

The Changing Nature of Debt and Equity: A Legal Perspective

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Historically, the law has distinguished sharply between debt and equity, and between the duties a corporation owes to its stockholders and those it owes to holders of its debt securities and its other creditors. Over the past several years, changes in the business world, particularly the increase in leveraged buyouts and the use of nontraditional forms of securities, have put a strain on the traditional legal analysis. This paper will briefly examine the legal principles that historically have applied both to solvent corporations and to those that are insolvent and undergoing reorganization under the Bankruptcy Code. It will also explore how the courts are attempting to cope with the new problems, and the difficulties the courts face in applying traditional principles to solving those problems.

Traditional Analysis—The Solvent Corporation

The duties of a solvent corporation and its management to its stockholders are fiduciary in nature. They are both very broad and very general. Management is required to operate and manage the business of the corporation with care and with due regard to the interests of the stockholders. However, holders of common stock typically do not have the right to require management to take specific action, and management enjoys considerable discretion in determining what action is in the

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best interests of stockholders, and in balancing long-term and short-term interests.¹

The duties of a solvent corporation and its management to creditors are primarily contractual in nature. These duties are specific, not general, and are spelled out in detail in the loan agreement or indenture under which credit is extended. The loan agreement or indenture will also state in specific detail the remedies to which creditors are entitled if the corporation breaches its contractual obligations. The corporation also must comply with statutory provisions restricting payment of dividends and redemptions or repurchases of its stock, and with state fraudulent conveyance law, and these laws may provide some further protection to creditors. These statutory provisions are again quite specific in nature, however, and usually will apply only when the corporation is either insolvent or approaching insolvency. A solvent corporation and its management have not traditionally been thought to have any general fiduciary duties to its creditors.²

The traditional legal analysis was based on certain unstated underlying assumptions as to how the business world worked. The capital structure of most corporations contained a substantial equity component, which was viewed as a cushion to protect creditors from the risk of insolvency. The debt to equity ratio of corporations engaged in a particular type of business did not vary greatly, and was generally moderate. Creditors accepted a fixed rate of return, with little prospect for appreciation, in return for a priority in right to payment over stockholders on the corporation's liquidation or insolvency. Debt instruments were regarded as having low risk, as compared to stock. What risk did exist fell into one of two categories: market rate risk or credit risk. The former was, for the most part, a risk that the corporation and its management could not influence or control.³ Increased credit risk could result either from general economic conditions affecting the corporation's business, or from mistakes in judgment by the corporation's management. Such mistakes in judgment, it was thought, would adversely affect both stockholders and creditors in a roughly similar

¹ *Paramount Communications Inc. v. Time Inc.*, Civ. Action Nos. 10866, 10670, 10935 (consolidated) (Del. Ch. July 14, 1989) (1989 Del. Ch. LEXIS 77). "The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors not shareholders are charged with the duty to manage the firm." P. 34.

² *Harff v. Kerkorian*, 324 A.2d 215 (Del. Ch. 1974), *affirmed*, 347 A.2d 133 (Del. Supr. 1975).

³ Market rate risk is also one that is relatively easy to control or allocate through the use of specific contract provisions, such as prepayment premiums, restriction on refunding, floating interest rate provisions, and so forth. *Morgan Stanley & Co., Inc. v. Archer Daniels Midland Co.* 570 F. Supp. 1529 (S.D.N.Y. 1983).

way. If the purchasers of debt instruments anticipated that a specific action might adversely affect a corporation's credit standing, and hence the value of their securities, they could negotiate contractual provisions prohibiting or restricting such action.

These underlying assumptions as to how the business world worked were, for the most part, generally accurate through the 1970s. As a result, the courts had relatively little difficulty in reconciling the duties of a corporation to its creditors and stockholders with the reasonable expectations of investors. In the last decade, however, things began to change.

Managements began to realize that managing the corporation's financial structure might be almost as important as managing the business in determining profitability and the return to stockholders. Debt rather than equity was increasingly used to finance the corporation's operations, or to acquire new assets.⁴ Even more important, debt was now increasingly associated with a leveraged buyout or other recapitalization of a corporation, rather than with the corporation's operations or the need to finance the acquisition of new assets. Leveraged buyouts were not a new discovery; they had been used for years, under different names.⁵ What was new was the circumstances in which, and the purposes for which, they were being used.

In earlier years, leveraged buyouts had been used as a tool to finance a transfer of ownership when the owners of a closely held corporation died or retired, or when a corporation wanted to divest itself of a subsidiary or division. The leveraged buyout aspect of the transaction was only incidental to its main purpose. Now, leveraged buyouts were being used for the purpose of restructuring a corporation to increase its profitability and the return to stockholders, almost independent of the needs of the corporation's operation. It was also now recognized, and had not been fully recognized earlier, that the substantial increase in leverage, and the increased risks which that leverage entailed, might not affect stockholders and creditors in even roughly similar ways. A substantial increase in leverage might bring the interests of creditors and stockholders into fundamental conflict, and contractual provisions that creditors had bargained for often proved inadequate to protect their interests.

⁴ See Kopcke, Richard W. 1989. "The Roles of Debt and Equity in Financing Corporate Investments." *New England Economic Review*, July/August, p. 25.

⁵ *Robinson v. Wangemann*, 75 F.2d 756 (5th Cir. 1935); Note: "Bootstrap Acquisitions: The Risk of Subordination in Bankruptcy," 48 *Boston University Law Review* 441 (1968).

The Traditional Analysis Revisited— Recent Developments

One response by creditors was to seek to reopen the issue of whether the corporation and its management owed them, as well as stockholders, fiduciary duties. These attempts failed. The courts reaffirmed earlier holdings that creditors, even creditors holding convertible securities, were not entitled to the corporate fiduciary protections enjoyed by stockholders, and that the creditors should protect themselves against self-interested issuer action by bargaining for appropriate contractual provisions.⁶

Creditors had somewhat more success with a more narrowly focused strategy. It is an established legal principle that a contract carries with it an implied covenant of good faith and fair dealing.⁷ The implied covenant will prevent a party to the contract from taking action that, although not contravening any express term of the contract, would frustrate its purpose or enable the party to circumvent the clear intent of the contract.

*Van Gemert v. Boeing Co.*⁸ involved a redemption of convertible debentures, which was challenged by holders of the debentures on the grounds they were given inadequate notice of the redemption and were thus unable to exercise their conversion rights. Boeing Co. had complied with the notice provisions contained in the debenture and the related indenture. The Court held that there was an obligation to give fair and reasonable notice of the redemption to the debenture holders, and that this had not been fulfilled despite compliance with the express terms of the indenture.

*Pittsburgh Terminal Corp. v. Baltimore & Ohio Railroad Co.*⁹ involved a spin-off by Baltimore & Ohio Railroad Co. of the stock of a subsidiary as a dividend in kind to its stockholders. The same date was fixed for declaration of and the record date for participation in the dividend in kind. The holders of convertible debentures claimed that this deprived them of the opportunity to convert before the record date, and thus participate in the spin-off dividend. The indenture called for advance notice of certain dividends, but did not clearly call for notice for the spin-off dividend. The Court held that the Baltimore and Ohio Railroad Co. had prevented the debenture holders from receiving the informa-

⁶ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. Supr. 1986); *Simons v. Cogan*, 542 A.2d 785 (Del. Ch. 1987), 549 A.2d 300 (Del. Supr. 1988).

⁷ See Uniform Commercial Code, 1-203; *Gilbert v. The El Paso Company*, 490 A.2d 1050 (Del. Ch. 1984).

⁸ 520 F.2d 1373 (2d Cir. 1975), 553 F.2d 812 (2d Cir. 1977).

⁹ 680 F.2d 933 (3d Cir. 1982).

tion they needed in order to exercise their conversion option and that this violated the implied covenant of good faith and fair dealing.

