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SAFEGUARDING INVESTMENT GRADE BONDS IN THE EVENT OF A LEVERAGED BUYOUT: LEGISLATION OR CONTRACT?

Prior to the takeover frenzy of the 1980s,[1] holders of investment grade bonds[2] held relatively safe investments.[3] The phenomenon of leveraged buyouts (LBOs), however, has undermined the security of investment grade bonds.[4] Because a post-LBO company (surviving company) assumes a massive amount of debt in addition to its pre-LBO (pre-existing) debt, the surviving company's ability to pay off all its pre-existing debt becomes more uncertain.[5] Despite this increased uncertainty, the pre-existing bondholders do not receive any additional return on their investment.[6] The bonds of the pre-existing bondholders, thus, lose value by becoming riskier investments that still produce the same returns as before the LBO.[7] *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*[8] illustrates the deleterious effects of an LBO on pre-existing, investment grade bondholders and mentions how such bondholders might protect themselves from LBOs.[9] Investors have two possible methods of safeguarding their investment grade bonds against the damaging consequences of an LBO: (1) legislative or regulatory intervention into the investment market,[10] or (2) explicit provisions in the bond contract that protect the investor in the event of an LBO.[11]

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1. *See* Prokesch, *Merger Wave: How Stocks and Bonds Fare*, N.Y. Times, Jan. 7, 1986, at A1, col. 1 (describing abundance of corporate takeovers in 1980s).

2. *See* American Bar Foundation, *Commentaries on Indentures*, at 7 n.3 (1971) [hereinafter *Commentaries*] (stating that technical definition of bond is long-term debt security that is secured by lien on some or all assets of borrower). A debenture is a long term debt security that is not secured. *Id.* No formal legal distinction exists between the terms "bond" and "debenture." Robertson, *Debenture Holders and the Indenture Trustee: Controlling Managerial Discretion in the Solvent Enterprise*, 11 Harv. J.L. & Pub. Pol'y 463, 463 n.2 (1989). This Note uses "bond" in accord with its broader usage as a term for all long-term debt securities.

3. *See infra* notes 18-19 and accompanying text (discussing conservative characteristics of investment grade bonds).

4. *See infra* notes 20-21 and accompanying text (contending that LBOs make investment grade bonds risky).

5. *See infra* note 22 and accompanying text (indicating that surviving company may not be able to pay all its debt).

6. *See infra* notes 23-24 and accompanying text (asserting that bondholders do not receive additional compensation for increased risk of bonds).

7. *See infra* notes 25-26 and accompanying text (discussing loss of value on bonds because of increased risk and low yield).

8. 716 F. Supp. 1504 (S.D.N.Y. 1989).

9. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1514-25 (1989).

10. *See infra* notes 70-132 and accompanying text (describing possible legislative and regulatory solutions to bondholder losses caused by LBOs).

11. *See infra* notes 133-75 and accompanying text (illustrating possible contract solutions to bondholder losses caused by LBOs).

In an LBO a group of investors use the assets of the target company to help finance the acquisition of that company.[12] The investors often obtain financing from banks and junk bond investors.[13] The investors use this financing to purchase the target company's outstanding stock at a premium over the current market value of the stock.[14] Following the investors' buyout of the outstanding shares of the target company, the investors frequently sell off some of the target company's assets to pay the debt that the investors owe the banks and the junk bondholders.[15] The surviving company usually will have little equity compared to a large amount of debt, which consists of the company's pre-existing debt and its LBO-generated debt.[16]

Bond rating agencies grade bonds according to the issuer's ability to pay the interest and principal due on the bonds.[17] Bonds with investment grade ratings have fairly low interest rates because the bonds are relatively secure.[18] Investors who hold investment grade bonds forgo the possibility of substantial returns and instead opt for modest and safe fixed returns.[19] A highly leveraged buyout, however, changes the character of investment grade bonds.[20] An acquiror in an LBO assumes a vast amount of debt that

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12. *See* Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491, 1493 (1987) (stating that target company's assets serve as security for acquiror's loans).

