# ARE RULE 23 CLASS ACTIONS A VIABLE ALTERNATIVE TO THE BANKRUPTCY CODE?

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## INTRODUCTION

In an earlier article,[1] I explored the ways in which out-of-court restructurings of financially troubled companies have become viable alternatives to the traditional chapter 11 bankruptcy reorganization, and the limits imposed by the securities and bankruptcy laws upon such alternatives. Since that time, I have learned of a new restructuring technique that has come into vogue in several judicial districts, notably the Northern District of Illinois and the District of Minnesota. In both jurisdictions, district court judges have employed a novel application of the Rule 23 class action[2] to approve a coercive tender offer[3] made to one or more public debt classes.

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1 Richard L. Epling, *Exchange Offers, Defaults, and Insolvency: A Short Primer*, 8 BANKR. DEV. J. 15 (1991).

2 See *infra* note 10 for a description of "opt out" and "non-opt out" class actions.

3 A coercive tender offer works in the following way. Pursuant to the terms of a proposed exchange offer for outstanding debt, such exchange is coupled with a consent solicitation or "exit consent" to the bondholders asking them to eliminate financial covenants in the indenture, such as net worth, asset sales or "equal and ratable" provisions. This technique, known as "covenant stripping," often coerces bondholders to accept the exchange offer. The reason it works is that nothing in the Trust Indenture Act (TIA) prevents alteration of covenants that do not govern the timely payment of principal or interest by less than a unanimous vote of the affected bondholders. *Cf.* TIA § 316(b), 15 U.S.C. § 77aaa. Thus, the non-consenting bondholders are left with a greatly weakened credit after a successful solicitation of the exit consents, even though the payment terms of their instruments have not been altered in the exchange.

Recent SEC staff positions suggest that the Commission's formerly permissive view of coercive tender offers may be changing, and that covenant stripping modifications may be treated as the exchange of a new security, subjecting the offeror to the registration requirements of the 1933 Securities Act (1933 Act). *See* Flanagin, *Securities Law Aspects of Insolvency — United States Law*, (Unpublished Manuscript, July 14, 1992); Wiegley, *Do "Exit Consents" Create a New Security?*, SEC TODAY, (Jan. 22, 1991).

A Rule 23 class action can be invoked with either one of two distinct goals in mind: (i) to include and bind all bondholders in a particular class of debt to the terms of an exchange offer; or (ii) to give favorable treatment to one group of bondholders, while specifically excluding others from participating in the benefits of the exchange offer. The first, inclusive, use of Rule 23, is the more common.

A potential involuntary bankruptcy situation occurs when the debtor commits an event of default under the indenture, usually by missing an interest payment. The normal procedure contemplated by the 1939 Trust Indenture Act (TIA)[4] is for bondholders possessing twenty-five percent or more of the principal amount of the claims to accelerate the entire obligation under the indenture[5] and take, through the indenture trustee, steps to enforce the collective obligations owed to the bondholders. Indeed, some bankruptcy courts have held that, absent acceleration, neither the bondholders nor the indenture trustee may file an involuntary petition in bankruptcy against the debtor when the indenture requires an acceleration request.[6] The TIA, however, preserves the right of each individual bondholder to sue the debtor directly for any nonpayment of principal or interest.[7] One or more bondholders owning less than twenty-five percent of the entire issue, therefore, may sue in state or federal district court alleging a monetary default and, if applicable, securities fraud claims under Rule 10-b(5)[8] and sections 11 and 12(2) of the Securities Act of 1933.[9]

The complaint must also allege that the bondholder plaintiffs represent not only themselves, but a class of those similarly situated. Thus, the plaintiffs seek to represent the bondholders

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4 15 U.S.C. §§ 77aaa - 77bbbb (1990).