Creditors have been less successful when they were unable to relate the alleged breach of the implied covenant of good faith to a specific provision of the indenture. *Broad v. Rockwell International Corporation*¹⁰ arose out of a tender offer following which Collins Radio Company was merged into Rockwell International Corporation and the holders of common stock of Collins Radio received \$25 per share in cash. Collins Radio had outstanding convertible subordinated debentures, which were assumed by Rockwell International Corporation. A supplemental indenture provided that, following the merger, the debentures would be convertible into \$25 per share of the Collins Radio common stock which would have been issuable on conversion prior to the merger. This effectively eliminated the value of the conversion right. The Court held that the elimination of the conversion right did not violate the implied covenant of good faith and fair dealing, and that the debenture holders were not entitled to a continuing conversion right into Rockwell International common stock, or to redemption of the debentures at the price provided in the indenture.

*Katz v. Oak Industries, Inc.*¹¹ involved an exchange offer and consent solicitation made by a financially troubled corporation to the holders of its long-term debt. The offer sought to exchange new securities and cash for part of the debt, and to obtain waivers with respect to the remaining debt. A bondholder argued that this was a breach of the implied covenant of good faith and fair dealing, as the corporation was seeking to do indirectly what it could not accomplish directly under the provisions of the indenture relating to redemption and waiver. The Court stated that the implied covenant should be used only where it was clear from the express terms of the contract that the parties who negotiated it would have agreed to proscribe the act later complained of as a breach of the implied covenant, had they thought to negotiate with respect to the matter. The Court found nothing in this indenture to indicate that the parties had intended to prohibit an exchange offer coupled with the giving of waivers, and refused to enjoin the exchange offer.

The most aggressive attempt by creditors to invoke the implied covenant of good faith and fair dealing arose in connection with the recent leveraged buyout of RJR Nabisco.¹² Institutional investors hold-

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

¹¹ 508 A.2d 873 (Del. Ch. 1986).

¹² *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*, No. 88 Civ. 8266 (S.D.N.Y. June 1, 1989) (1989 U.S. Dist. LEXIS 6253).

ing unsecured bonds of RJR Nabisco argued that the transaction violated the implied covenant of good faith and fair dealing relating to the bonds. RJR Nabisco had sold, and the institutional investors had purchased, bonds that were "investment grade." Statements made by RJR Nabisco and its management allegedly constituted express or implied representations, not contained in the indentures, that the company intended to maintain its creditworthiness and the "investment grade" quality of its outstanding debt securities. The increased debt incurred in connection with the leveraged buyout drastically impaired the value of the bonds previously issued, and, it was argued, misappropriated the value of those bonds to help finance the leveraged buyout and to distribute a windfall to RJR Nabisco's stockholders.

The Court rejected these arguments. It pointed out that express provisions in the indentures permitted mergers and the assumption of additional debt. The institutional investors were aware of these provisions and were sophisticated investors who freely bought the bonds and could have sold them at any time. They were aware of the nature of leveraged buyout transactions and the potential problems associated therewith, and had previously participated, at various levels, in other such transactions. The Court viewed their attempt to attack the leveraged buyout as a post hoc attempt to negotiate, with the benefit of hindsight, covenants other than those that had in fact been negotiated. The covenant of good faith and fair dealing should be used to protect bargained-for rights and ensure they are performed and upheld. It should not be used to permit creditors to shoehorn into an indenture additional terms that they wish had been included.

The Court stressed the need for certainty, which would allow parties to determine what transactions were permitted or prohibited by indentures. This certainty could only be achieved by focusing on express covenants and provisions, and not by speculating on what the parties might have intended. The Court thus rejected the attempt to expand contractual provisions by relying on general statements made by the corporation or its management. The Court also noted that, if the implied covenant of good faith and fair dealing were expanded in the manner sought by the institutional investors, no standard would remain for a court to use in its efforts to define this sort of action that a corporation could take. Bondholders might ask a court to prohibit not only a leveraged buyout, but also entering into a new line of business, building a new plant, or hiring more employees, all of which might involve additional expense, debt, and risk to the corporation's bondholders and other existing creditors.

In the wake of the *RJR Nabisco* case, the legal relationship between a solvent corporation and its creditors seems reasonably clear. Manage-

ment will manage the corporation's affairs for the benefit of the stockholders, to whom they and the corporation owe fiduciary duties. No such duties are owed to creditors. A corporation must honor its express contractual commitments to creditors, and it must also refrain from fraud or other conduct violating other statutory or common law rules that afford creditors some narrow further protection. An additional penumbra of protection may be created around express contractual commitments through use of the implied covenant of good faith and fair dealing. However, the implied covenant will not be extended to protect creditors from corporate action harmful to their interests where the action in question is not covered by express contractual commitments, or is expressly permitted by them.

If creditors are dissatisfied with the status quo, the courts have indicated, the solution is for them to protect themselves by negotiating appropriate contractual commitments and by refusing to purchase debt securities or otherwise extend credit to the corporation if such commitments cannot be negotiated. One can sympathize with the courts. The range of possible contractual provisions that might be negotiated is immensely broad, and in the negotiating process many trade-offs normally occur. Required to step in years after the debt securities were issued and at a time when conditions may be completely changed, and to attempt to define what is "fair" or what the parties would have agreed to if they had thought to address some issue, a court can only engage in guesswork and the exercise of hindsight. The task is sufficiently daunting to make even a judicial activist reluctant to take it on.

To what extent creditors will be successful in obtaining more stringent contractual commitments to protect their interests remains to be seen. There are problems. The buyers of debt securities are numerous and diverse. The buyers may not agree on what covenants an indenture should contain, or what trade-offs should be made between protective covenants and maturity, interest rate, and other substantive terms. Buyers usually come on the scene relatively late in the process, when the covenants have been fixed, at least tentatively, by negotiations between the issuer and underwriters. The underwriters, of course, have an interest in seeing that bondholders' rights are protected, at least to the extent that investors will be willing to purchase the bonds. However, the underwriters also must persuade the issuer to retain them, and thus are understandably reluctant to press the issuer too far. Issuers are reluctant to agree to stringent covenants, particularly with respect to widely held, long-term debt securities, where it may be difficult to impossible to obtain a modification or waiver of the covenants required by a subsequent change in circumstances.

The indenture trustee, it has been suggested,¹³ might be given an expanded role in negotiating adequate protective covenants. Indenture trustees, however, like bond counsel, historically have viewed their role as ensuring that the mechanical provisions of the indenture work properly and that the indenture complies with applicable legal requirements. They are unlikely to want to expand their role to encompass the negotiation of covenants, a role that might later subject them to criticism and liability if the covenants they negotiated prove inadequate. The possibility remains that institutional investors, rating agencies, indenture trustees, and underwriters may reach consensus as to certain covenants that should be regarded as "minimum" or "standard" and included in at least most indentures. Whether any such covenants could be imposed on issuers generally would depend on the extent to which institutional investors are willing to refuse to participate in issues that do not contain them. Thus far, little evidence has been found that institutional investors will do so. The recent decline in market value of outstanding debt securities not adequately protected by covenants may, however, be sufficient to bring about a change.

Fiduciary Duties of the Insolvent Corporation

The insolvent corporation and its management owe fiduciary duties to creditors, as well as to stockholders. This shift in responsibility takes place upon insolvency, even in the absence of a bankruptcy case or other formal proceeding.¹⁴ Relatively few cases are to be found involving insolvent corporations outside of bankruptcy, however, and most attention has been devoted to the fiduciary responsibilities of a bankrupt corporation and its management.

A corporation that is a debtor in possession in a case under Chapter 11 of the Bankruptcy Code has, with few exceptions, all of the rights, functions and duties that a trustee would have, had a trustee been appointed in the case.¹⁵ Like a trustee, the corporate debtor in posses-

¹³ Robertson, 1988. "Debentureholders and the Indenture Trustee: Controlling Managerial Discretion in the Solvent Enterprise." *Harvard Journal of Law and Public Policy*, vol. 11, p. 461.