13. *See* Sherwin, *Creditors Rights Against Participants in a Leveraged Buyout*, 72 MINN. L. REV. 449, 449-50 (1988) (identifying usual lenders in LBO); Comment, *Junk Bonds: Do They Have Value?*, 33 EMORY L.J. 921, 931-32 (1986) (explaining concept of junk bonds). A junk bondholder receives a high yield from the issuer because of the high risk of the bond. *Id.*

14. *See* Prokesch, *supra* note 1, at 1 (describing windfall that target company's shareholders receive as result of LBO).

15. *See* Sherwin, *supra* note 13, at 499 (asserting that corporate assets and earnings are primary sources that investors use to repay acquisition debt).

16. *See* McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 207 (1988) (stating that surviving company of LBO usually has little equity relative to debt).

17. *See* O'Neill & Weinberger, *Corporate Restructurings and Bond Ratings*, 17 MERGERS & ACQUISITIONS 36, 36 (1982) (stating that bond rating indicates likelihood that company will pay bond's principal and interest on time); Lehn, Blackwell & Marr, *The Economics of Leveraged Takeovers*, 65 WASH. U.L.Q. 163, 163 n.1 (1987) [hereinafter Lehn, Blackwell] (describing how rating agencies rate bonds). Rating agencies, such as Standard & Poor's and Moody's, grade securities to indicate to investors the quality of the securities. *Id.* These ratings reflect each agency's opinion of the company's ability to repay its debt. *Id.* An investment grade rating, the highest rating, indicates that the company appears to be capable of making interest and principal payments when such payments are due. *Id.* Investment grade ratings are AAA, AA, A, BBB for Standard & Poor's and Aaa, Aa, A, Baa for Moody's. *Id.* A speculative grade rating indicates that the issuer has risky characteristics or questionable credit strength and may not be able to keep current on interest or principal payments. *Id.* While Standard & Poor's rates speculative grade bonds as BB, B, CCC, CC, C, Moody's rates such bonds as Ba, B, Caa, Ca, C. *Id.* Because these bonds are more risky than investment grade bonds, speculative, or "junk," bonds pay higher yields than the investment grade bonds. *Id.*

18. *See Commentaries*, *supra* note 2, at 1 (stating that typical goal of investment grade bondholder is not substantial gain, but rather reasonable assurance that company will make principal and interest payments).

19. *See id.* at 1-2 (asserting that bondholders forego share in profits in return for periodic payments and for repayment of principal at fixed date).

20. *See* Knight, *Raids Put New Risk into Bonds*, Washington Post, Oct. 27, 1988, at D9, col. 3 (stating that LBOs make investment grade bonds less secure).

becomes the responsibility of the surviving company.[21] Because the company's risk of defaulting on its pre-existing debt increases as a result of the additional LBO debt,[22] rating agencies downgrade the rating of the pre-existing investment grade bonds to reflect the increased risk.[23] The surviving company, however, does not pay more interest on the pre-existing bonds to compensate bondholders for the additional risk created by the LBO.[24] The market value of the pre-existing bonds declines,[25] and the holders of the pre-existing bonds incur capital losses if the bondholders sell the bonds.[26]

In addition to the decreased value of the bonds, bondholders contend that LBOs damage the liquidity of their investment grade bonds.[27] Liquidity, which is an inherent characteristic of investment grade bonds, has two dimensions: (1) the ability of an investor to sell the bonds quickly, and (2) the ability of an investor to attain a reasonable price for the bonds.[28] An LBO usually does not affect the first aspect of liquidity because, after an LBO, an investor still may dispose of bonds easily in secondary markets.[29]

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21. *See* Prokesch, *supra* note 1, at 1 (stating that surviving company in LBO assumes substantial amount of debt to finance LBO).

22. *See* Barkley, *Fiduciary Duty to Bondholders*, 20 CREIGHTON L. REV. 47, 49 (1986) (stating that corporate debt is risky when possibility exists that corporation may not be able to pay all its debts). If a surviving company exchanges a substantial amount of equity for a significant amount of debt, the company's ability to repay its debt becomes more uncertain. *See* Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 668 (explaining that decrease in amount of issuer's assets increases likelihood of default on bonds).

