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CORPORATE BONDHOLDERS AND
DEBTOR OPPORTUNISM:
IN BAD TIMES AND GOOD

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ABSTRACT

Voluntary debt adjustments in investor-owned enterprises in financial distress are said to save the cost of bankruptcy reorganization for society, for the debtor and for creditors, including public bondholders. If public bondholders were a single sole lender, their return or their share of the savings from adjustment bargains that avert bankruptcy would be determined by a bargaining process that presumably would produce results as close to "fair" (whether that notion is defined by reference to efficiency or to equity) as the basic structure of society's legal system will permit. But the dispersion of numerous bondholders, each holding modest portions of their class of debt, generates collective action and aggregate action problems which subject them to the debtor's strategic behavior and to structural disadvantages in the adjustment process. If left unchecked, the debtor's strategic behavior will enable it to garner virtually the entire gain; and if only the structural tilt affects the readjustment process it enables the debtor to extract much more than it could from a sole lender. In either case, the cost of debt will presumably ultimately reflect the freedom of the debtor to resort to strategic behavior or to gain advantages from the structural tilt.

Possibly rules could be fashioned to encourage, or even to require, public bondholders to organize so that they might deal with the debtor as might a sole lender. Operation of those rules would introduce another level of agency costs in the bondholders' relation to the debtor. To offset that cost, and certainly in the absence of such organization, it is necessary to deny the debtor the advantages of strategic behavior. To limit the impact of structural tilt in the absence of organized bargaining by indisputably loyal bondholders' representatives requires preservation of the bondholders' hold-out possibilities embodied in the Trust Indenture Act and an overriding cap of "fairness" on any adjustment bargain. The cost of allowing the hold-out appropriately offsets the cost of the institutional disadvantage of the process by which a debtor, whose bargaining power stems in large part from its ability to hold out, obtains the consent of dispersed bondholders, even if debtor strategic behavior is categorically prohibited. Similarly, although judicial enforcement of an indeterminate "fairness" ceiling is costly, it is doubtful that it would be more costly than would be the absence of such a ceiling, at least if the only other controls on the debtor's behavior stem from remedies (requiring disclosure and less distortion in the choice open to bondholders) borrowed from the rules sought to govern takeovers.

Where the debtor acts unilaterally to take advantage of ambiguities or gaps in the language of the bond contract, the need for protection for the dispersed bondholders derives from the processes by which the initial terms of the contract are bargained and by which the public buys the bonds. If public investors are not adequately represented in the bargaining process when bonds are issued, nor adequately informed with respect to the gaps or ambiguities in the bond contract when they buy bonds in the market, the burden of vindicating the debtor's interpretation should be on the debtor rather than on the public bondholders.

The failure of the debtor (and the underwriter) adequately to apprise the public investors of the range of permissible opportunistic debtor behavior under the contract should be at the risk of the former rather than the latter. Public investors should not be exposed to risks of which they could not reasonably be expected to learn and they were not apprised when making investments whose fixed returns proclaim limited risks, particularly in a market that is a poor register of the import of such gaps and ambiguities and of the debtors potential to exploit them. This approach shifts the inquiry from the meaning of the contract to the adequacy of the disclosure. That shift does not leave narrower space for judicial discretion in dealing with the substantive problem or with the question of damages than does the contract interpretation process; nor does it leave less uncertainties for planners of transactions. But it offers the least costly accommodation of public investors' need for protection against the debtor's opportunistic behavior with its need for discretion to act under long-term contracts.

**CORPORATE BONDHOLDERS AND DEBTOR OPPORTUNISM:
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In recent years the expansion of corporate bonded indebtedness,¹ driven largely by takeovers (friendly and hostile) and anticipatory or responsive restructurings, has often been followed by a contraction of the issuer's assets and earnings, and frequently by a feared or foreseeable inability to pay or service the debt. Issuers' responses have been to effect "readjustments" that generally entail repurchase of bonds or exchange for new securities, at prices often above market but always at a substantial discount from principal amount, or substantial modification of the terms of the bonds, or both. The issuance of junk bonds, whether or not in connection with takeovers, and the restructuring and later "readjustments," have also produced legal questions about bondholders' rights. Both types of

1. In this article no distinction need be made between bonds and debentures. Both are hereafter called "bonds."

transaction raise issues that are reminiscent of the questions debated by courts and commentators with respect to comparable transactions involving preferred stocks in the 1930s and 1940s.

The corporation (i.e. common stock) may resort to strategic behavior that effectively compels the senior security holder to consent to relinquishment of rights or sale or exchange of securities at a discount. Or it may, by formally unilateral action that does not require senior's approval or consent, diminish the firm's assets available for, or dilute the claim of, the senior security holder.² The problems with which we are concerned have arisen in two contexts.

One context derives from the terms of the initial bond contract, and involves indisputably unilateral action by the debtor -- i.e. the common stock. It is illustrated by the dilution or elimination through merger or conversion privileges in convertible bonds, and by the issuance of junk

2. In both circumstances (as well as in both preferred-stock cases and bondholder cases) the courts struggle with the questions: (1) whether the terms of the investment contract permit or preclude the challenged behavior by the corporation, which is acting presumably at the behest, and for the benefit, of the common stock; (2) if the behavior is not thus precluded, is there any doctrinal basis (fiduciary, contract or other) for restricting it; and (3) if restrictions are to be imposed, whatever their doctrinal basis, by what criteria are courts to determine the substantive limits on the permissible alteration in the seniors' position.

bonds to effect extreme leverage. The injuries that result to the previously existing bondholders from the latter activity consist in their claims being diluted, their bonds becoming less secure, and the market prices of their bonds falling, sometimes substantially.

The other context derives from efforts to reduce the amount of outstanding debt and interest claims, or to amend the bond contract so as to dilute or amend protective covenants.³ The effort may be merely to reduce or lighten the burden of public debt on the enterprise, or it may take the form of a thorough-going rearrangement of the claims and entitlements of all participants. In either case, in order to effect the results, the bondholders must be induced to sell their bonds to the issuer⁴ (at a deep discount from principal amount, but possibly at a somewhat higher price than the prevailing market), or to exchange them for other securities on similar price terms. Or they must be induced

3. Two scenarios, short of insolvency reorganization, are frequently encountered when the enterprise's assets contract. In one, the common stock seeks to protect its gamble on the future of the firm's assets or to attract new equity by reducing the aggregate amount of outstanding debt at a discount or by inducing amendment of the bond contract to eliminate restraints on the exercise of its discretion in managing and distributing the firm's assets. In the other, a third party offers to buy the enterprise's assets and assume its liabilities, but only if the outstanding bond claims are substantially reduced or outstanding protective provisions in bond contracts substantially diluted.

4. Or to sell them to the third party which bids to buy the entire enterprise. See note 3, supra.

simply to consent to eliminating protective covenants in the bonds -- e.g., provisions that preclude payment of dividends or sale of assets or the like. Dispersed bondholders may, to a greater or lesser degree, be "compelled" to consent to such disadvantageous sales, exchanges or amendments by premiums, bribes or threats, or by structural tilts in the process that would not be available to extract such concessions from a sole lender.

Investment bankers, practicing lawyers and finance academics often tend to scant the problem generated for dispersed bondholders by such sale or exchange offers or amendment proposals, largely because their focus is on the desirability of solving the debtor's problems quickly and "efficiently" by voluntary readjustment rather than by insolvency reorganization.⁵ The latter is said to entail costs to the debtor, the bondholders and society that are

5. In a recent compendious article offering an excellent "Practitioner's Guide to Exchange Offers and Consent Solicitations" 24 Loyola of Los Angeles L. Rev. 527 at 620 (1991) the authors (N.P. Saggese, G.A. Noel and M.E. Mohr), all practicing lawyers with considerable experience in the area, point out: "In these tumultuous economic times, both healthy and troubled corporations will continue to search for efficient and cost-effective methods of restructuring outside of bankruptcy."

wasteful,⁶ and avoidable by voluntary readjustment. That focus, however, obscures, if indeed it does not ignore, the effects of such compelled concessions on potential bondholders' reasonable expectations and ultimately on the cost of debt capital. The long recognized divergence between the "practical ideal" of bankers, lawyers and managers who seek to "preserve the business" and get the rescaling job done quickly (i.e., now) and the so-called "punitive ideal" of those who would protect dispersed bondholders by requiring either full payment or concessions that are clearly informed and volitional has been characterized quaintly in the context of insolvency reorganization as an ethical conflict.⁷

It also has significant economic implications, at least if dynamic, rather than static, efficiency is the concern -- i.e., what will be the responses of potential bondholders who are induced to invest on a promise of repayment of

6. See e.g., Franks and Torous, *How Firms Fare in Workouts and Chapter 11 Reorganizations* (1991); Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority Claims* 27 J. of Fin. Econ. 285 (1990); Gilson et al. *Troubled Debt Restructurings* 27J of Fin. Econ. 315 (1990); Bebchuk and Chang, *Bargaining and The Division of Value in Corporate Reorganization*; Roe, *The Voting Prohibition in Bond Workouts*, 97 Yale L.J. 232, 235-236 (1987)(hereafter, "Roe"); Gordon and Malkiel, *Corporation Finance*, in Aaron and Pechman (eds.) *How Taxes Affect Economic Behavior* (1981) 131, 163-172.

7. See Foster, *Conflicting Ideals for Reorganization* 44 Yale L.J. 923 (1935).

\$1,000 but who learn that, in the interests of efficiency and avoiding waste, they are forced in a "voluntary" adjustment, to accept \$600 or less, although the debtor's assets exceed the \$600? In theory, at any rate, persons who understand that, for every promise to pay back \$1,000 in the event the enterprise runs into distress short of insolvency, only \$600 will be repaid, notwithstanding the availability of assets in excess of \$600, ought to demand a higher rate of interest than they would if they were to receive all the assets. Whether, in fact, efficient and rapid readjustment at the expense of deep cuts in bondholders' claims, while values remain for stockholders, will result in a higher cost of debt remains problematic.⁸ That problem is of relatively small moment in the case of a sole lender. But it assumes larger dimension in the case of dispersed lenders.

The sole lender is inevitably subject to some loss in addition to that caused by the contraction of the debtor's assets, by reason of the debtor's capacity for opportunistic or strategic behavior. Even if the contraction of the

8. In comparing the increase in the cost of all debt capital if the rules permit strategically powered amendments or exchanges with the savings from the "quick" adjustments for which some such rules and said to be necessary, it is relevant to note that those savings occur only in the relatively few cases of distressed enterprises seeking "voluntary" readjustment, but the cost is imposed on all debt. cf. Akerloff, The Market For Lemons 84 Q.J.E. 488 (1970).

debtor's assets produces an act of default, so that the creditors' right to principal matures, the legal system does not allow instantaneous costless realization by the lender of its entitlement. The debtor's capacity to invoke the delays that the legal system necessarily permits, to conceal assets and to impose the costs of litigating on the lender "compel"⁹ the latter to negotiate with the debtor for a settlement or readjustment that provides less than the loan agreement entitles the lender to receive -- whether in the form of cash or of a new agreement on less favorable terms

9. A sole actor's consent may fairly be described as "compelled", "coerced" or "pressured" when induced by a wide range of behavior by another party who seeks that consent -- e.g. application of physical force, credible threat of physical force or collateral harm, reliance upon the costs imposed by operation of the legal system to cause a rational actor to reject a formally available option to insist on full payment and accept disadvantageous contract modification. At the extreme, the concept of "compelled" consent may even reach the act of one party in taking advantage of collateral misfortunes of the other to extract acquiescence in modification of the arrangements between them. To recognize that the actor's choice may fairly be characterized as "compelled", "coerced" or "pressured" in each of those circumstances is not to say that the choice thus made should not be honored in each or in none. To imply that it should be honored in some, but not in others, raises questions as to the criteria by which to decide whether any particular case falls in the "honored" or "disregarded" category, and the justification for the criteria selected. On what principle can the threat of physical force vitiate the consent to modification it produces, but the threat of collateral harm (e.g. foreclosure on another loan) not vitiate the consent to modification it induces? The subject has been discussed widely in the literature of contract. See Farnsworth on Contracts (1990) Vol. I pp. 430-443; 456-457 Kronman and Posner (Editors) The Economics of Contract Law (1979) Ch. 4; See also note 81 *infra*.

than the old agreement. The sole lender presumably factors those frictions into the terms of the initial agreement or into the interest rate on the loan -- although it is puzzling to know how to translate the potential for strategic behavior by a debtor into a calculable interest factor.

That problem is magnified for dispersed bondholders, because they are exposed to an additional layer of opportunistic behavior by the debtor. The debtor can extract concessions from them in voluntary readjustments because of collective or aggregative action problems¹⁰ that

10. Dispersed bondholders -- whether the traditional "widows and orphans" or institutional investors (so long as there are many such lenders, rather than an easily-coordinated few (See e.g. Tauke, Should Bondholders Have More Fun? A Reexamination of the Debate Over Corporate Bondholders' Rights, 1989 Col. Bus. Rev., 1 pp. 69-70, (1989) hereafter "Tauke")) are subject in varying degrees to rational apathy and prisoner's dilemma problems that are not encountered by a sole lender.

Chancellor Allen, in a leading Delaware discussion on the matter (*Katz v. Oak Industries, Inc.* 508 A2d 875 (1986)) recognizes that a wide range of behavior may be characterized as "coercive" in one-on-one situations, and that the normative problem is to identify which behavior in that range should be, or should not be, sanctioned in which circumstances. He does not answer that question with any analysis beyond a problematic definition of "good faith performance." But more significantly, he fails to recognize that the problem of consent to contract modification is entirely different when it is sought by one party (or the agent for several participants) from dispersed other parties than from a sole actor -- although the difference appears not to have gone unrecognized by Delaware courts in other contexts than that of bondholders. Compare *Kahn v. United States Sugar Corp.* ____ A2d ____ (Hartnett 1986); *Lacos Land Co. v. Arden Group* 517A 2d 271 (Allen, 1986); *A.C. Acquisition Corp. v. Anderson Clayton & Co.* 519 A.2d 103 (Allen, 1986); *Capital Cities Co. v. Interco* 551 A.2d 787, 797 (Allen, 1988); *Eisenberg v. Chicago Milwaukee Co.* para.

do not arise in the case of the sole lender. The sole lender acts, presumably, on an informed and volitional basis to re-bargain its relationship with the debtor. On those assumptions, that rebargain reflects the optimal results of free contract in a competitive market, given the debtor's strained circumstances. Each party knowledgeably believes its individual interests are best served by the rebargain. The result is not the same as would be effected in an initial bargain; and it may not be socially optimal.¹¹ But it is the best that can be obtained in the context of contract modification when one of the parties (the debtor) has scope for opportunistic behavior which society finds it too costly to preclude.

Similar considerations of optimal social result and individual equity suggest that debtors should be precluded from effectively compelling a less-advantageous result in voluntary adjustments by dispersed bondholders than it reaches in voluntary adjustments with sole lenders. There is no reason to believe that public bondholders charge, or receive, a higher return per unit of risk than would sole

93, 544 CCH Fed. Sec L Rep. [1987 Tr. Binder] (Jacobs 1987).

11. See Aivazian, Trebillock and Penny, The Law of Contract Modifications: The Uncertain Quest For A Benchmark of Enforceability, ... 22 Osgoode Hall L.J. 173 (1984).

lenders. A priori the contrary seems true.¹² Nor is there any other reason for the legal system to offer relatively disadvantageous treatment to the former as the end of the hunt nears and readjustment is sought.¹³ On the contrary, in view of the gap between the power of (and the resulting differences in the protection obtained by) the scattered public bondholders and the power of the sole lender in the formation of the initial contract, there is more reason to narrow than to widen the power gap in the readjustment process, when the contingencies against which the bondholders have, often unwittingly, bought formally less

12. Compare Van Horne, *Financial Management and Policy* (9th Ed. 1991) 581-582. They generally receive less by way of protective covenants or restrictions on the debtor than do private lenders. See e.g. Van Horne, *supra*; Brealey & Myers, *Principles of Corporate Finance* (4th Ed. 1991) p. 603-604. Riger, *The Trust Indenture As Bargained Contract: The Persistence of The Myth* 16 J. of Corp. Law. 211 (1991); Kaplan and Stein, *The Evolution of Buy-Out Pricing and Financial Structure In the 1980's*.— That configuration argues for a higher interest rate unless debtors regard such restrictions as less costly in the hands of private lenders or the market is imperfect.

13. The gains from specialization in furnishing capital are said to create and to justify larger agency costs for dispersed stockholders than for a sole owner in relation to corporate management. A key question in corporate law is how to reduce that disparity. The gains from specialization are apt to be less for the bondholders vis-a-vis stockholders in the case of debt finance than for stockholders vis-a-vis management in the case of public equity financing. The relationship between lenders and borrowers is not comparably open-ended. Those differences argue, in a "rational" world, for narrower disparities in agency costs between public bondholders and private lenders than between public stockholders and sole owners.

protection than the sole lender mature. In theory, it is hard to see how the costs of such a less-advantageous result can be factored into the terms of the initial agreement or into the interest rate on debt acquired by public investors any more than the costs of lesser forms of strategic behavior are factored into the interest rate on private debt. In practice, it is even harder to see how, or how precisely, the market factors the costs of more extensive strategic behavior into interest rates paid to dispersed bondholders. Whatever may be urged about the efficiency of the stock market as a predicate for policy judgment, the bond market is considerably less efficient in reflecting the import of many protective covenants. Hence it offers a poor reflection of the potential for debtor strategic behavior or structural tilt in "voluntary" adjustment.

To the extent that the "voluntary" adjustment process produces a lower cost for all participants and society than does bankruptcy,¹⁴ the problem arises as to how any

14. The costs of bankruptcy undoubtedly exceed those of voluntary readjustment, as Franks and Torous *supra*, note 6 demonstrate. But that excess may not be as significant as the in-terrorem threat of bankruptcy suggests. (Gordon and Malkiel, *supra* note 6; Roe, *supra* note 6 at p. 273) The so-called "direct" costs (lawyers, bankers, accountants, etc.) of bankruptcy which are in any event modest, are not apt to be much less in the case of voluntary readjustment. The indirect costs (loss of creditors priorities or reduction in their claims, resulting complex capital structures, disruption of relations with suppliers consumers, and employees, and diversion of management attention from operations to financial readjustment) are considerably more substantial (See e.g. Weiss, *supra* note 6 at pp. 288-90; Franks and Torous, *supra* note 6; Brealey and Myers,

resulting net gain should be shared with public bondholders. That problem may arise either between public bondholders and the debtor (in the more modest scale-down of debts embodied in many conventional exchange offers) or among all participants (including banks, institutional lenders and trade creditors) in the debtor's effort to work out a more thorough-going readjustment of all claims. In applying the standard of the sole lender to proposed solutions for that problem, it is necessary to keep in mind that unlike banks, institutional lenders and trade creditors, bondholder-investors (both individuals and many institutional investors) are apt to have no collateral interests in the debtor that might be advanced by sacrificing some of their

Principles of Corporate Finance (4th Ed, 1991) p. ____). But a fair portion of those costs is also incurred in, or in connection with, voluntary workouts. A moderate rescaling of debt such as simply the replacement of an issue of publicly held bonds with either stock or a lesser amount of debt securities is apt to incur considerably less direct and indirect costs than either a complete work-out or an insolvency reorganization. But such a modest rescaling presumably occurs in circumstances in which the distress level of the firm, and therefore the imminence of bankruptcy, is much less than when a thorough workout and restructuring of all claims is sought.

debt claim.¹⁵ Hence the model sole lender in the position of the bond holders would be seeking to maximize the results of what turns out to be a bad investment, without expecting gains from other relationships with the debtor.

To remedy the vulnerability of public bondholders to the debtor's strategic behavior, it is necessary to examine that behavior and the mechanisms for diluting or eliminating it, and to compare the net benefit from such dilution or elimination with the cost of doing so - the likely diminution in the chances of substituting voluntary readjustment for insolvency reorganization and the magnitude of the benefits lost from such diminution.

