Hedge Funds and the Enforcement of Bondholder Rights

by

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Marcel Kahan has acted as expert for parties involved in some of the disputes discussed in this paper.

Introduction

Hedge funds have caused some of the most significant recent changes in financial markets. Like mutual funds, hedge funds are pooled investment vehicles that invest primarily in publicly traded securities. But unlike mutual funds, hedge funds are open only to rich individuals and institutional investors and are therefore exempt from most regulations. That most individuals cannot invest in hedge funds, however, has not hurt their popularity. The assets under management by hedge funds have grown at stratospheric rates, from $40 billion in 1990 to more than $1 trillion in 2005.

But the mere growth in hedge funds assets is only part of the reason why hedge funds have become so influential. Even at $1 trillion, hedge funds remain much smaller than mutual funds or pension funds. But what distinguishes hedge funds from other investors is that they often pursue from active and aggressive investment strategies. Thus, hedge funds use leverage, sell short, and invest in derivatives. They trade much more frequently than other investors. And once they have taken a stake, they get engaged to make changes happen, rather than wait for changes to happen on their own.

In an earlier article, we examined the involvement of hedge funds, as shareholders, in corporate governance and in corporate control transactions. We argued that hedge fund activism differs in quantity and quality from the activism of traditional institutional investors – it is more strategic, directed to more significant changes, and it involves greater costs – and we analyzed the reasons for these

differences and their normative implications.[1]

In this article, we turn to a different facet of hedge fund activism: their engagement as holders of corporate bonds. We argue that the rise of hedge funds and other activist investors has led to a transformation in the way bondholder rights are enforced. In the past, many violations of bondholders rights have remained undetected and unsanctioned. This historic under-enforcement problem is rooted in the collective action problems facing bondholders; in the lack of substantial incentives for the indenture trustee – the supposed bondholder representative – to represent bondholder interests vigorously; in contractual provisions in the bond indenture – the document that governs most bondholder rights – that make it difficult to detect violations and imposes barriers on the ability of bondholders to enforce their rights; and in a relative accommodating attitude of traditional bondholders when faced with requests potential violations or requests for amendments.

With the rise of hedge funds and other investors pursuing similar strategies, this historic under-enforcement problem has given way to a new enforcement paradigm. Hedge funds have become significant players in the corporate bond market, accounting according to some estimates for 89% of the U.S. trading volume for convertible bonds, 66% of the trading volume for distressed debt and 20% of the trading volume of below-investment grade (junk) bonds.[2] Unlike traditional investors in bonds – insurance

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[1] Marcel Kahan & Edward Rock, Hedge Funds and Corporate Governance and Control, forthcoming U. Penn. L. Rev. (2007)

[2] Henny Sender & Anita Raghavan, Worry Amid Hedge Fund Boom: Privileged Access to Information, WSJ, July 27, 2006, at A1.

companies and mutual funds – hedge funds rarely pursue passive buy and hold strategies. Rather, their investment is motivated either by opportunities for arbitrage or the potential for activism.

One important variety of this activism has hedge funds look for bonds where companies have violated, have arguably violated, or are about to violate, some contractual provisions, buy up a large quantity of the issue (and possible take a derivative position in it), and then pounce. Because hedge funds have the sophistication to detect potential violations, the financial resources to buy large amounts of bonds of a single issue, and the willingness to take on issuers – indeed, if needed, take them to court – and, perhaps most importantly, because hedge funds have decided to pursue, and become experienced in pursuing, this strategy, they have been able to greatly ameliorate the historic under-enforcement problem.

But not all is peachy-keen, and not just for the companies that find themselves as the unexpected targets of activism. Hedge funds are obviously motivated by the desire to make money, and how much money they make from this strategy depends on the remedy afforded to bondholders for violations of their rights. But as we show, this remedy scheme entails its own imperfections.

As a result of these imperfections, the remedy will, in some instances, be highly attractive to bondholders and result in an economic "windfall" – a payoff that is substantially larger than the harm that resulted from the covenant violations. In such cases, activist bondholders have incentives to enforce their rights aggressively: they may devote excessive resources to the detection of violations and pursue of claims that have limited merit. Companies have corresponding incentives to oppose bondholders:

they may force bondholders to jump through procedural hoops and raise non-meritorious defenses, even when a violation has clearly occurred, in order to delay a judgment.

The more aggressive stance of bondholders in enforcing their rights also has important implications for the drafting of covenants. For one, the costs of "flaws" in the drafting of covenants increases. Where covenants are underenforced, flaws rarely result in litigation, can often be easily eliminated through amendments, or are simply ignored by companies. But where covenants are over-enforced, litigation is much more likely and amendments more difficult. Secondly, the enforcement level, the ease of amendments, and the optimal substantive content of covenants are interrelated. Covenants that are optimal where the enforcement level is low and amendments are easy may be excessively strict where the enforcement level is high and amendments are costly.

In other instances, however, the remedy is unattractive to bondholders and bondholders will often be better off ignoring violations of their contractual rights even if they suffered harm. In these cases, bondholder rights will remain under-enforced – not even activist bondholders will bother to investigate much whether a violation has occurred and expend resources to pursue any claims. Companies, correspondingly, lack proper incentives to avoid actions that would violate the contractual rights of bondholders.

We refer to this recent enforcement paradigm –where, depending on the circumstances, some claims are aggressively enforced and others are virtually ignored, as one of selective enforcement. We will argue that, unlike the under-enforcement

problem of lore, the more recent selective enforcement problem lends itself to a relatively easy fix. We show that two relatively modest changes to the remedy scheme largely eliminate, respectively, the incentives for over- and under-enforcement. Moreover, both of the changes we propose represent variations of provisions already contained in corporate bond indentures and other loan agreements and are thus familiar to issuers, investors, lawyers, and investment professionals. As a result, network effects should present less of a barrier to the implementation of these changes.

In part I, we will give some illustrations of the recent actions by activist bond holders. In part II, we discuss the historic under-enforcement problem. In part III, we explain the sources of the current selective enforcement problem. In part IV, we discuss the implications of selective enforcement for the structure and drafting of covenants [to be added]. In part V, we propose changes to the enforcement regime that would largely eliminate both the under-enforcement and the over-enforcement problems.

I. Recent Examples of Bondholder Activism

A. He Says, She Says ...

One important set of instances of bondholder activism relates to disputes over the interpretation of indenture provisions. Here are a few examples:

(a) Citadel Broadcasting Corp. On February 6, 2006, Citadel Broadcasting Corp. entered into a Merger Agreement with The Walt Disney Company. According to the agreement, ABC Chicago FM Radio, Inc. (ABC), a Disney subsidiary, was to merge with Alphabet Acquisition Corp. (Alphabet), a Citadel subsidiary, with ABC shareholders

receiving one share of Citadel for each share of ABC. Prior to the merger, Disney was to distribute its stock of ABC to its shareholders, so that Disney shareholders (rather than Disney itself) would receive the Citadel stock in the merger. In addition, Citadel's controlling shareholder, Forstmann Little & Co., signed a Support Agreement obligating it to oppose any alternative transaction.

In 2004, Citadel had issued $330 million in 1.875% Convertible Subordinated Notes which, by the time of the merger agreement, traded at a substantial discount. The indenture for the Notes provided that, upon a Fundamental Change, holders would have th right to require Citadel to repurchase the Notes at par.

On February 21, 2006, holders of 31% of the Notes sent a notice of default to Citadel claiming that a Fundamental Change had occurred and, on April 24 sent another letter claiming that, as a result of the failure to cure the default, an Event of Default had occurred and declaring all principal and interest due and payable. The holders, it turns out, appear to have been a group of 6 hedge funds – Camden, Kamunting, RG Capital, SSI, Whitebox and Zazove – most of which had recently acquired the Citadel Notes.[3]

On July 16, Citadel filed a declaratory judgment action against these holders denying that a Fundamental Change had occurred. On September 1, The Bank of New York, the trustee for the Notes resigned and Citadel appointed HSBC as successor trustee. Two weeks later, holders of a majority of the Notes removed HSBC as trustee

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[3] According to the 13F filings by these funds, they held an aggregate of $46 million in Notes as of December 31, 2005 and an aggregate of $98 million as of March 31, 2006. Oddly, two of the named funds - Camden and SSI - dislolsed no holdings of Notes as of either date. However, Linden Capital, another activist hedge fund, acquired $39.5 million Notes between December 31, 2005 and March 31, 2006.

and appointed Wilmington Trust Company in its stead. On January 5, 2007, Wilmington Trust Company moved to intervene. The court, on March 1, granted the motion and dismissed the holders of the Notes as defendants.

The dispute between Citadel and the holders – and later the trustee put on place by the holders – centered on the definition of "Fundamental Change." As defined in the indenture, Fundamental Change included certain mergers of Citadel as well as any person becoming the beneficial owner of 50% of more of Citadel's stock. Probably not coincidentally, certain features of the Merger Agreement avoided the triggering of a Fundamental Change. Specifically, because Disney was to distribute the ABC stock to record holders as of a record date prior to the merger, it will be Disney shareholders (rather than Disney) who stand to receive the 52% of Citadel stock to be issued in the merger and thus, Citadel argues, no single person would ever own 50% of more of Citadel's stock. Morever, since it is Alphabet (rather than Citadel itself) that is to merge, the transaction, so Citadel argues, would not entail a merger of the "Company," defined as Citadel.[4] The public disclosures are less clear on the holders' arguments that a Fundamental Change did occur. One argument raised by the trustee in the counterclaim, was that Disney, as a result of the Support Agreement, became a beneficial owner of the 67.6% of Citadel stock held by Forstmann under Rule 13d-3 (which was incorporated into the indenture). Disney had indeed filed a Schedule 13D disclosing that it "may be deemed" to have beneficial ownership of that stock," though that Schedule also said that it should not be deemed to constitute an admission that

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[4] In the alternative, Citadel argued, the mergers falls under an exception for stock mergers.

