 (1986).

115. *See* Public Serv. Mut. Ins. Co. v. Goldfarb, 53 N.Y.2d 392, 442 N.Y.S.2d 422, 425 N.E.2d 810 (1981) (holding that, under a professional liability policy covering liability for

ant's personal assets. In *Doe v. Uhler*,[116] the plaintiff attached the defendant's real property to avoid possible liquidation intended to avoid a writ of execution. Obviously if the abuser is not of sufficient means to satisfy the order or is judgment proof, any victory will be hollow.[117]

One commentator suggests that incest victims may be able to recover under a claim of negligent infliction of emotional distress,[118] a tort recognized in Colorado[119] but not yet interpreted in this procedural setting. Although the underlying complaint in *Troelstrup* contained a count of negligence, the court did not address it as Troelstrup did not argue the issue. Nonetheless, given the court's approving reference to a Michigan case characterizing a negligence count as a "transparent attempt" to avoid the effect of inferring intent,[120] it seems reasonable to expect an insurer may prevail in a declaratory judgment action against such a count.[121]

A victim may also seek recovery by filing suit against others who may have been negligent in allowing the abuse to occur.[122] The parent who did not commit the incest but knew or should have known that the incest was being committed and negligently failed to intervene may be reached through his or her homeowner's insurance policy. This approach may fail if the policy contains language similar to that in

injury resulting from "assault" or "undue familiarity," the insurance company had a duty to defend dentist who had allegedly sexually assaulted an adult female patient).

116. 220 N.J. Super. 522, 532 A.2d 1133 (1987).

117. "Particularly as to child molesters, the wrongdoers are likely to be incarcerated . . . and there is little likelihood that a judgment recovered against the wrongdoer can be collected out of the wrongdoer's earnings. The wrongdoer will ordinarily be faced with substantial legal expenses depleting whatever assets he may have had." *J.C. Penney*, 804 P.2d at 703, 278 Cal. Rptr. at 78 (Broussard, J., dissenting).

118. Comment, *Tort Remedies for Incestuous Abuse*, 13 GOLDEN GATE U.L. REV., 609, 627-28 (1983).

119. *See* Towns v. Anderson, 195 Colo. 517, 579 P.2d 1163 (1978). In *Towns*, a minor brought suit against a plumbing company after he witnessed an explosion which injured his sister. He alleged the defendant had negligently exposed him to an unreasonable risk of bodily harm. In finding the plaintiff had stated a cause of action, the court adopted the RESTATEMENT (SECOND) OF TORTS, § 436(2) which provided: "If the actor's conduct is negligent as creating an unreasonable risk of causing bodily harm to another . . . the fact that such harm results solely from the internal operation of fright or other emotional disturbance does not protect the actor from liability."

The court also cited with approval the definition of bodily harm from the RESTATEMENT (SECOND) OF TORTS § 436A comment C: "long continued nausea or headaches may amount to physical illness, which is bodily harm; and even long continued mental disturbance, as for example in the case of repeated hysterical attacks, or mental aberration . . . ."

In subsequent cases, Colorado has limited third party claims of fear for another's safety where the third party was outside the "zone of danger." *See* Hale v. Morris, 725 P.2d 26 (Colo. Ct. App. 1986).

120. *Troelstrup*, 789 P.2d 418 n.7 (quoting Linebaugh v. Berdish, 144 Mich. App. 750, 757, 376 N.W.2d 400, 406 (1985)).

121. *But see* State Farm v. Nycum, __ F.2d __, 1991 WL 164632 (9th Cir. 1991), distinguishing *J.C. Penny* and finding coverage when the jury found liability on a general verdict which could have been premised on a finding of either intentional molestation or negligent touching. The court rejected an automatic application of the *J.C. Penny* doctrine in any case involving an allegation of molestation.

122. Parents of a three year old boy who was molested by an employee of a McDonald's restaurant sued the company alleging negligent hiring. The plaintiff sought $3.7 million in damages. Denver Post, Mar. 1, 1991 sec. B, at 2 col. 1.

Chacon[123] as discussed in section III. As *Chacon* involved a married couple, it may be distinguishable if the abuser lives with but is not married to the parent and thus not a relative within the meaning of the policy.