Before addressing that problem, it is relevant to note the treatment of a comparable problem in insolvency reorganization. Before the 1978 Bankruptcy Act, the holder of a \$1000 principal amount bond was formally entitled in insolvency reorganization under Chapter X to be paid from

15. Institutional lenders and trade creditors derive income from collateral relationships with the borrower that passive bondholders do not share e.g., prospects of continuing business relationships and sales of products and sales of services like investment advice, pension fund administration, registrar, stock transfer agent, insurance, etc. Hence, their interest in protective covenants is not likely to be as focussed as that of the passive bondholders who participate in the loan. How likely it is that collateral interest of that sort will induce disservice to public bondholders is subject to debate, whether the issue is one of faithless representation or merely indifference to the cost to the particular institution of yielding on the adjustment price. See Roe, *supra* note 6 at pp. 261-265.

the available assets of the debtor at least the promised \$1,000 or its cash equivalent before any junior security could share in the debtor's assets. To be sure, the reorganization process contemplates the payoff of creditors in securities of a new or reorganized debtor and a cumbersome and uncertain process for valuing the debtor's assets and the newly issued securities. The strategic manipulation available to junior securities in the process has confronted the dispersed bondholders with considerably greater disadvantage than would confront a sole lender; and it inevitably has resulted in the payoff to the creditors of inflated tickets.¹⁶ Hence, the promise almost never produced payment of the available assets - e.g. \$750. It generally produced much less in current cash value (e.g. \$600) notwithstanding the distribution of some assets to the junior debt or the equity.¹⁷ But the bargaining (before and

16. To blunt the more extreme aspects of the debtor's strategic behavior and the limitations on creditor power resulting, in part, from allowing creditor action by majority vote in the insolvency reorganization process, Chapter X of the Bankruptcy Act created a rigorous supervisory apparatus to be employed by the court and the S.E.C. and insisted upon the so-called absolute priority rule. See e.g. Dodd, *The Securities and Exchange Commission's Reform Program For Bankruptcy Reorganization*, 38 Col.L.Rev. 223 (1938); Swaine, *"Democratization" of Corporate Reorganization*, 38 Col.L.Rev. 256 (1938); Weiner, *The Securities and Exchange Commission and Corporate Reorganization* 38 Col.L.Rev. 280 (1938).

17. See e.g., Bebachuk and Chang, *supra* note 6; Weiss, *supra* note 6.

during the reorganization process) started with an entitlement to \$1,000 and a statutory prohibition against the dispersed creditors settling for less, if juniors were to participate¹⁸ except as distributable values might be inflated.

The Bankruptcy Act of 1978 significantly altered that picture.¹⁹ To be sure, it did not enshrine freedom of contract. It did not free the parties to make whatever bargains they chose. It retained external legal limits on the bargain the parties could make, but it substantially increased the magnitude of the potential for discounted payoff to creditors by reason of the strategic behavior of the debtor and the cumbersome reorganization and valuation processes. That Act reduced the settlement value of the bondholders' entitlement by allowing them to settle for payment that met the standard of liquidation value rather than that of matured principal amount. They thus were

18. In recognition of the dispersed bondholders' disadvantage, the law long ago decreed by fiat that at least in insolvency bondholders could not be forced to settle for less than was fair and equitable. See, e.g., Blum, The Law and Language of Corporate Reorganization, 17 University of Chicago Law Review 565 (1950). Whatever the meaning of that standard, it was externally imposed. It was not anchored in fiduciary notions, nor did the parties purport to agree in advance to that stricture -- except possibly as they understood it to be a legal requirement that attended their relationship.

19. It removed a great deal of the protection that Chapter X had offered creditors, quite apart from its "modification" of the absolute priority rule.

allowed to respond to the juniors' strategic behavior by accepting inflated tickets with a current value that was less than the minimum required under the old Chapter X.²⁰

Our concern is with an additional possibility for strategic behavior and further potential for loss to the creditors and gain to the stockholders -- opportunistic activity by the debtor (i.e., the stockholders) in inducing debt devaluation or reduction before insolvency, and corresponding reduction in creditors' aggregate claims and individual bargaining chips during any subsequent insolvency. Unless such strategic behavior is restrained by externally imposed standards, investors must take into account in buying bonds more than simply the potential for discount in the insolvency proceedings. They must recognize that their claims are subject to further diminution by reason of the pre-insolvency strategic behavior of the

20. Under the standard of § 1129 (a), the propriety of the bargain approved by the requisite number of bonds can only be determined by comparing the liquidation value of the debtor and the value of the new tickets given to the bondholders to ascertain whether the latter is less than the former. Neither value is readily determinable and each is the subject of bargaining.

debtor.²¹

The problem of distorted choice forced upon bondholders with respect to amendments or disadvantageous exchanges or resales of bonds to the debtor (as well as the problems raised by unilateral dilution of claims) is colored by the modest role of scattered public bondholders in the negotiation of bond contracts and the purchase of bonds. The process by which the initial bond contract is negotiated, or the public investor buys a bond, is not likely to produce from dispersed individual or institutional investors the informed consent to its terms -- particularly its more arcane protective provisions -- that is given by a sole lender.²² A sole lender has the power, and is apt, to

21. If information were costless and there were no other transaction costs, the interest rates on new bonds and prices on old bonds should have reflected the shifts in rational bondholder expectations resulting from these changes in the law. Possibly the euphoric atmosphere of the late 1970s swamped, or at least diluted, the impact of the changes in the Bankruptcy Act in 1978. If so, that tells its own story about how sensitive the market is to at least some kinds of changes in legal rights. The same problems afflict any effort to urge the market's potency to assimilate -- and elimination of any need to regulate -- the new kinds of strategic behavior of stockholders in recent pre-insolvency transactions.

22. To be sure, different substantive economic problems are encountered in effecting loan bargains with large blue chip corporate borrowers than with smaller start-up ventures or problematic non-growth companies. Protective provisions may be skipped in bond contracts with the former that would not be foregone in contracts with the latter, in view of the comparative economic risks and expected returns. See e.g. Simpson, *The Drafting Of Loan Agreements: A Borrower's Viewpoint*, 28 Bus. Law. 1161 (1973). There is reason to believe that the substantial erosion of protective covenants after 1970 was not readily appreciated by

extract (and the borrower is apt to yield) more penetrating and extensive protective provisions for given levels of risk and return than are obtainable by dispersed public investors.²³

To conclude that the dispersed public investor is less able than the sole lender to protect himself or herself or

investors or digested by the market until debtors made that erosion felt in the mid-1980s. See e.g. Brook, Debt Covenants and Event Risks.... Columbia Center for Law and Economics Studies, Working Paper #51 at pp. 31-32, 35 (1990); Bratton, Corporate Debt Relationships: Legal Theory In A Time of Restructuring, 1989 Duke L.J. 92, 106-109, 140-141 (hereafter Bratton II); Coffee, Unstable Coalitions: Corporate Governance As A Multi-Player Game 78 Georgetown L.J. 1495 (1990).

23. See e.g., Brook, supra note 22 at pp. 18-21 (1990). In the case of loans that are to be made by dispersed individual investors, the bargaining is done by underwriters and rarely by the indenture trustee. The latter, whose title is a misnomer and whose compensation depends upon the issuer selecting it to be the trustee has a built-in conflict of interest. It has little concern with the terms of the transaction beyond assuring that it is maximally inculpable. See Riger, supra note 12; Campbell and Zack, Put a Bullet In The Beast . . . 32 Bus. Law. 1705 (1977). The underwriters' interest is principally in the return to themselves from the transaction, including preserving a congenial relationship with the issuer for future services as adviser, underwriter, etc. Their only interests in protective provisions are to enhance the salability of the issue and to preserve their reputations. The former interest does not press hard on protective provisions because the opacity of the price terms obscures the import of those provisions. And in any event, neither interest is remotely comparable to the interest of a single lender in the protective provisions. The borrower often yields on terms, to a sole lender because it perceives that it will be able later to induce waivers of unduly protective covenants from private lenders that it is more difficult to obtain as readily from public lenders.

itself against the later opportunistic behavior of the borrower by provisions in the initial bond contract, is not to say that the contract is unilaterally dictated by the issuer. But in assessing the limits that the contract places on the issuer's discretion in operating under it and in effecting amendment or exchanges, the disadvantages of dispersed investors in the formulation of the initial contract are relevant.

I. THE DEBTOR'S ADVANTAGES IN THE AMENDMENT OR REPURCHASE OR EXCHANGE PROCESSES

The sole lender's comparative advantage over the dispersed bondholders in respect to the initial terms is even greater with respect to the process of amending the contract. As we have noted, in the bargaining over any diluting amendment (whether in insolvency reorganization or in voluntary work-out), the single lender is subject to the pressures generated by the contraction of the debtor's assets and the debtor's strategic power to hinder collection; but it can at least make a knowledgeable and often effective response to the debtor's opportunistic behavior.²⁴

But if the contract is between a corporate borrower and dispersed bondholders, then solely by reason of such

24. There is debate over the economic efficiency, if not the legal propriety, of the rules allowing a knowledgeable sole lender (which sees diminution in its borrower's assets and ability to pay) to rebargain the loan and consent to reduction in principal amount and modification of protective terms (Aivazian, Trebilcock and Penny, *supra* note 11). In some circumstances, the existence and exercise of the lender's power to consent are not apt to produce the most efficient results. But its exercise is not made relevantly nonvolitional or coerced simply because consent is induced not only by recognition of the debtor's inability to pay, but also by the debtor's power to obstruct the legal process to which the lender must resort in order to collect from the debtor's assets.

dispersal²⁵ the latter face considerably higher transactions costs in enforcing limits on the former's discretion to act opportunistically. With respect to amendments, the dispersed bondholders confront the problem of the latecomer term. As has been pointed out,²⁶ before one buys a bond or sets the bond contract terms, one has the option to forego the transaction without loss if it is not perceived to offer value at least equivalent to the payment. One is not subject to the mandate of the votes of fellow investors in deciding to make the initial investment. But amendment of the contract after one owns the bond is a process that does subject the bondholder to the mandate of a majority of fellow investors. It denies the bondholder the option to forego the transaction -- i.e., by selling the bond at a price unaffected by the proposed disadvantageous amendment. In short, the scattered bondholders are subject to the debtor's power to trade on the process of voting to reach a collective choice, a peril to which the sole lender is not

25. The indenture trustee has little incentive, or indeed obligation, to bargain for the bondholders with respect to debt modification; and certainly it lacks the incentives of a sole lender. And the underwriter is either long since gone, or driven by an interest that is not entirely concentric or coincident with that of the public bondholders - e.g. to underwrite the substitute securities or otherwise offer services to the debtor.

26. Bebchuk, Limiting Contractual Freedom in Corporate Law...102 Harvard Law Review 1820 (1989); Easterbrook and Fischel, The Corporate Contract, 89 Col.L.Rev. 1416, 1442-1444 (1989).

exposed either in the initial purchase or in the amendment stage, and to which the individual bondholder is not exposed in the initial purchase.

The relatively disadvantageous position of dispersed bondholders with respect to the amendment process is not mitigated if the debtor solicits an exchange or repurchase of bonds rather than simply an amendment. In both cases, scattered bondholders lack the sole lender's power both to extract information from, and to bargain with, the debtor.

When the debtor's effort to induce the bondholders as a class to vote for a disadvantageous amendment, or to make a resale or exchange, is accompanied by strategic behavior in the solicitation of votes or consents, the bargaining power of bondholders vis-à-vis stockholders is further disadvantaged. The bondholders' consent can fairly be said to be coerced or distorted, and certainly not given with the freedom of choice that a sole lender would have. To be sure, the non-volitional character of the resulting consent varies in its intensity, from effective coercion to a mere tilt of the playing field, as the nature of the debtor's strategic behavior varies. It is that range of behavior in the amendment and repurchase or exchange process to which we turn.

A. Strategic Behavior and Structural Tilt

Reduction in the aggregate principal amount of the debt (and attendant reduction in the aggregate interest claim on

the company)²⁷ can only be effected by inducing some or all of the bondholders to sell or exchange their bonds with the company at less than then principal amount.²⁸ Elimination or dilution of protective terms of the bond contract also generally requires the consent of the holders of a majority or more in principal amount of the outstanding bonds. In either case, the requisite bondholder consent may be induced by the debtor engaging in various forms of strategic behavior that taint the informed and volitional character of the consent. Or the institutional arrangements confronting dispersed bondholders and a single debtor create a structural tilt in the solicitation process that effects

27. The stockholders' incentive may be simply to reduce the debt so that, without yielding control or ownership of the assets, they can obtain more credit or new equity, or otherwise advantage themselves vis-à-vis the bondholders. Or the incentive may be that of a stranger to the enterprise who seeks to acquire it, but will only do so if the debt claims are reduced. In that case, the issue is how to distribute, as between stockholders and bondholders, the amount that the stranger is willing to pay for the assets. The infusion of new control and resources may offer more reason to permit the stockholders to exact concessions (or tribute) from the bondholders than in the case of a purely internal reshuffle of claims. But in either case, the power of the stock so to exact tribute must be justified by standards that would justify exacting such tribute from a sole lender, and in any event must be limited in the absence of adequate market restraints or bargaining power.

28. It can also be effected by redeeming a portion of the bonds, but that would require payment of full principal amount to those whose bonds are redeemed. The Trust Indenture Act (§ 316 (b)) effectively prohibits amending the contract to reduce the principal amount of the claim.

pressure on bondholders that is unavailable to the borrower for use against a sole lender. No less important, the possibility of such behavior cannot be said to have been reasonably anticipatable from the terms of the initial bond contract or any discourse attending the acquisition of the bonds.

Possibly the strongest form of strategic behavior is illustrated by the debtor's acquisition of the requisite majority of the outstanding bonds and voting to lower the interest rate or to reduce, or postpone the payment date for, the principal²⁹ or otherwise to dilute protective terms of the contract. In such a case, there can be no doubt that the "majority consent" provision in the bond contract is being used to effect the amendment without the requisite consent of "the bondholders." The terms of the bond contract authorizing amendment may (or may not) have contained a prohibition against the debtor (or its stockholders) voting on amendment. But it is hard to believe that any court today would interpret a "majority consent" provision to validate a stripping of bondholders' entitlements by vote of the debtor (or its stockholders) as

29. On the assumption that the bond is not subject to the Trust Indenture Act.

holder of a majority of the bonds.³⁰ Relevant legislation and learning³¹ pointedly suggest hostility to such an interpretation, even if a court were disposed to so read a loan agreement that does not expressly prohibit it.

Other forms of strategic behavior do not entail such formal control of bondholder collective consent, but effectively coerce the bondholders' consent by distorting the choice open to them in being asked to accept or reject a proposal. Just such a consent is virtually certain to be the response to an offer to repurchase at a premium above market all (and certainly a limited portion of) the bonds responding to the offer, but on the condition that those who accept first vote to amend the bond contract to the disadvantage of those bonds that are not repurchased. The bondholders are thus not simply subject to the vote of a majority of their class on a proposal to reduce or dilute their claim. They are confronted with a choice under which if a majority accepts, the acceptors may be better off (depending on how wise or perceptive is their decision) but rejectors are certain to be worse off than they were or than

30. Compare *Aladdin Hotel Co. v. Bloom* 200 F2d 627 (8th Cir. 1953) with *Katz v. Oak Industries, Inc.* 508 A. 2d 875, 881 (Del. Ch. 1986); and see *Hackettstown National Bank v. D. G. Yeungling Brewing Co.* 74 Fed. 110 (2d Cir. 1896).

31. Trust Indenture Act, § 316 (a); Bankruptcy Act, § 1126 (e). See also Model Debenture Indenture (Amer. Bar Foundation) § 101 definition of "Outstanding".

the acceptors are -- by reason of the stripping of protective provisions of their claims or loss of liquidity for their bonds; and their choice must be made before they know whether a majority has accepted or will accept. In those circumstances, it is not accurate to say that their opportunity for choice is coerced in the sense that they are physically forced to accept or threatened with physical force. But it is certainly accurate to say that their opportunity for choice is so distorted by the debtor's prescription that acceptance of the offer is the only choice reasonably available to dispersed risk-averse investors--unless perhaps the initial compensation for exposure to that risk is markedly substantial. It requires an invincible repose upon form and a myopic indifference to substance to conclude that the absence of an express prohibition against such an inducement in the bond contract constitutes the bondholders' consent to the debtor thus voting indirectly,³² and makes the amendment so produced a volitional act of the remaining bondholders sufficient to bind the non-exchangers to the amendment. That courts have recently shown such repose³³ does not make the bondholders' selection of the

32. Even apart from the import of an express prohibition in the contract against the debtor voting the bonds it may hold.

33. See e.g. *Katz v. Oak Industries, Inc.* 508 A.2d 875 (Del. Ch. 1986); cf. *GAF v. Union Carbide* 624 F. Supp. 1015, 1021, 1031-1032 (S.D.N.Y. 19____).

only reasonable alternative that the debtor makes available (i.e. acceptance of the debtor's offer) relevantly volitional, quite apart from not being nearly the equivalent of a sole lender's consent.³⁴

Such debtor behavior is not the only form of strategic behavior that effects a relevantly non-volitional consent by bondholders collectively. Case law and the current press reveal whipsaw techniques of selective inducement that have a comparable import. Thus the offer of a cash payment to selected bondholders to consent to disadvantageous revisions in the bond contract has been acknowledged, although only in dictum,³⁵ to produce amendments that lack the requisite consent. The offer of special payment to the holders of the first 51% of the bonds who consent produces a no less flawed consent, as Congress has repeatedly implied in prohibiting such whipsaw effects on public security holders in other

34. More often than not, the object of the transaction is to reduce outstanding claims against the debtor rather than merely to strip away protective covenants from continuing bonds. But the same coercive component powers the transaction -- those who do not accept the offer remain holders of bonds that no longer contain the protective covenants which they had when they were bought.

35. *Kass v. Eastern Airlines, Inc.* 12 Del. J. of Corp. Law 1074, ____ (Del Ch. 1986); see also *Katz v. Oak Industries, Inc.*, supra note 33, at p. 881.

contexts.³⁶ So too is an offer of a lesser principal amount and interest rate of secured debt or unsecured debt of shorter maturity in exchange for outstanding unsecured debt.³⁷ Less coercive, but nonetheless significantly pressuring is an offer for only so large a proportion of the issue that those who decline the offer will be left with an illiquid security.³⁸ Finally, there is the structural tilt in the process created by the institutional disadvantage resulting from numbers, dispersion and the consequent need for collective action. That tilt may be accompanied by a strategically timed solicitation of votes to amend the bond contract, or an offer to buy back at a deep discount from principal for cash or for other securities all bonds

36. Williams Act (§ 14 (d), Rules 14d-8 and 14d-10); '33 Act restrictions on underwriters relations to dealers in connection with underwriting S.A. Rel. No. 4697 (5/28/64) at footnote 1. Another type of pressure is exerted if the transaction is a tender offer and withdrawal rights are denied.

37. For a concise description of a variety of such forms of strategic behavior and a probing analysis of the legal consequences see Vlahakis, *Deleveraging: A Search For Rules In a Financial Free-for-All, M&A and Corporate Governance* Law Reporter, Vol. V, No. 2, p. 290 (Oct. 1990).