Disney was a beneficial owner. According to the most recent filings, discovery in the case is ongoing.

(b) Spectrum Brands. In January of 2007, Sandell, Sandelman, and Xerion, three hedge funds, send a notice of default to Spectrum Brands alleging that the company's borrowing under its Revolving Credit Facility violated the indenture for the 8-1/2% Senior Subordinated Notes due 2013 issued by the company. The company disputed that a default had incurred and took the unusual step of filing with the SEC its own lengthy analysis of the indenture provision purportedly showing that no such violation had occurred.[5] Apparently, however, Spectrum Brands was not sure it would prevail. Two months later, on March 12, it announced that it entered into an Exchange and Forbearance Agreement with Sandell and Sandelman.[6] According to that agreement, the company agreed to offer to exchange the 8-1/2% Senior Subordinated Notes for new Toggle PIK Exchange Notes due 2013.[7] These Toggle PIK Exchange Notes were to have an initial interest rate of 11%, which was to increase semi-annually to 15.25% unless redeemed, and the indenture was to contain covenants similar (except for the covenant allegedly breached) to those in the old Notes. As part of the exchange offer, any covenants in the old Notes were to be removed and any defaults waived. By the

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[5] Spectrum Brands, Inc. Form 8-K, Jan. 16, 2007, Exhibit 99.2.

[6] it is unclear what happened to Xerion. Xerion, however, held only $5 million of Notes when the notice of default was given, compared to $26 million for Sandell and $66 million for Sandelman.

[7] For $1000 in old Notes, holders were to receive $950 in new Notes and a $50 cash consent payment.

time of agreement was executed, Sandelman had increased its holdings of the old Notes from $66 million to $150.71 million (out of $350 million outstanding) and together with Sandell held a majority of the outstanding Notes – sufficient to approve the removal of covenants and waivers contemplated by the Exchange and Forbearance Agreement . The exchange offer was commenced four days later and by the March 29, the expiration of the solicitation period, 98.52% of the old Notes had ben tendered.[8]

B. What "Substantially" All?

Bond indentures typically provide that a company may transfer "all of substantially all" of its assets to another entity if the transferee assumes all the obligations under the indenture. In that case, the original issuer (the transferor) is often released from these obligations. This clause has recently generated a number of disputes.

(a) Jean Couto. On August 24, 2006, the Jean Couto Group (JCG) announced the sale of its U.S. drug stores to Rite Aid Corp. As part of the transaction, Rite Aid agreed to assume $850 million of JCG's 8.5% Senior Subordinated Notes due 2014 under the indenture clause relating to a sale of "substantially all" assets and JCG was to be released from the indenture.[9] Some noteholders, however, took the view that the sale did not involve "substantially all" assets, that JCG would remain liable under the indenture, and that transaction would be subject to other indenture convents (including

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[8] An additional 0.66% of the old Notes were tendered by April 13, the expiration fo the exchange offer. Holders of these notes did not receive the $50 consent payment.

[9] Form 6-K, Exhibit 99.1, Sep. 18, 2006.

one applying to significant asset sales not involving "substantially all" assets.) In December 8, 2006, JCG filed a declaratory action against the indenture trustee in the Southern District of New York., A group of Noteholders, consisting mostly of hedge funds and asset management companies, intervened. Concurrent with the litigation, JCG made an offer to buy the notes coupled with a solicitation of consent by a majority of bondholders to remove any covenants that stood in the way of the Rite Aid transaction. On March 30, 2007, on the eve of trial, JCG and a majority of Noteholders struck a deal. JCG agreed to offer to buy the notes at price determined by discounting the remaining scheduled payments at a treasury yield plus 150 basis points and the noteholders agreed to sell and deliver their consents to the indenture amendments.[10]

(b) Wendy's. On June 27, 2006, Wendy's International Inc. announced its plans to spin off its 82.75% stake in Tim Horton's to its shareholders.[11] In this case, the tables were turned. A group of bondholders – consisting of both traditional holders and a hedge fund – alleged that the spin-off constituted a transfer of "substantially all" of Wendy's assets and was not permitted (unless Tim Horton's assumed the obligation, which would have created numerous problems). Wendy's argued that the spin-off involved less than "substantially all" assets. The group sued for a preliminary injuction,

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[10] Jean Couto Group, Press Release, March 30, 2008, JCG's original offer involved a discount rate of treasury plus 200 basis points.

[11] Katherine Hunt, Wendy's confirms plan to spin off rest of Tim Horton shares, available at http://www.marketwatch.com/news/story/wendys-confirms-plan-spin-off/story.aspx?guid=%7BCB0D4AB6-6D73-433E-BA3C-69F0FEB7FC73%7D&dateid=38895.7024686458-878428444

but lost.[12]

C. The Failure to File Racket

Several bond issuers have recently run into problems – usually instigated by hedge funds – as a result of their failure to file financial reports with the SEC. Corporate bonds inevitably contain a covenant requiring issuers to file with the indenture trustee copies of any reports required to be filed with the SEC. When the issuer does not or cannot make the required SEC filings, and thus does not provide copies to the trustee within the requisite time period, a default usually arises.[13] If the trustee or bondholders then give a notice of default to the company, and the default continues for the a requisite "cure period", an Event of Default occurs which entitles the trustee or bondholders to accelerate. This can give bondholders substantial leverage over the company.

One early instance of the failure to file racket involved HealthSouth. In 2003, HealthSouth became involved in a corporate accounting scandal in which it was accused of inflating its earnings by $1.4 billion. In light of the ensuing investigation by the SEC and the Department of Justice, HealthSouth announced in March 2003 that its prior financial statements should no longer be relied upon and that it would not be able to file its Annual 10-K Report on a timely basis. This resulted in violations of covenants

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[12] 9/8/06.

[13] Some issuers have argued, based on the wording of the covenant, that a default only arises if the company fails to provide copies to the trustee of any reports actually filed with the SEC, but not when the company makes no filings with the SEC. Bearingpoint.

contained in its various bond indentures, to wit those for the company's 6.875% bonds due 05, 7.375% bonds due 06, 7% bonds due 08, 8.375% bonds due 11, 7.625% bonds due 12, 10.75% bonds due 08, and 8.5% bonds due 08. Although HealthSouth was current on all interest payments, some bondholders, reportedly hedge funds, issued a notice of default."[14]

In response, the company, on March 11, 2004, filed a complaint in the Circuit Court of Jefferson County, Alabama against the trustees and bondholders to prevent the acceleration of the bonds, disputing whether notice was properly provided under the relevant indenture provisions and arguing that performance of the covenants was excused or had been waived. The court granted a TRO preventing acceleration of the bonds pending a hearing for a preliminary injunction.

With the lawsuit pending, HealthSouth sought to amend the indentures to remove any problems. To achieve this, they commenced a "consent solicitation" on March 16, 2004[15] offering holders $10 per $1000 principal amount to, in effect, waive the default. The initial deadline for submitting consents – April 14 – was extended to April 28, and then to May 13. At that point, the consent payment offered was raised to $13.75. By May 13, Healthsouth had obtained the requisite consents from holders of the 10.75% due 08 and the 8.5% due 08, but not from holders of the other issues. So it extended the deadline again to May 27, and then June 4. By June 8, the company had reached

[14] Nov. 3, 2003 8-K and Press Release.

[15] Mar. 16, 2004 8-K and Consent Solicitation.

an agreement with a bondholder group with significant holdings in the other issues[16]. The company agreed to consent payments of $30 for the 6.875% due 05, 7.375% due 06, 8.375% due 11, $32.50 for the 7% due 08, and $45 for the 7.625% due 12. In addition, HealthSouth agreed to reduce shorten the maturity of the 7.625% due 12 and the 8.375% due 11 to January of 09 and of the 7% due 08 to January of 07. The final consent payments made to the bondholders who held out was very high considering the technical nature of the defaults and the shortening of the maturity represented another concession of the company.[17]

Since HealthSouth, numerous other companies have become subject to the failure to file racket. (See table.) Some hedge funds have reportedly developed models predicting which companies will become unable to file financial reports in order to purchase the bonds before the failure to file is announced and then benefit from consent payments or acceleration.

The "failure to file" issue is an interesting one more generally. There are two recent Delaware Chancery opinions that pick up a different aspect. Under 14 (c) and the rules promulgated under it, you are not allowed to hold an annual meeting (or special meeting) without having sent out your annual report. Thus, for those companies which, because of accounting problems or whatever, have not filed their 10-Ks, they are barred by federal law from holding shareholder meetings at the same time as they may be required by Delaware law to do so (e.g., to sell all or substantially all the assets or to

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[16] FIND OUT COMPOSITION

[17] ESTIMATE TOTAL BENEFIT TO BONDHOLDERS.

approve a merger or elect directors). See Newcastle Partners v. Vesta Insurance Group, 887 A.2d 975 (Del. Ch. 2005) aff'd 906 A.2d 807 (Del. 2005)(table); Esopus Creek Value v. Haof, 913 A.2d 593 (Del. Ch. 2006). Delaware has basically taking the view that the SEC can't be serious. It is an interesting intersection of state corporate law and federal securities law.

D. It Isn't Over Until the Fat Lady Sings

On August 31, 2006, Metaldyne Corp., an automotive supplier, announced that it had entered into a merger agreement with Asahi Tec Corp. pursuant to which Asahi was to acquire Metaldyne. The merger was conditioned on obtaining consents and waivers from Metaldyne bondholders.[18] Prior to the merger, the bonds traded at around 80 cents on the dollar, and Metaldyne had planed to make a tender offer for the bonds (with tendering bondholders delivering the requisite "exit consents") at around the pre-announcement market price.[19] At that price, bondholders would obviously not suffer any losses from the merger - but also obtain no gains.