VII. CONCLUSION

With its decision in *Troelstrup*, the Colorado Supreme Court, joining a developing national trend, has foreclosed a major avenue of compensation for victims of child molestation. Yet it is unclear if the *Troelstrup* court was responding to social needs or insurer pressures. As abhorrent as the reality of sexual abuse of a child is, there is no clear reason for this exception to the *Butler* rule. Reference to Colorado's criminal statutes is unpersuasive as the offense is sexual contact with a minor which can "reasonably be construed as being for the purposes of sexual arousal, gratification or abuse."[124] This incorporates the reasonable person review of the act specifically rejected in *Troelstrup* as overbroad. Additionally, as discussed above, a guilty verdict is admissible only as prima facie evidence.

Also troubling is the rejection of expert testimony as irrelevant. Where the determinative issue is the intent of the insured to cause harm, as set forth in *Butler*, it seems that expert evidence on this very point is crucial. Yet the court declared such testimony as irrelevant. Insurers argue that this trend represents sound public policy,[125] yet it seems to represent a fundamental shift in twentieth century tort law theory.[126] The argument that an abuser will be less likely to commit acts of abuse if he realizes that his homeowners insurer will not be available to defend him or satisfy a judgment is spurious.[127]

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123. Chacon v. American Fam. Mut. Ins. Co., 788 P.2d 748 (Colo. 1990).

124. COLO. REV. STAT. § 18-3-405 (1986). *See supra* note 6 for the full text of the statute.

125. *See* Grady & McKee, *supra* note 21, at 177-78.

126. In the late nineteenth century, liability insurance was viewed strictly as a contract between the insured and the insurer. The insured was generally an employer, and an injured employee had no direct recourse against the insurer. This changed in the early part of the twentieth century. Insurance began to be regarded as a source of compensation for injured persons. This switch in viewpoints was driven by a larger change in the perceived purpose of tort law. Tort law had been a means to punish the blameworthy for their misdeeds, so that losses would "lie where they fell" unless the plaintiff could find a culpable defendant. Twentieth century tort theorists began to view tort law as an efficient way to spread the costs of injury throughout society. G. WHITE, TORT LAW IN AMERICA, 146-153 (1980). The trend adopted by *Troelstrup* is a swing backwards, focussing on the bad acts of the defendant and ignoring the compensation needs of the victim. *See generally*, R. RABIN, PERSPECTIVES ON TORT LAW, 1983; G. CALABRESI, IDEAS, BELIEFS, ATTITUDES, AND THE LAW (1985).

127. The availability of insurance coverage for child sexual abuse will affect the perpetrator's choice to commit the act only if financial responsibility is one of his concerns. Moreover, child sexual abuse is criminal conduct. A perpetrator covered by a homeowner's policy would not be more likely to sexually abuse a child because he had a homeowners policy as he would still be subject to criminal liability. If financial responsibility is a concern, the perpetrator has knowledge that his action will harm the child. The very fact that a perpetrator knows he will become financially responsible for the injuries sustained . . . indicates that he is substan-

Rather than carving a wholesale exception to the *Butler* doctrine, the court could have created a rebuttable presumption, placing the burden on the alleged molester to show through credible evidence, including expert testimony, that he did not have the intent to injure. Or the court simply could have required insurers to specifically exempt coverage in the language of their policies. The fact that this unique situation required an exception to *Butler* dispels a "parade of horribles" argument of a twenty page policy of which eighteen pages are enumerated exceptions to coverage.

Ultimately, the boundaries and implications of this new area of tort law remain to be determined by the courts in Colorado and other jurisdictions which have chosen to follow this trend in the law.[128] The needs of the victims, however, have not changed. With this major avenue of recovery now blocked, needed and deserved compensation may become unavailable in many cases, thus increasing the suffering of the victims.

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tially certain that the child will be injured by his conduct [thus establishing the requisite intent to injure and triggering the policy exception].

Comment, *supra* note 7, at 175-76 (1988).

128. The California legislature recently passed a bill reversing the decision in *J.C. Penny*. *See* 1991 Ca. S.B. 1147. The bill provides that in a civil action for damages for injury resulting from an act of child molestation, the defendant's intent may not be implied absent an evidentiary hearing on the matter and an insurer is not exonerated unless the trier of fact specifically finds that the insured harbored a preconceived notion to intentionally harm. *See also* Debra J. Saunders, *California's Child Molesters' Relief Act*, WALL ST. J., Oct. 3, 1991, at A18.