5 TIA §§ 315(b); 316(a)(1).

6 *See In re* The Marcade Group, Inc., Case No. 92 B43920 (JLG) (Bk. S.D.N.Y.) Memorandum Opinion dated August 7, 1992. In *Marcade*, the court held that six bondholders could not petition for involuntary bankruptcy relief where a "no action" clause in the trust indenture prevented an individual bondholder from exercising a "remedy" under the indenture or the securities unless 25% of the principal amount of the then outstanding securities had first made a written request to the indenture trustee to pursue such a remedy. The court did not analyze, nor did the bondholders argue, the effect of TIA § 316(b) upon such indenture provisions that arguably impair an individual bondholder's right to sue on its own instrument after an event of default has occurred. *See also* In re Iroquois Brands, Ltd., No. 91-01018 - H3 - 11, 1991 Bankr. LEXIS 1915, at 1 (S.D. Tex. March 7, 1991).

7 TIA § 316(b).

8 1934 Act, Rule 10b-5, 17 C.F.R. 240. 10b5.

9 15 U.S.C. §§ 77k, 77l (1990).

(or some subset of the bondholders that they alone define) as a class under Rule 23(b). Regardless of how the class is defined, the plaintiffs always request that its members not be permitted to opt out under the applicable portions of Rule 23.[10]

At this point, the litigation is put on hold, and the debtor and the plaintiffs enter into settlement negotiations that usually exclude the other bondholders. What emerges from these discussions is a settlement agreement between the debtor and the plaintiff group. These parties then request the court to: (i) certify the bondholders or some subset of the bondholders as a non-opt out class under Rule 23(b); (ii) send a form of notice to all members of the affected class that a settlement has been reached; and (iii) hold a hearing at which the tentative settlement is approved by the court as a class action settlement and made binding upon all members of the newly formed class, whether they like it or not.[11]

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[10] Rule 23(b) provides in part:

> (b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:
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> (1) the prosecution of separate actions by or against individual members of the class would create a risk of
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> (A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or
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> (B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or
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> (2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or
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> (3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

FED. R. CIV. P 23(b).

[11] One commentator has noted:

> Once notice is given and the other members have had the opportunity to appear and challenge the settlement, any compromise or settlement approved by the court is proper and a class member who has

At the hearing, the settling parties argue that this judicial procedure does not infringe upon two important investor protections. First, the prohibition against altering the payment terms for principal and interest of an individual bondholder without that holder's consent[12] can be overridden in a judicial proceeding.[13] Second, the solicitation to the bondholders in the notice of class action settlement does not have to comply with the registration requirements of the 1933 Securities Act[14] because it is a judicially approved solicitation and thus exempt from the 1933 Act pursuant to section 3a(10).[15] Therefore, it is the *class action* device that permits the settlement proponents to avoid the TIA and 1933 Act, and to achieve a bankruptcy reorganization without bankruptcy.

This gambit leaves the non-participating bondholders with the options of seeking to file an involuntary bankruptcy petition against the debtor or appearing in court and objecting to a settlement in which they did not participate — assuming, of course, that the beneficial owners have actually received timely notice in the first place.[16]

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> failed to intervene or opt-out will be barred from objecting to the trial court's action on appeal.

7B WRIGHT & MILLER, FEDERAL PRACTICE AND PROCEDURE, § 1797, at 360 (1986); Marshall v. Holiday Magic, Inc., 550 F.2d 1173 (9th Cir. 1977).

On the other hand:

> [I]f the class member appears in response to the notice and puts forth his objections, he can attack the dismissal or compromise on appeal from the entry of the final judgment. If the appellate court upholds the trial court's decision, however, the objectors will be bound by the judgment therein.

7B WRIGHT & MILLER, § 1797, at 360-62; *see* Curtiss-Wright Corp. v. Helfand, 687 F.2d 171 (7th Cir. 1982).

12 TIA § 316(b).

13 H.R. REP. 1016, 76th Cong., 1st Sess. (1939) at 56 says in pertinent part:

> Under [section 316(b)], the indenture must provide that, except as to an interest postponement consented to as provided in [section 316(a)], the right of any indenture security holder to receive his principal and interest when due and to bring suit therefor may not be impaired without his consent. *Evasion of judicial scrutiny of the fairness of debt-readjustment plans, is prevented by this prohibition.*

*See also* Continental Bank & Trust Co. v. First Nat. Petroleum Trust, 67 F. Supp. 859 (D.R.I. 1946) (emphasis added).