23. *See* Robertson, *supra* note 2, at 471 (asserting that downgrading of bond ratings is familiar consequence of LBOs).

24. *See* McDaniel, *supra* note 16, at 286 (describing how companies inadequately compensate pre-existing bondholders because interest rate on bonds does not rise with companies' incurrence of additional LBO-debt).

25. *See* R. POSNER & K. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 236 (1980) (asserting that, as debt of company rises and yield on bonds remains constant, market value of bond declines). Posner and Scott note that, if a company issues debt at a price that reflects one degree of business risk and leverage, and then increases that risk and leverage, the value of the debt will fall. *Id.* The term "leverage" refers to the amount of debt in relation to equity in the company's capital structure. *Id.*

26. *See* McDaniel, *supra* note 16, at 207 (explaining that bondholders will incur losses by selling bonds after LBO).

27. *See* Answering Brief of MetLife and Jefferson-Pilot at 10, Metropolitan Life Insurance Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989) (No. 88-8266) [hereinafter MetLife's Answering Brief] (contending that LBO fundamentally alters character of investment grade bonds by impairing liquidity of bonds).

28. *See* Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260, 263 (1968) (defining liquid market as one that enables investors to dispose of shares without undue delay and without incurring unreasonable loss); Schreiber and Schwartz, *Efficient Price Discovery in a Securities Market: The Objective of a Trading System* in MARKET MAKING AND THE CHANGING STRUCTURE OF THE SECURITIES INDUSTRY 19, 25 (1985) [hereinafter MARKET MAKING] (defining two dimensions of liquid market: ease in finding buyer and reasonableness of price at which investor can dispose of shares).

29. *See* Wu, *supra* note 28, at 263 (contending that investors can sell shares readily in secondhand market after LBO). A market is primary if the company that issued the securities

An LBO, however, adversely affects the second dimension of liquidity, an investor's ability to sell the bonds at a reasonable price in the secondary market.[30] Bonds become less liquid because the bondholders cannot quickly convert their investment grade bonds into cash without suffering a price reduction.[31] A liquid market assumes that the public has confidence in the market and will invest in the market.[32] In the primary market a company will have difficulty selling bonds unless creditors believe that the company has sufficient equity with which to repay its debt.[33] The relationship of the

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receives the proceeds from the sale of the securities. BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 306 (2d ed. 1987). A secondary market involves the buying and selling of previously issued securities. *Id.*

30. *See generally* MARKET MAKING, *supra* note 28, at 25 (asserting that investment may be illiquid if investor, because of price volatility, is uncertain about ability to convert investment into cash).

31. *See* Prokesch, *supra* note 1, at D4, col. 1 (discussing non-liquid market for bonds after takeovers). Prokesch notes that Pantry Pride's leveraged buyout of Revlon, Inc. illustrates an LBO's effect on the marketability of pre-existing investment grade bonds. *Id.* Prior to the announcement of the LBO, Revlon bonds traded at par. *Id.* When Pantry Pride launched a $1.5 billion LBO of Revlon, the Revlon bonds subsequently fell from a rating of investment grade A to a rating of speculative grade B. *Id.* Investors became wary of Revlon bonds because Revlon appeared to be a debt-laden company. *Id.* Revlon bonds, consequently, dropped to a trading price of $87. 875. *Id.*; *see also* Wallace, *Buyouts Devastating Bondholders*, N.Y. Times, Oct. 26, 1988 at D1, col. 3 (stating effect of proposed LBO on Kraft, Inc. bonds). Wallace asserts that Phillip Morris's proposed LBO of Kraft, Inc. adversely affected the liquidity of Kraft's bonds. *Id.* Kraft's bonds were selling at prices twenty points lower after Phillip Morris proposed an LBO of Kraft. *Id. But see* Macey, *Externalities, Firm-Specific Capital Investments and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 182 (discussing bondholders' pricing of bonds). Macey contends that investors who buy bonds consider how equityholders in the company will act in the future. *Id.* Bondholders, consequently, buy bonds only after realizing that the equity of the firm may later dissipate. *Id.*; *see* Lehn, Blackwell, *supra* note 17, at 185 (asserting that, when buying bonds, bondholders account for potential adverse actions of equityholders). Bondholders who forego protective covenants in bond contracts presumably receive higher interest rates and bear the increased risk of a company's later distribution of equity to its shareholders. *Id.*; *see also* Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, in ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 258, 260 (1980) (contending that bondholders price bonds in accordance with potential risk of issuing company). Smith and Warner argue that bondholders understand that, after a company issues bonds, the management of the company might try to maximize the return to the shareholders by distributing the company's equity to the shareholders. *Id.* In pricing bonds, therefore, investors estimate how management will treat shareholders and pay a price that reflects the possibility that management subsequently may transfer wealth to the shareholders. *Id.*; *see also* Bratton, *supra* note 22, at 733 (stating that, as long as company can repay its debts, company has not legally harmed bondholders). Although the market value of investment grade bonds may decline due to an LBO, pre-existing bondholders may be able to avoid actual monetary loss. *Id.* If bondholders retain their less valuable pre-existing bonds and the surviving company avoids bankruptcy, the bondholders would not incur loss. *Commentaries*, *supra* note 2, at 2.