¹⁴ See *New York Credit Men's Adjustment Bureau v. Weiss*, 305 N.Y. 1, 110 N.E.2d 397 (N.Y. 1953); *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506 (2d Cir. 1981), *cert. denied*, 445 U.S. 990 (1982); Norton, 1975. "Relationship of Shareholders to Corporate Creditors Upon Dissolution: Nature and Implications of the 'Trust Fund' Doctrine of Corporate Assets." *Business Law*, vol. 30, p. 1061.

¹⁵ U.S.C. 1107(a). A "debtor in possession" simply means a debtor that continues to operate and manage its business in a Chapter 11 case in which no trustee has been appointed. 11 U.S.C. 1101(1).

sion and its management must act with due regard for the interests of both stockholders and creditors. This dual responsibility often gives rise to problems. The law relative to the responsibilities of fiduciaries to differing classes of beneficiaries originated, and has been most fully developed, in the context of trust law, not corporate law. While the trustees administering a trust may owe duties to classes of beneficiaries having different interests, and may have difficulty in reconciling those interests, the conflict normally arises in relatively common situations, where precedent exists to guide the trustee in making the decision. For instance, the trustee may not invest the trust assets entirely or disproportionately in non-income-producing assets, since that would penalize income beneficiaries and unfairly benefit remaindermen. Nor may the trustee invest in wasting assets, or refuse to make expenditures to maintain trust property, where that would unfairly benefit the income beneficiaries to the detriment of the remaindermen.

In a corporate context, the situations are more diverse and less standardized. A Chapter 11 trustee, or the management of the debtor in possession, must make decisions both in operating the business and in negotiating a plan of reorganization. These decisions will affect stockholders and various classes of creditors. The law indicates that the decisions must be made with due regard for the interests of all concerned. Little guidance can be found, however, as to how the conflicting interests should be reconciled or as to how a decision as to what is fair should be reached.¹⁶

Management has been accustomed, prior to insolvency, to representing the interests of stockholders. In many cases management will also hold a substantial interest in the corporation's stock. Also, the filing of a Chapter 11 case does not change the manner in which a corporation's directors are selected; they continue to be elected by stockholders. It is thus not surprising that management may continue to be concerned primarily with stockholder interests, despite the shift in its legal duties. If it becomes apparent that management is not properly exercising its responsibilities to creditors, the creditors may seek the appointment of a trustee.¹⁷ In rare cases, they may persuade the court to interfere directly with management of the debtor in possession.¹⁸

It is not necessarily creditors who will be dissatisfied with manage-

¹⁶ The most comprehensive discussion is in Case, 1988. "Fiduciary Duty of Corporate Directors and Officers, Resolution of Conflicts Between Creditors and Shareholders, and Removal of Directors by Dissident Shareholders in Chapter 11 Cases." Williamsburg Conference on Bankruptcy, page 373 (ALI-ABA 1988).

¹⁷ 11 U.S.C. 1104(a).

¹⁸ *In re Gaslight Club, Inc.*, 782 F.2d 767 (7th Cir. 1986); *In re United Press International, Inc.*, 60 B.R. 265 (Distr. Col. 1986); *In re FSC Corp.*, 38 B.R. 346 (W.D. Pa. 1983).

ment. In a minority of cases, the debtor's board of directors and officers may be taking their new fiduciary responsibilities to creditors quite seriously, to the dismay of stockholders. The stockholders may conclude that management has sold out to the enemy, and attempt to elect new directors who will be more responsive to their interests. The stockholders will generally be allowed to do so.¹⁹ However, where the attempt to shift management occurs late in the reorganization process and would seriously jeopardize confirmation of a plan or reorganization, the bankruptcy court may restrain the stockholders from changing the board of directors in accordance with normal state law procedures.²⁰

Treatment of Creditors and Stockholders in a Plan of Reorganization

The focal point of a Chapter 11 case is the negotiation and formulation of a plan of reorganization. If no trustee has been appointed, only the debtor may file a plan during the first 120 days of the case. Thereafter, any party in interest may file a plan. The court may, for cause, extend or reduce the 120-day period. If a trustee has been appointed in the case, any party in interest may file a plan at any time, but the custom is to allow the trustee a reasonable opportunity to formulate and file a plan first.²¹

Negotiation of the plan's substantive terms involves the debtor's management, the trustee if one has been appointed, a committee appointed to represent unsecured creditors, additional committees that may be appointed to represent particular groups of creditors or stockholders, any indenture trustees, and major individual creditors, particularly secured creditors. The parties are free to negotiate the substantive economic terms of the plan, depending on the debtors' financial condition and prospects and the parties' relative bargaining power. However, in formulating the plan they must keep in mind a number of technical legal requirements that must be complied with.

The Bankruptcy Code distinguishes between claims and equity securities or interests.²² The plan must classify claims and interests, based largely on their nature and status under applicable law, and

¹⁹ *In re Lionel Corp.*, 30 B.R. 327 (S.D.N.Y. 1983); *In re Saxon Industries, Inc.*, 39 B.R. 49 (S.D.N.Y. 1984).

²⁰ *In re Johns-Manville Corp.*, 52 B.R. 879 (S.D.N.Y. 1985), *aff'd.*, 60 B.R. 842 (Dist. Ct. S.D.N.Y. 1986), reversed and remanded, 801 F.2d 60 (2d Cir. 1986), *op. on remand*, 66 B.R. 517 (S.D.N.Y. 1986).

²¹ 11 U.S.C. 1121.

²² 11 U.S.C. 101(4) ("claim"); 101(11) ("debt"); and 101(15) ("equity security").

specify the treatment to be afforded to each class.²³ Claims or interests may not be included in a single class unless they are substantially similar in nature.²⁴ Thus, secured claims must be classified separately from unsecured claims; and secured claims secured by different collateral, or by liens having different priorities in the same collateral, may not be included in the same class.²⁵ Some unsecured claims, such as certain claims for wages, for employee benefits, for consumer deposits, or for taxes, are entitled to priority in payment over other unsecured claims.²⁶ These will usually also require separate classification, and the plan's treatment of them may be specified by law and subject to negotiation only to a limited extent.²⁷ Unsecured claims may not be classified with secured claims, or with priority claims. Some difference of opinion exists as to whether all unsecured claims must ordinarily be included in a single class, or may be broken into two or more classes that are treated differently under the plan. However, provision is made for a separate class of small claims, known as administrative convenience claims, that are normally paid in cash.²⁸ The Bankruptcy Code recognizes the validity of contractual subordination agreements, and such agreements will be given effect in a Chapter 11 case.²⁹ Subordinated debt should be classified separately from non-subordinated debt, and the treatment given to it in the plan should reflect the effect of the subordination. Finally, preferred stock issues and common stock will be dealt with as separate classes of equity securities.

A proper classification of claims and interests is important. The class in which a claim or interest is placed determines what the holder will receive under the plan. Acceptance or rejection of the plan is by vote of each impaired class.³⁰ Well-planned classification can maximize the likelihood of acceptance by creditors and stockholders. Improper classification may make the plan unconfirmable, or may preclude resort to use of the cramdown provisions.

Once the plan has been negotiated and drafted, it is filed with the court, together with a disclosure statement which must be approved by the court as containing sufficient information to allow creditors and stockholders to make an informed decision as to whether to accept or reject the plan. The plan and disclosure statement are then submitted to

²³ 11 U.S.C. 1123(a)(1) and (3).

²⁴ 11 U.S.C. 1122(a).

²⁵ *Brady v. Andrew (In re Commercial Western Finance Corp.)*, 761 F.2d 1329 (9th Cir. 1985).

²⁶ 11 U.S.C. 507(a).

²⁷ 11 U.S.C. 1129(a)(9).

²⁸ 11 U.S.C. 1122(b).

²⁹ 11 U.S.C. 510(a).