14 15 U.S.C. § 77l-77z (1990).

15 15 U.S.C. § 77c.

16 *See* In re Southland Corp., 124 B.R. 211 (Bk. N.D. Tex. 1991). In *Southland*, the court held that in a bankruptcy plan solicitation, notice of the plan and ballot had to be given to the *beneficial* owners of the securities, because they were the true economic creditors. The case highlights a problem involving any solicitation to bondholders in that these securities generally are held "in street name" by the De-

In the following discussion, I will explore the efficacy of using a class action as a substitute for an exchange offer, pre-packaged bankruptcy plan or garden variety chapter 11 reorganization. If one accepts the policy expressed in section 316(b) of the TIA (and not everyone does)[17] that payment terms of each bondholder cannot be altered outside of a bankruptcy proceeding without one's consent, then what follows may be troubling. Alternatively, it can be argued that the old bondholder protections from the 1930s stand in the way of easy out-of-court resolutions of complex restructuring problems and cause unnecessary bankruptcies.

## I. Statutory Framework

### A. *Rule 23*

Class actions are governed by Rule 23 of the Federal Rules of Civil Procedure (FRCP). Rule 23 provides that, under certain circumstances, "[o]ne or more members of a class may sue or be sued as representative parties on behalf of all . . . ."[18] Only a class action maintained under section (b)(3) of FRCP 23 allows individual members of a class to "opt out" of the class and to pursue separate remedies. In a class action brought under FRCP 23(b)(1) and (2), therefore, all members of the class will be bound by the result.

### B. *Rule 24*

Intervention is governed by Rule 24 of the FRCP. Rule 24(a)(2) allows a party to intervene as of *right*:

> [W]hen the applicant claims an interest relating to the property or transaction which is the subject of the action and the

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pository Trust Institution or by a broker-dealer. The street name holder generally is the only one who knows the identity of the actual beneficial owners. Thus, there is a real risk that the beneficial holders will never learn (or will learn too late) of the existence of a class action settlement that seriously affects their rights.

17 *See* Roe, *The Voting Prohibition in Bond Workouts*, 97 Yale L.J. 232 (1987) (arguing that TIA § 316(b) should be repealed because it gives too much leverage to holdouts among the bondholder group and leads to failed workouts and unnecessary bankruptcy filings). *See also* Hearings on H.R. 2191 and H.R. 5220 before a Special Subcommittee of the House Comm. on Interstate and Foreign Commerce, 67th Cong., 1st Sess., 145, 161 (1939) (statement of Harold V. Amberg: "The denial of the right of the security holders by group action (sec. 316) to waive a default in payment of principal, even of a serial maturity, will automatically discourage any attempts at voluntary reorganization . . . particularly in relation to small debtor corporations.").

18 Fed. R. Civ. P. 23(a).

> applicant is so situated that the disposition of the action may as a practical matter impair or impede the applicant's ability to protect that interest, unless the applicant's interest is adequately represented by existing parties.[19]

Federal Rule 24(b) also allows for permissive intervention in the court's discretion.

### C. *Section 316(b) of the TIA*

Section 316(b) of the TIA reads as follows:

> The indenture to be qualified shall provide that, notwithstanding any other provision thereof, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such security . . . shall not be impaired or affected without the consent of such holder.[20]

This provision precludes impairment of two separate rights of each individual holder without the holder's consent: (i) the right to receive payment of principal and interest when due; and (ii) the right to sue for past due principal and interest. As noted above, the legislative history of the TIA indicates that the individual consent requirement was intended to require that all restructurings of core terms of public debt securities be subjected to the judicial scrutiny of a bankruptcy court.[21]

## II. INTERVENTION

Consider a simple hypothetical example to illustrate the problem. Troubled Company has the following capital structure:

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| $50 million | Senior Secured Bank Debt |
| 20 million | Ordinary Trade Debt |
| 75 million | Subordinated 15% Debentures with $5 million annual sinking fund payments |
| 10 million | Preferred Stock with mandatory dividend payment |
| 30 million | Common Stock; $1.00 par value |

Assume that Troubled Company has an unleveraged enterprise

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19 Fed. R. Civ. P. 24(a)(2).