Two of the bond issues – the 11% Senior Subordinated Notes and the 10% Senior Notes – contained a change of control covenant which would have been triggered by the merger and would have required the company to offer to purchase the notes at 101% of their principal amount. (The consents the company sought involved, among others, elimination of this requirement.) After the merger was announced,

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[18] Metaldyne Corp., Form 8-K, August 31, 2006.

[19] Vipal Monga, Investors Clash over Metaldyne, Daily Deal, Sep. 25, 2006.

hedge funds and other activist bondholders banded together. The activists either already had or, more likely, acquired sufficient Notes to assure that the change of control provision could not be eliminated without their consent. They then entered into lockup agreement – one for each set of holders – which obligated them to consent to the elimination of the covenant only if a supermajority – holders of 90% of the group for the Senior Subordinated Notes and of 80% of the group for the Senior Notes, respectively – agreed.[20] Metaldyne was now forced to negotiate. It ended up making a consent payment of $127.50 for $1000 principal amount to the holders of the Senior Subordinated Notes and $80 for $1000 principal amount to the holders of the Senior Notes. In addition, it agreed to purchase at least $25 million (and, depending on certain factors, up to $75 million) of the Senior Notes at par, secure the Notes with liens on its assets, and tighten other covenants protecting the noteholders.[21] Partly due to the added protections, the notes traded at ___ after the merger was consummated, meaning that activists forced Metaldyne to improve its offer by ___%.

E. Read the Fine Print

(a) Regal Entertainment, an issuer of convertible bonds, paid dividends in 2004 and 2005 which triggered an adjustment of the conversion price under an indenture

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[20] Majority of Holders of Metaldyne 11% Senior Subordinated Notes Due 2012 Announce Execution of Lockup Agreement, BusinessWire Oct. 13, 2006; Majority of Holders of Metaldyne 10% Senior Notes Due 2013 Announce Execution of Lockup Agreement, BusinessWire Nov. 3, 2006.

[21] See Metaldyne Corp., Consent Solicitation Statement, Dec. 4, 2006, at 1-8, 31-36.

formula. The company calculated the adjustment by multiplying the prior conversion price by a fraction with the numerator being the market price of the company's stock prior to the ex-dividend date less the excess dividend and the denominator being the market price of the company's stock prior to the *ex-dividend date*. The adjustment, as calculated, conformed to the wording of conventional anti-dilution provisions in convertible bond indentures. The Regal indenture, however, specified – according to the company due to a scrivener's error – the use of the market price prior to the *dividend date* in the denominator. Amaranth LLC, a hedge fund that had since attracted notoriety for different reasons, noticed this discrepancy and began purchasing around $90 million of notes in early 2005. It argued that, had Regal made the adjustment actually required, a holder converting $1000 of notes would have gotten 69.4 shares of Regal stock, rather than 64 shares. As the stock price of Regal was about $20, this difference amounted to about $110 per $1000 principal amount, or $10 million for Amaranth.

Regal brought a declaratory action in the Delaware Chancery Court that its interpretation was correct. In April 2006, the court certified this as a defendant class action with Amaranth, against its objection, designated as class representative. But Amaranth soon faced bigger problems. It lost $6.5 billion in commodities speculation and, in the fall of 2006, essentially went bust. It eventually agreed to the dismissal of the Regal case without prejudice against any holder other than Amaranth.

(b) Energy Corp. Energy Corp of America brought a declaratory judgement action against a group of holders of its 9-1/2% Senior Subordinated Notes led by activist

investor Mackay Shields and several Merrill Lynch funds. The suit related to the calculation of the "net proceeds" of an asset sale. Under the indenture, the "net proceeds" must be used to redeem notes at 100% of par if not used for certain specific purposes within 1 year after an asset sale. Net proceeds, in turn, was defined, as:

> The aggregate cash proceeds received by [ECA] in respect of any Asset Sale ... net of ... taxes paid or payable as a result thereof (after taking into account any available tax credits or deductions and any tax sharing arrangements) ...

Specifically, Energy Corp. argued that $84 million in taxes resulting from the sale reduced the "net proceeds" for purposes of the indenture. By contrast, Mackay argued that "net proceeds" were only reduced by the $38 million in taxes that were actually payable – the difference in the figures being due to certain tax credits and deductions that were unrelated to the asset sale in question.

The District Court ruled in favor of Energy Corp. But the Circuit Court reversed and ruled in favor of the noteholders. The court reasoned that the phrase "any available tax credits or deductions" "on its face, appears to include all available credits and deductions that are used to reduce the tax burden caused by the asset sale" even if they are not related to the asset sale. In effect, the Circuit Court declined to read the qualification "as a result thereof" (which applied with respect to "taxes paid or payable") also to the "available tax credits or deductions" (even though these credits and deductions reduce the amount of taxes paid or payable).

After the Circuit Court ruling, the company and the holders settled the litigation. In the settlement agreement, the Company agreed to make Asset Sale Offers for a total of $38 million of Notes in three stages of the next year and to limit to amount of debt it

will incur until the offers are completed.

(c) KCS Energy. On July 12, 2006, KCS Energy Inc. merged into Petrohawk Energy Corp. KCS had issued $275 million in 7-1/8% Senior Notes due 2012 which contained a change of control covenant. The indenture for the Notes contained covenant according to which a "change of control" is deemed to have occurred (and Noteholders obtain certain rights) if a majority of the directors of the company was neither "nominated for election or elected" with the "approval" of a majority of KCS's pre-merger directors.

A group of Noteholders, reportedly organized by W. R. Huff Asset Management[22] (an firm specializing in high yield bonds), then took the position that the merger triggered a change of control. In August of 2006, the group, which held a majority of the outstanding Notes, removed U.S. bank as indenture trustee and replaced it with Law Debenture Trust Co. of New York.[23] Shortly thereafter, upon instructions of 70% of the group of Noteholders,[24] Law Debenture filed a suit in the Delaware Chancery Court.[25]

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[22] Telephone Conversation with Joseph McLaughlin, Partner, Simpson, Thatcher & Bartlett, LLP., August 17, 2007. Mr. McLaughlin represented Petrohawk in the litigation described herein.

[23] Petrohawk Energy Corp. v. Law Debenture Trust Co. of N.Y., 2007 WL 211096 (S.D.N.Y.).

[24] Oral Argument, page 48, 50-51 (counsel for trustee stating that trustee is acting upon instructions of holders of 70% of Notes to bring lawsuit).

[25] See Law Debenture Trust v. KCS Energy, Memorandum Opinion, Delaware Court of Chancery, August 1, 2007 (the opinion also discusses other arguments raised by the trustee).

Post-merger, the board of Pertohawk, the company surviving the merger, had nine directors. Four of these were former KCS directors who become members of Petrohawk's board as a result of the merger. The others were long-standing Petrohawk directors. Prior to the merger, however, the board of KCS adopted a resolution "confirm[ing] and approv[ing] the nomination and election of each of the [Post-Merger Directors] as the members of the Board of Directors of the surviving corporation."[26] The trustee, alleging that none of the old Petrohawk directors had been "nominated for election or elected" by KCS's pre-merger directors, claimed that a change of control had occurred.

The Chancery Court, reasoning that the Noteholders were "attempting to exploit imprecise contract drafting" and to "use a technicality" to obtain a benefit, rejected the claim.[27] The case is presently on appeal.

II. The Under-Enforcement Problem

(a) The Enforcement Scheme

There are several elements in the enforcement structure that have contributed to an historic under-enforcement of bondholder rights. To understand the enforcement scheme, it is important to distinguish between a "default" and an "Event of Default" and between the different remedies provided by the indenture. A "default" basically includes *any* breach of a provision in the indenture; however, a breach of the indenture other

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[26] Id. at 8.

[27] Id. at 2, 25.

than a payment default generally becomes an “Event of Default” only if either the trustee or holders of 25% of the bonds give a "Notice of Default" to the company and the company fails to cure the default within a specified time period.[28]

It is only upon an Event of Default that bondholders obtain any remedies under the indenture. Once an Event of Default occurs, an indenture typically provides for two categories of remedies. First, the bonds can be accelerated: that is, the principal and any accrued interest become immediately payable.[29] Second, any other remedy to collect the payment of principal and interest or to enforce the performance of any provision in the indenture may be pursued.[30] The second category encompasses suits to collect principal that has become due as a result of an acceleration.

An intricate scheme that relies heavily on the indenture trustee determines who can exercise these remedies, and when they can be exercised. The indenture trustee has the power, unless holders of a majority of bonds give instructions to the contrary, to accelerate the bonds or to take any other remedy to collect the payment of principal and interest or to enforce the performance of any provision in the indenture.[31] That is good if the trustee has proper incentives to take enforcement actions. Alas, as discussed below, there are reasons to believe that the trustee’s incentives are weak. This raises the question of the ability of bondholders to enforce their rights when the trustee does

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[28] See, e.g., Commentaries on Indentures, supra note 21, at 207.

[29] See, e.g., Model Simplified Indenture, supra note 33, at 756 (§6.02).

[30] See, e.g., Model Simplified Indenture, supra note 33, at 757 (§6.03).

[31] See, e.g., Model Simplified Indenture, supra note 33, at 756-7 (§§6.02, 6.03).

not take any actions on its own.

Here, indentures distinguish between three kinds of enforcement actions. First, any individual bondholder has the right to bring suit for the payment of the principal of and interest on the bonds after their respective due dates.[32] This right is unqualified and can thus be exercised independently by any holder regardless of whether the trustee or the other bondholders approve of such suit. But, as interpreted by courts, this right is limited to sue for payment of principal or interest after the specific due dates noted in the security and does not include the right to sue for payment of principal that has become due as a result of an acceleration. Apart from this right to sue, bond indentures confer no express enforcement rights on individual bondholders. Thus, this right to sue is not helpful to enforce violations of protective covenants.

Second, holders of 25% of the bonds have the right to accelerate.[33] This right is qualified only in that holders of a majority of bonds have the right to revoke any acceleration (to de-accelerate). But the value of the acceleration right is limited in that holders have no right to individually sue the company for payment of the accelerated principal.