38. Cf. Rule 13e-3 governing "going private" transactions; *Eisenberg v. Chicago Milwaukee Corp.* [1987 Transfer Binder] (CCH) Fed. Sec. L. Rep. para 93, 544 (Del. Ch. 12/1/87).

tendered.³⁹ The atmosphere of uncertainty surrounding the declining condition of the debtor, the pressure to make a relatively quick decision in an atmosphere of imminent bankruptcy often deliberately created by the debtor, and the inability of scattered bondholders either to consult each other or to get at the facts so that they might hazard a guess at the risks of the future if they do not sell, results (possibly unreasonably) in fear of a drop in the price of the unsold bonds. That fear has a pied-piper effect which Wall Street professionals acknowledge produces a "coercive element" in the situation.⁴⁰ Indeed, precisely that fear has underpinned a characterization by the Delaware Supreme Court of a two-tiered tender offer as a "coercive" imposition by a third party, and therefore properly precludable by management.⁴¹ And that same kind of fear is part of the underpinning of strictures under the Williams

39. The rush to amend is not driven in such a case by the incentive to consent in order to receive the cash. It is driven by the fear of being stuck with a less favorable and less easily marketable claim (and a lower market price), and the need to calculate whether the cash gained is worth the expected reduction in market price. It requires a great faith in "the word" to conclude that the absence of a warning of such possible behavior when the bonds were issued or purchased justifies a finding of free and informed consent by bondholders to the amendment when the offer is made later.

40. See e.g. Wall St. Journal, March 26, 1990 p. c1 column 6.

41. See Unocal Corp v. Mesa Petroleum Co., 493 A 2d 946, 956 (1985).

Act⁴² and Rule 19c-4.⁴³ In short, the perceived "stampede" effect raises questions about the distorted character of the choice thus offered to bondholders and the extent to which it should be permitted.⁴⁴

Increasingly, institutional investors or other holders of large amounts of bonds have been able to band together to overcome some of the disadvantages resulting from numbers or dispersion or occasionally of debtor strategic behavior, and to cause rejection of inadequate offers⁴⁵ or possibly even to negotiate bargains comparable to those that a sole lender might achieve. But the bargaining position of dispersed bondholder-investors when amendment, resale or restructuring

42. See, e.g., § 14(d) and Rule 13e-3; but see *Radol v. Thomas* 534 F.Supp. 1302, -- (S.D. Ohio, 1982) aff'd 772 F.2d 244, ___, (6th Cir. 1985) cert. den. - U.S. - (1986).

43. SEA Rel. No. 25,891 (July 7, 1988) [1987-1988 Transfer Binder] Fed. Sec. L. Rep. para. 84,247 at page 89,216.

44. It also raises questions about whether consent to facing such a choice can, and should be required to be, spelled out in the bond contract and prospectus before such an offer is permissible.

45. The startling suggestion in Note, 91 Col. L. Rev. 846, 878-881 (1991) that strategic behavior does not in fact "coerce" bondholders must be read in light of the qualifications it acknowledges (possibly more consideration was offered in the solicitations that succeeded and did not rely upon exit consents than in those that did rely on exit consents and failed) and doesn't acknowledge (bondholders organized more successfully in the failed cases than in the others).

is proposed even in such circumstances, is worse, and in other circumstances is considerably worse, than that of the sole lender.

B. Legal Responses to Strategic Behavior
and Structural Tilt

In a free market economy, the response of the legal system to strategic behavior that indisputably coerces choice, or forces a distorted choice on, the parties to a continuing arrangement, is presumably to prohibit the behavior or at least to set limits on its exercise. When strategic behavior is indulged in rearranging corporate structure, so that the coercive impact is obvious, it has occasionally been prohibited or discouraged,⁴⁶ but often, particularly in Delaware, been permitted.⁴⁷ When structural tilt is the debtor's primary advantage (e.g., a well timed vote or offer is solicited unaccompanied by selective pressures or bribes), the societal response has often been to require disclosure of information material to the solicitee's decision.⁴⁸ But the adequacy of the information

46. Williams Act §§14(d)5-7 and Rules thereunder; Rule 13e-3; cf. *Unocal Corp. v. Mesa Petroleum Co.* supra note 41.

47. see Note ____ infra.

48. That is the import of the tender offer and proxy rules under the Securities Exchange Act of 1934.

thus required to be disclosed⁴⁹ and of the choice thus offered⁵⁰ are problematic. Occasionally, in the past, courts have suggested that the choice offered to dispersed senior investors should be judicially examined because it is seen as sufficiently distorted to require an overriding restriction of substantive fairness -- i.e. fairness of result -- which, however, has generally been found to have been met.⁵¹ The doctrinal basis for that restriction is not entirely clear.

(1) Doctrinal Bases

(a) Strong arguments can be urged to support the conclusion that fiduciary theory does not offer a coherent doctrinal approach to, or adequate restrictions on, such strategic actions by the common stock vis-à-vis the bondholders. For purposes of this paper, it is not

49. See Vlahakis, *supra* note 37.

50. See e.g. Bebchuk, *Toward Undistorted Choice and Equal Treatment In Corporate Takeovers*, 98 Harv.L.Rev. 1683 (1985).

51. cf. *Barrett v. Denver Tramway Corp.* 53 F.Supp. 198 (D.Del. 1943) *aff'd* 146 F.2d 701 (3rd Cir. 1943) *Bove v. The Community Hotel Corp. of Newport, R.I.* 105 R.I. 36, 249 A.2d 89 (1969); *Bowman v. Armour & Co. (Superior Court Cook Co. 1959)* *rev'd on other grounds* 17 Ill. 2d 43, 160 N.E.2d 753 (1959); *Zobel v. Amer. Locomotive Co.* ___ Misc. ___, ___, 44 N.Y. S.2d 33, 37 (Sup. Ct. N.Y. County 1943); *Dratz v. Occidental Hotel Co.* ___ Mich. ___, ___, 39 N.W. 2d 341, 347-350 (1953).

necessary to probe the impact of fiduciary theory on the divergence between management's interests or the interests of controlling stockholders who actively direct corporate affairs and those of either the bondholders or public stockholders.⁵² Those divergences indeed pose problems that neither contract nor market seems able wholly to solve; and

52. In this paper, the bondholders' problems are treated as deriving from the conduct of the common stock, rather than from the conduct of management or the board of directors apart from the common stock. That there is a divergence of interest between management and common stock in the operation of the enterprise is by now a commonplace, recognized alike by pure free contract and free market protagonists and by those with considerably less faith in the ability of the market or contract to effect equity or efficiency. Generally they both also recognize that because neither the market nor contract is adequate for the purpose, on occasion constraints must be imposed by way of the more open ended concept of fiduciary obligations or other regulatory strictures on management, to set limits on the extent to which it will exercise its discretion improperly to favor itself at the expense of the group. To be sure, they differ as to the adequacy of particular constraints on management's power to disserve stockholders -- whether those constraints be envisioned as imposed by contract, by the market, or by regulation. It is also recognized widely that there may be circumstances in which management's interests are more closely aligned with those of bondholders than with the stockholders, by whom alone they are generally elected. See e.g., Easterbrook, Two Agency-Cost Explanations of Dividends 74 *Amer. Econ. Rev.* 650 (1984); Tauke, *supra* note 10, at pp. 32-33 (1989); Coffee, Stockholders versus Managers: The Strain in the Corporate Web, 85 *Mich. L. Rev.* 1, ____ (1986); Coffee, Unstable Coalitions, *supra* note 22; Note, 78 *Geo. L. J.* 1495 (1990); but cf. Brook, *supra* note 22 at 37-42. Nevertheless, at all times, management's diversion to itself of corporate assets or its slackness or waste in operations poses a threat and does a disservice to both bondholders and stockholders. Cf. *Francis v. United Jersey Bank* 87 N.J. 15, 432 A.2d 814 (1981) Mitchell, The Fairness Rights of Corporate Bondholders 65 *N.Y.U.L. Rev.* 1165 (1990).

while fiduciary notions may offer some clues to a solution, in actual application they are far from adequate.⁵³

Possibly other regulatory restrictions, or at least more rigorous fiduciary constraints, are appropriate for those problems, but that matter need not be addressed here. For the bulk of the cases that pose the problems with which we are concerned, it is reasonably clear that management is acting as the agent of the common stock vis-à-vis bondholders. It is therefore appropriate for our purposes to treat all action taken by management as the equivalent of action taken by stockholders, e.g., as though a single stockholder was also the president and dominant director of the company.⁵⁴

53. If they are less than adequate as protection for common stockholders against management, they are no better as protection for bondholders. Nor would allowing bondholders to enforce fiduciary obligations offer any additional deterrent to management's diversion or misappropriation to itself of corporate assets. But cf. Mitchell, *supra* note 52.

54. Even if the fiduciary notions that justify restriction on management conduct vis-à-vis common stock (e.g., restrictions against diversion of assets or insufficient diligence and care or on implementation of management risk preferences) could equally justify comparable restrictions on management vis-à-vis bondholders, the conflict between the interests of stockholders and bondholders does not permit management consistently with fiduciary doctrine to be the agent of both. cf. *McMahan & Company v. Warehouse Entertainment, Inc.* 900 F^{2d} 576 (2d Cir. 1990). And even if such common agency were permissible, the problem of finding a "fair" solution for the fiduciary to adopt when the conflict materializes is no more solvable by draping a fiduciary mantle over the parties than by invoking less open textured and more particularized doctrine. But cf. McDaniel, "Bondholders and Stockholders," 13 *Journal of Corporate Law* 205 (1988); Mitchell, *supra* note

As between the residual claimants and the senior (i.e., prior but limited) claimants, a fiduciary relationship is rarely accepted by courts.⁵⁵ The reasons therefor are not

52.

55. The received teaching (see e.g. American Bar Foundation Corporate Debt Financing Project, Commentaries On Indentures pp 1-2 (1971)) and judicial learning decline to find place for fiduciary notions in dealing with alterations in, or operation under, non-convertible bond contracts (see, e.g., Revlon Inc. v. MacAndrews and Forbes Holdings, Inc. 506 A.2d 173, ____ (Del. 1986); Katz v. Oak Industries, Inc.; supra note 30; Kass v. Eastern Airlines, Inc. supra note 35; Continental Ill. Bank & Trust Co. v. Hunt Int'l Resources, Inc. #6827, 6831 (Del. Ch. 7/2/85); Wolfensohn v. Madison Fund 253 A2d 72 (Del. 1969); Lisman v. Milwaukee 161 Fed. 472 (E.D. Wisc. 1908). Similar learning generally attends judicial treatment of convertible bonds (e.g. Simons v. Cogan 542 A 2d 785, 786 (Del Ch) affd. 549 A 2d 300 (Del. 1988); Harff v. Kerkorian 324 A2d 215; revd. 347 A 2d 133 (1975); Norte & Co. v. Manor Healthcare Corp. Nos. 6827, 6831 (Del Ch. Nov. 21, 1985); Broad v. Rockwell International Corp. 642 F 2d 929 (5th Cir. 1981); Parkinson v. West End Street Ry. 173 Mass. 446, 53 N.E. 891 (1899); Kessler v. General Cable Corp 92 Cal. App. 3d 541, 155 Cal. Reptr. 94 (Cal. Ct. App. 1979); Fox v. MGM Grand Hotels, Inc. 137 Cal. App. 3d 524, 187 Cal. Reptr. 141 (Cal Ct. App. 1982); Browning Debenture Holders Committee v. DASA 560 F.2d 1078 (2nd Cir. 1977); Broad v. Rockwell Int'l Corp. 614 F.2d 418 (5th Cir. 1980) (hereafter Broad I) vacated 642 F.2d 929 (5th Cir. 1981) (en banc) cert. den. 454 U.S. 965 (1981) (hereafter Broad II). Occasionally, in the context of the obligation to give notice, courts see limited room for the fiduciary notion in the case of convertible bonds (e.g. Green v. Hamilton Intl. Corp. No. 76 Civ. 5433 (S.D.N.Y. 7/14/81); Pittsburgh Terminal Corp. Baltimore & Ohio R.R. 680 F 2d 933 (3rd Cir. 1982); Van Gemert v. Boeing 520 F.2d 1373, 1382 (2d Cir. 1975), (cf. 553 F.2d 812 (2d Cir. 1977)) but cf Meckel v. Continental Resources Co. 758 F.2d 811 (2d Cir. 1985) see also Hoff v. Sprayragen 52 F.R.D. 243 (S.D.N.Y. 1971)); and it has been argued that all of the traditionally cited cases question either need not be read to preclude fiduciary protection of some sort for bondholders or are simply wrongly decided. E.g. McDaniel, Bondholders and Stockholders 13 J. of Corp. Law 205, 265 et seq. (1988); Mitchell, supra, note 52.

For discussion of relationship of common to preferred see infra, TAN ____.

hard to decipher, notwithstanding increasingly articulate recognition of the similarities between the two groups as passive investors⁵⁶ and of the validity of imposing fiduciary restrictions to protect the common stockholders from their "agents." Fiduciary discourse may nourish constraints on stockholder discretion vis-a-vis bondholders that are inappropriate in theory⁵⁷ and inadequate in practice. Moreover, adumbrations from contract doctrine, although thus far inadequately perceived by many courts⁵⁸ are apt to provide adequate protection in the case of senior securities, even if not in the case of the residual claimants.⁵⁹

56. See Tauke, *supra* note 10 at pp. 19-25; McDaniel, *supra* note 54 at pp. 218-221; Mitchell, *supra* note 52; Lewellyn, What Price Contract? An Essay In Perspective 40 Yale L.J. 704 (1931); Berle, Studies In the Law of Corporate Finance, at 156 (1932).

57. Because the arrangements between common stockholders and senior security holders imperatively require in the normal conduct of the enterprise looser restrictions on the former in self serving behavior than are required in order to make management faithful agents of the common stock, judicial reliance upon the same construct to define restrictions on the two relationships may well tend either unduly to restrict those on the former or unduly to loosen those on the latter.

58. See McDaniel *supra* note 54.

59. See Tauke, *supra* note 10 at pp. 15-19, 26-29.

Fiduciary theory contemplates a dependent relationship in which the fiduciary acts for the interest of the beneficiary and not for itself in dealing with the beneficiary's assets. Notwithstanding its origins in the law of trusts, a broad range of commercial relationships has been characterized as fiduciary.⁶⁰ The expansion of the applicability of the concept has been accompanied by complexities, by incoherence in justifying it, and by loosening of the restrictions upon the behavior of fiduciaries. The most rigorous version of the concept requires the fiduciary to deal with assets or gains from their use solely for the beneficiary's benefit, and precludes any self-dealing or sharing in the assets or their gains except as a court may allow ex ante. Less rigorous forms of fiduciary constraint are premised on the proclaimed impropriety of self-dealing, and in varying degrees forbid it except with the nominally informed consent of the beneficiaries, and even then impose a "fairness" limit on the sharing of the gains or losses from the self-dealing.

60. See e.g., Sheperd, *The Law of Fiduciaries* (1981); Weinrib, *The Fiduciary Obligation*, 25 U. of Toronto L. 1 (1975); Frankel, *Fiduciary Law* 71 Cal. L. Rev. 7951 (1983); DeMott, *Beyond Metaphor; An Analysis of Fiduciary Obligation* 1988 Duke L.J. 879 (1988); Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure* 25 U.C.L.A. L. Rev. 738 (1978).

In contrast, the relationship of common stock to bonds (and to preferred stock), although consensual, is adversarial in origin and operation and lacks the essential import of a fiduciary or agency relationship -- i.e. acting for another under the other's direction and control. It contemplates open-ended discretion and self-dealing with the common assets by the common stock without any need for bondholder consent, or any bondholder entitlement to share in gains other than as provided by the terms of the contract. Neither the fiduciary's expected self-denial nor its obligation to preserve the value of the assets for the beneficiary fits the legitimates aspiration of the common stock, which is given discretion and expected to take the risks involved in seeking to maximize the value of the common assets for its own benefit,⁶¹ subject only to the

61. I.e., it is not given the funds to use them "on behalf of" the lender to the exclusion of its own sharing in the gains from use of the funds as would be a trustee with respect to its beneficiaries or as is an agent with respect to its principal or management with respect to common stock.

Possibly neither equity nor efficiency requires bondholders to be protected only by tort or contract and its import. A world can be imagined in which common stock and its agents are required to deal with bondholders' funds for the benefit, or on behalf, of bondholders, but it is hard to imagine why common stock would accept bondholders' funds and would also contribute its own funds unless it could deal with the combined assets for its own benefit as well as the bondholders' benefit. In that case, the puzzle which finance academics find in seeking to understand how or why corporate capital structure contains conventional debt would be further complicated. See e.g., Fama ____ 63 J. of Bus. 571 (1990). It would then be necessary to develop procedural mechanisms and substantive formulae to determine how bondholders and stockholders would share in the decision making to invest and manage the combined funds and to

restrictions of the contract (and of "law").⁶² Bondholders are entitled to the return of only a limited amount -- principal at a fixed date and interest in the interim. Common stockholders have no such entitlement, either to a fixed sum or a fixed date; but they have no limit on their return, although they must leave their funds at risk for an indefinite period. Arguably, the obligation to return the limited amount that is the bondholder's investment at a fixed date (along with interest in the interim) of itself so limits the controller's use of the bondholder's investment that, for the bargain between them to be productive during the period of the loan, the former must be free, at least in regular operations, from the indeterminate restrictions that are implicit in the fiduciary notion. The fact that, realistically viewed, the loan must be renewed may act as a restraint on stockholder strategic behavior in the use of the funds in operation that reduces the need for fiduciary

distribute their proceeds. Application of the fiduciary concept to conventional bondholder entitlements would implicate precisely those problems.

62. Consistently with that arrangement bondholders are given no non-contract or non-statutory power to interfere with management (by vote or by suit) or with common stock with respect to decisions to pay dividends or shift assets.

constraints during its term.⁶³

To the extent that the fiduciary concept has come to permit self dealing, it does not offer any special clue as to how to share the gains or losses therefrom beyond the notion of "fairness". The equality that a partner or a minority stockholder may claim with the controllers in the assets or their growth is not available as a criterion of fairness to define the appropriate division of gains or losses between stockholders and bondholders. The terms of their arrangement contemplate inequality, not equality -- a fixed repayment date, a prior share and only a limited share

63: It is not clear that the distinction between bonds and preferred stock (for which fiduciary constraints are sometimes said to be applicable) can be rested, as the Delaware courts suggest, on the formal role of underwriters and the indenture trustee as bargaining for the putative public bondholders, which the Delaware courts assume is absent for putative preferred stockholders. Underwriters are not less necessary for the issuance and distribution to the public of preferred stock than of bonds. Possibly the fact that bonds must be paid (or refinanced) whereas preferred stock is permanently committed to the venture justifies invocation of the fiduciary aura for some aspects of the relationship between the latter and common stock, even though it may not be appropriate for bonds. But the respects in which contract protects the two types of senior security in their relationship to the residual claimants offer similar bases for rejecting the fiduciary rubric for both in those respects -- even if "fiduciary" protection against managerial slack or diversion of assets to itself is needed more by those who are "permanent" investors than by those who have a fixed payment date.

for the bondholders.⁶⁴ Notwithstanding the speculative character of "junk" bonds⁶⁵ the relationship between bondholder and debtor does not contemplate sharing capital gains by the latter with the former, except as they may be

64. The difficulty with conceptualizing (much less achieving) optimality for the joint interests of the peculiar combination of debt and equity claims is discussed in Baird, "Fraudulent Conveyances, Agency Costs and Leveraged Buyouts," 20 Journal of Legal Studies 1, 10-15 (1991). That difficulty infects any effort to define the standard of fairness to which to hold a fiduciary, in contrast to the standard of fairness for allocation by a fiduciary of goodies among beneficiaries of the same class. Cf. Barir, *Fiduciary Duty Toward Corporate Bondholders* (1990) LLM Paper, Harv. Law School; Barkey, 20 *Creighton L. Rev.* 47 (1986). The admonitions from the law of trusts as to how a trustee should respond to the request of a settlor to a trustee to deal with the conflict between income beneficiaries and remaindermen are neither enlightening nor relevant to the bondholder-stockholder relationship or to how a stockholder or its agent should divide gains with, or avert losses to, bondholders. The analogy loses all force when parties deliberately elect to be treated unequally as is reflected in the difficulty entailed in allocating the proceeds of a cash-out merger fairly between common and preferred stock. See e.g. *Dalton v. Amer. Investment Co.* 490 A.2d 574 (Del. Ch. 1985) *aff'd* 501 A.2d 1238 (Del. 1985); *Jedwab v. MGM Hotels, Inc.* 509 A.2d 584 (Del. Ch. 1986).