20 15 U.S.C. § 77 fff (1990).

21 *See* Continental Bank & Trust Co. v. First National Petroleum Trust, 67 F. Supp. 859, 872 (D.R.I. 1946). *See also* SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, PART I, STRATEGY AND TECHNIQUES OF PROTECTIVE AND REORGANIZATION COMMITTEES, 871-72 (1937) (stating that "[p]roponents of voluntary debt readjustments should not be permitted to have the imprimatur of federal courts placed on their plans so easily and so expeditiously.").

value of $100 million. Thus, the stockholders' equity has been eliminated, and the debentures (and the trade debt if it is *pari passu* with the public debt) are partly in and partly out of the money. Finally, assume that a mandatory principal retirement payment to the debentureholders has been missed, so there is a non-waivable monetary default under section 316(b) of the TIA.

Next, consider two possible scenarios. In Scenario A, debentureholders holding $20 million principal amount of the issue commence a class action for themselves and others similarly situated to collect the past due amounts. They define the class as all the *original* holders who bought without knowledge of alleged omissions of material fact in the offering circular under which Troubled Company sold the debentures. Original holders, who allegedly bought without knowledge of the fraud, own $50 million of the issue, the other $25 million being in the hands of secondary purchasers who bought in the open market.

After six months, the class plaintiffs present a proposed settlement to the court that would give only the *original* holders (i) cash equal to thirty-five percent of the principal amount of their claims; and (ii) new debentures with a principal amount equal to sixty-five percent of their claims, with a nine percent coupon and no mandatory principal retirement until maturity ten years hence. Plaintiffs and the debtor say that their proposed settlement will enable Troubled Company to cure its default to secondary holders. The settlement does not seek to alter otherwise the legal or contractual rights of any other debt or equity holder of Troubled Company. The excluded minority holders disagree and would like to defeat the settlement or gain inclusion in the plaintiff class so they can receive the cash payment and new debentures.

Scenario B has the same fact pattern, except that now the plaintiff class is defined as *all* of the debentureholders and the proposed settlement: (i) has no cash component; (ii) causes Troubled Company to issue new debentures with principal equal to 100 percent of the principal of the fifteen percent debentures; (iii) eliminates all sinking fund payments to retire principal; (iv) extends the maturity date to ten years hence; (v) reduces the coupon to nine percent per annum; and (vi) causes Troubled Company to issue one share of new preferred, no par stock for each $5 of principal amount of new debentures issued — the new preferred has already been authorized by Troubled Company before the default and is *pari passu* with the old preferred stock. No other class of debt or equity will be affected by the settlement, which is now noticed to the debentureholders.

No class vote is taken among the debentureholders, and only three dissenting holders file objections and come to the settlement hearing. Can the court, or *should* the court, approve such a settlement?

In the balance of this section, I examine the issues raised by Scenario A and the attempt to gain standing to be heard or inclusion in the plaintiff class. In Section III, I look at the issues common to both Scenarios A and B, and the power of the court to override the TIA, the Securities Act and, perhaps, the Bankruptcy Code.