Third, holders of 25% of the bonds also have the right to pursue any other remedy. But, unlike the right to acceleration, this right is qualified by the so-called no-action clause. That clause requires that:

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[32] See, e.g., Model Simplified Indenture, supra note 33, at 757 (§ 6.07). This is one of the few provisions that the Trust Indenture Act prescribes. See Trust Indenture Act, §316(b), 15 U.S.C. §77ppp(b) (1994).

[33] See, e.g., Model Simplified Indenture, supra note 33, at 756 (§6.02).

(1) a holder notifies the trustee of a continuing Event of Default;

(2) holders of at least 25% of the bonds request the trustee to pursue a remedy and offer indemnity, satisfactory to the trustee, against any loss, liability and expense;

(3) the trustee fails to take any action for 60 days; and

(4) holders of a majority of outstanding bonds do not give any instructions to the contrary.[34]

In effect, then, to enforce covenants violations without the cooperation of the trustee, bondholders eventually have to jump through the hoops of the no-action clause. Specifically, this entails three things:

● Collective Action: the bondholders form a group holding at least 25% of the outstanding bonds, first to give notice of a default, second (if the default is not cured) to accelerate, and third to request the trustee to pursue a remedy.

● Delay: In addition to the delay entailed by assembling the groups of bondholders and the delay caused by the so-called cure period – the span between the time the company receives a notice of default and the time at which the default ripens into an Event of Default – there is the 60 day waiting period specified by the no-action clause before holders can take an action.

● Willingness to Write a Blank Check: Perhaps most importantly, the request to the trustee must be accompanied an offer to indemnify the trustee against any loss, liability and expense. But any bondholder would legitimately be reluctant to offer blank-check indemnification -- covering all expenses and any liability that may result -- to a trustee whose actions it does not control. Where no single bondholder owns 25% of the outstanding bonds, this furthermore means that several bondholders must be willing not just to indemnify the trustee, but also to bear the risk that other bondholders who agreed to indemnify the trustee fail to do so and that they have to make good on their fellow bondholders' promise.

The scope of these problems, of course, shrinks if a single entity that wants to enforce

[34] See, e.g., Model Simplified Indenture, supra note 33, at 757 (§6.06).

any violation holds 25% of the outstanding bonds or, even more so, if the trustee is willing to take enforcement actions. If a single entity holds 25% of the bonds, and if that entity wants to enforce a violation, the need to form any group is eliminated, as is the delay associated with such group formation, and the requirement to offer indemnity to the trustee becomes less cumbersome.

Historically, however, even though bondholdings are concentrated relative to share ownership, it was rare for a single holder to own 25% of the bonds. According to ownership data assembled by Best's Market Guide Corporate Bonds for 1995,[35] the five largest holders held more than 25% of the outstanding bonds in seven of twelve issued sampled and more than 50% of the bonds in only two of twelve issued sampled. This suggests that it will usually be necessary to assemble a group of bondholders, albeit often only a smallish one, to pass the 25% threshold.

(b) The Trustee

As discussed above, the indenture trustee has important powers in the enforcement scheme. Unless the trustee receives contrary instructions by holders of a majority of bonds, the trustee has the power to issue a notice of default to the company, or not to do so; to accelerate the bonds upon an event of default, or not to do so; to pursue any other remedy, including to sue the company if it fails to pay upon acceleration, or not to do so. The trustee, of course, is not obligated to coordinate its action with anyone and is not subject to the waiting period build into the no-action

[35] 1995 was the last year this guide as published.

clause, and thus can act faster than bondholders can. And, importantly, the trustee (but not bondholders) is entitled to indemnification of its "reasonable" out-of-pocket expenses (e.g. to pay outside legal counsel) by the company as well as from any funds collected for the bondholders.[36] If the trustee had proper incentives to act as an effective representative of the bondholders, the difficulties bondholders face in enforcing their rights on their own would be relatively unimportant.

Alas, the trustee's incentives are limited. Usually, trust departments of large banks act as indenture trustees. The initial indenture trustee is selected by the company before the bonds are issued and usually serves as trustee until the bonds mature.[37] A different trustee is appointed only if the initial trustee resigns or holders of a majority of outstanding bonds remove the indenture trustee.[38] If the trustee resigns or is removed, the company usually selects a replacement trustee, either by itself or together with the bondholders.[39]

Although the term "trustee" evokes strictly-enforced fiduciary duties, the trustee in fact has virtually no obligations towards the bondholders until an Event of Default

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[36] See, e.g., Model Simplified Indenture, supra note 33, at 760 (§7.07).

[37] Trust Indenture Act, §310(b)(i), 15 U.S.C. §77iii(b)(i) (1994).

[38] See, e.g., Model Simplified Indenture, supra note 33, at 761 (§7.08) (establishing removal rights); Interlake Indenture §608(c) (same).

[39] Model Simplified Indenture, supra note 33, at 761 (§7.08) (company selects replacement trustee); RJR Indenture, §7.08 (majority of holders may remove trustee and appoint successor trustee with company's consent).

occurs.[40] Specifically, the trustee has no obligation to give a "notice of default" to the *company*, which could cause the default to ripen into an Event of Default.[41] The only substantive pre-Event of Default obligation of the trustee is to inform bondholders of any default known to the trustee.[42] Once an Event of Default has occurred, however, the trustee must comply with a “prudent man” standard.[43]

The trustee typically receives a fixed annual fee, plus an additional fee if it performs further services for the company.[44] And although the trustee is entitled to be reimbursed for its out-of-pocket expenses, the trustee receives no extra compensation for its own efforts if its duties increase as a result of an Event of Default.[45]

Thus, pre-Event of Default, the trustee’s basic economic incentive is to do nothing. Taking any action entails effort for which the trustee is not compensated and entails the possibility of generating an Event of Default, which increases the trustee’s

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[40] See, e.g., Elliott Associates v. J. Henry Schroder Bank & Trust Co., 655 F.Supp. 1281 (S.D.N.Y.), aff'd 838 F.2d 66 (2d Cir. 1988) (holding that indenture trustee owes no general fiduciary duty to bondholders and that only implied duty is to avoid conflicts of interest).

[41] See, e.g., Model Simplified Indenture, supra note 33, at 796 (note 3 to §§7.01, 7.02).

[42] See, e.g., Model Simplified Indenture, supra note 33, at 760 (§7.05) (providing obligation to give such notice unless trustee determines that withholding such notice from the bondholders is in their interest).

[43] Trust Indenture Act, §315(c), 15 U.S.C. §77iii(c) (1994).

[44] See Amihud et al., supra note 11, at 479, note 111.

[45] The trustee can, however, obtain additional fees if the company files for bankruptcy under Chapter 11 of the Bankruptcy Code and the trustee is appointed as a member of the creditors' committee.

duties and its risk of liability.[46] Post-Event of Default, the liability regime creates some incentives for the trustee to act – to the extent necessary to satisfy the "prudent person" standard – but it is doubtful whether the fear of liability alone is sufficient to induce the trustee to take optimal actions to represent bondholder interests.[47] Though trustees may sometimes do more that what is legally required,[48] the economic incentive structure indicates that trustees cannot be relied on to represent the bondholders effectively.

The lack of vigor shown by trustees in defending bondholder rights is illustrated by the recent conflict involving convertible notes issued by Regal Entertainment Group. As discussed above, the indenture for the notes provided for changes in the conversion rate upon the payment of certain dividends according to a formula where the numerator was based (in part) on "the average of the Volume Weighted Average Prices for the three Trading Dates ending on the date *immediately preceding the Ex-Dividend Date*" and the denominator was based on "*such* average of the Volume Weighted Average Prices for the three Trading Dates ending on the date *immediately preceding dividend date*."

Regal took the position that averages referred to in the numerator and the denominator were the same and that the use of the term dividend date in the denominator (rather than Ex-Dividend Date) was a scrivener's error. Amaranth, a hedge

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[46] See Amihud et al., supra note 11, at 469-485 (providing a more elaborate discussion of trustee's incentives).

[47] Trustees also have no significant reputational incentives to provide effective bondholder reputation. See Amihud et al., supra note 11, at 484-485.

[48] sharon steel?

fund and holder of $80 million of notes, wanted to convert its notes and argued the dividend date in the denominator was not the same as the Ex-Dividend Date in the numerator and claimed that, as a result, the Conversion Price was about 10% lower than the price calculated by Regal. Though the company's argument was not implausible – the formula it advocated was the one conventionally used for adjustments in conversion rates – Amaranth had a strong claim based on the literal wording of the indenture.

Faced with this dispute, the indenture trustee could have sided with Amaranth (whose interests coincided with those of the other bondholders) and brought a suit against the company when it failed to convert the notes at the rate calculated by Amaranth. Or the trustee could stayed neutral and let Amaranth fight for its own rights (and those of other bondholders). But the trustee apparently took a third course: it agreed to amend the indenture to replace the reference to "dividend date" in the denominator with a reference to "Ex-Dividend Date" under a provision giving the trustee the power to enter amendment without consent of the bondholders to cure ambiguities. In other words, it appears that the trustee not only did nothing to advance the economic interest of bondholders; it instead acted contrary to the interest of Amaranth (and presumably other bondholders) even once dispute between the company and Amaranth had arisen.

(c) The Detection Scheme

Before the issue of any enforcement of a bondholder right even arises, one must be aware that an indenture provision may have been violated. In some instances, a

violation of a bondholder right will be evident. If the company fails to make an interest payment when due, it does not take much for bondholders to realize that the interest payment supposed to come in did not arrive. But with respect to many protective covenants, a violation will not be so evident. Consider for example the standard restricted payment and debt incurrence covenants. These covenants, respectively, limit the ability of a company to pay dividends (or purchase its own shares) or to incur additional indebtedness. The right of the company to take these actions is circumscribed by financial tests depending, respectively, on the company's aggregate income relative to prior restricted payment and on the company's current income relative to its interest expense and other fixed charges. The calculations required to determine whether the tests have been complied with tends to be complex. This complexity is enhanced by the fact that the subsidiaries that are consolidated with the company for purposes of these calculations are not always the same as those consolidated with the company for purposes of the company's filings under the securities laws, that indentures often specify deviations from GAAP for purposes of these calculations, and that indentures contain numerous special rules and exceptions.