³⁰ As to what constitutes impairment, see 11 U.S.C. 1124.

the holders of each impaired class of claims or interests, together with a written ballot providing for the acceptance or rejection of the plan. Acceptance of the plan by a class of claims requires the vote of the holders of at least two-thirds in amount and more than one-half in number of the claims in that class which have voted. Acceptance of the plan by an impaired class of equity securities requires the vote of holders of at least two-thirds of the securities in the class which have voted.³¹

The plan of reorganization is not legally effective until it is confirmed by the court. Confirmation involves a determination that a number of requirements have been satisfied. In the absence of active opposition to confirmation, the court's inquiry into many of the requirements will be brief. The requirements will vary depending on whether or not the plan has been accepted by each impaired class of claims or interests.³²

If the plan has been so accepted, the principal remaining requirements include a determination that the holders of claims or interests in each impaired class will receive or retain under the plan property of a value that is not less than they would receive if the debtor were liquidated in a Chapter 7 case.³³ This determination requires presentation to the court of a liquidation analysis and evidence as to the liquidation value of the debtor's assets. The analysis is relatively uncomplicated and straightforward. No going concern valuation is required. The court must also determine that confirmation of the plan is not likely to be followed by liquidation or the need for further reorganization, except to the extent contemplated by the plan.³⁴

The bankruptcy court may confirm a plan even though it has not been accepted by each impaired class of claims or interests, if the plan does not discriminate unfairly, and is fair and equitable to each nonaccepting impaired class.³⁵ "Fair and equitable" is a term of art, embodying a rule, known as the absolute priority rule, that claims and interests be ranked in order of their legal priority and satisfied in that order.³⁶ Junior claims or interests may not participate under the plan unless the plan provides for full satisfaction of senior claims or interests. Full satisfaction need not be in cash or cash equivalents. The "order" of

³¹ 11 U.S.C. 1126(c) and (d).

³² If any class of claims is impaired, the plan must have been accepted by at least one class of impaired claims. 11 U.S.C. 1129(a)(10).

³³ 11 U.S.C. 1129(a)(7).

³⁴ 11 U.S.C. 1129(a)(11).

³⁵ 11 U.S.C. 1129(b)(1).

³⁶ The absolute priority rule, and the basis for it, are discussed in Baird and Jackson, 1988. "Bargaining After the Fall and the Contours of the Absolute Priority Rule," *University of Chicago Law Review*, vol. 55, p. 738.

priority is not temporal; the period over which senior claims are to be paid may extend beyond the period for paying junior claims, so long as the senior creditors receive interest and the payments to them are reasonably assured.³⁷

The Bankruptcy Code specifies what types of treatment will be "fair and equitable" as to specific types of claims or interests. These provisions, known as the cramdown provisions, are complex and need not be discussed in detail. However, two general points should be made.

First, the plan will usually provide for the issuance of securities in satisfaction of all or part of some claims or interests. Determining whether such a plan is fair and equitable requires a valuation of the securities and other consideration to be distributed under the plan. This, in turn, will require a valuation of the debtor's business. This valuation is a going concern valuation, based on projected revenues, cash flow and earnings, and not simply a liquidation valuation.³⁸ Such a valuation is time-consuming, expensive, and highly uncertain. As a result, all parties have a considerable incentive to negotiate a plan that will be acceptable to all impaired classes, thus enabling the plan to be confirmed without resort to the cramdown provisions and without regard to the absolute priority rule.

Second, both the rules relating to the classification of claims and the cramdown provisions assume that claims and interests can be broken down into categories on the basis of a few common characteristics, and that it will usually be possible to place particular claims or interests into a particular category without litigation and with a high degree of certainty. A given claim will be put into a particular class depending on whether it is secured or unsecured, whether or not it is entitled to priority under some provision of the Bankruptcy Code, or whether it is subordinated debt or senior debt. Other characteristics, such as the maturity of the claim, or the contractual interest rate to which the claim is entitled, will usually not be relevant. Two issues of unsecured debentures, one of which bears interest at 11 percent and matures in five years, and the other bears interest at 9 percent and matures in ten years, may be grouped together in a single class, and be treated similarly under the cramdown provisions.

³⁷ *Prudential Ins. Co. v. Monnier (In re Monnier Bros.)*, 755 F.2d 1336, 1342 (8th Cir. 1985).

³⁸ See Fearon and Julis, 1983. "The Role of Modern Finance in Bankruptcy Reorganizations." *Temple Law Quarterly*, vol. 56, p. 1. For a particularly thorough judicial valuation, see *In re Jartran, Inc.*, 44 B.R. 331 (N.D. Ill. 1984).

Leveraged Buyouts and New Types of Debt Instruments in Bankruptcy Cases

The increasing volume of debt associated with leveraged buyouts, and the more exotic forms of debt instruments used, create considerable uncertainty as to how claims and interests will be treated in a Chapter 11 case. For bankruptcy purposes, a leveraged buyout is not one that is characterized simply by the amount of debt involved. It is a purchase of a business in which the credit of the acquired business itself, rather than that of the buyer, is used to finance a significant portion of the purchase price.

A leveraged buyout may be attacked on a number of bases or legal theories. For instance, state corporate statutes restrict a corporation's repurchase or redemption of its own stock, if the corporation's capital would be impaired thereby or the corporation rendered insolvent.³⁹ In a well-planned leveraged buyout, appraisals and valuations will be obtained to ensure that these rules are not violated. However, value is a question of fact and, if the leveraged buyout fails, the appraisals and valuations may be subject to challenge with hindsight. Case law also exists holding that, where a corporation repurchases or redeems its own stock and issues a note for the price, the note will be subordinated to other claims against the corporation if it later becomes insolvent or is involved in a bankruptcy case. This may be true even though the corporation was not insolvent and had adequate capital at the time the repurchase or redemption took place, and the transaction fully complied with state corporate law.⁴⁰

Fraudulent conveyance law may also enable a trustee or debtor in possession to attack a leveraged buyout. This issue may arise either under Section 548 of the Bankruptcy Code or under applicable state law.⁴¹ The trustee or debtor in possession may avoid any transfer of property made, or obligation incurred, by a debtor with actual intent to hinder, delay, or defraud present or future creditors. This is not usually a problem in transactions involving publicly held corporations. However, the trustee or debtor in possession may also avoid, without regard to actual fraudulent intent, a pre-bankruptcy transfer or obligation for

³⁹ For example, Delaware Corporation Law 160(a); Revised Model Business Corporation Act 6.40.

⁴⁰ *Liebowitz v. Columbia Packing Co.*, 56 B.R. 222 (Distr. Ct. D. Mass. 1985). See also 11 U.S.C. 510(b).

⁴¹ The substantive provisions of state fraudulent conveyance law will usually not differ materially from those of section 548. However, section 548 applies only where the transfer or obligation sought to be avoided occurred within one year of the bankruptcy filing. The statute of limitations under state law is usually considerably longer.

which the debtor did not receive a reasonably equivalent value, if the debtor was insolvent at the time of the transaction or was rendered insolvent by the transaction, or if the debtor was engaged in a business for which the remaining property was unreasonably small capital. Even where the buyer pays a fair price for the business, a question remains whether reasonably equivalent value has been given, since the money ended up in the hands of the corporation's stockholders. Whether the price was fair, and whether the debtor was left with an unreasonably small capital, are, again, questions of fact. The risk of an attack based on fraudulent conveyance law is perhaps the most dangerous, because it cannot easily be eliminated or minimized by restructuring the form of the transaction.