The first issue for the omitted bondholders will be whether they may intervene in the class action case. As discussed in Part II, failure to intervene can destroy the right of appeal. As set forth above, a proposed intervenor of right must meet the requirements of Rule 24(a). In particular, the following four elements must be satisfied: (i) timely application; (ii) an interest relating to the subject matter of the action; (iii) potential impairment, as a practical matter, of that interest by the disposition of the action; and (iv) lack of adequate representation of the interest by the existing parties to the action.[22]

Several recent circuit court cases have addressed the question of timeliness. In *United States v. Kemper Money Market Fund, Inc.*,[23] the court enumerated four factors to be considered in determining whether or not a motion to intervene is timely:

> Among the factors to be considered are: the length of time the intervenor knew or should have known of her or his interest in the case; the extent of prejudice to the original litigating parties from the intervenor's delay; the extent of prejudice to the would-be intervenor if her or his motion is denied; and any unusual circumstances.[24]

In practice, the analysis of these standards has been extremely fact-specific, and decisions often depend on the other procedural facts of the case. For example, one court has held that once complex settlement negotiations that are well-publicized have begun, parties may not be allowed to intervene.[25]

The omitted secondary holders in Scenario A will argue that they intervened in the case promptly after discovering that settlement talks were underway. With respect to the second and third factors, the intervenors will argue that any settlement that will pro-

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[22] Southmark Corp. v. Cagan, 950 F.2d 416 (7th Cir. 1991) (citations omitted).

[23] 704 F.2d 389 (7th Cir. 1983).

[24] *Id.* at 391.

[25] Bloomington v. Westinghouse Electric Corp., 824 F.2d 531, 535 (7th Cir. 1987) (denying intervention, in part, because the application for intervention was not timely when made eleven months after publicly announced settlement talks began).

vide cash or new instruments with better coupons and/or amortization terms to the class member debentureholders will necessarily deplete the assets of Troubled Company and will so affect its financial condition as to breach several covenants under the indenture and deny non-class member debentureholders their full recovery with respect to the notes.[26]

Each of these arguments is grounded in the idea that the subject matter of the litigation is the trust indenture and the debentures purchased thereunder. A debentureholder has an interest in both the indenture and the debentures, and that interest will necessarily be impaired to the extent that a settlement weakens the financial condition of the debtor vis-a-vis the non-class member debentureholders. In this connection, the stronger argument — because it is grounded in contract — is that the settlement will result in breaches of indenture covenants (if any exist), such as any limitations on making restricted payments or incurring additional indebtedness (because in both scenarios the settlement contemplates the issuing of a new instrument), or any requirement for maintaining adjusted consolidated net worth.

Having shown that an intervening debentureholder has an interest that will be impaired by any proposed settlement with the class action plaintiffs, the fourth element is easily proven: the class action plaintiffs cannot adequately represent the intervenors because their interests are adverse to the interests of the omitted debentureholder. In *In re City of Philadelphia Litigation*,[27] for instance the court concluded that the existing class did not adequately represent the interests of certain other claimants due to potential conflicts with respect to settlement even though "the interests of the core and peripheral claimants [were] similar in many respects."

In sum, the court's determination of whether or not a given debentureholder is an appropriate intervenor will be highly fact-specific.

## III. Ability to Bind Non-Consenting Bondholders to a Class Action Settlement

All putative class members and allowed intervenors will have standing to contest the proposed settlements. The issues raised by both Scenarios A and B are largely the same. In both cases, no vote is solicited from the beneficial owners of the bonds; their

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26 This issue raises many of the problems with coercive tender offers described at *supra* note 3.

27 File No. 85-2745 (E.D. Pa., July 25, 1986) (slip op.).

only remedy is to appear at the settlement hearing and object. The settlement proponents in both scenarios define the scope of the class, and in each case there will be holdouts within the class. In Scenario A, dissenters *within* the class are likely to be in a minority, as this group is being treated better than debentureholders who own the "stub" of the issue. Scenario B presents the opposite problem — there may even be a majority within the class who would oppose the proposed exchange. Such creditors might view their recoveries in a bankruptcy case as preferable to the proffered settlement because the absolute priority rule will give them 100 percent of the new common stock and eliminate the old preferred and common shareholders. Finally, Scenario B presents the question whether the *preferred stockholders* may object because their consents have not been solicited, even though their equity interests are diluted by the settlement.