65. Characterizing junk bonds, however perceptively, as residual equity or even "equity in drag." (I. Bulow, L.H. Summers and V.P. Summers, Distinguishing Debt from Equity in Debt, Taxes and Corporate Restructuring, Shoven and Waldfogel, eds. (1990) at p. 135.) does not alter their character as debt, since they do contain express limits on their return and on their final payment at fixed payment dates. In short, they are not residual claimants with unlimited upside potential even though they carry rates of interest and lack protective covenants that should signal high risk.

embodied in repayment of principal or redemption price.⁶⁶ Nor does the notion of "fairness" as a limit on managerial self-dealing offer any help in defining the limits on stockholder - bondholder adjustments that is unique to the fiduciary concept.

If importing the fiduciary notion from the agency context to the stockholder-bondholder relationship casts too deep a shadow over common stock discretion in the continuous operation of the enterprise, in the crisis situations with which we deal, it is apt to offer bondholders too little protection. In the agency context in corporate law, the fiduciary notion has been stretched so far out of its historic shape and become so mutable⁶⁷ as to sap its capacity to perform its original function. The legitimate

66. To be sure, during the term of the bond its market price may fluctuate, and gains or losses may be realized by those who transact in the bond. But nothing in economic theory or morals (or law) requires, or indeed suggests, that the common stock should so conduct the affairs of the enterprise (e.g. by underinvesting, shifting assets, expanding) as to stimulate gains or avert losses for bondholders in such market transactions. This is not to deny that the debtor should not violate the express terms of the bond contract or frustrate reasonable expectations from the specified arrangements as to behavior prohibited by those terms.

67. SEC v. Chenery Corp. 318 U.S. 80, 85-86 (1943).

(and possibly not so legitimate)⁶⁸ needs for managerial discretion (and corresponding looseness of fiduciary restraints) in matters of "care" appears to have infected managerial obligations of "loyalty," so that very little remains in the fiduciary notion by way of legal restriction of managerial conduct -- i.e. on self dealing at the expense of stockholders.⁶⁹ And the fiduciary notion has not operated any more restrictively to protect minority stockholders against majorities seeking self-aggrandizement from the common assets,⁷⁰ although it offers equality as a

68. The legitimacy of the broad managerial discretion that derives from the considerations underlying the business judgment rule finds less, or different, justification in the recent spate of statutory immunizations of management from monetary liability.

69. ALI Project On the Principles of Corporate Governance (T.D. No. 11, Part V, April 1991) and recent Delaware law (see e.g. Unocal case; supra note 41; Grobow v. Perot 539A 2d 183 (Del. 1988) and their progeny) not only create porous standards of restraint on managerial self aggrandizing behavior, but even create less demanding standards of judicial review. See ALI Project, supra, T.D. No. 11, Part VII and T.D. No. 10, Part VII (May 1990). See also Revised Draft UPA §§ 403, 404. While occasionally in other jurisdictions some bite is furnished for the fiduciary notion in corporate law, e.g. Coggins v. New England Patriots Football Club, Inc 397 Mass 525, 492 N.E.2d 1112 (1986), the jurisprudence generally reveals only loose teeth.

70. See Marsh, Are Directors Trustees? 22 Bus. Law. 35 (1966); ALI Project, supra note 69, T.D. No. 11, Part V, Ch. 3. The tensions between the two leading Massachusetts decisions dealing with the problem in close corporations (Donohue v. Rodd Electrottype Co. 328 N.E.2d 505 (1975) and Wilkes v. Springside Nursing Home Inc. 353 N.E. 2d 657 (1976)) reflect the difficulty with the felt need to impose restrictions (and therefore to characterize the relationship as fiduciary) and the inability to define appropriate restrictions or limits on a fiduciary who is, by

more concrete measure of fairness in limiting self dealing with the common assets. The slackness in the fiduciary restraints on management would not, if the notion were applied to the common stock - senior security relationship, entirely remove all shadow over necessary common stockholder discretion in regular operations. But it would not offer senior security-holders necessary protection in crises when common stockholders seek to readjust claims. It has not produced significant protection for preferred stockholders against the efforts of common stock to alter the bargain to the latter's advantage.⁷¹ There is no reason to expect it

definition, entitled to share in the assets.

71. Courts have long recognized in application, if not in theory, that the preferred stock -- common stock relationship is dominated by contract rather than by fiduciary notions. Although the fiduciary idea has been increasingly invoked in recent years to restrict the common stock's agents' discretion with respect to the preferred stock, its invocation has been largely rhetorical. The Delaware courts have suggested that fiduciary notions might fill in the interstices in the contractual definition of the relationship but rarely applied them to protect the preferred. In *Eisenberg v. Chicago Milwaukee Co.*, supra, note 30 the Court actually held that the preferred stock was wronged by reason, in part, of violation of fiduciary obligations which were felt to be the basis for finding improper "coercion" to accept the majority stockholders tender offer. That such coercion is improper even in the absence of a fiduciary relationship is evident in the *Unocal* case, supra note 41. *Dart v. Kravis Kohlberg and Roberts* (Del. Ch. 19__) and *Kumar v. Racing Ass'n of America CCH Fed. Sec. L. Rep.* para. 95, 896 (Del. Ch. May, 1991) entailed behavior that can be explained as easily as constituting a violation of contract as of "fiduciary" duties. The fiduciary mantra did not help the preferreds in *Wood v. Coastal Gas Corp.* 401 A2d 932 (Del. 1979); *Dalton v. American Investment Co.* 490 A2d 574 (Del. Ch. 1985) aff'd 501 A2d 1238 (1985); *Rosan v. Chicago Milwaukee Corp.* (Del. Ch. 1990); *Jedwab v. M.G.M. Hotels, Inc.* 509 A2d 584 (Del

to operate any more effectively to protect bondholders.

What is required is recognition that the senior investor-residual claimant relationship is not a deposit of funds ad lib for which the only feasible protection is the rapidly eroding fiduciary restriction on the person with whom the funds are deposited and who is given controlling powers. The existence of substantial contractual restrictions in the case of senior securities is important. In part those restrictions reflect the fact and desirability of looser control by the seniors over the residual claimants than by the latter over their agents with respect to conflicts of interest in non-crisis operations, or even in activities that do not seek alteration of the contractual terms governing their relationship.⁷² And in larger part they respond to the need for tighter control over the behavior of the residual claimants in readjustment

ch. 1986); Kirschner Bros. Oil Co. v. Natomas Co. 229 Cal. Repr. 899 (1986). Compare Baron v. Allied Artists Pictures Corps 337 A.2d 653 (Del. Ch. 1975). Looser notions of fairness or "constructive fraud" were similarly unable to protect preferreds against alteration of their contracts in the 1930s and 1940s. See Brudney, Standards of Fairness and The Limits of Preferred Stock Modifications, 26 Rutgers L. Rev. 445 (1973); Latty, Fairness - The Focal Point in Preferred Stock Arrearage Elimination 29 Va. L. Rev. 1 (1942), Dodd, Fair and Equitable Recapitalizations, 55 Harv. L. Rev. 780 (1942).

72. E.g., in issuing additional debt or slipping through loopholes in anti-dilution clauses of convertible securities.

transactions that entail self-dealing and more conflict of interest than common good.

To be sure, some obligations traditionally fastened on a fiduciary that are not otherwise imposed upon persons dealing at arms-length may rationally be imposed on the common stock vis-à-vis bondholders or preferred stockholders.⁷³ One is the obligation to disclose when seeking, and a fortiori when "pressuring," a change in the contractual arrangements. But it is not clear how or why that obligation is not also part of the "good faith" obligation of contracting parties to each other.⁷⁴ Another

73. Management (nominally stock representatives) is said to have special obligations to creditors if insolvency occurs; (See e.g. *In re STN Enterprises* 779 F.2d 901 904 (2d Cir. 1985; Vlahakis *supra*, note 37; McDaniel, *supra* note 54). If, in theory, there is no equity left for the common stock, management loses its legitimacy as decision maker with respect to corporate assets, and that role is adopted by bondholder committees, who may explicitly or implicitly delegate responsibility to the old management, who in that case become the creditors' agents. To characterize those obligations as fiduciary (cf. *Pepper v. Litton* 308 U.S. 205 (1939)) is simply to acknowledge that insolvency may transform creditors into "owners". Managers' obligation not to divert corporate assets to themselves at the expense of creditors in all other circumstances is more contractual than fiduciary. To be sure, the standards as to when the enterprise is "insolvent" so as to trigger such obligations become problematic in practice.

74. That question is classically illustrated in *Zahn v. Transamerica Corporation*, 162 F.2d 36 (3rd Cir 1947) and a companion case, *Speed v. Transamerica Corporation* 235 F.2d 369 (3rd Cir. 1956) which involved the effort of Transamerica, the parent of Axton-Fisher Inc., to capture the value of its subsidiary's hidden assets from the holders of its subsidiary's convertible stock by calling the stock without disclosure of true values. In its first opinion, the Court of Appeals invoked the fiduciary conception to forbid the parent from thwarting the stockholders'

is a constraint upon forcing, or even only "pressuring," the choice one asks persons to make to alter a previously existing more or less continuous relationship. The roots of that constraint are not confined to the fiduciary relationship, notwithstanding that they have occasionally been so characterized in describing the relationship of common stock to preferred stock both in the conduct of corporate affairs and in the readjustment of claims against

conversion privilege by imputing a fiduciary prohibition against calling the convertible stock. But that rationale suggested that the parent had no comparable fiduciary obligation to the public holders of the subsidiary's non-convertible stock to call the convertibles. The incongruity was dissolved in the second opinion by measuring the damages to which the holders of the convertible stock were entitled as if the wrongdoing was (as it undoubtedly was) a failure to disclose the value of the hidden assets to the holders of the convertible stock so that they might choose to convert and share in those assets rather than submit to the call. The obligation to disclose was demanded no less by the federal securities laws or adumbrations from the law of contracts than by fiduciary obligations. Allusion to the latter obscured the role of the former and induced over-kill for the problem at hand. Comparable inter-relationships between disclosure obligations rooted in contract or federal securities laws and those rooted in fiduciary theory are involved in *Pittsburgh Terminal Corp. v. B&O RR Co.* 680 F.2d 933 (3rd Cir. 1982) cert. den. 459 U.S. 1056 (1982); *Van Gemert v. Boeing* 520 F.2d 1373 (2d Cir. 1975) cert. den. 423 U.S. 947 (1975); *id* 553 F.2d 812, 815 (2d Cir. 1977) and *Howing Company v. Nationwide Corp.* 927 F.2d 263 (1991).

Although the justification for, and in polar cases the restraints imposed by, the fiduciary obligation differ significantly from those of the "good faith" obligation, as the demands of the former are relaxed and those of the former are expanded there is overlap in their import.

corporate assets.⁷⁵ Hence it is not necessary, and is costly, to invoke the contemporary vision of the fiduciary relationship to address those problems for bondholders. Possibly fiduciary restraint in accordance with its historic strictness against self-dealing will be revitalized to preclude the kind of conduct embodied in debtor strategic behavior to alter the bond contract. But, that possibility does not preclude application of other legal doctrines, which incidentally do not contain the disadvantages of the contemporary fiduciary concept.

75. The extensive discussion by Chancellor Allen in *Jedwab v. MGM Grand Hotels, Inc.*, 509 A. 2d. 584, 593-594 (Del. Chancery 1986) essays delineation of a distinction to separate the one from the other. He talks of "'preferential' rights (and special limitations) on the one hand and rights associated with all stock on the other." And he goes on to suggest that "with respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract; where however the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards."

Just what the contours are of "a right shared equally with the common" was not required to be, nor was it, spelled out by Chancellor Allen. Nor did he discuss more generally how to identify or enforce obligations that were fiduciary in character but not covered by the contract or reasonable inferences from it. Compare e.g., *Rosan* with *Eisenberg* and *Kumar*. It is difficult to see how or why preferred stock should be treated like "all" stock (i.e., the equivalent of common stock) with respect to many attributes not covered by contract, such as the distribution of merger proceeds or voting rights.

(b) To conclude that the fiduciary paradigm is inadequate, and may be inapposite, for the bondholder-stockholder relationship does not mean that stockholders' agents' strategic behavior should not be subject to restraints in the interest of dispersed bondholders -- as is evidenced in the varied statutory restrictions on such behavior.⁷⁶ Among the strands of common law (or equity) doctrine that courts have long spun to restrict or limit the consequences of one party's discretionary behavior in dealing with another,⁷⁷ adumbrations from contract doctrine

76. Thus where the temptations for stockholders to gamble especially riskily with bondholders' funds approach the irresistible, Congress has imposed restrictions. See e.g., Investment Company Act of 1940, §§ 18, 23; cf Trust Indenture Act of 1939, §§ 310, 315, 316. See also regulation prescribing safety and soundness for bank lending practices discussed in Clark, *The Regulation of Financial Holding Companies*, 92 Harv. L. Rev. 787 (1979); Symposium on Bank Regulation 59 J. of Bus. 1 (1986). Gilbert, Stone and Trebing, *The New Bank Capital Adequacy Standard*, Fed. Res. Bank of St. Louis Rev. June, 1985.

77. See e.g. concepts such as unjust enrichment (Dawson, *Unjust Enrichment* (1958)); constructive fraud (see cases cited note 51, supra) or conversion of another's property or contract rights (see e.g., *Shidler v. All American Life and Finance Corp.* 775 F.2d 917, 925-926 (8th Cir. 1985)); or "real" fraud and attendant disclosure requirements e.g. *Metropolitan Life Ins. Co. v. R.J.R. Nabisco, Inc.* 716 F. Supp. 1504 (S.D.N.Y. 1989) at pp. 1514 and 1522; *Harff v. Kerkorian* 347 A.2d 133 (Del. 1975).

Wholly external policy considerations also may limit the common stock's discretionary behavior. Thus, whether the debtor seeks bondholder consent to amendments of the bond contract by offering to buy bonds at a premium or simply by offering payments for the votes, the problem of vote-buying is implicated. The mysteries of case law (particularly in Delaware) on buying stockholders' votes are hard to penetrate. Compare e.g. *Chew v. Inverness Management Corp.* 352 A2d 426 (Del Ch. 1976) with *Schreiber v. Carney* 447 A2d 317 (Del Ch. 1982), and *Kass v. Eastern*

offer the most relevant predicate for determining whether and how to restrict common stock discretion in effecting amendments or repurchases or exchanges of bonds.

The focus on the contractual relationship suggests one important open ended question arising in the performance of a relational contract: how does the "good faith" performance obligation restrict the discretion of the parties in effecting modification of the long-term relationship that the contract embodies?⁷⁸ With respect to some kinds of interpretive problems -- principally those

Airlines, *supra* note 35. It is not necessary to probe those mysteries or to determine the line that the case law seeks to separate permissible from impermissible vote buying among common stockholders. Moral and political theory may (or may not) interdict efforts by members of the same class of voters to bribe one another. See Clark, *Vote Buying and Corporate Law*, 29 *Case Western Reserve L. Rev.* 776 (1979); Easterbrook and Fischel, *Voting In Corporate Law*, 21 *J. of Law and Econ.* 395 (1983). But the express conflict of interest and lack of contractual homogeneity of interest between the debtor and its bondholders and the structural hostility to the debtor voting on behalf of bondholders that is recognized explicitly in the Trust Indenture Act and many bond contracts implicitly create an obstacle to vote buying by the debtor that is not generally present in the case of vote buying among stockholders (but cf. N.Y.B.C.L. § 609(e)) or indeed among citizen voters.

78. See e.g. Farnsworth on Contracts (1990), Vol. II, pp. 310-332; Muris, *Opportunistic Behavior and the Law of Contracts*, 65 *Minn. L. Rev.* 521, 552-572 (1981), *Restatement of Contracts (Second)* §205; Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 *Harv. L. Rev.* 369 (1980); Summers, *The General Duty of Good Faith - Its Recognition and Conceptualization* 64 *Cornell L. Rev.* 810 (1982).

stemming from gaps or ambiguities in the delineation of the unilateral behavior expressly authorized or prohibited -- invocation of the "good faith" notion offers help, notwithstanding its often-ended nature. It seeks to derive some idea of the parties' expectations, or possibly a reasonable interpretation, from the language used and the objects of the arrangements, and to preclude frustration by one party of the other's expected benefits or protection. If, for example, the effort is to discern the import of a prohibition against asset shifts or asset distribution or claim dilution, the terms of the contract that address those possibilities offer a fulcrum for raising expectations, or support for arguments from hypothetical consent by rational actors. But with respect to the amendment or repurchase process, for which the consent of both parties is needed, the terms of the contract offer less of a clue to the import of the "good faith" notion.⁷⁹ Certainly in the exchange or

79. Reliance upon the "good faith" notion to determine how freely given must be the bondholders' consent to amendment has produced bizarre results in Delaware. In *Katz v. Oak Industries, Inc.*, supra, note 30, the Chancellor defined the good faith limitation on the debtor's strategic behavior in amendment matters to require that it be "clear from what was expressly agreed," that the parties "would have agreed to proscribe" the challenged strategic behavior. See also *Kass v. Eastern Airlines, Inc.*, supra note 35; *Kessler v. General Cable Corp.* 155 Cal. Repr. 94 (1979). That definition presents problems on at least two counts. It betrays a certain bias by its focus on requiring clarity that the parties would have "proscribed" certain strategic behavior instead of on evidence as to whether it is the kind of conduct that bondholders would reasonably have believed they were authorizing or permitting. Moreover, analytically it ignores the possibility that if the parties were to begin

repurchase process, and to a large extent in the amendment process, conceptions of fairness play a larger role than any illumination that is apt to be offered by particular terms of the contract in determining the meaning of the consent that should attend such transactions.⁸⁰ Content for such

again they might have traded off some protections for others or for higher or lower interest. One cannot determine what the parties would have done in rebargaining only one clause of an integrated and complex agreement by assessing that clause alone. The "good faith" notion becomes wholly indeterminate. cf. Charney, Hypothetical Bargains: The Normative Structure of Contract Interpretation 89 Mich. L. Rev. 1815 (1991).

That the notion can be read more sympathetically to bondholders -- with the emphasis (albeit not the holding) more on forbidding strategic behavior that was not clearly authorized than on permitting such behavior unless it was expressly forbidden -- is clear from cases dealing with disclosure or notice provisions (such as *Pittsburgh Terminal Corp. v. Baltimore & Ohio Railroad* 680 F 2d 933 (3rd Cir. 1082); *Van Gemert v. Boeing Co.* 520 F 2d 1323 (2d Cir. 1975); 553 F 2d 812 (2 d Cir. 1977)) as well as others, as distinguished from substantive protective covenants (*Broad II supra*, note 55; *Metropolitan Life Ins. Co. v. R.J.R. Nabisco, Inc.* 716 F.Supp. 1604 (S.D.N.Y. 1989)).

Significantly, because the matter is one of contract, the fact that many debtors are incorporated in Delaware may be less troublesome for bondholders than for preferred stockholders because the law of the place of contract, generally New York, governs the interpretation of the contract. But cf. *Pisik v. BCI Holdings Corp.* (N.Y. Sup. Ct. June 21, 1987).