Lawyers and judges are aware that the transactions to which fraudulent conveyance statutes were intended to apply bear little resemblance to most leveraged buyouts. A strong argument can be made that a leveraged buyout is a legitimate business transaction, usually done openly with disclosure to all parties, and without any actual intent to defraud or attempt by creditors to take advantage of a financially pressed debtor. Scholarly arguments have been made that fraudulent conveyance law should not be used to defeat such legitimate business transactions.⁴² Some cases have accepted this argument. Nonetheless, leveraged buyouts have now been successfully attacked in a number of cases.⁴³ The current state of the law can fairly be characterized as confusing and unsettled. Disclosure documents and legal opinions used in connection with leveraged buyouts give the banks, bondholders, and other parties extending credit fair warning that the obligations that they are acquiring may or may not stand up in the event of a fraudulent conveyance attack in a bankruptcy case.⁴⁴

⁴² Baird and Jackson, 1985. "Fraudulent Conveyance Law and Its Proper Domain." *Vanderbilt Law Review*, vol. 38, p. 829. See also, Carlson, 1985. "Leveraged Buyouts in Bankruptcy." *Georgia Law Review*, vol. 20, p. 73.

⁴³ *United States v. Gleneagles Investment Co., Inc.*, 565 F.Supp. 556 (M.D. Pa. 1983), affirmed in part; *United States of America v. Tabor Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), cert. denied; *McClellan Realty Corp. v. United States*, 107 S.Ct. 3229 (1987); *In re Ohio Corrugating Co.*, 70 B.R. 920 (N.D. Ohio 1987); and *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488 (N.D. Ill. 1988). See also, Sherwin, 1988. "Creditors' Rights Against Participants In A Leveraged Buyout." *Minnesota Law Review*, vol. 72, p. 449 (1988).

⁴⁴ For instance, the disclosure documents in one transaction included the following language:

If in a lawsuit by an unpaid creditor, such as a trustee in bankruptcy, a court were to find that, at the time the Company incurred the indebtedness represented by the Debentures and the Senior Bank Debt, the Company (i) was insolvent, (ii) was rendered insolvent by reason of such incurrence, (iii) was engaged in a business or transaction for which its remaining assets constituted unreasonably small capital or (iv) intended to incur, or believed that it would incur, debts beyond its ability to pay

A risk also exists that debt issued in a leveraged buyout may be subordinated in a bankruptcy case on the grounds that it was actually a capital contribution. This determination may be made when the ratio of debt to equity was unreasonably large, when the debt was incurred to stockholders more or less in proportion to their stock ownership, and where the circumstances indicate that the holders of the debt knew or should have known that no reasonable likelihood existed that the debt could be repaid on the terms agreed to. In some leveraged buyouts, an investor, or an investor and its affiliate, will acquire both equity interests and debt instruments in the transaction. Where the debt instruments are zero-coupon, or provide for the deferral of interest if cash flow will not permit its payment, or for payment of interest in kind with stock or additional debt, a bankruptcy judge may be persuaded that the "debt" looks very much like capital, and should be subordinated to the claims of other creditors.

I do not imply that leveraged buyouts are legally defective, or that the debt arising from them will invariably, or even usually, be successfully attacked in a bankruptcy case. My point is that considerable uncertainty remains. In part this uncertainty may be dispelled as additional cases are decided. Leveraged buyouts became common only ten years or so ago. Most of the failed leveraged buyouts that have thus far been tested in the courts involved relatively small corporations, and the buyouts may not have been structured with as much care as in later transactions involving larger corporations. There is some hope that the law will become clearer over the next few years, as the first wave of failures involving large, well-structured leveraged buyouts gives rise to judicial opinions. However, this is far from certain. Most of the issues involved are very fact-oriented. Even courts applying the same statutory provisions, and interpreting them in much the same manner, may arrive at very different conclusions from case to case depending on the particular circumstances involved. I thus would expect that confusion and uncertainty will persist for some time.

So long as the uncertainty does exist, Chapter 11 cases involving failed leveraged buyouts will be difficult ones. In the absence of general agreement as to how these claims rank relative to other claims, disputes will occur as to proper classification and treatment of claims and interests. In most Chapter 11 cases, negotiations result in a plan of

as such debts matured, such court may find the Acquisition involved one or more fraudulent conveyances and permit such indebtedness to be avoided. Moreover, the Debentures and the Senior Bank Debt could be subordinated to claims of existing and future creditors of the Company.

reorganization acceptable to all or almost all classes because the law is sufficiently clear to allow creditors and stockholders to have some idea as to how the cramdown provisions would operate, and as to how they might be affected thereby, in the absence of agreement. In other words, the cramdown provisions often need not be utilized precisely because their existence drives the parties towards agreement. In the absence of any certainty as to how the law would ultimately treat claims and interests, reaching an agreement will be a lengthy and difficult task.

It has also been suggested that the parties financing the larger leveraged buyouts are too sophisticated, and have too much at stake, to let these issues be decided by the courts.⁴⁵ The investors, it is suggested, will be motivated to act quickly at the first sign of failure, and to negotiate a reasonable settlement without the delay, the expense, and the roll of the dice involved in bankruptcy litigation. This may in fact occur in some cases. But where financing is provided through the issuance of junk bonds that are publicly held, or held by a relatively large number of institutional investors, it remains to be seen whether these investors will be able to resolve their differences in the manner suggested.

Conclusion

At least some significant percentage of the leveraged buyouts that have taken place over the last few years will fail, and the corporations involved will seek reorganization under Chapter 11. In these cases, the debtor in possession's management will be making decisions that will have an important effect on what creditors and stockholders will receive under a plan of reorganization with only vague guidance as to how it should discharge its fiduciary responsibilities. Even competent management, trying to discharge fairly its obligations to conflicting classes of creditors and stockholders, and advised by competent counsel, will find it difficult to determine the rights and relative standing of various classes of creditors and stockholders, and how these should be reflected in any plan of reorganization. In this atmosphere of confusion and uncertainty, the traditional distinctions between classes of debt and equity may blur. Until recently, a general understanding held that secured debt had to be paid before unsecured debt, and that preferred stock more or less had to be satisfied ahead of common stock. Senior classes were expected to

⁴⁵ Jensen, Michael C. 1989. "Eclipse of the Public Corporation." *Harvard Business Review*, September-October p. 61, pp. 72-73.

make some concessions in favor of junior classes during the negotiation of the plan of reorganization, but the legal rules set relatively narrow boundaries for the extent of concessions that could be obtained. Over the next few years, the situation may be a good deal more fluid. Parties may be unable to reach concessions as to a plan, and resort to cramdown provisions and a judicial determination of rights may be more frequent.

Discussion

Richard T. Peters*

Charles Normandin is to be complimented for his excellent effort identifying and forecasting legal trends in an area in which statutory and decisional law has lagged by several years behind the state-of-the-art developments in the financial and business community. It does indeed appear likely that the massive amount of debt represented by conventional debt instruments and hybrid securities arising from the wave of leveraged buyouts will constitute the principal area of future legal activity dealing with the changes in the traditional nature of debt and equity. Further, it is in the context of bankruptcy, corporate reorganization, and out-of-court workouts that such changes will have their greatest impact upon the rights of secured lenders, trade creditors, bondholders, and stockholders.

To date, the courts have only begun to delve into the intricacies of the rights, priorities, and entitlements of the holders of acquisition debt of a failed leveraged buyout. Currently, the primary focus of litigants, and correspondingly the courts, consists of attempts to apply fraudulent conveyance law (either under section 548 of the Bankruptcy Code or parallel provisions of state law) to the participants in the leveraged buyout,¹ or to seek to equitably subordinate the acquisition debt to the

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¹ See, for example, *Kupetz v. Wolf*, 845 F. 2d 842 (9th Cir. 1988); *Wieboldt Stores v. Schottenstein*, 94 Bankr. 488 (N.D. Ill. 1988); *Mellon Bank v. Metro Communications, Inc.* (*In re Metro Communications, Inc.*), 95 Bankr. 921 (Bankr. W.D. Pa. 1989); *Ohio Corrugating Co. v. DPAC, Inc.* (*In re Ohio Corrugating Co.*), 91 Bankr. 430 (Bankr. N.D. Ohio 1988); *Anderson Industries, Inc. v. Anderson* (*In re Anderson Industries, Inc.*), 55 Bankr. 922 (Bankr. W.D. Mich. 1985).

claims of other creditors of the acquired or merged company.² Especially probative is Normandin's observation that a Bankruptcy Court may well be inclined to treat certain acquisition debt of a failed leveraged buyout as a capital contribution rather than true debt where a threefold test is met: that is, when the ratio of debt to equity was unreasonably large; when the debt was incurred (or, presumably, paid outright) to stockholders more or less in proportion to their stock ownership; and where the circumstances indicate that the holders of the debt knew or should have known that there was no reasonable likelihood that the debt could be repaid on the terms agreed to.³ Under such circumstances, it is suggested that the Court, in a case of reorganization of the failed leveraged buyout, may regard the acquisition debt as a substitute for the previously existing equity capital of the failed enterprise, for purposes of determining distributions under the leveraged buyout's confirmed plan of reorganization.