There has been little reported caselaw on whether or not a class action settlement under FRCP 23 can override the minority bondholder protections of section 316(b) of the TIA by binding non-consenting (or participating) members of a bondholder class. To date, there have been only three cases in which this situation has been presented, each of which the United States District Court for the Northern District of Illinois resolved. In addition, a fourth case presented the issue on appeal to the Eighth Circuit, but the court dismissed the case because the appellant lacked standing.

As further described below, the courts in the *MBank Dallas* and *Kemper Investors* cases held that the class action itself fulfills the second right available to bondholders under section 316(b) of the TIA — the right to sue for principal and interest — despite the fact that FRCP 23(b)(1) and (2) preclude opting out and bringing an individual suit. Implicit in each of these courts' findings and conclusions is the notion that a judicially approved compromise under which holders receive less than the full amount of principal and interest on their securities does not "impair or affect" their rights within the meaning of section 316(b) of the TIA. The court in *Macleod-Stedman*, however, was unwilling to grant class certification that precluded opting out because of the conflict with section 316(b) of the TIA. Finally, the lower court in *Alleco* certified the class pursuant to FRCP 23(b)(1) and (2) and approved the class settlement agreement. A non-participating class member appealed these determinations, but saw the appeal dismissed because of failure to make a motion to intervene in the trial court. A detailed description of these cases follows.

1. *MBank Dallas, et al. v. LaBarge, Inc.*[28] MBank Dallas, as successor indenture trustee, and Continental Assurance Company (CNA), individually and as representatives of a debentureholders class, brought suit against the issuer LaBarge for declaratory judgment as to their rights and those of the putative class regarding a resolution of the defaulted debenture issue. The court certified the class claim of CNA as a plaintiff class action under FRCP 23(a), (b)(1)(A) and (B) and (b)(2). The trustee, CNA and LaBarge negotiated a settlement involving an exchange of new securities for the debentures.

The court found that the settlement was fair and in the best interests of the debentureholders, the trustee and LaBarge, and produced a greater recovery for the debentureholders than would either acceleration of the debentures or liquidation of LaBarge. The debentureholders approved the settlement by over sixty-four percent, but the settlement was contingent on completion prior to the effective date of the 1986 Tax Reform Act, which would have made the settlement unworkable. The court overruled all objections to the settlement and denied a motion of one debentureholder to intervene. The court specifically found that the settlement did not violate section 316(b) of the TIA because the right of the debentureholders to bring suit had not been impaired; indeed, the class action litigation was just such an action.

2. *Kemper Investors Life Ins. Co. v. Las Colinas Corp., et al.*[29] Kemper Investors brought suit individually and as a class representative of defaulted secured notes issued by Las Colinas for a declaratory judgment as to the rights of the class. The complaint alleged, among other things, nonpayment of interest. The court certified the suit as a class action pursuant to FRCP 23(b)(1) and (2). Subsequently, Kemper Investors and Las Colinas negotiated a settlement providing for an exchange offer to the noteholders, which apparently was registered under the 1933 Act, giving them an election to receive new securities or cash, unless elections exceeded the available amount of one or the other.

In approving the settlement, the court found that the noteholders had not been deprived of their right to sue for principal and interest under section 316(b) of the TIA because the suit was

[28] No. 86C 9583 (N.D. Ill. 1986).
[29] Case No. 88C 9162 (N.D. Ill. 1988).

in the exercise of that right. The court also found that the proposed settlement would provide the best available recovery on the notes, and individual suits by noteholders would circumvent the best interests of the noteholders as a whole with the potential of disparate treatment.

3. *Continental Assurance Co. v. Macleod-Stedman, Inc.*[30] Continental Assurance Company (CNA) individually and as a class representative of holders of defaulted mortgage notes brought suit against Macleod-Stedman, the issuer, for a declaratory judgment that the terms and conditions of the issuance and exchange of securities in a restructuring were fair and that such securities should be exempt from the registration provisions of the 1933 Act. At the time of the suit, holders of 89% of the face value of the mortgage notes had accepted the restructuring in principle.