80. Deriving that meaning is difficult enough when the contract and the underlying arrangements contain positive signals about what the parties to the contract would have "expected" or agreed upon if they had considered the particular discretionary behavior that gives rise to the controversy - e.g., whether prohibitions against the debtor voting bonds that it holds implicate prohibitions on the debtor seeking to affect the vote by strategic behavior; whether the debtor's inchoate right to repurchase bonds permits or precludes a self tender in the absence of express reference to a self-tender. But, as the signals about the parties' putative wishes that emanate from the terms and arrangements become dimmer, the court is obliged, whether

conceptions is offered by adumbrations from contract doctrine,⁸¹ such as the idea of undue influence or duress or the considerations underlying the notion of contracts of adhesion.⁸² Those concepts serve, among other things, to restrain one party from forcing the consent of another to a disadvantageous change in the relationship between them, or at least to limit the consequences of such a change.⁸³

under the "good faith" rubric or otherwise, to impose a solution that it (or it thinks society) deems "fair" or conforms to community standards.

81. See Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 *Wisconsin L. Rev.* 667 (1984) (hereafter Bratton I) for a probing analysis of the role of contract doctrine in addressing the stubborn problems facing holders of convertible bonds when debtors seek to avoid anti-dilution and anti-termination provisions.

82. See e.g. Farnsworth on Contracts Vol. I (1990) p. 430-448; Hillman, *Modification Under Restatement Second of Contracts*, 67 *Cornell L. Rev.* 680, 681-684 (1982); Dawson, *Economic Duress -- An Essay in Perspective*, 45 *(Mich. L. Rev.* 253 (1947); Hale, *Bargaining, Duress and Economic Liberty* 43 *Col. L. Rev.* 603 (1943); Muris, *Opportunistic Behavior and the Law of Contracts* 65 *Minn. L. Rev.* 521, 532-552 (1981).

The concept of unconscionability (cf. *Williams v. Walker - Thomas Furniture Co.* 350 F.2d 445 (App. D.C. 1065)) and considerations underlying the import to be given to disparities in bargaining power and contracts of adhesion are also relevant. See Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 *Harv. L. Rev.* 1174 (1983); Riger, *supra* note 12; Bratton I, *supra* note 81.

83. By requiring a "fair" result when a change is forced from which the yielding party's net "give-up" is not matched by any comparable contribution from the other.

To be sure, when comparable problems were encountered decades ago in the context of common stockholders' efforts to induce holders of preferred stock to alter their contracts, courts often were unable to see improper pressure on the preferreds to acquiesce in the transaction, and therefore were reluctant to intervene to enjoin or to modify the consequences of the alterations.⁸⁴ Instead, they formally verbalized a generic external standard of "fairness" of the result to measure the propriety of the behavior.⁸⁵ Although, that notion of "fairness" was criticized as constituting a shadow over preferred stock recapitalization transactions, both for planners and for

84. See e.g., *Shanik v. White Sewing Machine Corporation* 19 A2d 831 (Del. 1941) *Kreiker v. Naylor Pipe Co.* 29 N.E.2d 502 (Ill. 1940); *Johnson v. Lamprecht* 15 NE. 2d 127 (Ohio 1938). But cf. *Kamena v. Janssen Dairy Corporation* 31 A.2d 200 (N.J. Ch. 1943) *aff'd* 35 *aff'd* 35 A2d 894 (19__); *Patterson v. Durham Hosiery Mills* 200 S.E. 906, 909 (1939).

85. On occasion, they characterized the problem as whether the common stock's power to effect the alteration by merger or otherwise was exercised in a manner that constituted "constructive fraud"; if the result of the transaction did not meet the substantive standard of "fairness," the common stock's behavior could be found thereby to have constituted "constructive fraud." See e.g. cases cited *supra* note 51. It is hard to tell if the courts were examining the results of the transaction in order to determine whether the "give-up" was substantially the equivalent of the "get" (in which case the transaction was found to be "fair"), or if the question of fairness entailed inquiry only into the degree of "coercion" exercised by one party over the other (quite apart from any norm of substantial equivalence of the assets exchanged). See e.g. *Kamena v. Janssen Dairy Corp.*, *supra* note 83.

litigators,⁸⁶ in operation it was of little benefit to preferred stockholders.⁸⁷

Both the definition of a substantively "fair" transaction and the proof in court of its "unfairness" present considerable, if not intractable, valuation difficulties. Those difficulties do not, however, justify judicial myopia in examining the coercive or distorting impact of strategic behavior by common stock on the process of choice thrust upon dispersed senior investors. Nor do they justify judicial reluctance to prohibit or nullify or limit such behavior or the consequences of an institutional or structural tilt that deprives dispersed investors of the freedom of choice open to a sole lender. Indeed, the sooner the mote in the judicial eye is removed so as to permit recognition of the coercive or distorting import of such

86. See Gibson -- How Fixed Are Class Shareholder Rights? 23 Law and Contemporary Problems 283, 291-296 (1958).

87. See Walter, Fairness in State Court Recapitalization Plans - A Disappearing Doctrine 29 B.U.L. Rev. 453 (1949); See also Brudney, *supra* note 71; Latty, *supra* note 71; Dodd *supra* note 71. That protection for preferred stock against some forms of such "coercion" was ultimately offered by statutory requirements of class voting suggests that it could not effectively be obtained ex ante by contract -- at least in view of the judicial stance toward the volitional character of "consent" by dispersed investors. See Note, 9 Cardozo L. Rev. 1335 (1988). The impotence of contract cum market to protect preferred stockholders is not likely to be lessened in the case of bondholder consent.

behavior, the less pressing are apt to be the problems of defining or proving substantive "fairness".

(2) Appropriate Responses to Strategic Behavior and Structural Tilt

In the cases with which we are concerned, whether the fiduciary notion or signals from the contract are the focus of our inquiry or some external conception of "fairness" is the guide, the starting point is the same. To determine whether strategic behavior in the amendment or exchange process should be prohibited or restricted, we start with the notion that the bondholder's informed consent to the proposal is a necessary condition to its validity. Essential to the meaning of that consent⁸⁸ is the notion that the bondholder's choice be adequately informed⁸⁹ and undistorted (by physical force or by selective offers of rewards that discriminate among, or otherwise whipsaw, bondholders) -- i.e. leave them with no reasonable option but to consent. Such strategic behavior is unacceptable. Guidance, if not a mandate, to that conclusion is offered by

88. Whether the consent is said to be anchored descriptively in fairly imputed expectations or normatively in the hypothetical consent of the rational wealth maximizing actor at the time of the amendment.

89. See e.g note 74 supra.

the considerations that underpin the imposition of sanctions offered by contract doctrine for duress or undue influence or even for disparity in bargaining power. Notwithstanding that the Delaware courts are unable to follow that guidance to find such strategic behavior sufficiently coercive,⁹⁰ there is no doubt that such conduct distorts choice at least as significantly as behavior that constitutes duress or undue influence, quite apart from its flaws if compared with the choice available to the sole lender. And there is no offsetting gain from giving public bondholders so much less freedom of choice than sole lenders in matters of readjustment.⁹¹

The only basis for claiming that such strategic behavior should not be deemed preclusively to taint dispersed bondholders' choice is that they understood, or were told about, being confronted later with the possibility

90. See e.g. *Katz v. Oak Industries, Inc.*, supra note 30; *Kass. v. Eastern Airlines Inc.* supra note 35; cf. *Cogan v. Simons*, supra note 55.

It is difficult to tell whether Chancellor Allen's decisions are a function of his unwillingness to invoke the freedom of choice of a sole investor as the reference point in determining improper "coercion" or his inability to see any relevant distinctions along the spectrum from physical force to nuisance value in determining when the bondholder's choice leaves no reasonable alternative to consent. Possibly because he believes that fiduciary notions protect common stock more fully than they or contract doctrine protect senior security holders he has less difficulty in occasionally seeing distinctions where only stockholders are involved.

91. See TAN 13 supra.

of having to respond to that behavior in the original bond contract or when they bought the bond. There is no doubt that bondholders are never so told ex ante, explicitly or implicitly,⁹² except as the market penetrates the opacity of the bond contract for the bondholders, understands the

92. Whether or not the issuer is effectively the drafter of the original bond contract (see Bratton I, *supra* note 81 at 713-714; Riger, *supra* note 12), it has a much larger role in determining its terms than do the scattered bondholders who have little or no input into the process. Moreover, the mechanics of the amendment process and the resulting perils to the bondholders from the stockholders' strategic behavior down the road are among the items in the bond contract that are least likely to be called to the attention of individual bondholders by the issuer or the underwriters. And as psychological studies suggest, the distant nature of the contingent events diminishes the passive investor's ability to assess the risks, in contrast to the import of the concentrated focus of the active sole lender. Without explication of such matters, it is difficult to impute public investors' ex ante consent to the process of a more or less forced ex post amendment or exchange. It is possible that the debtor has no notion of the possibilities of such behavior when the bond contract is drafted. But that should not exculpate it from fault for imposition of the resulting disadvantages on the bondholders by reason of its failure to call them to the bondholders' attention. See Bratton, *The Interpretation of Contracts Governing Debt Relationships*, 5 *Cardozo L. Rev.* 371 374-377 (1984); Bratton I, *supra* note 81 at pp. 703-704 (1984). The failure to give such ex ante advice about the possibility of strategic behavior to influence their later consent on amendments or exchanges can fairly be said to implicate the disclosure requirements of the federal securities laws (1933 Act; Rule 10b-5, even in the absence of "fiduciary" obligations to bondholders). Nevertheless, that implication is apt to be of small import because by the time it materializes in investors being faced with the previously unexplained distorted choice, the statute of limitations is likely to be an insurmountable hurdle to claiming violation of those laws. But common law courts' consciousness of the lack of investor consent may be raised by the reference. See Ayres and Gertner, *Filling Gaps In Incomplete Contracts* ... 99 *Yale L.J.* 87 (1989).

perils to which they may be exposed in the amendment or exchange process, and induces them to charge a higher interest rate or to price the bonds in light of those risks. The assumption that price reflects the market's perception of the particular meaning of each boilerplate provision is subject to considerable doubt -- even if the market were capable of "rationally" reflecting the variations in risk potential embodied in each or all of the provisions.⁹³ Not all standardized protective provisions attract the same

93. There is good reason to question whether in general bond markets are as "efficient" as the stock market (SEC Commissioner Roberts' speeches (First Annual New England Regional Securities Conference, (June 14, 1991) ("entitled Transparency"); National Organization of Investment Professionals May 7, 1991) particularly the market for bonds of firms in distress (See Cowan N.Y. Times Mar. 29, 1991, p. D1 at D6). There is also reason to doubt that either bond buyers (see Coffee, *supra* note 22 at pp. 1505-1509) or bond rating agencies adequately parse and translate the range of protective provisions into price. The decline in bond ratings after (but not before) highly leveraged restructurings of the late 1980s carries its own message of the adequacy of the ratings. The low level of competition among, and the modest staffing of, the rating agencies and other factors that may account for their inefficient performance and the sharp drop in bond prices after issuance of new debt (see e.g. Asquith and Wizmen Event Risk, Covenants and Bondholder Returns In Leveraged Buyouts 27 J. of Fin. Econ. 195 (1990)) are discussed in Coffee, *supra* note 22, at pp. 1510-1515. See also Tauke, *supra* note 10, 30-45; 69-70; Bratton I, *supra* note 81, pp. 700-701, 704-708; But cf. Crabbe "Event Risk: An Analysis of Losses To Bondholders...", 46 J. of Fin. 689 (1991); Brook *supra* note 22 at pp. 33.

If the market conveys the same message to bondholders that explicit ex ante advice about risk of strategic behavior would convey, requiring the message to be explicit would not alter that efficient world. And it would make the world more equitable, at least to the extent of reducing misperceptions and clarifying ex ante expectations.

attention or degree of notice by players in the market. In part this is true because generally the economic factors that affect price so far overwhelm the significance of the protective provisions that the price impact of the latter is hard to trace. The matter is further complicated because the protective provisions vary in their significance for the quantum of risk to which they expose the investor. And finally, the mechanisms for getting the information to the market⁹⁴ are neither perfect nor subject to uniform incentives for all protective provisions, so that their impact on price is indeterminate, if not doubtful.⁹⁵ There

94. The issuer or underwriter have small incentive to discuss gaps or omissions; and purveyors of investment advice or of market literature are apt to focus more on the economics of low risk investments than on their legal pitfalls.

95. See e.g. Tauke, *supra* note 10 at pp 30-33. Consider how dim is the light shed on investor understanding of the bond problem by earlier judicial action in the matter of vote buying (e.g., cases cited note 77, *supra*) or forcing distorted choice upon preferred stockholders (e.g., cases cited notes 51 and 84 *supra*). Consider also the sophistication of investors who "mispriced" the potential for debtor unilateral opportunistic behavior as revealed in the dilution problem (*Metropolitan Life Ins. Co. v. R.J.R. Nabisco, Inc.* 716 F. Supp. 1604 S.D.N.Y. 1989) and the refunding problem (*Morgan Stanley & Co., Inc. v. Archer Daniels Midland Company*, 570 F.Supp. 1529, 1532 (S.D.N.Y. 1983); *Franklin Life Ins. Co. v. Commonwealth Edison Co.* 451 F. Supp. 602, 606 (N. D. Ill. 1978), *aff'd* 598 F. 2d 1109 (7th Cir. 1979); *Harris v. Union Electric Co.* 787 F 2d 355 (8th Cir. 1986). It is difficult to accept the argument (*Met Life supra* at p. 1520) that the decline in price after a judicial interpretation of a protective covenant means not that the market was unaware of the risk but that the prior price properly reflected that risk as remote.

is no empirical evidence to support the notion that the market prices all protective provisions, and little to suggest that it prices any but the most significant ones -- i.e., those addressed to contingencies that are thought (from time to time) to have the largest impact on price, discounted by the probability of the contingency occurring.⁹⁶

If individual bondholders can not be said to have consented ex ante to facing such distorted choice in the amendment or exchange process⁹⁷ and the market does not

96. See Tauke, *supra* note 95; Bratton I, *supra* note 81, at 700-701; cf. Crabbe, *supra*, note 22; Brook, *supra* Note 22; see also Weiss and White, Of Econometrics and Indeterminacy: A Study of Investors Reactions to Changes In Corporate Law, 75 Calif. L. Rev. 551 (1987) for a discussion of the problem of measuring investor sensitivity to legal attributes and entitlements of their investments and to changes in them. The extent to which the market for stock may fail to reflect uncertain self aggrandizing entitlements and behavior by corporate controllers has been adverted to in Eisenberg, the Structure of Corporation Law-89 Col. L. Rev. 1461 1516-1518; Bebchuk, in Harvard L. & E. Paper #46 (1988) 50-62; cf. Coffee 89 Col. L. Rev. 1618, 1676-1677.

97. With respect to knowledgeable participation in a bargaining process, it is not at all clear that institutional investors like mutual funds or pension funds that buy or invest in bonds are more properly analogized to a single private lender or even a syndicate of such lenders than to an individual investor. See note 104 *infra*. See cases cited *supra* note 95. Certainly to the extent that they buy bonds in the secondary market the analogy to individual investors is the more apposite. To the extent that they buy on original issue, the agency costs of a widely dispersed group of institutional investors are apt to be much larger and their decisions less focused than those of a sole lender or the participants in a banking syndicate that lends privately. See Berlin, Bank Loans and Marketable Securities Federal Reserve Bank of Phila. Business Review, July-Aug. 1987, p. 9. Cf. Tauke *supra* note 10, at p. ____

adequately reflect the potential for such distortion, it is difficult to find any justification for permitting the debtor to inflict such a choice on them. On the contrary, whether the doctrinal conclusion rests on the ideas of duress, undue influence or bargaining power disparities, or on the notion of "good faith" performance of the contract, efficiency and equity call for prohibition of such behavior. The debtor must be denied the stick embodied in the power to exercise such strategic behavior if only because it gives the debtor considerably more discretion than the bondholders or the market would otherwise give in deciding how small to make the carrot it offers to bondholders in "voluntary" readjustments.⁹⁸

Proposals for removing the stick by remedies short of the categorical prohibition of strategic behavior are not adequate. Disclosure of the underlying economic circumstances and expectations impelling the solicitation of the exchange or readjustment is likely to be sufficiently difficult to leave substantial information asymmetry between

note 67.

98. But cf. note, 91 Columbia L. Rev. 846 (1991).

debtor and bondholders.⁹⁹ And, in any event, even adequate disclosure about the debtor's prospects would not remove the coercive impact of the strategic behavior.¹⁰⁰ Efforts to soften that impact by requiring pro-rated acceptance of an oversubscribed offer are also insufficient if the decision to tender is not freely made - i.e. is subject to distorted choice. That distortion may be reduced, but not eliminated, by requiring the offer to remain open for a period within which offerees will have time to study it, take counsel, and decide. The fact that the solicitation will necessarily leave them worse off than before if they fail to tender remains an improper goad that precludes minimally volitional choice. That goad is lessened if they are required to be given the option to tender only after the results of the

99. See Vlahakis, *supra* note 37. In this respect, the voluntary adjustment entails a significantly greater disparity between the information available to the public investor and the debtor than between the public investor and the bidder in a takeover bid by a third party.

100. Possibly an adequate initial disclosure of amendment possibilities (i.e., admonition about the distortion possibilities and the range of the costs of their use in the past) will be so awkward that it will result in issuers agreeing to a contractual prohibition against later extracting bondholders' consent to amendment by injecting distortion into the consent solicitation process.

offer and consent solitiation are made public.¹⁰¹ But the bond holders are still forced to make a choice or cast a vote on a take-it-or-leave-it basis. No one represents their interest in organizing opposition or in illuminating the considerations to be taken into account in deciding whether to accept the offer.¹⁰² They have no opportunity to inquire of, or negotiate with, the debtor or, in the case of a complete workout, with the other claimants.

Such proposals may dampen the impact of debtor strategic behavior, but they leave the playing field on

101. This theme was developed by Bebchuk for correction of key difficulties created by hostile takeovers. See e.g. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*. 98 Harv. L. Rev. 1683 (1985); see also Coffee and Klein, *Bondholder Coercion*. . . . Columbia Center for Law and Economics Studies, Working Paper No. 53 (1991); and Pozen suggestion, in *The New York Times*, March 3, 1991, Section 3, p. 9; The suggestions for such restrictions in connection with takeovers deal with a process that entails possible competitive bids (from the target as well as from other bidders) -- a process that has no counter-part in the voluntary readjustment. Moreover the suggestions rest in fair part on preserving the benefits that third party takeovers may offer. See Bebchuk, *The Sole Owner Standard For Take-Over Policy* 17 J. of Legal Studies 197 (1988). But voluntary readjustments are for the most part purely internal reshuffling of claims and therefore lack that justification -- unless perhaps they are induced by a third party bidder for the entire enterprise. In such cases, the analogy to takeover bids is more apposite, both because of possible social gain and because of less substantial information asymetry between the parties.

102. Even the doubtful value that an indenture trustee offers for bondholders when collective action is to be taken is absent when only aggregative action (e.g. response to a repurchase offer) is required.

which the dispersed bondholders must make their choice tilted against them, quite apart from any strategic behavior by the debtor. The fact of their being numerous and the resulting need for collective or aggregative action import an advantage to the debtor in timing, information and volition that precludes replication of the relatively free choice, and certainly of the bargaining process, available to the sole lender. The pied-piper effect on dispersed offerees thus created by the debtor's advantageous position and the impact of the transient fears generated in the market¹⁰³ may not induce all offerees to march out like children;¹⁰⁴ but as the professionals in the business

103. The bondholders are required to decide quickly on a matter on which little corporate information is publicly available, and uncertainties about the likelihood and consequences of an insolvency proceeding make impossible either an efficient market or rational comparison by individual bondholders of the value to be received if the offer is accepted with the value remaining if it is not accepted.

104. Institutional investors undoubtedly hold the vast majority in principal amount of outstanding bonds. They are apt to have significantly greater competence and resources to participate in the voluntary adjustment process -- whether a moderate refunding or a thorough-going workout -- than individual investors. (Roe, *supra* note 6 at pp. 259-260). But so long as they are merely passive investors (rather than active lenders) they suffer from the muted incentives (albeit not so strongly) that afflict dispersed individual investors in respect of the voluntary adjustment process. Collective action among them is obstructed by many factors. Not only may there be differences among institutions in the investment objectives and kinds of bonds held, but some may hold both bonds and stock in the same issuer. The problem is aggravated by the relatively modest holdings that bonds of particular issuers may represent in their total portfolio and the consequent free rider impulses. In all events, institutional investors rarely are

acknowledge, inevitably they import a coercive element and induce dispersed bondholders to accept much less than is available, and certainly much less than would a sole lender.