Accepting the foregoing thesis as valid for analytical purposes, the recharacterization of leveraged buyout acquisition debt as legally inferior to pre-buyout and possibly post-buyout general unsecured debt raises a number of other issues in connection with bankruptcy cases. The Bankruptcy Code, for instance, restricts one basic right to creditors only (that is, eligibility to file an involuntary petition against the debtor),⁴ and permits other remedies during a bankruptcy case to be pursued by any "party in interest" (for example, the right to seek the appointment of a trustee or examiner).⁵ The term "party in interest" is not defined in the Code, however, and, accordingly, the courts have developed a pragmatic test for determining whether a particular entity is a party in interest with respect to a particular proceeding before the court.⁶ One court formulated the test as "whether the prospective party in interest has a sufficient stake in the outcome of a proceeding as to require representation."⁷

As Franklin Allen points out, one of the fundamental attributes of debt has historically been that "debtholders . . . have the right to force

² *In re Matter of The Hawaii Corp.*, 694 F.2d 179 (9th Cir. 1982); *McConnell v. Estate of Butler*, 402 F.2d 362 (9th Cir. 1968); see generally, P. Blumberg, *The Law of Corporate Groups*, Ch. 5 (1985).

³ Charles P. Normandin, "The Changing Nature of Debt and Equity: A Legal Perspective," this volume.

⁴ 11 U.S.C. § 303(b)(1).

⁵ 11 U.S.C. § 1104(b).

⁶ See, for example, *In re Public Service Co. of New Hampshire*, 88 Bankr. 546 (Bankr. D.N.H. 1988).

⁷ *In re Amatex Corp.*, 755 F.2d 1034, 1042 (3d Cir. 1985).

bankruptcy" upon their obligor's default.⁸ Whether all holders of leveraged buyout acquisition debt will be entitled to exercise this right in the event of a failed leveraged buyout, however, remains to be determined. Under the Bankruptcy Code, an involuntary petition may be filed only by the holders of "claims" as defined in section 101(4) of the Code or an indenture trustee representing the holders of claims.⁹ Stockholders are not afforded the right to commence an involuntary case against the corporation based solely on their equity security interests.¹⁰ If, however, the stated conclusion is correct, that leveraged buyout acquisition debt may be treated as equity for purposes of plan classification and treatment, one is led inexorably to inquire whether an indenture trustee, debentureholder, selling stockholder, or other holder of acquisition debt arising from a failed leveraged buyout will be eligible as a petitioning creditor under section 303(b) of the Code. Moreover, under the 1984 amendments to the Bankruptcy Code, an entity is eligible to serve as a petitioning creditor only if its claim is not "the subject of a bona fide dispute."¹¹ The disqualifying "bona fide dispute" may be either factual or legal in nature, with at least one court opining that an entity is not eligible to be a petitioning creditor unless it would be entitled to summary judgment on its claim under state or federal law.¹² It should be anticipated, therefore, that a material dispute regarding the proper legal characterization of a petitioner's leveraged buyout acquisition claim as equity rather than debt would serve to disqualify the holder as a petitioning creditor.

Even with respect to remedies arising during the course of a bankruptcy case that can be asserted statutorily by any party in interest, the standing of acquisition debt holders to invoke certain remedies may be questioned by the courts. One such remedy is the right to seek the appointment of an examiner or trustee on one or more of the bases contained in sections 1104(a) and (b) of the Code. Although statutorily the appointment may be sought by any party in interest, some courts have been reluctant to order even the seemingly mandatory appointment of an examiner (where the debtor's fixed unsecured debts exceed

⁸ Franklin Allen, "The Changing Nature of Debt and Equity: A Financial Perspective," this volume.

⁹ 11 U.S.C. § 303(b)(1). A "claim" as defined in § 101(4) is contrasted with an "equity security" as defined in § 101(15) of the Code. Equity security interests have been held to not constitute claims for purposes of the Bankruptcy Code definition. *In re Pine Lake Village Apartment Co.*, 8 B.C.D. 1334 (Bankr. S.D.N.Y. 1982).

¹⁰ 2 *Collier on Bankruptcy* ¶ 303.08(7) (15th ed. 1989); 3 *Collier on Bankruptcy* ¶ 59.08(1) at 580 (14th ed. 1977).

¹¹ 11 U.S.C. § 303(b)(1).

¹² *In re Stroop*, 51 Bankr. 210, 212 (Bankr. D. Colo. (1985)); but see *In re Lough*, C.B.C 2d 375, 379 (Bankr. E.D. Mich. 1986)

\$5 million¹³) if it appeared that the movants (typically class action claimants in securities fraud litigation accompanying the reorganization case) held no cognizable economic interest in the reorganization case.¹⁴ Depending on the nature of the leveraged buyout and the capital structure of the resulting enterprise, it would not be surprising for the courts to similarly curtail the rights in bankruptcy of the holders of acquisition debt.

Even greater problems are likely to arise in connection with the formulation of the failed leveraged buyout's Chapter 11 plan. Difficult legal issues will be confronted with respect to the classification and treatment of claims and equity interests, and, as part of the treatment, the distribution of voting power and management rights in the reorganized company.

The changing nature of debt and equity, in the context of the failed leveraged buyout's Chapter 11 case, will be prominently displayed in the area of classification¹⁵ where the various creditor and stockholder constituencies have been unable to reach agreement as to the terms of a consensual plan. Classification often becomes critically important in this context because of the plan proponent's need to obtain "acceptance" of the plan by each class of impaired claims and interests. Failing acceptance of the plan by (i) "at least two-thirds in amount and more than one-half in number" of the allowed claims voting,¹⁶ and (ii) "two-thirds in amount" of allowed interests voting,¹⁷ the plan proponent must resort to the Code's cramdown provisions in order to obtain confirmation of the plan.¹⁸ At risk, if the acceptance of each impaired class is not obtained, is the possibility that no class of claims or interests junior (for example, stockholders) to the dissenting class (for example, subordinated, unsecured debt) will be entitled to receive a dividend under the plan or retain an interest in the reorganized company.¹⁹

As a result of the statutory scheme, the plan proponent will attempt to structure the plan by classifying claims in a manner most likely to

¹³ 11 U.S.C. § 1104(b)(2).

¹⁴ See, for example, *In re De Laurentiis Entertainment Group Inc.*, Case No. LA 88-17251-AA (Bankr. C.D. Cal.) ((Order, After Hearing, Denying Motion for Appointment of Examiner, entered Jan. 17, 1989); *In re Castle Entertainment, Inc.*, Case No. LA 83-12251-CA (Bankr. C.D. Cal.) (Findings of Fact and Conclusions of Law re "Motion for Appointment of an Examiner," entered Feb. 23, 1984).

¹⁵ The concept of classification is governed by the seemingly innocuous provisions of 11 U.S.C. § 1122(a):

[A] plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.

¹⁶ 11 U.S.C. § 1126(c).

¹⁷ 11 U.S.C. § 1126(d).

¹⁸ 11 U.S.C. § 1129(a)(8) and 1129(b)(1).