The court recited the procedural backdrop for the case as follows:

> The trustee would not execute the documents necessary to complete the settlement principally because it believed the settlement adversely affected rights of the nonconsenting Noteholders which were protected by the Indenture itself and the [TIA]. . . . CNA sought class certification [under FRCP 23(b)(1) and (2)] with a no opt out class as a means of avoiding any requirement of consent mandated by the Indenture or [the TIA]. Without issuing an opinion or ruling on class certification, the court indicated its conclusion that the Indenture and the TIA required that any Noteholder who was a part of the settlement had to consent to it and that class certification could not be used to avoid this requirement.[31]

This case ultimately provides little precedential value, however, because CNA subsequently withdrew its request for class certification and obtained the consent to the settlement by all of the noteholders by purchasing the notes held by non-consenting noteholders for fifty to sixty percent of face value.

The *Macleod* court went on to determine that the exchange offer was fair and in the best interests of the noteholders, the trustee and Macleod-Stedman, and produced a greater recovery for the noteholders than would either acceleration of the notes or liquidation of Macleod-Stedman. By this time, however, there were no objections to the settlement and no motions to intervene because, as noted

30 694 F. Supp. 449 (N.D. Ill. 1988).
31 *Id.*

above, all noteholders either had consented to the proposed settlement or had been bought out.

4. *The Harry and Jeanette Weinberg Foundation Inc. v. Alleco Inc.*[32] The Harry and Jeanette Weinberg Foundation (the "Foundation") appealed the district court's decision to certify the holders of nine and one-half percent Convertible Senior Subordinated Debentures due in the year 2010 (the "Debentures"), issued in an original, principal face amount of $105,000,000, as a class and to approve a class settlement reached by an informal committee of debentureholders with Alleco and Service America Corporation.

The Foundation raised eight separate objections in its appeal papers. The Foundation's objections were primarily procedural — no justiciable case or controversy, lack of subject matter jurisdiction, lack of standing, inadequacy of representation by the purported class representative and inadequacy of notice. The Foundation also asserted that the class action suit contravened the provisions of the TIA. This allegation, however, was based on the trustee's obligation to provide class members with written notice, written request, and an offer to indemnify or a percentage interest under section 315 of the TIA. The brief did not specifically raise the inherent conflict between class action procedures and section 316(b) of the TIA. Furthermore, the reply brief filed by the Foundation did not raise the TIA issue at all; the Foundation discussed the TIA cause of action entirely as a question of notice to class members. As such, the cause of action based on the class action conflict with the TIA was not sufficiently well framed to have provided the appellate court with grounds for reversal. Subsequently, the court dismissed the appeal on procedural grounds, holding that an unnamed, non-intervening class member, such as the Foundation, had no standing to appeal. The failure to be granted intervention as a named party at the trial court level thus proved fatal, even though the Court conceded that the settlement agreement affected the Foundation's substantive rights as a bondholder member of the settling class.

## IV. Conclusion

As noted above, the legislative history of section 316(b) of the TIA indicates that the legislature intended to protect minority bondholder interests.[33] For example, in the *Continental* case,

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[32] No. 91-2641 (8th Cir. 1991), *appeal dismissed sub nom.* Croyden Associates v. Alleco, Inc., Bankr. L. Rep. (CCH) ¶ 74,710 (1992).

[33] Continental Bank & Trust Co. v. First Nat'l Petroleum Trust, 67 F. Supp. 859 (D.R.I. 1946).

holders of a majority of the outstanding debt proposed to waive past-due interest over the objection of a minority. The court, citing the TIA legislative history, held that such a waiver was not permissible.[34] This conclusion is consistent with the view of a recent commentator. Professor Roe of the University of Pennsylvania Law School advocates permitting bond restructurings absent unanimous consent, but believes that section 316(b) of the TIA is a bar to this process that only Congress can remove.[35]