Categorical prohibition of strategic behavior (in contrast to the proposals to reduce its impact), although necessary¹⁰⁵, is not sufficient to overcome the information

so involved in a bond investment as to be fairly analogized to a sole lender. If only a simple refunding is involved, it may well not be worth the cost to do more than follow the Wall Street rule. How extensive will be their participation in a more thorough-going work-out is more problematic, but certainly it is not likely even to approach that of a sole lender. Cf. institutional investors' apparent willingness "to take the money [\$90 per share] and run" when others held out successfully for \$110 per share in the AT&T - NCR takeover battle. (Mergers & Acquisitions, Vol. 26, No. 1 (July/Aug. 1991) p. 6).

105. That remedy generates some cost to offset its gains. Stockholders will be forced to make their proposals more attractive to bondholders - both in simple refundings and in more thorough-going workouts. The added power thus given to bondholders will not preclude the exchange or amendment by requiring unanimity or super-majority or otherwise. It will merely allow choices to be made without extraneous distorting influence to be injected by the common stock. As a result, it will alter the terms of, but hardly preclude, some advantageous compromise sought by the common stock in the amendment or exchange. By the same token, it will impose only a minimal added obstacle to acquisitions by strangers. The common stock will simply receive less of the proceeds of the sale. That at the margin it may prevent such transactions raises the questions of how significant is the margin and whether the absence of such marginal transactions impairs either efficiency or equity sufficiently to offset the gains from the prohibition.

asymmetry and distortion in the choice process¹⁰⁶ that face the dispersed bondholders in responding to the debtor's readjustment initiative. They can be brought closer to a bargaining position approximating that of a sole lender if (and they will need further regulatory protection unless) an effective representative can act or bargain on their behalf. Valid bondholder acceptance of the offer or the work-out must be conditioned (by court or by legislative or

106. Reduction, albeit not elimination, of those obstacles would be aided by the application of the federal securities laws. Such application implicates the questions whether the exchange is covered by the '33 Act and the consent solicitation is covered by the proxy rules. See Saggese, Noel and Mohr, A Practitioner's Guide to Exchange Offers And Consent Solicitations 24 Loyola L. Rev. 527 (1991); 8 Bankruptcy Developments Journal 15 (1991); Vlahakis, *supra* note 37. It also implicates the disclosure requirements of Rule 10b-5 (notwithstanding that bonds are the securities involved), and the Williams Act regulatory requirements, which appear to reach bond tender offer or repurchase transactions. See, e.g., Section 14(e) of the Exchange Act and SEA Rel. No. 6158 [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 82, 373 at page 82, 581 (Nov. 29, 1979); cf. L.P. Acquisition Co. v. Tyson 772 F.2d 201, 208 (6th Cir. 1985); Henry Heide Inc., SEC No-Action Letter [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) para 78, 838, page 81, 836 (5/1/72). See also Rules 14e-1 and 14e-3; SEC No-Action Letter Salomon Brothers Inc., CCH Fed. Sec. L. Rep. para. 79, 643 (9/28/90). But Cf. Coffee & Klein Bondholder Coercion ... Col. Law & Econ. Studies, Working Paper #53. Although the SEC seems loath to impose on issuer debt tender offers the regulatory rules it has promulgated for equity securities under the Williams Act, (See Coffee, *supra*, Vlahakis *supra* note 37; but cf. Breedon speech.) attention to these strictures is relevant where a simple repurchase or exchange offer is made unaccompanied by debtor strategic coercion.

administrative action¹⁰⁷) on the existence of bargaining or active representation on behalf of all by holders of a substantial number of bonds -- e.g., 25% of principal amount -- who are organized into a cohesive group. The actions of a cohesive group representing all the bondholders, with no conflict of interest or collateral interest, remove much of the problem of structural tilt. But intrinsic to establishing the propriety of any exchange bargain thus stuck by an agent for a dispersed group is the principal's consent.¹⁰⁸

107. The difficulties in achieving such protection by contract (see Vlahakis *supra* note 37 at p. 298) require such protection by regulation or by prescribing explicit advance disclosure of the import of its absence.

108. Whether the law should permit the dispersed principals to give open ended consent in advance to the agent's bargain in such significant transactions is the subject of current debate. That debate raises the question whether such advance consent can ever be given sufficiently knowledgeably and volitionally to make it "valid." Possibly such bondholder consent might be validated by explicit provision in the bond contract expressly identifying permissible forms of debtor strategic behavior and prohibiting all others. Such a provision could be required by legislation or it could be required by courts as a condition for refraining from sanctioning such strategic behavior. In any event, few, if any bond contracts contain such consent. Categorical prohibition of strategic behavior, albeit not of the tilt inevitably accompanying a simple debtor tender offer or amendment proposal, may be effected by judicial action or it may be embodied by appropriate provision in the Trust Indenture Act.

Two sets of problems traditionally arise when consent to a transaction is required from dispersed members of a group. The first centers on whether the group's consent should be deemed to be sufficiently given if demonstrated by some sort of vote that binds non-acquiescers, or whether each member should be given the right to consent individually and be entitled to retain his or her claim notwithstanding the group majority approval of the agent's bargain - i.e., the hold-out problem. The second centers on whether any bargain made by an agent and approved by vote of the group that binds a dissident either to continue with the enterprise or to surrender the investment should leave a cash-out alternative that is analogous to the fair value authorized by the appraisal remedy for stockholders - i.e. the fairness problem. For each set of problems the inquiry starts with ascertaining whether the interests and incentives of those acting on behalf of the dispersed bondholders in the adjustment process adequately coincide with those of the bondholders. If a court can be persuaded of the unity, or at least the absence of any conflict or divergence, of interest between the agent and the principals, the process may bring the bondholders sufficiently close to the position of a sole lender so that

if an adequately informed majority¹⁰⁹ of some sort approves the bargain there is little or no reason to permit hold-outs or perhaps even to require a fairness test. But if, as is often likely to be the case, the circumstances do not demonstrate such undivided loyalty in bargaining or if there is no bargaining on behalf of the bondholders, it is hard to find reasons sufficient to deny them the protection of rules permitting holdouts and requiring a "fairness" cap on the readjustment transaction, notwithstanding majority approval of it.

(3) The Hold-Out Problem

At the outset, two considerations must be noted. The essential virtue of collective approval by vote in the case of dispersed holders of common stock is that the more demanding unanimity rule for obtaining contemporaneous approval by the members of the class is neither feasible nor appropriate. To prescribe a unanimity rule, or to entitle a common stockholder to retain the original open-ended bundle of claims when the participation of all other members of the class is terminated or materially altered, is effectively to preclude many desirable economic transactions, not merely to

109. i.e. a majority that has been given the pros and cons of the bargain that bondholders' loyal representatives struck.

increase their cost. That difficulty does not exist when the consent of bondholders is at issue. Unlike residual claimants, they have a claim to be paid a maximum amount on or before a fixed date. It is therefore possible to terminate or even alter the claims of other members of the class and yet to continue the dissenters as claimants. Or it is possible to require them to accept payment as provided in their contract. In either event, to be sure, the right of an individual to retain the claim may well raise the cost of the readjustment transaction to the debtor. But that is far from the preclusive effect of a similar entitlement for residual claimants. If it is thus not necessary to require binding collective action by bondholders with respect to altering or terminating their claim for principal (at least in the absence of bankruptcy reorganization with its attendant protective apparatus), it is also not appropriate to do so. On the contrary, in view of the promise of payment and of priority at or before a definite time, the bondholders' expectations should not be diluted by imputing¹¹⁰ consent in advance to collective action to waive such payment -- unless there are good reasons to override

110. On the assumption that the possibility of such waiver by collective action has not been provided for expressly in the contract and brought to the investor's attention explicitly or by the market.

such expectations.¹¹¹

The other preliminary consideration to be noted is that in addressing the hold-out problem in the voluntary adjustment process, the fons et origo of the problem is the built-in power of the debtor to hold out. The frictions of the legal system enable the debtor's stockholders to gamble on the creditors' money when the collective assets contract to a level that barely exceeds (or indeed is lower than) the creditors' claims. That power of the debtor, which is greater in the case of dispersed lenders than in the case of a sole lender, may not alone justify empowering dissident creditors to hold-out at the risk of causing "voluntary" readjustment to fail, but it argues for a critical assessment of how great is that risk.

If the debtor offers cash or marketable securities in exchange for the old bonds with a market value in excess of the price of the latter, the entitlement of each bondholder to reject the offer and retain the bonds until full payment does not present any serious risk of failure of a contemplated readjustment. It has been argued that to allow any bondholders who so choose to retain their bonds,

111. This is not to say that, notwithstanding structural tilt, dispersed bondholders should not be bound by informed vote of a majority on many matters with respect to which debtors may seek concessions. It is to say that on the crucial question of payment of principal the bias intrinsic in structural tilt should be offset by a right in each holder to retain the claim.

notwithstanding that others vote to, or do, turn theirs in for less than principal amount is to give each offeree a disincentive to accept the offer. The theory is that those who are aware that some of their numbers will receive more than the acceptors do (even if not the full principal amount) by holding out for a larger payment after the acceptors are paid off will decline to tender their bonds, and that enough of them will so decline as to prevent or discourage the debtor from seeking voluntary adjustment.¹¹² In contrast, to allow majority vote to bind all to accept the debtor's offer will facilitate voluntary adjustment by precluding the possibility of disparate payoffs.

If the debtor could effect the entire transaction -- the offer to exchange the debt plus the payoff of non-exchangers as well as exchangers -- instantaneously, the disincentive would indeed operate, because few would be willing to accept a discount if they knew that by doing so they assured others of their class of a high probability of simultaneously receiving more of the debtor's depleted assets than they received. A collective good -- payment of all at more than market price, albeit less than principal -- would thus be lost by reason of individual incentives driving some of the

112. See e.g., Roe, The Voting Prohibition in Bond Workouts...97 Yale L. J. 232 (1987); Coffee and Klein, Bondholder Coercion Columbia Law Center For Law and Economic Studies, Working Paper No. 53.

offerees to try to receive more than others. But if the holdouts are exposed to delay in payment and to the real possibility of receiving less ultimately than do those who accepted the exchange offer, the configuration of incentives alters from that of the pure timeless model. Those who hold out would be seen as gambling to assert a claim for more than the offered exchange price, but at the cost of certain delay in receipt and some real likelihood of receiving less than the exchange price from a debtor in distress. Those who accept the offer avoid that gamble.

In many cases debtors seek voluntary adjustment when bankruptcy is not imminent, but neither is recovery; the enterprise is in distress and prospects under the prevailing capital structure are gloomy.¹¹³ If enough gain is offered from a sale or exchange, such an exchange is not likely to be refused by too many bond holders because of concern that others who hold out may gain more. That the holdout possibility may raise the price of reducing or eliminating the debt hardly makes it preclusive. That it brings the price closer to a sole lender's settlement price is in its favor.

In the case of a debtor seeking simply to eliminate or exchange one or more issues of its public bonds, the fact

113. See e.g. Elliot, *Leverage Snaps Back*, Corp. Fin. October, 1989 at 61, 62. [check]

that some persons may own or acquire only a portion of the outstanding bonds, does not mean that they are certain - or even likely - to hold out for a payoff that would force the debtor to pay (or other creditors to contribute) more in the aggregate to the bond holders than would be sought by a sole owner of all the bonds. Nor need such hold-outs kill the "voluntary" exchange. If the debt represents a large enough portion of the holdout's assets, they are likely to push the adjustment price up, but not suicidally. If they own a small enough portion they can be left to linger.¹¹⁴ In

114. Hold-outs for whom the debtor's bonds are a relatively small portion of a diversified portfolio (e.g. some vulture funds) see Schiffrin article in Forbes 8/6/90 at p. 74) may be analogized to highly leveraged equity for which there is powerful inducement to gamble, and possibly lose, others' money in the bargaining process. But the analogy is not entirely apposite. On the upside, the bondholder hold-out has less to gain from the gamble than a comparably leveraged equity owner, because the claim is not residual but is capped by a principal amount. On the downside the market premium offered in the immediate adjustment has to be compared with the delayed and contingent recovery in bankruptcy. Such a hold-out may take larger risks than would a sole lender in bargaining with the debtor, but unless bankruptcy is imminent and a complete workout with all creditors is involved the hold-out can be left outstanding without precluding elimination or reduction of the bulk of the issue.

Possibly the debtor will be induced to offer the public bond holders less than if there were no hold outs, in order to pay the potential hold outs more. But the SEC has power to preclude such discriminatory behavior in tender offers (See Roberts speech). And in any event, the dictates of fairness, particularly in the shadow of bankruptcy, require offer of equal payment for all members of the bond class by the debtor, (cf. Morgan & Co. v. Missouri v. Pacific RR. Co. 85 F2d 351 (8th Cir. 1936)), notwithstanding the permission to holdout.

Moreover, bargaining with, or payments by other creditors or bondholders to, hold-outs do not present the same problems as does debtor strategic behavior in the first

either event, the debtor will be pressed to offer (and to pay) more in total to the class of bond holders than if there were no holdout possibilities.

It is possible that through miscalculation the debtor will decline to raise its adjustment price and the holdouts will be sufficiently numerous and greedy to prevent the voluntary readjustment from succeeding - so that bankruptcy reorganization will ensue. But the debtor's and its managers' incentives to avoid bankruptcy are not less strong than those of the hold outs. Miscalculations may occur more

instance. Possibly ideal intra-class relationships among bondholders should preclude many forms of self interested behavior by some members at the expense of others in dealing with their common claims -- at least if such opportunistic behavior was not expressly authorized by their contract. But the possibility of opportunistic behavior hold-outs is a risk that is not without benefit to other members of the class. There is no empirical evidence to suggest that the non-holdout (i.e. tendering) bond holders would be worse off (or better off) by making such payments to hold-outs than they would be if hold-outs were prohibited and a majority vote bound all -- at least in the absence of a mechanism for assuring effective bargaining with the other participants by the bond holders or by someone on their behalf. The experience of preferred stock entitled to a class vote in recapitalizations and mergers (see notes 51, 84 and 87 supra) does not suggest strong bargaining when a class lacks cohesiveness. See also discussion of adjustments for railroad preferreds in Blum, *The Interstate Commerce Commission As Lawmaker: The Development of Standards For Modification of Railroad Securities* 27 U. of Clu. L. Rev. 603, 654-657 (1960).

frequently than in the case of a sole lender,¹¹⁵ but there is little reason to believe that in the simple case of refunding outstanding bonds they will occur frequently enough to offset the benefits of allowing the holdout.¹¹⁶

The hold-out is said to create a more difficult problem if the adjustment is powered less by the incentive of a premium over market and more by the fear of bankruptcy. The notion is that the exchange is a necessary condition for avoiding imminent bankruptcy reorganization, and it is therefore to the interest of all bondholders collectively to accept the exchange; but each bondholder individually may rationally conclude that he or she is better off, in the event that insolvency is not avoided, by retaining the old bonds, so that in the ensuing bankruptcy proceeding his or

115. See e.g. Insistence by bondholders of Harcourt Brace Jovanovich upon a price that General Cinema regarded as too high and that stockholders were not willing to yield to meet. *Mergers and Acquisitions* Vol. 26, No.1 (July/Aug. 1991) p. 14; *Wall Street Journal*...

116. A somewhat more complicated problem is presented when several different kinds of creditors (bond holders, banks and trade creditors) are involved, and the debtor is seeking to negotiate a complete workout with all claimants even when bankruptcy is not imminent. To be sure, the uncertainties about the debtor's future, disparities of information and mistrust among creditors create difficulties for concluding negotiations and settlement among many parties. Hold-outs add to those difficulties. But so long as hold-outs are not able formally to block the work-out, they represent only a transaction cost, troublesome but not fatal. The question remains whether that cost is less than the increase in the cost of debt capital that should rationally follow elimination of the hold-out possibility.

her claims will be superior to those of the persons who exchanged.¹¹⁷ The result, it is said, will induce enough hold-outs to constitute costly obstruction to, if not wholly to preclude, a successful scale down exchange, or voluntary readjustment, and will thus produce insolvencies which would not otherwise occur.

The argument for forbidding holdouts and substituting majority voting is somewhat stronger when informed by fear of bankruptcy than by incentives to accept offers in excess of market price. Doubtless a majority vote regime would enable some voluntary adjustments to succeed that a rule allowing hold-outs would cause to fail. But the majority vote process will produce smaller pay-offs to dispersed bondholders, as much because of its institutional tilt¹¹⁸ as

117. See Roe, note 6 supra at pp. 235-246. The current state of bankruptcy law (In re: Chateaugay Corp. 109 Bankr. Rept. 51 (Bank. S.D.N.Y. 1990) encourages the view that if bankruptcy follows a voluntary readjustment the exchangers will be much worse off than the holdouts.

118. A majority vote sought by the debtor in the absence of an organized bondholder group or representative leaves bondholders short of information, without an opposition to make the case for any other offer, and facing a solicitation process that is timed by the debtor in an atmosphere of stress that it tinctures. Even if the bondholders are organized, there is the problem of the integrity of their representatives in the bargaining process. Plainly the pay-off to the class will be affected by the divergent or conflicting interests of those who bargain with an eye to advancing their own collateral interests (see note 15 supra) It has been suggested that such conflicts exist even under a rule allowing hold-outs and that therefore such a rule is inadequate to address those conflicts. (Roe supra note 6 at pp. 262-265) Until the conflicts of interest are in fact prevented by a regulatory apparatus in place, the benefits of the unanimity

because it lacks the buoying-up effect of the hold-out possibility. The crucial question is whether the resulting cost to bond holders and to society is more than the cost of the number of failed adjustments that a hold-out regime causes.

In answering that question it is necessary to consider the extent to which the voluntary readjustment process averts the insolvency proceeding. If the debtor's underlying economic condition -- i.e., its stream of expected earnings or the present value of its assets -- exceeds, or would exceed, the old interest or debt claims in the absence of the readjustment, then the readjustment is not necessary or appropriate to avoid insolvency and the resulting costly reorganization proceeding. It would simply shift values from the old bondholders to the stockholders. On the other hand, if the underlying economic condition of the firm precludes, or would contract to preclude, meeting the lesser claims outstanding after the voluntary readjustment, then that readjustment will not prevent insolvency. In short, it is only the case of a debtor whose

rule should not be denied to bondholders without a showing that its costs exceed its benefits. Similarly, the possibility of evading the unanimity rule created by the perversities of Delaware courts (cf. Roe, *supra* note 6 at pp. 246-250) suggests that repeal of the evasion device, rather than of the unanimity rule, is the appropriate response.

developing economic condition will enable it to meet the reduced claims but not the pre-adjustment claims, whose creditors will benefit solely by reason of the voluntary readjustment. And that condition must be estimated at the time of the readjustment, if bondholder's interests are not to be sacrificed for the benefit of stockholders.¹¹⁹

It is reasonable to assume that when debtors seek readjustment, the first type of case is trivial but the second type is of some significance.¹²⁰ Moreover, the information available to the debtor about its future is significantly greater than that available to dispersed lenders, and indeed to some extent greater than the information available to a sole lender. Hence the debtor is tempted to exploit such an informational advantage to create the doubtful, if not entirely false, impression of an enterprise that imperatively requires voluntary readjustment because it will go under without it but would not go under

119. I.e., by reducing their claims through voluntary readjustment and then finding either an expansion of earnings to meet their old claims or a contraction of earnings against which they have reduced their claims.