Alternatively, consider the transactions with affiliates covenant. This covenant basically requires that transactions between the company (or a subsidiary) with a large shareholder or a sister company (an affiliate) are on terms not less favorable to the company that those obtained in an arm's length transactions. Unlike the restricted payment and debt incurrence covenants, this covenant does not require complicated calculations (though it also tends to include numerous special rules and exceptions). The detection problem here rather lies in the fact that, without detailed knowledge and

analysis of the terms of the transaction, it is hard to determine whether the terms satisfy the fairness test specified in the covenant.

How is it then that bondholders or the trustee learn about these covenant violations? There are basically two ways. First, the company is generally obligated to furnish the trustee with annual compliance certificates. For public bonds, these certificates must be signed by an officer and state that the signatory has reviewed the company's activities during the preceding year to determine whether the company has complied with all the covenants and concluded that the company has not (or has) violated any covenant.

The self-reporting scheme, alas, is of limited value to bondholders. For one, the company has no obligation to report any violations prior to the time that the compliance certificate is due. Moreover, these compliance certificates contain no background information that would enable the trustee (or anyone else) to confirm their conclusions. Thus, as long as there is some plausible interpretation (or perhaps even if there is only an implausible one) leading to the conclusion that no violation has occurred, it is likely that the company will find some way to get the compliance certificate signed. [49]

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[49] In these respects, compliance certificates for public bonds differ markedly from their equivalent for bank agreements or private placements of debt securities. In those agreements, certificates must be furnished quarterly and must contain detailed calculations showing compliance with financial covenants. In addition, companies are usually obligated to notify holders of any default within a few days after they become aware of a default or after they receive notice of a debtholders alleging that a default has occurred. Finally, lenders are entitled to seek additional information, which includes the right to receive any financial report or date that they may reasonably request, to examine the company's books of account, reports and other papers, and to inspect the company's properties, and to discuss the company's affairs with its officers, employees, and accountants as often as may be reasonably requested. Kahan & Tuckman

The second avenue for bondholders or the trustee to learn of any violation is through their own investigation. But the trustee, in the absence of bad faith, is entitled to rely conclusively on such compliance certificates, has no duty to investigate or determine independently the company's covenant compliance, has no contractual right to seek additional information from the company – and, as discussed below, has no incentive to do any of the above. Thus, if anyone investigates, it will likely be the bondholders. However the incentives and the ability of bondholders to investigate covenant compliance are reduced by the collective action problems, by the fact that it is often not easy to obtain the information needed to discern whether a covenant has been violated, and by the complexity of the analysis even if all the necessary information can be obtained.

(d) Evident, Complex, and Ambiguous Defaults

For both the detection scheme and the enforcement scheme, it is helpful to distinguish between evident defaults, complex defaults, and ambiguous defaults.   By evident defaults, we mean violations of bondholder rights that are neither complex (i.e., they do not require much investigation or analysis to determine that a violation has occurred) nor ambiguous (i.e., there is relatively little room for dispute over whether a violation has occurred).

An example of a relatively evident default is the failure of the company to supply the trustee with the reports that the company is required to file with the SEC.   If the company fails to submit these reports to the trustee on time, and the obligation of the company to deliver the reports is unambiguous, it takes little information to determine

that a covenant has been violated and there is little scope for a dispute as to whether a violation has occurred. But even though the company's obligations to file report is about as evident as it gets, and whether and when the company did file reports is easily ascertainable, litigation on whether a failure to file has triggered an Event of Default has generated litigation. [Discuss some of the disputes.]

Defaults that are not evident either involve a more complex set of facts or covenants (complex defaults) or involve some ambiguity as to whether a violation has occurred (ambiguous defaults) or often both. Defaults relating to more intricate or imperfectly drafted covenants, such as violations of restricted payment, negative pledge, asset sale, or change of control provisions, will often be complex or ambiguous. [Examples]

Although both the enforcement scheme and the detection scheme function far from perfectly even for evident defaults, both schemes work much better for evident defaults than for complex and ambiguous defaults. For evident defaults, the trustee will frequently become aware of the default soon after it occurs – either because the default involves the trustee directly (as in the case of a company's failure to furnish SEC reports to the trustee) or because a holder informs the trustee of the default. Even if the trustee takes no actions, in the case of evident defaults, holders do not have to do much digging to determine that a default has occurred. Indeed, if the occurrence of a default is indisputable, a company will ordinarily inform the trustee of the occurrence of a evident default when it submits the annual compliance certificate. When the trustee becomes aware of the default, the trustee is likely to send a notice of default to the holders. Thus, evident defaults will come to light, sooner or later, and often sooner.

When an evident default is discovered, either the trustee or the bondholders can give a notice of default to the company. Though the trustee is not required to issue such a notice (and has some incentives to avoid triggering an Event of Default), the trustee is more likely to issue a notice when the existence of a default is evident. And even if the trustee does not issue a notice, coordination among bondholders to form a group holding 25% of the bonds is easier when the existence of a default is evident. If, after a notice, the default ripens into an Event of Default, the trustee becomes subject to the prudent person standard. Thus, when the occurrence of an Event of Default is evident, the trustee will often pursue remedies on behalf of bondholders and , even if the trustee does not, coordination among bondholders is easier.

For complex and ambiguous defaults, by contrast, the detection and enforcement scheme involve much greater imperfections. Take ambiguous defaults first. If there is some ambiguity as to whether a default has in fact occurred, the company will invariably want to take the position that no default has occurred. As a result, it is likely that the company will issue a compliance certificate stating that no default has occurred. Since the certificate need not provide any back-up information, it will provide no indication that a default *may* have occurred which could lead the trustee or (more likely) bondholder to make further investigations. And since the trustee is both entitled to (in the absence of bad faith), and has incentives to, rely on the compliance certificate, the trustee will not engage in any investigation.

Bondholders, of course, can engage in investigations and, if they do, they will sometimes discover the presence of an ambiguous default. (How easy this is depends on the complexity of the default.) If bondholders do not, the default may never come to

light. But even if they do, the trustee may not be cooperative in propagating the default and taking any enforcement action. Since it is disputed whether a default has in fact occurred, the trustee will be more reluctant to issue a notice of default to other bondholders, to issue a notice of default to the company, or to take any enforcement action. This means that the burden of notifying other bondholders and assembling a bondholder group for purposes of giving a notice of default to the company, accelerating the bonds, and complying with the no-action clause falls on the bondholder discovering the default. And if the default is ambiguous, coordination among bondholders is rendered more difficult since other bondholders first need to determine on their own whether a default is likely enough to have occurred to warrant any further action.

Now consider complex defaults. Complex defaults are likely to take longer to be detected than simple defaults and may never come to light. Since the trustee has no general duty to examine whether a default has occurred, the trustee will generally not become aware of the default on its own.[50] And, by definition, it is more difficult for bondholders to detect complex defaults than it is to detect evident defaults. If the complex default is unambiguous, the company should learn of it through a diligent review when it prepares the annual compliance certificate. But even assuming that the company will in fact disclose the default if it learns of it (i.e. that the company is honest), there is no assurance that the company will be diligent enough to learn of the default. Obviously, a compliance review can initially only lead to the company finding a problem,

[50] The exception here are defaults that the relate to the company's failure to file certain documents with the trustee, such as copies of SEC reports or compliance certificates.

which the company would then be obligated to disclose. Thus, the company's incentive is to make the initial compliance review as cursory as it can get away with. If that initial review reveals no problem, the company's incentive is to stop and have the compliance certificate issued. If the initial review reveals a problem, the company's incentive is to investigate further to see whether, upon more careful analysis, the problem remains. If the problem disappears, the incentive is again to stop. If it remains, the company may engage in further review. Only if, at each stage of the review process, the company concludes that a covenant has been violated will even a honest company be forced to report so in its compliance certificate.

Thus, complex defaults will tend to become public in one of two circumstances. First, if the company self-report such a default because it is unable or unwilling to take the position that no default has occurred. Second, if bondholders though their own investigation detect a default.

Once a complex default is detected, if the default is unambiguous, the trustee may be amenable to take actions to protect the interests of the bondholders. (If the trustee is not amenable, however, coordination among bondholders can be rendered harder by the complexity of the default.) Furthermore, complex defaults are often also ambiguous. In that event, the trustee may not take any action and the effective burden of coordination imposed on bondholders is highest.

(e) The Under-Enforcement Problem

The structure of the detection and the enforcement scheme has in the past created a problem of a general under-enforcement of bondholder rights, which was

particularly strong for complex and ambiguous defaults. Defaults, or the facts giving rise to a ambiguous default, were often either not detected or detected only late. Once detected, the task of taking enforcement actions fell either on the indenture trustee – a person not well incentivized to represent bondholders effectively – or on a group holding a least 25% of the outstanding bonds – a group which is affected by collective action problems if no single bondholder owns 25%, and which problems are aggravated by the strictures of the no-action clause. As a result, the trustee and bondholders often did not vigorously pursue their contractual rights.

(f) Hedge Funds and the Enforcement of Bondholder Rights

The rise of hedge funds and other activist bondholders has lead to a fundamental change in the way bondholder rights are enforced. The reasons are several. First, these investors take a pro-active approach to their rights as bondholders. They research potential claims they may have against the company, they investigate whether a default may have occurred, and they are willing to raise claims in situations where there are prospect for gains. In conjunction with this pro-active approach, these investors have developed substantial expertise both in analyzing bond indentures and in negotiating with the issuer. Second, if these investors will take positions in bonds (often *after* they have determined that they have a potential claim) that a large enough both to meet the various thresholds fo the enforcement of bondholder rights in the bond indenture and to make an active approach worthwhile given the costs of activism to the investor. Third, because many of these investors specialize in activism, they tend to know each other and know they will face each other again. Thus, they can more easily cooperate with

each other to enforce bondholder rights. This, in turn, makes it easier for them for to meet the various thresholds fo the enforcement of bondholder rights.