¹⁹ 11 U.S.C. § 1129(b)(2)(B)(ii).

result in the acceptance of each impaired class by the requisite percentages. For example, in order to offset the anticipated rejection of the plan by a dissident creditor holding a large unsecured claim, the plan proponent may attempt to classify the claims of the company's subordinated bondholders (who are expected, in this instance, to vote in favor of the plan) in the same class. Although not entirely free from doubt, it appears that such classification is currently permissible.²⁰ (The subordinated debt will share *pari passu* with unsecured creditors *vis-à-vis* the debtor, but will be deemed to have assigned any consideration received under the plan to the holders of senior indebtedness as defined in the governing indenture.) It is problematic, however, whether the foregoing classification will be upheld under Normandin's thesis if the subordinated debt in the example consists of leveraged buyout acquisition debt. At a minimum, the essential character of the acquisition debt as a replacement of the previously existing equity in the company gives rise to an additional ground of objection to the described classification in favor of the dissenting creditor. Failure to reach agreement as to the terms of a consensual plan can also be expected to give rise to classification disputes between holders of the acquisition debt and general unsecured creditors; holders of the acquisition debt and any pre-existing subordinated debt; and the holders of subordinated acquisition debt and the new stockholders.

Also unresolved is the question of how management and voting power will be allocated among the various constituencies upon the reorganization of the failed leveraged buyout. Current provisions of the Bankruptcy Code unfortunately lend little guidance in this area. The Code specifies that the plan must prohibit the issuance of nonvoting equity securities; provide for an "appropriate distribution" of voting power among the classes of securities possessing voting power; adequately provide that any class of equity securities having dividend preference over another class of equity securities be entitled to elect directors representing the preferred class upon default in the payment of dividends;²¹ and that the retention post-confirmation of the debtor's officers and directors must be "consistent with the interests of creditors and equity security holders and with public policy."²²

The current Code provisions are mandatory and are modeled on the corresponding provisions of Chapter X of the former Bankruptcy Act.²³ While scant authority exists under the new Code as to what will

²⁰ 5 *Collier on Bankruptcy* ¶ 1122.03(7) at 1122-17 (15th ed. 1989).

²¹ 11 U.S.C. § 1123(a)(6) and (7).

²² 11 U.S.C. § 1129(a)(5)(A)(ii).

²³ 5 *Collier on Bankruptcy* ¶ 1123.01(6) (15th ed. 1989).

constitute an "appropriate distribution" of voting power, certain cases decided under Chapter X of the old Act and the commentary thereunder are enlightening.²⁴ At the heart of the provision is the notion that creditors who relinquish their contractual rights to receive payment in a fixed amount, at a stated maturity, return, and priority in exchange for stock in the reorganized enterprise, assume the risk that the reorganized company will be successful; by so doing, the former creditors are entitled to the assurance that the company is being managed in their best interest.

Allocating voting power, control, and management rights upon the reorganization of a failed leveraged buyout may prove difficult. Subordinated acquisition debt may not be able to negotiate participation in the company's cash or senior indebtedness upon reorganization, and may correspondingly demand a large percentage of the reorganized company's common stock and attendant voting rights. The courts may once again be called upon to determine the true character of the obligation incurred by the company and whether the subordinated bondholders have already assumed the risk of the company's success as the basis for recovery of their investment.

The foregoing are but a few of the issues that are likely to arise in the corporate reorganization context, as the traditional distinctions between debt and equity become obscured in the future. I agree with Normandin's observation that case precedent is essential in the areas of classification, treatment, and cramdown so as to enable the parties financially interested in a failed leveraged buyout to resolve their differences through the process of negotiation rather than litigation.

²⁴ See, for example, *In re Sharp Ice Cream Co.*, 25 F.Supp. 417 (E.D. Pa. 1938); *In re Chain Investment Co.*, 102 F.2d 323 (7th Cir. 1939); *Highland Towers v. Bondholders Protective Committee*, 115 F.2d 58 (6th Cir. 1940); see also 6A *Collier on Bankruptcy* ¶ 10.21 (14th ed. 1977); Krotinger, 1941, "Management and Allocation of Voting Power in Corporate Reorganizations," *Columbia Law Review*, vol. 41, pp. 646, 672-82.

Discussion

*Robert E. Scott**

Charles Normandin's paper is a perfectly straightforward example of conventional legal wisdom concerning the eroding distinctions between debt and equity. His story has three parts.

- (1) The law regulates debt and equity differently because firms owe different duties to shareholders than they do to creditors. The shareholder relationship is fiduciary; the creditor's is an arm's length transaction.
- (2) In recent years, the blurring of the distinctions between debt and equity caused by increases in leveraging has led those creditors holding risky debt to seek protection from the managers of solvent firms in the form of fiduciary duties, regulations of good faith and the like. Here they have been largely unsuccessful, the courts generally holding that newly subordinated debt could have protected itself through explicit contracts. Normandin has his doubts about the wisdom of these holdings since creditors may not be able to obtain such contractual protection from firms.
- (3) Once the firm goes insolvent, however, it owes fiduciary duties to all claimants (creditors and stockholders). Here the "problem" is that financial innovation makes classifying debt and equity for bankruptcy reorganization purposes very difficult and uncertain, thereby leading to increased costs in negotiating

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reorganization plans. Here Normandin asserts the value of greater clarity, but does not hold out much hope.

This story, I would like to suggest, contains at least two unstated assumptions. I would like to challenge each one.

The first assumption is generic: that the law is essentially a constraint within which one maneuvers as best he can. In this exercise, it is best to be armed with a trained guide who can point out the baffling mysteries of incomprehensible regulations along the way. To the contrary, I would assert, the law of corporations, secured financing, and bankruptcy (what I will call "commercial law") is not a constraint but a variable: the relevant legal regulations should not just be taken at rhetorical face value. Rather, commercial law is functional: its underlying purposes are to facilitate value-maximizing transactions. The problems come when the functional unity, the logic of the commercial law, is forgotten and the traditional categories or forms of regulation are seen as ends in and of themselves. In this situation, one we face now, the law may seem slow to adapt its regulatory framework to innovation precisely because the underlying conception has itself been lost.

As a derivative of the first premise there is a second assumption. Since the law is a given, no particular value lies in trying to develop a unified conception of the legal regulations. Among five blindfolded men describing an elephant, each visualizes a completely different animal. Similarly, in law, one sees a different scheme of regulations depending on which legal problem one focuses on. This approach thus accepts as a given the traditional legal conception of debt and equity as a contrast between two incommensurables: a) a firm owes legally *imposed* fiduciary duties to shareholders; b) a firm enters into *voluntary* contractual relationships with its creditors. (To be sure, one might try to maneuver but the categorizations are fixed.)

I want to offer a different story, one that challenges both of these assumptions. In the process, I suggest that the problem Normandin identifies—the subordination of existing debt caused by increased leveraging (thus forcing creditors to bear risks normally associated with equity)—is only half of the legal puzzle (and not, to my mind, the more interesting half).

In addition to the problem of treating debt like equity on the downside, a parallel phenomenon is to be found on the upside. Creditors, especially in secured credit relationships, are able to capture some of the upside benefits of equity. This, in turn, raises questions concerning the normative justification for legally protected security interests and lender control liability.

A Contractual Approach

I suggest that the firm's relationship to all its claimants—shareholders and creditors—is fundamentally contractual. To be sure, this is not a startling insight to economists or organizational theorists, all of whom are used to thinking about a firm as a set of contractual relationships. But I want to make a stronger claim. Not only is a contractual theory of the firm valid as a matter of pure theory, but it is the most useful way of understanding the relevant *legal rules* themselves.

To understand the legal regulation of debt and equity in contractual terms, it is useful to think of two different contractual paradigms—discrete or complete contingent contracts on the one hand and relational contracts on the other. A discrete or complete contingent contract is one where the parties are presumed capable of specifying all the relevant terms that govern their relationship at the time of contracting. In this environment, the function of legal rules is to provide a menu of off-the-rack contract terms (or default rules) that will apply unless the parties explicitly opt out and customize an alternative arrangement.