120. See Asquith, Mullins and Wolff, Original Issue High Yield Bonds: Aging Analysis of Defaults, Exchanges and Calls 44 J. of Fin. 943, 933-935 (Sept. 1989) suggesting that, at least in their sample, about one-third of the exchanges were followed by default. Franks and Torous *supra*, note 6, suggest a somewhat smaller proportion. See also Curran, Hard Lessons From the Debt Decade, Fortune, June 18, 1990 p. 76, 81; Stein, Insult to Injury, Barron's, May 28, 1990 at 42, 45.

with it. In short, the circumstances that make the hold-out phenomenon an unacceptable obstacle to a putatively desirable economic consequence are apt to occur less frequently than is assumed by those who urge its unacceptability as a policy predicate. And the circumstances are not easily detectable ex ante.¹²¹

Empirical evidence in this matter is thin. But notwithstanding the presence of the hold-out entitlement by reason of the Trust Indenture Act, it appears that a majority of attempted work-outs are successfully effected; a few attempts abort into bankruptcy, but a larger number of those that are completed end up in bankruptcy or further distress.¹²² Whether the overall cost of permitting hold-outs in voluntary readjustments or work-outs, is more likely to be tolerably modest than intolerably substantial cannot be answered with certainty, but the data suggest that the former is more likely. And disallowing such hold-outs is not without indeterminate costs that may be modest or may be substantial. On the present state of the evidence, an institutional bias in favor of bondholders is an

121. Dispersed lenders are less likely to pierce that impression and more likely to accept it than is a sole lender.

122. See Franks and Torous, *supra* note 6 at pp. 3-4. The aborted work-outs may reflect the relatively perilous condition of the debtor as much as the hold-outs' behavior.

appropriately heavy weight on the scales which measure whether it is preferable to chance the limited number of bankruptcies that could be avoided by eliminating a hold-out rule¹²³ than to add a significant uncertainty to the initial cost of all debt by eliminating the buoying-up effect of allowing holdouts.

(4) Substantive Fairness

Quite apart from the question whether each bondholder should be entitled to retain the investment notwithstanding group willingness to terminate it, are the questions whether the readjustment bargain should be subject to an externally applied standard of fairness, and if so, what is the standard. At the very least, the bondholders' entitlement to challenge the transaction for failing to produce a "fair" result may be justified by the considerations that justify the stockholders' appraisal rights.¹²⁴ But more is involved. The voluntary adjustment process centers on the

123. It does not detract from this conclusion that however much the 1978 Bankruptcy Act reduced the protection previously offered to public bondholders against exploitation by the debtor and others, it still offers bondholders more protection than the wholly unsupervised voluntary readjustment.

124. See discussion of those considerations in Brudney and Chirelstein, *Cases and Materials on Corporate Finance* (3rd Ed.1987) pp. 661-666.

conflict of interest between debtor and creditors; but many transactions that trigger appraisal rights do not entail so intrinsic a conflict. Hence the structural tilt affecting the voluntary readjustment process creates more significant doubts about the integrity of the group's consent - whether collective or aggregative - to the readjustment.¹²⁵ In the absence of a demonstration that those -- if any -- acting for the bondholders in the readjustment process acted single-mindedly for their benefit, those who are bound by the group's tainted approval¹²⁶ should be permitted to challenge the substantive fairness of the result. In the process of prosecuting or settling that challenge,

125. When the effort to adjust debt is part of the effort to transfer all the assets to a new buyer rather than merely an internal readjustment of claims, somewhat different considerations are involved. Presumably, the new buyer is adding something to the assets, so that there is a social value in encouraging such purchases. That value is lacking when all that is involved is an internal readjustment. A requirement of a "fair" price by third parties leaves them with a need to pay no higher and probably a lower purchase price than they would have to offer a sole lender. But it is likely to leave them with higher transactions costs including litigation over fairness. Whether marginal transactions that are discouraged will constitute a social loss sufficient to offset the added cost to bondholders from a rule that would not provide for a "fair" price for them is problematic.

126. If the hold-out rule prevails, possibly only those who acquiesce in the transaction-albeit without approving it - should be authorized to bring a challenge on behalf of the class. Hold-outs should be authorized to act only on behalf of themselves.

presumably a fair price or amendment will be reached.¹²⁷ The non-trivial cost of permitting such challenges may appropriately be a potential cost to be contemplated from seeking debt finance from the public rather than from a sole lender.

Allowing the bondholders to challenge the offer as unfair raises the problem of determining what is a "fair" price. The difficulty with finding a solution arises because the bondholders have assumed the fundamental risk that they will not be (or be entitled to be) paid back until the prescribed payment date, even if the value of the assets contracts, unless the contraction is so great as to induce a bankruptcy proceeding. The market price of their bonds may therefore decline considerably before the payment date without them having any remedy at law. At the time of the proposed amendment or repurchase neither contingency has occurred, yet the stockholders seek to impose additional loss or risk on the bondholders and shift values to themselves by the transaction. If the shift in values that the commons thus seek to induce should not be totally precluded, should it be wholly permitted or only partially permitted? If the latter, how determine to what extent?

127. I.e. One that is bargained for, and approved judicially, even though the agent of the bondholders may have interests that do not wholly coincide with theirs. Cf. *Rievman v. Burlington Northern R. Co.* 118 F.R.D. 129 (S.D.N.Y. 1987).

It is difficult, if not impossible, to construct a model of fairness based on the sole lender and the terms to which he or she would consent -- either in the initial contract with respect to later amendment or exchange, or at the time of the amendment or exchange.¹²⁸ Clues, but not answers, may be found in the learning on a comparable problem created by preferred stock recapitalizations a half century ago. A range of possible solutions was examined by courts and commentators.¹²⁹ One of them that is particularly appropriate for strong forms of strategic behavior is to treat the debtor's conduct as equivalent to redemption of the bonds requiring a cash pay out of the redemption price.¹³⁰ To ease the Procrustean effect of that

128. Cf. Baird, *supra* note ____.

129. See Brudney and Chirelstein, *Cases and Materials on Corporate Finance* (3rd ed., 1987) pp. 276-283.

130. Cf. *Bowman v. Armour* 17 Ill. 2d 43, 160 N.E.2d 753 (1959); *Sharon Steel Corp. v. Chase Manhattan Bank N.A.* 691 F.2d 1039, 1053 (2d cir. 1982), cert. denied 460 U.S. 1012 (1983). Doctrinally, the problem is one of contract, and does not enclose the courts in the box of Delaware statutory law. Hence, imputing redemption as the measure of injury is not precluded by the judicial posture that hobbles Delaware courts construing their state's corporation code. Cf. *Rothschild Int'l Corp. v. Liggett Group, Inc.* 474 A.2d 133 (Del 1984); *Rauch v. R.C.A. Corp.* 861 F.2d 29 (2d Cir. 1988). The difficulty with such a solution, however, is that the due date for payment of principal -- whether it be the time provided in the contract or acceleration upon bankruptcy -- has not arrived. But although the formal contingency against which the bondholders contracted for repayment has not arisen, invocation by stockholders of their strategic power to repurchase or exchange may fairly be said to create the substantive equivalent of that formal contingency.

approach, it would be appropriate to allocate the "intrinsic value" of the enterprise's assets between the bondholders and stockholders in the ratio of the redemption price to the value of the assets remaining after payment of that price -- on the assumption that intrinsic value is determined by experts rather than the market.¹³¹ This solution would leave room for argument over the intrinsic value of the assets and ultimately (probably in court)¹³² for settlement that is much closer to the kind of bargain a sole lender would make.

If less of debtor strategic behavior and more of structural tilt affects the bondholder's choice, the problem of defining substantive fairness is more difficult. Possible solutions maybe derived from the "investment value" doctrine developed by the SEC to respond to recapitalizations deemed to be "forced" under the Public Utility Holding Company Act of 1935.¹³³ That doctrine and

131. Market price is inappropriate in part because it reflects rebargaining uncertainties against a background of legal rules whose meaning is the subject of our inquiry. Moreover, market price reflects an atmosphere of acute information asymmetries, in part because it offers no independent value for the entire stream of earnings apart from the existing capital structure.

132. Cf. *Rievman v. Burlington Northern*, supra, note 127.

133. See Note, 33 U. of Chi. L. Rev. 97 (1965).

variations on it¹³⁴ address the measure (and settlement value) of the claim of a senior security-holder in a reorganization that is not entirely voluntary because it is the result of regulatory statute. It would divide the "intrinsic value" of the reorganized enterprise between juniors and seniors in the ratio of the present values of their respective claims to expected earnings, with the seniors' claims being determined by discounting their entitlement to share in expected earnings at a lower rate than applies to the juniors to reflect their lower risk.¹³⁵ There are limitations on the utility of that concept to measure fairness in the context with which we are concerned.¹³⁶ It may also be fairly argued that the compulsion on bondholders entailed in the structural tilt is much less than the necessity to accept some form of reorganization in response to the regulatory strictures of the statute. But to the extent that the contingency "forcing" the bondholders to rebargain (the debtor's pursuit of "voluntary" readjustment) is not one against which the

134. See Latty, Fairness - The Focal Point in Preferred Stock Arrearage Elimination, 29 Va. L. Rev. 1 (1942); Dodd, Fair and Equitable Recapitalizations, 55 Harv. L. Rev. 780 (1942).

135. Latty would vary the formula somewhat by not requiring differential discount rates in determining the present value of the claims.

136. See Brudney, The Investment Value Doctrine And Corporate Readjustments, 72 Harv. L. Rev. 645 (1959).

bond contract was drawn and their choice is not that open to a single lender, the teaching of the investment value doctrine is relevant.¹³⁷ Nevertheless the problem remains of a proceeding that turns upon a battle of experts on intractable questions of valuation.¹³⁸

A fairness standard thus defined invites attention to the solution offered for comparable difficulties by the insolvency reorganization process.¹³⁹ The comparison is troublesome to the extent that the standards of the Bankruptcy Act permit the bondholders to bargain down in the valuation process from liquidation value rather than from the matured contract price that was the touchstone of the absolute priority rule.¹⁴⁰ That the 1978 Bankruptcy Act eliminated many, and diluted other, protections that Chapter

137. So long as bondholders retain hold-out rights, there is less strength to objections from them that the doctrine forces them to take too little.

138. See discussion by Hartnett of a comparable problem in an issuer tender offer, *Kahn v. United States Sugar Corporation* (Del. Ch. 1986); see also *Smith v. Shell Petroleum, Inc.* (Del. Ch. 11/26/90). Cf. Rule 13e-3 under the Exchange Act, requiring a "fairness" opinion that has fueled apparently interminable litigation in *Howing Company v. Nationwide Corp.* 927 F2d 263 (6th Cir. 1991). Use of market prices in measuring fairness is afflicted with the problems alluded to in note 131, *supra*.

139. i.e., the dilution of the bondholders' entitlements on the contingency of bankruptcy by allowing them then collectively to accept less than the promised amount.

140. Compare Bankruptcy Act §§ 1129 (a) (7) and 1129 (b).

X offered for seniors against equity holders does not argue for further dilution of protection in the pre-bankruptcy adjustment process.¹⁴¹ On the contrary,¹⁴² it argues for a more demanding standard for permissible bondholder compromise in pre-insolvency reorganization than during insolvency reorganization. The presumed excess of assets over liabilities prior to insolvency argues for the bondholders to receive (and for the stockholders to be willing to give) a larger proportionate (and absolute) share of the assets than during insolvency, when there are presumably no assets other than nuisance value available for the equity.¹⁴³ And the absence of the protective procedures of the Bankruptcy Act (however diluted in 1978) in the pre-insolvency readjustment suggests a need for a higher standard of a minimum permissible bargain than may be

141. But cf. Roe, *supra* note 6, at pp. 266-267.

142. Quite apart from arguments for restoring protection in bankruptcy reorganization.

143. It does not detract from this conclusion that the bargaining structure appears to enable stockholders to fare proportionately significantly better in voluntary restructurings than they do in bankruptcy reorganization. Gilson et al, *Troubled Debt Restructurings* 27 J. of Fin. Econ. 315 (1990); Gilson, *Bankruptcy* in 27 J. of Fin. Econ. 355, 364 (1990); Frank and Torous, *supra* note 6 at p. 16.

required in the insolvency reorganization process.¹⁴⁴

II. UNILATERAL ACTION

Thus far we have considered the debtor's efforts to influence the amendment process or sales or exchanges and their impact upon the integrity of the bondholder consent they solicit. When we shift to consideration of simple unilateral acts by the debtor that do not require bondholders' contemporaneous consent we confront a different problem -- one that emphasizes disclosure rather than regulatory restriction, and focuses on conventional contract doctrine and the "good faith" performance obligation. Efficiency considerations argue for the firm's residual claimants to have considerably more unilaterally exercisable discretion vis-à-vis its debt in operating the enterprise¹⁴⁵ than in seeking to amend the debt contract or make "tilted" exchange offers. The latter efforts involve principally

144. Prepackaged bankruptcy plans could significantly dilute such protection as the Bankruptcy Act offers to bondholders, both procedurally and substantively, notwithstanding the disclosure requirements of § 1126 (b) of the Act. See e.g. Kirschner, Kusnetz, Salarsh and Gatarz, Prepackaged Bankruptcy Plans...21 Seton Hall L. Rev. 643 (1991). That possibility argues for perserving rather than further diluting the protection of bondholders in voluntary adjustments.

145. I.e., in altering operating risks, deciding to reinvest rather than pay dividends, deciding whether to seek new financing or assets, etc. See Baird, *supra*, Note ____; Van Horne *supra* note ____ at 467-472.

redistributional considerations. The former go principally to maximizing the value of the enterprise.¹⁴⁶ The breadth, incidence, and relative significance of those activities on behalf of the common stock doubtless help to account for the historic focus of the bond contract on the residual claimants' discretion in such matters; and the complex clauses restricting that discretion have been addressed to those problems more than to possible idiosyncracies in the amendment or exchange process.

The resulting structure and terms of the bond contract offer a fairly well developed framework and language in which to locate and decipher the contours of the debtor's good faith performance obligation in such matters.¹⁴⁷ By the same token, the financial community's familiarity with the range of a debtor's operating problems (and avoidance mechanisms to skirt possible contract restrictions on discretion) makes it feasible in the interpretive process to consider the conscious ex ante trade off (at least by

146. Because the bondholder has only a limited interest in the outcome of the exercise of such discretion, fiduciary restrictions on that exercise, such as presumably protect residual claimants against management, may be counter-productive.

147. In contrast, it is difficult to find clues to limit the scope of the discretionary powers of the residual claimants in the generally mute language of the contract with respect to repurchase or exchange offers, and even the amendment process -- unless, the contract contains provisions such as those prohibiting the debtor from voting the bonds it holds. See note 80, supra.

private lenders) of some of those protective provisions for other terms, such as higher interest rates.

It is not necessary for present purposes to probe the subtleties of the interpretive process in the law of contracts. It is enough to recognize (1) that express language generally cannot be interpreted without some reference to the institutional background of (if not the particular participants' special intentions in) the transaction, especially in the case of long term relationships under contracts that are necessarily incomplete and therefore inevitably contain gaps or omissions in their standard clauses,¹⁴⁸ and (2) that despite the carefully drawn explicit terms of the standard form bond contract, the ingenuity of debtors seeking opportunistic advantages pries apart many apparently firmly sealed joints. In such cases, it is not often that an actual intent of the parties with respect to such language can be claimed to exist, (even if it is deemed relevant), except perhaps in terms of the general thrust or aspiration of the particular provision, such as an offer of protection against dilution or elimination of a conversion privilege, or against refunding with cheaper money, or against loss in a merger of debtor or successor obligation on existing debt.

148. See Goetz and Scott, Principles of Relational Contracts 67 Virginia L. Rev. 1089, 1092-1095 (1981).

It is in that context that the notion of "good faith performance" offers substantial utility. There is room to argue over whether that notion may be invoked properly only in cases where the other apparatus of interpretation produces uncertainty as to the proper solution¹⁴⁹ or also in less uncertain cases to implement the more general theme of the particular risk allocations made by the structure of the agreement.¹⁵⁰ But in any case, the boundaries of "good

149. E.g., where the language of the standard form contract does not require, but does not forbid, a certain result. Compare e.g., *Harris v. Union Elec. Co.* 622 SW2d 239 (Mo. App. 1981) with *Harris v. Union Elec. Co.* 787 F.2d 355 (8th Cir. 1986). The latter case implicitly rejected the interpretive premise of the court in the former case. Compare *Broad I* with *Broad II*, *supra* note 55. See also the *Franklin Life Ins. Co. v. Commonwealth Edison Co.* 451 F.Supp. 602 (S.D.Ill. 1978) *aff'd* 598 F.2d 1109 (7th Cir. 1979) rehearing *en banc* denied ___ F2d 576 ; cert. denied 444 U.S. 900 (1979)(preferred stock); *Morgan Stanley & Co. Inc. v. Archer Daniels Midland Company* 570 F.Supp. 1529 (S.D.N.Y. 1983) (involving prohibitions against refunding with cheaper money); *Sharon Steel Corp. v. Chase Manhattan Bank Corp. NA*, *supra*, note 78; *McMahan & Co. v. The Warehouse Entertainment Corp.* 900 F.2d 576 (2d Cir. 1990). The argument would be that the "good faith" duty cannot be made the path to override the requirements of explicit language, but it is useful in interpreting such language and in ascertaining the scope to be given to express authorizations or prohibitions

150. E.g., plaintiffs' arguments in *Metropolitan Life Ins. Co. v. R.J.R. Nabisco, Inc.* 716 F.Supp. 1604 (S.D.N.Y. 1989); (hereafter *Metlife* case) and *Hartford Fire Ins. Co. v. Federated Stores Inc.* 723 F. Supp. 976 (S.D.N.Y. 1989) to the effect that their entitlements should be judged in light of the institutional arrangements and circumstances that existed when the contract was drafted (such as managerial conservatism in matters of capital structure and dividends) notwithstanding radical changes in those circumstances over the life of the contract. See also *Rothschild International Corp. v. Liggett Group, Inc.* 474 A.2d 133 (Del. 1984).

faith" and the content given to it in the interpretive process are not easily cabined, -- particularly since the concept necessarily implicates external policy judgments beyond the limited search for the intention or expectation of the parties¹⁵¹ Use of the notion often will legitimately permit judges of equal sobriety and wisdom to reach opposite results because of different interpretive approaches or different policy judgments or both.

Against that background, it is relevant that in the case of dispersed lenders the scope of the debtor's unilateral discretion in operating matters is neither explained to, nor apt to be fully understood by, the bondholders.¹⁵² The absence of informed adversarial

151. See Bratton I, *supra*, note 81 at 691-719 Tauke, *supra* note 10 at 78 et seq.

152. As we have seen, the role of the underwriter is a poor substitute for an agent acting solely on behalf of the bondholders. And it is doubtful that either the market or the rating agencies can (or do) adequately analyze or reflect the perils of the debtor's opportunistic behavior that are created by gaps and uncertainties in protective covenants. (See note ____ *supra*) However limited may be the issuer's power in bargaining over such matters, the issuer is significantly better positioned than dispersed individual (and often institutional) bondholders to affect, and certainly to be charged with knowledge of the terms of, the contract. The predicate (by way of knowledge and bargaining and monitoring power) for placing the risk on the private lender for the consequences of the presence or absence of protective terms and for the light they may be said to offer on the meaning of the requirement of "good faith" performance by the debtor are wholly lacking in the case of the dispersed individual, and often institutional, buyers of bonds. See Riger *supra* note 12; Tauke *supra*, note 10 at pp. 30-35; Bratton I *supra* note 81 at 699-708; Berlin, *supra*, note 97.

bargaining remotely comparable to that of a sole lender furnishes good reason to urge upon courts an interpretive process that produces an ample meaning for the debtor's good faith obligation to respect the import of protective covenants as a limit on the debtor's discretion.¹⁵³ In the case of private lenders, the good faith performance obligation of the issuer might fairly be read through a lens that focuses the risk on the lender by permitting "unusual"

153. See Bratton I, *supra* note 81; cf. Tauke *supra* note 10, at pp. 67-77; See also Rakoff, *Contracts of Adhesion: An Essay In Reconstruction* 96 Harv. L. Rev. 1173 (1983); Riger, *supra*, note 12.