A basic point that courts considering this matter apparently have overlooked concerns the relation between Rule 23 and the TIA. Rule 23 is a rule of *procedure* while the TIA is part of federal *substantive* law. Although the TIA can be overridden by a court applying other substantive law, it cannot be overridden by a court applying a rule of procedure. Procedural rules give the court no standards to guide it in making its decision; it is left to the court to determine what is "fair" in the abstract. For example, Congress clearly intended the TIA to be subject to the terms of the Bankruptcy Code, but only because the Bankruptcy Code is a comprehensive system for adjudicating creditors' rights.[36] The Bankruptcy Code contains a number of important safeguards for protecting minority interests, among them: a right to adequate disclosure of information (Code § 1125),[37] the right to vote for or against a plan (Code § 1126),[38] the best interests requirement (Code § 1129(a)(7)),[39] and the fair and equitable and

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34 *Id.* at 871-72.

35 Interestingly, this article is cited by James E. Spiotto in THE APPLICABILITY OF THE EXEMPTION UNDER SECTION 3(A)(10) OF THE SECURITIES ACT TO DEBT RESTRUCTURINGS, SECTION 316(B) OF THE TRUST INDENTURE ACT, AND SECTION 3(A)(9) EXCHANGES, PLI, Nov. 12-13, 1990. Mr. Spiotto, however, concludes that "[s]ection 316(b) is a response to the 25% limitation on holders bringing suits for past due amounts and does not (and cannot be read to) bar a settlement on how the debt will be paid." *Id.* at 100. Mr. Spiotto has represented the class action plaintiffs in the *Macleod-Stedman*, *LaBarge* and *MBank Dallas* cases.

36 In fact, it is clear from the legislative history of the TIA and the writings of William O. Douglas (the primary draftsperson of the TIA) that Section 316(b) was specifically designed to prohibit disenfranchisement of individual bondholders absent judicial scrutiny and that the procedure envisioned was a *bankruptcy* proceeding. In this connection, it is important to note that the class action procedure was in existence, though in slightly different form, in 1939 (the date the TIA was enacted) and nowhere in the legislative history of the TIA is there mention that the type of judicial scrutiny envisioned included a class action proceeding.

37 11 U.S.C. § 1125 (Supp. 1984).

38 11 U.S.C. § 1126 (Supp. 1984); *see also In re* Hart Ski Mfg. Co., 5 B.R. 734 (Bankr. D. Minn. 1980) (opining that the right to vote for or against a reorganization plan could not be alienated or waived).

39 11 U.S.C. § 1129(a)(7) (Supp. 1988) provides generally that each creditor

unfair discrimination rules (Code § 1129(b)).[40] All these substantive rights designed to protect minority creditors are absent in a class action proceeding. By using Rule 23 as a substitute for the Bankruptcy Code or the TIA, the courts are elevating a rule of procedure to the status of substantive law. This misapplication can lead to aberrant results where some debentureholders are treated better than others holding the same instruments, as in Scenario A, or where a minority of cooperative debentureholders forms a pact with the debtor to preserve common equity interests at the expense of the subordinated creditors and preferred stockholders, as in Scenario B.

This policy concern, however, has not been the subject of recent case law in this area. As the proceedings described above indicate, either the issue has not been specifically framed for, and therefore not addressed by, the courts, or the class proponent has bought out or otherwise silenced objectors. The only indication of a policy preference has been in the *MacLeod-Stedman* case, in which the trial court seemed to agree with the notion that the unanimity constraints of section 316(b) of the TIA cannot be circumvented through a class action procedure. Given the later procedural posture of the case, however, it is difficult to predict with any degree of certainty what a court — even in the Northern District of Illinois — would do if confronted with another class action settlement of this nature.

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must receive value under a plan of not less than it would receive if such debtor were liquidated under Chapter 7 of the Code.

40 11 U.S.C. § 1129(b)(2)(B) (Supp. 1988) provides generally that as to a dissenting class of unsecured creditors, a plan cannot discriminate unfairly between that class and other creditor classes and either must pay them in full or provide that no junior class may receive or retain any value in the reorganized debtor.