III. The Selective Enforcement Problem

The rise of hedge funds and other activist bondholders and their increased involvement in the bond market has significantly reduced the under-enforcement problem discussed above. Rather than from systematic under-enforcement, bondholders and companies now suffer from a mix of under-enforcement and over-enforcement – a phenomenon to which we refer to as selective enforcement. To understand the reasons for the selective enforcement and the problems it generates, it is important to review the remedy scheme provided by the typical bond indenture.

(a) The Remedy Scheme: The Importance of Acceleration

The key feature of the remedy scheme for bonds is the right of the trustee or holders of at least 25% of the outstanding bonds to accelerate. By acceleration, the outstanding principal of the bonds and all accrued interest becomes immediately due and payable. In effect, acceleration entails the end of the lending relationship, with bondholders getting their money (assuming the company pays) and bidding good-bye. Acceleration is the principal remedy provided for defaults: it is the only remedy specifically stated to be available and the only remedy regularly sought if an Event of Default has occurred. Though technically the trustee or bondholders (after compliance with the no-action clause) could seek any other remedy to enforce the performance of any provision – which presumably includes seeking damages – bondholders rarely, if

ever, seek damages upon an Event of Default and the amount of such damages would be difficult to prove.

(b) The Attractiveness of Acceleration

It is the acceleration remedy that is the cause for the selective enforcement problem. The reason is that the attractiveness of acceleration turns on three factors, of which only one generally ought to be relevant from the perspective of providing proper enforcement incentives.

Whether and to what extent acceleration is attractive to bondholders – and conversely, to that extent the threat of acceleration can be used to extract concessions from the company – depends on the hypothetical value of the bonds post-Event of Default, assuming that no default has occurred (and bondholders have no right to a remedy). We will refer to this hypothetical value as the "non-accelerated bond value." Acceleration means that bondholders seek immediate repayment and (assuming the company has sufficient assets) implies a payment of 100 cents on the dollar for each accelerated bond. Acceleration is attractive if the non-accelerated bond value, as a fraction of the principal amount, is less than 100%, and becomes more attractive the lower the non-accelerated bond value and the larger the bond issue.[51] But if the non-accelerated bond value is more than 100% of the principal amount, acceleration is unattractive.

What factors then determine the non-accelerated bond value? The issue price of

[51] This is slightly simplified because it excludes option value of acceleration right.

most corporate bonds is usually at or very close to their principal amount,[52] which implies that the non-accelerated bond value when the bonds were issued was very close to 100% of their principal amount. But there are three principal factors that can result in a change in the non-accelerated bond value once the bonds are issued.

- Treasury Interest Rate Movements: The vast majority of corporate bonds are issued at fixed interest rates and their value is thus subject to fluctuations in market interest rates. The interest rate payable on treasury securities issued by the United States forms a benchmark for the market interest of securities with minimal default risk. If the rate payable on treasury securities with a maturity similar to the bond in question has declined since the bond was issued, the non-accelerated bond value will increase. If the rate payable on treasury securities with a maturity similar to the bond in question has increased, the non-accelerated bond value will decrease.

- Changes in Default Risk: Unlike treasury bonds, most corporate bonds entail a non-minimal risk of default. To compensate holders for this risk, corporate bonds carry a yield that is higher than the yield of a treasury security with a similar maturity (i.e., they are issued at a higher interest rate). We will refer to this difference as the default risk premium. The risk of default, of course, can vary over time. When the default risk increases, the non-accelerated bond value declines reflecting the higher likelihood of non-payment. When the default risk declines, the non-accelerated bond value increases. Changes in default risk are thus a second factor causing changes in the non-accelerated bond value.

- Stock Price Movements and Convertible Bonds: For convertible bonds, there is a third reason why the non-accelerated bond value may change. Convertible bonds carry, in addition to the right to payment of principal and interest, the right to convert the bonds into stock at a specified conversion price. Because of this right, convertible bonds have a lower yield (i.e., are issued at a lower interest rate) than an equivalent bond with similar maturity and default risk. At issuance, the conversion price of a convertible bond is generally at a premium over the market price for the stock. That is, conversion becomes only attractive is the market price increases. To make up for the lower interest rate, the market price must (ex post) increase sufficiently so that the gains upon conversion equal the loss from the lower interest rate. Theoretically, it is possible to calculate by how much the market price of the company's stock must have increased at any point in time so that the non-accelerated bond value remains at 100% of the principal amount if there are no movements in treasury interest rates and no changes in default risk. If the market price of the company's stock increases by a greater amount, the non-accelerated bond value will increase. If it increases by a less amount or

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[52] Discuss OID bonds and why this is true for them as well.

declines, non-accelerated bond value will decrease.[53]

(c) Acceleration and Selective Enforcement

That the non-accelerated bond value is not equal to 100% of the principal amount of course does not constitute a problem per se. The whole point of acceleration is to provide bondholders with a remedy. That point would be lost if the non-accelerated bond value were equal to the principal amount since, in that case, bondholders could sell their bonds in the market for the bonds principal amount even if they had no right to accelerate and there would be no need to resort to an acceleration. Rather, the question is whether, if the non-accelerated bond value if less than the principal amount, that difference – which is a measure of the benefit to bondholders from accelerating – is in some way related to the company's breach or not.

(i) Changes in Default Risk

The relationship between changes in the non-accelerated bond value and the company's breach is strongest where a decline in the non-accelerated bond value is due to an increase in default risk. The principal function of protective covenants is to protect bondholders against certain actions by the company or other events that increase the default risk. Thus, when the company has violated a covenant and the default risk after the violation is higher than it was when the bonds were issued, there is a prima facie case that the covenant violation has caused, or is the cause of, the increase in default risk. Thus, to the extent that the non-accelerated bond value has

[53] Also changes in variance.

declined due to an increase in default risk, acceleration constitutes an proper remedy.[54]

To be sure, even with respect to changes in default risk, acceleration is not a perfect remedy. The default risk of a bond could have increased for reasons completely unrelated to the covenant violation. In that event, acceleration arguably overcompensates bondholders because it compensates them for losses not unrelated to the breach. Alternatively, the default risk could have declined prior to the breach, but then increased as a result of the breach. In that event, acceleration arguably under-compensates bondholders.

But although acceleration does not always work perfectly in these instances, it is hard to devise a superior remedy. When the default risk of the company has increased, it is practically impossible to determine to what extent the decline is related to the covenant violation. This difficulty is enhanced because covenants sometimes function as trip-wires. That is, they are designed to be more likely to be violated by companies where the default risk has increased substantially, even though the specific act that causes the violation did not directly increase the default risk by all that much. We are thus not troubled by the fact that bondholders, when an Event of Default occurs, are compensated for the total increase in default risk.[55]

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[55] We are similarly not much troubled if, prior and unrelated to the Event of Default, the company's default risk has declined. Though, in this instance, acceleration may not be immediately attractive, bondholders retain the option to accelerate at some subsequent point in time. In effect, therefore, bondholders are protected against any subsequent increase in the default risk (as a result of which acceleration would become attractive) *whether or not that increase is related to the covenant breach.* The company, in turn, would either have to live with the prospect that its bonds could be accelerated with little or no prior warning (an unpleasant prospect which will deter many

(ii) Changes in Treasury Interest Rates

Unlike changes in default risk, changes in treasury interest rates are completely unrelated to the company's breach. The company has no control or influence over treasury interest rates, which are determined by macroeconomic factors and policy decisions by the Federal Reverse Board. There is thus no reason why the attractiveness of the acceleration remedy – a measure that in analogous to the amount of damages bondholders receive upon breach – ought to vary with changes in the treasury interest rates.

But, of course, the attractiveness of acceleration does so vary. As a result, a selective enforcement problem is generated. When treasury interest rates have decreased, and the non-accelerated bond value has accordingly increased, bondholders will have insufficient incentives to act. This means that they will not expend resources on detecting defaults, in pursuing arguments that ambiguous defaults constitute actual defaults, or in forming groups necessary to give notices of defaults, accelerate, and complying with the no-action clause. The company, in turn, will be more inclined to take actions that may result in a default, knowing that the default may not be detected and, even if detected, that no enforcement measures may be taken. In short, bondholder rights will be under-enforced.

When treasury rates have increased, the situation is reversed. As a result of the increase in treasury rates, the non-accelerated bond value will have declined and

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breaches) or it would have to seek an amendment to the indenture and/or a waiver of a default and pay the holders or consenting to it. In either case, we believe, no significant under-enforcement problem ensues.

bondholders will be looking for way to get out of what now looks like a bad deal early (to reinvest the money at the higher interest rates). As a result, bondholders may expend excessive resources on detecting defaults, aggressively push arguments that ambiguous defaults constitute actual defaults, be quick in forming groups, pursue even minor defaults vigorously. In addition, if the company were to seek an amendment to the indenture, bondholders may refuse to go along (even if they were offered proper compensation) if the company already has, or they expect that the company will, breach one of the indenture provisions. In short, bondholder rights will be over-enforced.

(iii) Stock Price Movements and Convertible Bonds

Whether changes in the non-accelerated bond value of convertible bonds attributable to stock price movements should be compensable through acceleration is more complex. The answer to this question turns in part on the distinction between provisions designed to prevent (or be triggered by) an increase in default risk ("protective covenants") and provisions designed o protect the value of the conversion feature (so-called "anti-dilution" provisions).