Neither efficiency nor equity is well served if the original contract lacks clearly understandable protective provisions, or those provisions are readily circumventable or amendable -- at least in the absence of quite explicit disclosure of the probability of losses to investors from the borrower's later opportunistic behavior in the matters covered by the protective provisions. Thus, if the rules of law permit a corporation to engage in unusual or reasonably unforeseeable behavior that is a particular instance of otherwise generally prohibited conduct, such as may be claimed for refinancing with cheaper funds or diluting or destroying the conversion privilege or even issuance of junk bonds, the initial pricing of original debt becomes troublesome. A rational buyer who knows of the reluctance of courts to protect against such opportunistic behavior must expect maximum opportunism, and should price ex ante on that expectation. For equity to be done, the exposure of the bondholder to maximum opportunism must be brought home plainly to the buyer, not merely left to filtration by the market. If there is no efficiency objection to the opportunistic possibilities created by the ambiguous provision, it is hard to see why the demand of equity that the peril be made clear to the buyer should not be fully satisfied. Whether efficiency is satisfied by a regime that permits substantial opportunistic dilution is another question.

or reasonably unforeseeable behavior that the contract does not expressly prohibit. In the case of dispersed bondholders there is reason to alter the focus, and if not completely to shift the risk, at least to require courts to read thematically (rather than literally) the scope of express prohibitions on the issuer's conduct and of bondholders' reasonable expectations as to their import. To be sure, this raises the question of limits on the interpretive process when the contract contains no relevant express language;¹⁵⁴ but that is not likely to occur often enough to present serious difficulties.¹⁵⁵

154. See Metlife case, *supra* note 150 at 1521-1522. The entire absence of a protective covenant (such as a prohibition against issuance of additional debt or against shifting the risk level of assets) confronts a court with a considerable obstacle to finding a thematic predicate to protect public bondholders against such behavior. That obstacle is considerably greater than is created by the presence of a prohibition whose scope is the issue (such as anti-dilution clauses in convertibles or liquidity clauses in straight bonds). But in the interpretive process, history has its claims, as the elimination of the historic prohibition against issuance of additional debt suggests.

The scope of the disclosure obligation of the debtor (i.e. what is "material") is similarly affected.

155. The talk by courts and commentators (Sharon Steel; Corp v. Chase Manhattan Bank N.A., *supra*, note 126 at pp. 1048-1052; Metlife case, *supra* note 149 at 1520; Katz v. Oak Industries Inc., *supra* note 33 at pp. ____; Vlahakis, *supra* note 37) about the impact on price of judicial tampering with the boilerplate in bond contracts is largely irrelevant to our problems. The argument that the standard clauses in bond contracts should not be subject to interpretation on the basis of varying factors peculiar to a particular case that are not expressly articulated in its terms, or on meaning reflecting the subjective intent of the particular parties, is based on the premise that the market understands, and reflects the meaning of, the terms in price. If meaning may vary from bond contract to bond

A comparable interpretive dichotomy is suggested by another consideration -- the impact which the interpretation will have on the ability of the parties to such arrangements to alter them in future contracts. Thus the issuers have (and public investors effectively lack) the power and the incentive to seek in future contracts a change of language that they regard as disadvantageously interpreted by a court. And empirically it is clear that issuers do make such changes, and underwriters agree to them. On the other hand, if the language is interpreted by courts to favor the issuer, the likelihood that the dispersed bondholders and

contract or from issuer to issuer in light of background circumstances in each case that are not common to all, those possibilities will add to uncertainty and cause bonds to be inefficiently priced. But if the problem is, by definition, one of resolving ambiguities or filling gaps that permit opportunistic behavior, uncertainty and waste are inevitable. A market presumably aware of the gaps and ambiguities must discount for incalculable variations of possible debtor opportunistic behavior if courts will not fill them. A market unaware of them runs the risk of mispricing (see note ___ supra). The issue is whether the range of those variations may be narrowed by an interpretive stance that avowedly favors creditor protection or debtor protection without troublesome emphasis on individual variations in particular contracts and circumstances. If such a stance is required by considerations of efficiency, considerations of equity as well as efficiency suggest systematic favoring public bondholders rather than the debtor.

To imply fiduciary obligations is to create wider uncertainty than a simple bondholder favoring stance, at least as the fiduciary concept has been stretched in the corporate agency context. It may be noted, however, that imputing loose fiduciary obligations to management has not been claimed to create intolerable uncertainties in pricing stock.

underwriters will be able to induce a "corrective" change in that language in future contracts, although not absent, is apt to be less.¹⁵⁶ Possibly sufficient "correction" will be made by the pricing of future issues that do not alter the language to offset the impact of the the non-protecting interpretation, but the accuracy of such pricing is problematic. To the extent, therefore, that the judicial interpretation of protective language is likely to be altered in later contracts if it favors the dispersed bondholders, but not likely to be altered if it disfavors them, there is an argument that the court should adopt the former stance rather than the latter.

Suggestion of a judicial stance toward public investors that differs from that toward private lenders raises the question whether the same language in a contract can appropriately be read one way in the former case and another in the latter. Viewed solely as a matter of interpreting

156. See the history of anti-dilution provisions discussed in Kaplan, *Piercing The Corporate Boilerplate...* 33 Univ. of Chi. L. Rev. 1, (1965) and Bratton I, *supra* note 81 at pp. 690-1, but cf. Bratton, I *supra* pp. 684-685, 703 and 713, note 171, and the development of protective covenants to meet evasion of existing covenants by debtors engaging in leasing instead of borrowing. Bradley & Myers *supra* at p. 602. Compare the limited protection offered by the poison puts and super poison puts to replace the relinquished covenants against issuance of additional debt. Steinwurtzel and Gardner, *Super Poison Puts As a Protection Against Event Risks*, *Insights* Vol. 3, No. 10 (Oct. 1989); Coffee, *Unstable Coalitions*, *supra* note 22 at 1511 note 54; Riger, *supra*, note 12.

language, a negative answer seems called for, although not necessarily so.¹⁵⁷ But the problem with which we are concerned may more appropriately be seen as one of disclosure. The risk of inadequate appreciation of the scope left for the debtor's opportunistic behavior by the terms of the contract may fairly be placed upon the private lender who presumably can deal with the matter, but not on the public investor who cannot deal with the matter unless he or she is adequately informed of the possibilities. In the absence of disclosure to the public investor of unusual or reasonably unforeseeable possibilities of debtor opportunistic behavior, liability for such behavior should be placed upon the issuer - or even the underwriter. Indeed, that is presumably the purport of the federal securities laws.¹⁵⁸ They thus tend to bring the position of

157. Such a possibility was intimated by the court in the Metlife case, *supra* note 150 at pp. 1518, 1519. A rule that interprets contracts with public bondholders differently from those with private lenders would not preclude resale of bonds originally acquired in a private transaction. Such a rule might induce debtors to insist on prohibiting resale of privately placed debt, or on requiring that in the event of any such resale, the public be informed by the reseller of the risk that the bond's protective provisions are porous in specified areas.

158. See e.g., *McMahan & Co. v. The Warehouse Entertainment Corp.* 900 F2d 576 (2d Cir. 1990); cf. *Harris v. Union Electric Company*, 787 F2d 355 (8th Cir. 1986); but cf. *Franklin Life Ins. Co. v. Commonwealth Edison Co.*, *supra* note 149; *Kessler v. General Cable Co.*, *supra* note 55.

the public bondholder into line with the risk return position of the sole lender. In short, in the absence of adequate disclosure to the public investor, the same language that would permit opportunistic behavior by the debtor in a contract with a private lender need not permit it in a contract with public bondholders.

Such a rule may lower the return on bonds if the requirement to disclose inhibits behavior by the debtor that it believes it needs discretion to indulge; or it may raise the return if the debtor insists on preserving the discretion notwithstanding the disclosure. In either case, the contract will be more equitable to public bondholders and presumably more efficient for society than if the public is induced to invest without such disclosure.¹⁵⁹ Moreover, a requirement of disclosure coupled with underwriter liability for failure to disclose may stimulate underwriters to insist upon protective provisions in the bond contract that put the burden on the issuer to justify unforeseen or reasonably unforeseeable opportunistic behavior.¹⁶⁰

159. But cf. Buchanan, *The Economics of Corporate Enterprise* (1940) pp. 452-459.

160. See e.g., Bratton I, *supra* note 81 at pp. 690-691 on efforts to add "lazy lawyer" clause; Kaplan *Piercing The Corporate Boilerplate*...33 *U. of Chi. L. Rev.* 1, at p. 18. (1965)

The consequences of such an approach may be illustrated in judicial treatment of the conversion privilege in senior securities. A merger, whether contrived or bonafide, which cashes out the common stock wipes out the bondholders' conversion privilege. The question may fairly be asked whether so draconian a result should be tolerated in the absence of an express provision therefore, and in the presence of express language designed not merely to avoid the historic elimination of the privilege in the event of merger, but to preserve it.¹⁶¹ Possibly the good faith performance obligation does not require preservation of the conversion option for a presumably knowledgeable private lender which failed to protect itself adequately in the bargain.¹⁶² But in the absence of adequate disclosure to

161. Case law generally gives an affirmative answer to that question. See e.g. Broad II *supra* note 55; Kessler v. General Cable Corp. *supra*, note 55; Simons v. Cogan, *supra*, note 55; Gardner and Florence Call Cowles Foundation v. Empire Inc. 589 F. Supp. 669 (S.D.N.Y. 1984) vacated on other grounds 754 F.2d 478 (2d Cir. 1985); cf. Levine v. C & O RR Co. 400 N.Y.S. 2d 76 (App. Div. 1977).

162. Good faith might reasonably dictate preservation of the conversion option in the case of a purely internal reshuffle. But cf. Simons v. Cogan, *supra* note 55. That result is somewhat more problematic if a 3rd party acquires the debtor. Nevertheless, good faith suggests preserving the option for those who placed their bet on a conversion right and sought to protect it against elimination. A cashout merger does not require elimination of that right. Good faith supports an obligation to protect it as best as possible -- e.g. on a basis diluted by the value of the cash paid out to the debtor's common stock. The court rejected that solution in Broad II, *supra* note 55, 642 F.2d 953 note 23 because it viewed the failure to include such a solution as in some sense a consent to loss of the conversion privilege -- a view that suggests a niggardly conception of

public investors before they decide, there is good reason not to saddle them with a complete loss if they are thus non-culpably ignorant of its possibility and therefore unable to protect themselves against it. That seems to be the consideration that underlies the decisions defining the notice requirements in the contracts when convertibles are called.¹⁶³

Similarly, the absence of protective provisions historically inserted for the benefit of the bondholders with respect to subsequent dilution by issuance of additional debt¹⁶⁴ or the meaning of provisions apparently precluding subsequent refunding with cheaper money¹⁶⁵ might appropriately be read to limit the protection they offer to private lenders. Presumably they knowledgeably traded or

good faith.

163. See *Pittsburgh Terminal Corporation v. Baltimore and Ohio R.R. Co.* supra note 55; *Van Gemert v. Boeing Co.* supra, note 55; but see *Meckel v. Continental Resource Co.* 758 F.2d 811 (2d Cir. 1985); *Abramson v. Burroughs corp.* Fed. Sec. L. Rep. (CCH) para 93, 456 at p. 92, 254 (S.D.N.Y. 1972); *Terrell v. Lomas & Nettleton Fin. Corp.* 496 S.W.2d 669 (Tex. Civ. App. 1973); *Gampel v. Burlington Industries Inc.* 43 Misc. 2d 846, 252 N.Y.S. 2d 500 (N.Y. Sup. Ct. 1964); *Kaplan v. Vornado, Inc.* 341 F. Supp. 212 (N. D. Ill. 1971)

164. See *Bratton II*, note 22 supra at 135-142; *Coffee, Unstable Coalitions* supra, note 22 at 1505-1507, 1512, 1555.

165. See *Morgan Stanley Mo v. Archer Daniels Midland Co.* supra note 149; *Franklin Life Ins. Co. v. Commonwealth Edison Co.* supra note 149.

forewent the protection for higher interest or other benefits,¹⁶⁶ and what they left in the contract by way of protection should be read narrowly. But the same provision need not carry the same consequences for public investors, at least in the absence of adequate disclosure to them of the meaning of the change in protection or of the limits of the protection offered by the language used in the contract. Whatever is the judgment of a private lender about the value of the trade-off or the scope of express language, unless public investors are informed of the import or underlying considerations, they have no way of deciding whether the trade-off is one they wish to make or the range of debtor behavior that the contract permits is acceptable. The risk of an opportunistic run by the debtor through the gap thus created in the protective line for creditors should be placed on the debtor (or the underwriter) for failure to disclose the gap.¹⁶⁷

It does not detract from the propriety of such an allocation of risk between debtors and public bondholders

166. Metlife case, *supra* note 150; Hartford Fire Insurance Co. v. Federated Stores, Inc. *supra* note 150.

167. Cf. Harris v. Union Electric Company, *supra* note 158; McMahan & Co. v. The Warehouse Entertainment Corp. 900 F.2d 576 (2d Cir. 1990). See also Ayres and Gertner, Filling Gaps In Incomplete Contracts ... 99 Yale L. J. 87 (1989) (suggesting gap filling rules for cases in which one party may be tempted to seek advantage over others by failing to fill gaps.); Ayres, Back to Basics:....77 Va. L. Rev. 945 (1991).

that the market seems to price bonds on more (rather than less) protective assumptions about the meaning of such clauses.¹⁶⁸ Whatever may be the miracles that the market can perform, registering the appropriate equilibrium between gains and losses from loopholes in protective covenants is not one of them.¹⁶⁹

168. See e.g. price effects of decision to redeem in *Harris v. Union Electric Co.*, supra note 158, at p. 359 *Franklin Life Ins. Co. v. Commonwealth Edison Co.* supra note 149; *Morgan Stanley & Co. v. Archer Daniels Midland Co.* supra note 149, and price changes that produced the *Metlife* case, supra note 150.

169. To prescribe a disclosure obligation for issuers and underwriters implicates the question of determining damages for violation of the obligation. See Ayres, supra note ____ at 996; *Harris v. Union Electric Co.* supra note 159 at 367-368. One approach would rest on determining what would be the value of a fair contract. See *Mills v. Electric Auto-Lite Co.* 396 U.S. 375 (1970). The perils, if not the fallacy, of that approach, at least if based on market prices, are illustrated in the result of the case on remand. 552 F2d 1239 (7th Cir. 1977) cert. denied 434 U.S. 922 (1978). See academic finance prescriptions for valuing particular protective covenants -- e.g. Smith and Warner, *On Financial Contracting* 7 J. of Fin. Econ. 117 (1979); Asquith and Wizner, supra note ____ Crabbe, supra note ____ Van Horne, *A Linear Programming Approach to Evaluating Restrictions* . . . 1 J. of Fin. and Quant. Analysis 68 (1966).

CONCLUSION

Voluntary debt adjustments in investor-owned enterprises in financial distress are said to save the cost of bankruptcy reorganization for society, for the debtor and for creditors, including public bondholders. If public bondholders were a single sole lender, their return or their share of the savings from adjustment bargains that avert bankruptcy would be determined by a bargaining process that presumably would produce results as close to "fair" (whether that notion is defined by reference to efficiency or to equity) as the basic structure of society's legal system will permit. But the dispersion of numerous bondholders, each holding modest portions of the their class of debt, generates collective action and aggregative action problems which subject them to the debtor's strategic behavior and to structural disadvantages in the adjustment process. If left unchecked, the debtor's strategic behavior will enable it to garner virtually the entire gain; and if only the structural tilt affects the readjustment process it enables the debtor to extract much more than it could from a sole lender. In either case, the cost of debt will presumably ultimately reflect the freedom of the debtor to resort to strategic behavior or to gain advantages from the structural tilt.

In assessing the propriety of rules to reduce the debtor's advantages and the dispersed bondholders disadvantages in the voluntary readjustment process, the costs of the rules must be measured against their gains. The former consists principally in the discouraging impact the rules may have on voluntary readjustment and the consequent increase in bankruptcy reorganizations with their attendant costs. The latter consists in the impact the rules will have on the cost of debt capital and the frustrated expectations of public investors.

Precluding the debtor from engaging in strategic behavior is the least cost remedy for bond holders. It has been suggested that such preclusion be effected by rules that do not categorically prohibit the strategic behavior but instead lessen the distortion in the choice with which the debtor's strategic behavior confronts the bondholders. That approach may well be appropriate in the takeover context, where competition with the bidder is possible so that the price received by the public investors may be affected and assets may be shifted to their "best use". But in the voluntary adjustment process, that approach does not sufficiently alter the debtor's advantageous position or adequately protect the bondholders against structural tilt. It leaves the debtor with unerodable information advantages and control of timing and the bondholders with the obstacles generated by collective or aggregative action problems.

Possibly rules could be fashioned to encourage, or even to require, public bondholders to organize so that they might deal with the debtor as might a sole lender. Operation of those rules would introduce another level of agency costs in the bondholders' relation to the debtor. To reduce that cost, and certainly in the absence of such organization, it is necessary to deny the debtor the advantages of strategic behavior. To limit the impact of structural tilt in the absence of organized bargaining by indisputably loyal bondholders' representatives requires preservation of the bondholders' hold-out possibilities embodied in the Trust Indenture Act and an overriding cap of "fairness" on any adjustment bargain. The cost of allowing the hold-out appropriately offsets the cost of the institutional disadvantage of the process by which a debtor whose bargaining power stems in large part from its ability to hold out obtains the consent of dispersed bondholders, even if debtor strategic behavior is categorically prohibited. Similarly, although judicial enforcement of an indeterminate "fairness" ceiling is costly, it is doubtful that it would be more costly than would be the absence of such a ceiling, at least if the only other controls on the debtor's behavior stem from remedies (requiring disclosure and less distortion in the choice open to bondholders) borrowed from the rules sought to govern takeovers.

Where the debtor acts unilaterally to take advantage of ambiguities or gaps in the language of the bond contract, the need for protection for the dispersed bondholders derives from the processes by which the initial terms of the contract are bargained and by which the public buys the bonds. If public investors are not adequately represented in the bargaining process when bonds are issued, nor adequately informed with respect to the gaps or ambiguities in the bond contract when they buy bonds in the market, the burden of vindicating the debtor's interpretation should be on the debtor rather than on the public bondholders. When knowledgeable private lenders trade off some protections in the bond contract for other gains, the risk of failing to protect themselves may appropriately be placed on them rather than on the debtor. In such cases, notwithstanding any good faith performance obligation of the debtor, the failure of the contract to interdict certain forms of opportunistic behavior may justify construing the language narrowly to cover only clearly and expressly specified risks. But when the same language is to be construed to deny public investors the missing protection against debtor opportunistic behavior, a different problem is presented. Good faith performance may demand more restraint from the debtor in such cases. But whether or not it does, the failure of the debtor (and the underwriter) adequately to apprise the public investors of the range of permissible opportunistic debtor

behavior under the contract should be at the risk of the former rather than the latter. Public investors should not be exposed to risks of which they could not reasonably be expected to learn and they were not apprised when making investments whose fixed returns proclaim limited risks, particularly in a market that is a poor register of the import of such gaps and ambiguities and of the debtor's potential to exploit them.

This approach shifts the inquiry from the meaning of the contract to the adequacy of the disclosure. That shift does not leave narrower space for judicial discretion in dealing with the substantive problem or with the question of damages than does the contract interpretation process; nor does it leave less uncertainties for planners of transactions. But it offers the least costly accommodation of public investors' need for protection against the debtor's opportunistic behavior with its need for discretion to act under long-term contracts.