A relational contract, on the other hand, is one where conditions of uncertainty and complexity prevent the parties from accurately specifying all relevant terms of their relationship at the time of contracting. In this case, silence is ambiguous. Parties face more difficult contracting problems. If they agree to specific obligations, subsequent events will outstrip their contract and the agreement will require further adjustment. Furthermore, this adjustment must be carried out in a noncompetitive environment in which each faces the threat of strategic maneuvering by the other. One response, therefore, is to define the contractual obligation in general terms. These terms are called different things in the law—best efforts contracts, fiduciary obligations, and the like—but in each case they are functionally no different from the more precise terms in discrete contracts. They represent a general commitment that each party will act in the future so as to maximize the joint value of their contractual enterprise.

A Contractual Analysis of the Legal Regulation of Debt and Equity

With this reconceptualization, the different legal treatments of debt and equity can be clarified.

(1) The law has historically assumed that debt contracts are discrete (complete contingent contracts). This is because the principal subject matter of the exchange was credit at a fixed price. Under this conception, if the creditors' asset cushion is eroded by subsequent risky debt,

the creditors are presumed capable of purchasing contractual protections in the form of negative pledge clauses and the like. In the absence of such protective agreements, the assumption is that creditors have assumed the risk of subordination for a price.

(2) On the other hand, the relationship between equityholders and the firm is seen as a relational contract. This is because equity claims are more complex and involve ongoing relationships. In this environment, the firm (through its margins) and the shareholders could not feasibly anticipate all future circumstances and assign risks explicitly at the time of contract. Rather, the legal default rule is a general fiduciary obligation that characterizes all principal-agent relationships. Managers must act so as to maximize the joint interests of the parties. Furthermore, given the difficulty in monitoring such contracts, the principal owes a higher duty of good faith and fair dealing as a precommitment against cheating on the contract.

So what has happened? As debt contracts become more like equity, it becomes clear that they are primarily relational. Creditors are providing a range of equity-like contributions to the firm—contributions that cannot be priced out accurately in the initial debt instrument.

Predictably, legal disputes have centered on whether the “relational” obligations of good faith and best efforts should be applied to debt contracts. The issue, then, is not whether shareholders are owed fiduciary obligations and creditors contractual ones. The issue in these leveraging disputes is which legal default rule best suits the needs of most debtors and creditors.

As debt contracts become relational, the costs of contracting and of controlling conflicts of interest rise and the parties require more creative terms. It is not a question of what contract terms issuers *will be willing* to accept. Issuers will accept whatever the market demands. Rather, the doubt as to whether issuers will agree to specific contractual protections for existing debt is caused by uncertainty over what default rules most parties would prefer. In a relational setup, the trade-offs are more severe: (a) Specific contractual restrictions will reduce monitoring costs, but they are error-prone and may not fit particular creditors’ needs. (b) Alternatively, general obligations of good faith and best efforts are flexible and promote mutual adjustment, but are difficult to police.

The only way the law has historically been able to make the choice between rules of thumb and general standards is through the quasi Darwinian process of trial and error and innovation—a process that is going on right now. In short, the problem of existing debt being subordinated as leveraging increases is essentially a transition problem. It is not very interesting in the long run except in its contractual dimensions (which are interesting to people like me who study optimal default rules in contractual settings).

(3) What about the function of insolvency? Normandin points out that upon insolvency the firm's managers owe a fiduciary duty to all parties, including creditors as well as equityholders. Once again, however, the focus on fiduciary responsibilities is essentially a red herring.

The key issue upon insolvency is that *individual* contracting behavior can no longer lead inevitably to value-maximizing results. Even if each individual claimant has negotiated an optimal contractual arrangement with the insolvent firm, the various claimants as a group face a classic collective action problem. Individual maximizing behavior is now inconsistent with the interests of the various claimants taken as a whole.

Yet, viewed *ex ante*, each of the claimants would be willing to agree to forgo his individual rights in order to join a collective proceeding, so long as it maximized the joint interests of all. This is merely an application of a simple prisoner's dilemma game in which parties unable to bargain because of their large numbers will systematically pursue destructive self-interest even though they would collectively benefit from agreements to cooperate. Hence, upon insolvency the law of bankruptcy imposes a collective solution in order to implement this "*ex ante* creditors' bargain."

Here the problem for the law is how to collectivize so as to maximize joint welfare without permitting individual advantage-taking or rent-seeking behavior by individual claimants seeking to improve their pre-bankruptcy position. Many problems arise once the firm is insolvent, not the least of which is that bankruptcy proceedings take time. They do not begin instantly nor are they resolved instantly, so opportunities for maneuvering are inevitable. But the overriding challenge for the law is to select the right decisionmaker in the collective proceeding.

Management no longer represents all interests adequately. A solvent firm's profit-maximizing behavior benefits both equityholders and creditors. But once the firm is insolvent, the problem is who should decide whether to liquidate or reorganize, and on what terms. Secured creditors have too much to lose and too little to gain from delay, thus they err toward prompt liquidation. Equity has too much to gain and too little to lose from delay since cash-outs destroy probability distributions. They err toward reorganization. Unsecured or general creditors are often the best proxies for the joint interests of all parties: they have something to gain and to lose from the choice between liquidation and reorganization. Indeed, the trustee explicitly represents this constituency.

This framework can then be applied to the current problem of leveraged buyouts and fraudulent conveyance law. If leveraged buyouts were always good things (that is, value-maximizing) or bad things (redistributional), it would be an easy problem for the law. But the problem is that the leveraged buyout device invites occasional redistribution (from creditors to shareholders) under the guise of a legitimate

value-maximizing transaction. Thus, two distinct questions are found in the regulation of leveraged buyouts.

(1) The first is the subordination of existing creditors through increased leverage. This is a question of choosing the optimal default rule. If fraudulent conveyance law applies, the firm has to get the agreement from all creditors in order to opt out of the prohibition against leveraged buyouts. If fraudulent conveyance law is held inapplicable, individual creditors can police against increased risk by purchasing debt restrictions.

As an empirical guess, it seems easier to opt into debt restrictions than to opt out of fraudulent conveyance law. Thus, as to this issue fraudulent conveyance law should not apply to leveraged buyouts.

(2) The problem, however, is that leveraged buyout transactions are vulnerable to managers engineering redistribution among claimants (with the managers then sharing the windfall gains). Here the law might well require mandatory policing mechanisms in order to avoid subsidizing fraud or other non-value-maximizing activities.

One solution to this apparent conundrum is to apply fraudulent conveyance law more selectively. This can be accomplished by focusing on the second prong of the test of constructive fraud.

To qualify as a fraudulent conveyance, the transfer must a) be without fair consideration and b) render the firm insolvent or without sufficient capital. Courts have tended to adopt an all-or-nothing approach, finding that the transaction is not for fair consideration. But if courts would regard leveraged buyouts in general as satisfying the fair consideration test, then they could use the second prong to assess the *specific* effects of a leveraged buyout. The law could thus police suspect transactions (those that result shortly in insolvency) without undermining the entire financing device.

Relational Theory and Secured Financing

I just want to highlight the fascinating question left untouched by Normandin's paper. As debt contracts become more relational, not only do creditors share more downside risks but they also share more of the upside. This can be seen in the associated returns from financing a successful venture over time. In order fully to exploit the returns from financing growth opportunities, firms issue secured debt which functions to cement the relational contract and reduces costly conflicts of interest (including underinvestment or shirking). The value of wrap-around security (asset-based financing) is in the de facto control (the arm-twisting) given to creditors.

This control is essentially benign if we properly understand the

function of the relationship. Nevertheless, fear of de jure control and its associated liabilities drives the relationship underground, into a type of "silent" partnership. In turn, we begin to see the very problems that we began with—where the legal categories no longer clearly represent the underlying function of legal regulation and, in time, the function gets lost.