Anti-dilution provisions often do address actions that reduce the share price, such a stock splits or dividends. Unlike most protective covenants, however, anti-dilution provisions do not prohibit these actions, but instead provide for an adjustment of the conversion price if the company takes these actions (e.g., they provide that the conversion price be halved if the company's stock is split 2-for-1).[56]

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[56] More rarely, provisions designed to protect the value of the conversion right offer bondholders a special right to put the bonds (e.g. when the stock into which the

Acceleration is a problematic remedy for breaches of anti-dilution provisions. Such breaches, in principle, occur when a company issues fewer shares upon conversion that the anti-dilution provision mandate. Fortunately, however, acceleration is in practice not used to rectify these breaches. Consider first the case where bondholders, upon conversion, stand to receive stock with a value greater than the principal amount. In that case, bondholders would not want to accelerate but instead seek specific performance of the anti-dilution provision. That is, they will seek a court order forcing the company the convert the bonds at the properly adjusted conversion price (or, if the conversion price is in dispute, a court determination as to which price is proper). This, in effect, is what happened in the Regal Entertainment case.[57] Because, for these kind of provisions, specific performance is available and the preferred remedy for bondholders, no under-enforcement problem ensues.

Now consider the case where bondholders stand to receive stock with a value lower than (e.g. 90% of) the principal amount even if the conversion price is calculated the way they deem proper. In that event, bondholder may like the idea of tendering the bonds for conversion, accepting the lower number of shares that the company deems proper, then issuing a notice of default, and accelerating as soon as the cure period has passed. If bondholders succeeded in this, they would gain, in the example, an extra 10% in value. The problem with this strategy is that the company could pay holders the higher number of shares (i.e. the number that the bondholders deem proper), and then

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bonds are convertible is delisted). **DISCUSS**

[57] Except that it was Regal, not bondholders, who instituted the suit, presumably for strategic reasons.

either do nothing further or (if the default is ambiguous) sue the holders for a repayment of the extra shares. By doing that, the company would not only avoid generating a default; it would also call the bondholders' bluff because, in their futile attempt to generate the default, they would have converted their bonds into shares with a value below the principal amount. As a result, no over-enforcement problem ensues.[58]

But even If acceleration is not used to remedy breaches in anti-dilution provisions in convertible bonds, changes in stock price movements will affect incentives of bondholders to enforce protective covenants.[59] For protective covenants, there is no reason why attractiveness of the acceleration remedy ought to vary with stock price movements. As a result, a selective enforcement problem is generated. When the stock price has increased by more than needed to compensate bondholders for the lower interest rate carried by convertible bonds, and the non-accelerated bond value has accordingly increased, bondholders will have insufficient incentives to enforce their rights. When stock prices have increased by less or decreased, the non-accelerated bond value will have declined and bondholders will have excessive incentives to enforce.

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[58] This is a bluff only if the market value of the share is less than the unconverted value of the bonds under the company's interpretation of the indenture. If the value of the bonds under the company's interpretation is less than par, but the value of the shares into which the bonds can be converted under the bondholders' interpretation is more than the value of the bonds under the company's interpretation, the strategy of trying to generate a default by converting some bonds is sensible for the bondholders. This situation, however, is relatively infrequent and the company could still pay the higher number of shares and sue for a repayment. Moreover, as shown below, even this situation would be remedied by our proposals below.

[59] DISCUSS HOW ONE CAN TELL.

Though stock price movements can generate both under- and over-enforcement, the over-enforcement problem is likely to be more common and severe. For an under-enforcement problem to ensue, the stock price of the company has to appreciate substantially. However, if the stock price has gone up sufficiently to make acceleration unattractive, it is unlikely that the company's default risk has deteriorated. Moreover, even if accelerating is presently unattractive (due to an increase in the stock price), bondholders always retain the option to accelerate at some future point if the stock price declines. This option to accelerate at some future point is both valuable to bondholders and unpleasant for the company.

By contrast, the mere fact that the stock price has failed to get closer to (and exceed) the conversion price can substantially reduce the value of the conversion option. If the conversion right has no or little value, the non-accelerated bond value will be substantially less than the principal amount (even if there is no change in credit risk) because the interest rate of convertible bond is low. As a result, in these settings, any potential default creates incentive for bondholders to seek acceleration.

(d) Concluding Remarks

The increased prominence of hedge funds and other activist investors has significantly reduced, though not eliminated, the under-enforcement problem generated by the enforcement scheme. Much more than in the past, some investors look out for potential violations of bondholder rights and are willing to enforce them vigorously. But, even in today's environment, such enforcement remains haphazard. A significant reason for this lies in the imperfections in the remedy scheme. The remedy scheme,

which relies on acceleration as the prime remedy for violations of protective covenants, generates a tendency for over-enforcement when treasury interest rates have increased and, in the case of convertible bonds, when the stock price has declined or increased only by little. But it results in under-enforcement when treasury rates have declined. These imperfections lie on top of the imperfections in the enforcement scheme which generate an overall tendency towards under-enforcement.

IV. [To the added] Implications for Structure and Drafting of Covenants

The new, tougher, enforcement environment for corporate bonds has made it, *other things being equal*, more expensive for companies to issue bonds. If, under the previously prevailing enforcement standard, some covenant violations for not detected, potential violations were not pursued, and the company had to pay relatively little to get waivers, and under the now prevailing standard, more violations are detected, more potential violations are pursued, and the company had to pay more to get waivers, then, other things being equal, the company's costs have increased.

If the previously prevailing enforcement standard reflected an equilibrium – that is, if companies and bondholders bought bonds being aware and taking account of the various enforcement imperfections – this means that, going forward, adjustments will be made to bring the corporate bond market back into equilibrium. In this part, we will discuss various forms that these adjustments may take.

A. Weaker Covenants

One possible adjustment to the tougher enforcement environment is weaken the strength of the covenants that are included in bond indentures. Tougher enforcement

coupled with weaker covenant protection is clear one way to return the overall protection back to an equilibrium.

At least with respect to the covenant requiring a company to file reports with the trustee – a covenant that has recently caused trouble for several companies – there is evidence that covenants have already become weaker. For example, in May 2007, Rayonier Inc. filed forms of senior and subordinated indentures with the SEC that provided for a (relatively conventional) 60 day cure period for covenant violations in general, but a special – and by conventional standards very long – 180 day cure period applicable to failure to file reports with the trustee.[60] In the same month, CACI International Inc. issued 2-1/8% Convertible Senior Subordinated Notes that provided for a 90 day cure period for a failure to file reports with the trustee (as well as most other covenant violations). But the indenture provided that, if the company elects, the remedy to holders for an Event of Default caused by such a failure to file shall consist for the first 90 days exclusively of the right to receive additional interest at a rate of 0.25%.[61] In effect, then, for both Rayonier Inc. and CACI International Inc., a failure to file reports has to last for 180 days after a notice of default is sent to trigger a right to acceleration.

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V. Fixing the Selective Enforcement Problems

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[60] Rayonier Inc., Form __, Exhibit 4.2, Form of Senior Indenture, Section 6.1(d)

[61] also other May 2007 bond, Inverness?

In this Part, we will propose some modifications that would fix most if not all of the selective enforcement problems described above. Rather than inventing entirely novel and untried clauses, we propose modifications that use (with some modifications) standard terms included in debt instruments and familiar to both the legal and the investment community. The modifications needed to solve the under-enforcement problem differs from those that solve the over-enforcement. We discuss the under-enforcement problem first.

(a) The Under-Enforcement Problem

From a financial perspective, the under-enforcement problem arises when the present value of the expected interest and principal payments on a bond exceeds its principal amount. Under the standard acceleration clause, bondholders receive the principal amount (plus only accrued interest) when they accelerate and they may not wish to do so when keeping the bonds results in the receipt of payments with a higher expected value.

Based on this insight, it is easy to devise a way to solve the under-enforcement problem: let bondholders receive, upon acceleration, an amount based on the (higher) discounted value of the principal and interest payments that they would have been entitled to receive absent acceleration, rather than on the (lower) principal amount of the bonds. While this may sound abstract, unduly complex, and overly theoretical, exactly this approach to acceleration has long been used in privately placed bonds and, more recently, has been incorporated in redemption clauses and even in some default provisions of indentures for publicly issued bonds. The clauses incorporating this

approach are known as “make-whole” provisions (or “yield maintenance premium” provisions). They specify a method for calculating of the discounted value of the scheduled principal and interest payment and provide that, if the value exceeds the principal amount, the company must pay the discounted value. (The term “make-whole” amount refers to the excess, if any, of the discounted value over the principal amount.) To calculate the discounted value of the scheduled payments, “make-whole” provisions employ as discount rate the yield on treasury security rates with a maturity matching the respective payment stream on the bonds plus, in some cases, a fixed premium.

Consider, for example, the $70 million in 6.87% Senior Notes issued by Northwest Pipe Company due November 15, 2007. The Notes require interest payments on May 15 and November 15 of each year and also mandatory prepayments of $5 million each November 15 starting in 2001. Assume the Notes are accelerated on May 16, 2005. At that point, $50 million Notes are outstanding and the scheduled remaining payments are:

November 16, 2005: $ 6,717,500 ($5 million principal and interest on $50 million)
May 16, 2006: $ 1,545,750 (interest on $45 million)
November 16, 2006: $ 6,545,750 ($5 million principal and interest on $45 million)
May 16, 2007: $ 1,374,000 (interest on $40 million)
November 16, 2007: $ 41,374,000 ($40 million principal and interest on $40 million).

To calculate the make-whole amount, these payments are to be discounted at a rate equal to the yield on treasury securities with a maturity equal to the Remaining Average

Life of the Notes (inhere 2.2 years)[62] plus 0.50% (50 basis points). The table below contains hypothetical calculations of the discounted value and the make-whole amount for different discount rates.

Discount Rate	Discounted Value of Scheduled Payments	Make-Whole Amount
5.50%	$51,470,952	$1,470,952
6.00%	$50,969,022	$ 969,022
6.50%	$50,474,893	$ 474,893
6.87%	$50,114,166	$ 114,166
7.00%	$49,988,405	0

As the table shows, this method yields a positive make-whole amount for discount rates below the interest rate on the notes which declines to about 0 as the discount rate approaches that interest rate.[63]

In private placements, such provisions have long been commonplace. In a study of private placements of debt from the years 1986 to 1990, Kahan and Tuckman found that 87% of issues used a similar formula to calculate the amount payable upon acceleration and 85% of all callable debt used this formula to calculate the price at which the company was permitted to redeem its debt. More recently, publicly issued

[62] The remaining average life is obtained by dividing the sum of the scheduled principal times the time to payment ($5 million times 1/2, $5 million by 1.5 and $40 times 2.5) by the total amount of principal ($50 million).

[63] The reason why the make-whole amount is not exactly 0 at a 6.87% discount rate is that the semi-annual interest payment are in amounts based on the arithmetic average of the interest due for a year (i.e. half the annual 6.87% interest due) but are discounted at a rate based on the geometric average of the annual discount rate (i.e at $(1+.0687)^{½}$.

bonds have started to use these clauses. Thus, for example, in 2006, Simon Property Group, LP issued $400 million each in 5.75% Notes due 2012 and 6.1% Notes due 2016 which must be paid off with a make-whole amount if redeemed or accelerated; and Iron Mountain Inc. issued $200 million in 8-3/4% Senior Subordinated Notes due 2018 which must be paid off with a make-whole amount if redeemed prior to 2011 or if accelerated after a willful action by the company with the intention of avoiding the payment of the make-whole amount.

It is easy to see how make-whole provisions solve the under-enforcement problem generated by declines in the treasury rate. If the treasury rate declines, the discount rate, which is based on current treasury rates, declines as well, resulting in a positive make-whole amount. This results in bondholders receiving additional money upon acceleration in an amount that varies with the increase in the non-accelerated bond value resulting from the decline in treasury rate. The net effect is that enforcement incentives are not affected by such declines.

A notable feature of the debt securities that employ make-whole provisions relates to the size of the premium on treasuries used to calculate the discount rate. One plausible approach would be to use the premium over treasuries at which the debt was issued. In that case, when treasury rates remain unchanged, the discounted value is equal to the principal amount and the company must pay no additional make-whole premium. In practice, however, the premium used is substantially lower. In Kahan and Tuckman's study, it averaged 33 basis points for a sample of 34% investment grade and 66% junk bonds. By comparison, the additional yield over treasuries of AAA-rated companies was 59 basis points, of BBB-rated companies was 169 basis points, and of

B-rated companies was 496 basis points. (AAA and BBB are investment grade ratings, B is a junk rating.) In publicly-issued bonds with make-whole provisions, as well, the premium used to calculate the make-whole amount is lower than the premium over treasuries at which the bonds are issued. The Simon Property Notes, for example, were issued at initial yields of about 75 and 97 basis points over treasuries but the premium over treasuries for purposes of calculating the make-whole amount was, respectively, 20 and 25 basis points; and for the Iron Mountain Notes, the initial yield was about 350 basis points over treasuries and the discount rate was set a 75 basis points over the treasury rate. These make-whole provisions are thus designed to a generate a positive make-whole amount (in an amount that is declining over time) when there is no change in treasury rates.

Using a premium for purposes of calculating the make-whole amount that is less than the premium at which the bonds were issued makes sense from the enforcement perspective. Kahan and Tuckman conjecture that this positive make-whole amount in private placements serves to compensate holders for the costs of making the initial investment decision. Like making the initial investment decision, it is costly to detect potential defaults and take enforcement measures. A lower premium for purposes of calculating the make-whole amount provides incentives for bondholders to undertake (and compensates for the undertaking of) these costly activities.

(b) The Over-Enforcement Problem

The over-enforcement problem arises when the treasury rates have increased or, in the case of convertible bonds, when the stock has failed to appreciate sufficiently,

and the non-accelerated bond value for these reasons (and not (just) because of an increase in the default risk) is below the principal amount. When the over-enforcement problem is present, the company would rather make payments of scheduled interest and principal (with assurances to the bondholders that they will in fact receive these payments), and honor its conversion obligation, than pay off all the bonds immediately.

As currently drafted, most indentures already contain provisions that, in principle, enable the company to do just that. These provisions go by the name of “satisfaction and discharge” or defeasance. To effect a defeasance (or, more precisely, a covenant defeasance), a company must deposit with the trustee treasury securities that generate sufficient cash to pay all scheduled interest and principal (with any excess to be returned to the company). Because the company’s payment obligations are now backed by treasury securities held in by the trustee in trust for the benefit of the bondholders, any default risk is virtually eliminated. As a result of a covenant defeasance, the company is no longer obligated to comply with protective covenants and violations of these covenants no longer constitute grounds for an acceleration. But, in the case of convertible bonds, the company remains obligated to honor its conversion obligations.

It is easy to see how defeasance fixes the over-enforcement problem without generating an under-enforcement problem.[64] As discussed above, when a company has violated a covenant, bondholders ought to be compensated for any increase in default risk, but not for any decline in the non-accelerated bond value due to an

[64] Exception: conversion protective covenants that are not anti-dilution.

increase in treasuries rate or (for convertible bonds) a failure of the stock price to appreciate.

Through defeasance, the company assures the bondholders of payment according to the terms of the bonds; bondholders are thus protected against (and compensated for) any increase in default risk. But, in the case of defeasance, bondholders receive only the interest and principal payments originally scheduled. Bondholders thus do not benefit from the early repayment of bonds the value of which has declined due to an increase in treasury rate or (for convertible bonds) a failure of the stock price to appreciate. Or, from the company's perspective, an increase in treasury rates makes it cheaper to defease (fewer treasury securities need to be bought to effect a defeasance because their yield is higher) and the conversion obligations are unaffected.

As currently drafted, however, defeasance provisions are often not helpful to companies. The reason is that indentures usually contain one of two (and occasionally both) conditions to defeasance. Some bond indentures permit the company to effect a defeasance only if no default has occurred. Thus, once a default has occurred – the very context we are most interested in – defeasance is unavailable. Other bond indentures permit defeasance only of bonds that either mature or are to be called for redemption within one year. For those bonds, defeasance would be effective post-default, but only if the default occurs shortly before the bonds mature. (Although defeasance would also be available for bonds that can be redeemed within one year, this does not effectively fix the over-enforcement problem as the company would be required to repay the bonds prior to their original maturity and in addition pay a

redemption premium.)

Neither of these conditions, however, serves an important function (and indeed, many bond indentures do not contain one or the other). Since defeasance effectively removes any default risk, there is no evident reason why defeasance should be limited to instances where no default has occurred.[65]

Thus, we suggest modifying the standard bond indenture to permit the company to effect a covenant defeasance up until the time the bonds are accelerated, without any limitation related to the time until maturity. So drafted, a company that receives a notice of default would have time either to cure the default or to effect a defeasance before an Event of Default occurs.

Our proposed fix has several properties worth highlighting. First, because defeasance effectively removes all default risk (rather than merely compensates for any increase in default risk), bondholders receive a surplus that resembles the surplus that results from using a discount rate in the make-whole context that incorporates a low premium over treasuries. As discussed in that context, we believe that a surplus is justified to compensate bondholders for the costs of detecting potential defaults and taking enforcement measures.

Second, when there is dispute over whether a default has occurred, our fix would force companies to chose either to effect a defeasance (and thus forego any argument that no default has occurred) or to litigate whether a default has occurred (and thus forego the defeasance option). We consider this not to be a big problem, or even to be

[65] DISCUSS TAX ISSUES AND STOCK MARKET REQUIREMENTS.

a mild plus. For one, even when there is a dispute, the outcome will be fairly predictable. Moreover, companies have an excessive incentive to dispute defaults when the pre-judgement interest rate is set at too low a level. The standard pre-judgement interest rate on debt securities is the interest rate on the securities which is, by definition, below the market rate when there is a potential over-enforcement problem. By making defeasance an available option, we largely remove the over-enforcement problem; and by forcing the company to chose between defeasing and litigating defaults, we provide incentives for companies not to raise low-merit arguments designed to protract litigation and motivated by an insufficient pre-judgement interest rate.

Third, although the defeasance option, as modified, largely eliminates the over-enforcement problem, some imperfections remain. Some companies may have difficulty raising the funds required to effect a defeasance before the cure period expires. While we do not think this is a significant draw-back – most companies have relationships with banks and banks can act very fast when needed – it could be addressed by permitting the company to extend the period to effect a defeasance (possibly in exchange for some additional payment). More importantly, the defeasance option we propose does not eliminate over-enforcement incentives for one particular type of violation: to wit, violations of covenants designed to protect the value of the conversion right (and compliance with which thus remains required post-defeasance) which do *not* take the form of anti-dilution provisions (and are thus enforced via acceleration, not specifically). Convertible bonds often contain one such covenant, which provides holders with a right to put the bonds to the company upon the

occurrence of certain events which are likely to have an adverse effect on the conversion right, such as a delisting of the stock into which the bonds are convertible or a merger where the stock is exchanged for non-publicly traded equity securities.

Conclusion to be added

Table
AES Corp
Asyst Technologies
Bally Total Fitness Holding Corp.
Bearingpoint
Bell Microproducts
Brocade
Carmike Cinemas
CNET Networks
Computer Sciences
Connetics
Dresser
Emcore
Ferro
Finisar Corp
Getty Images
Health South
KB Home
Key Energy Services
Medarex
Mercury Interactive
Metromedia
Navigant
Navistar Int'l
Novell
Riverstone Networks
Saks Inc.
Sanmina-SCI Corp
Tenet Healthcare
Terayon

United Rentals
Unitedhealth Group
UTStarcom
Valeant Parmaceuticals
Vitesse Semiconductor
Willbros Group, Inc.