32. *See generally* Wu, *supra* note 28, at 263 (contending that investor confidence in security is vital for security to be liquid).

33. *See* Baxter, *Leverage Risk of Ruin and the Cost of Capital*, 22 J. FIN. 395, 395 (1967) (positing that it is difficult for company to sell bonds unless creditor believes that debtor has sufficient equity cushion).

company's debt to equity also applies when pre-existing bondholders seek to sell bonds in the secondary market after an LBO.[34] The value of bonds, therefore, drops when potential buyers believe that the bonds have become more risky after an LBO.[35]

The multibillion dollar buyout of RJR Nabisco, Inc. (RJR) by the investment firm of Kohlberg, Kravis, Roberts & Co. (KKR) is an example of an LBO's devastating impact on the value of pre-existing investment grade bonds.[36] During the 1980s RJR issued investment grade bonds on the basis of RJR's financial strength and RJR's pledge of future profitability.[37] RJR's investment grade bonds with a solid credit rating and stable price were popular investments.[38] Many bond investors, consequently, accepted indentures from RJR that lacked protective covenants.[39] The few RJR bond issues that contained protective covenants paid a lower yield than did RJR's covenant-free bonds.[40]

On October 20, 1988, RJR management announced its plan to acquire the outstanding stock of RJR by means of an LBO.[41] After an extensive bidding war between KKR and an investment group led by RJR management, RJR's board eventually accepted KKR's bid of $24.9 billion for the purchase of RJR's common stock at $109 per share.[42] Because RJR was to assume billions of dollars of debt to finance the LBO, market prices of RJR's pre-existing investment grade bonds plunged.[43] Rating agencies sub-

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34. *See* Wallace, *A Bruising Battle Over Bonds*, N.Y. Times, Nov. 27, 1988, at D1, col. 2 (stating that trading of bonds on secondary market will drop if companies are debt-laden after LBO).

35. *See generally* MARKET MAKING, *supra* note 28, at 55 (illustrating that market value of security changes because of market participants' evaluation of security changes).

36. *See* Wallace, *supra* note 31, at D1, col. 1 (describing damage inflicted on RJR bondholders by KKR's leverage buyout of RJR).

37. *See* Vlahakis and Nussbaum, *Old Indentures—New Transactions: Issuers and Debtholders Beware*, MERGERS AND ACQUISITIONS: TODAY'S STRATEGIES AND TECHNIQUES 28, 54 (1989) (relying on its financial strength, RJR issued relatively covenant-free, low interest debt in 1980s).

38. *See* Knight, *supra* note 20, at D9 (stating that RJR investment grade bonds once were popular investments).

39. *See generally* Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 117 (asserting that, with largest, most stable corporate borrowers, bond contract protection appeared superfluous given these institutions' strength and clear interest of management in maintaining stability).

40. *See infra* note 67 and accompanying text (describing original MetLife-RJR indentures that contained contractual protection and paid lower yields than covenant-free bonds).

41. *See* Gilpin, *Bid for RJR Jolts Bonds*, N.Y. Times, Oct. 21, 1988, at D11, col. 1 (reporting RJR management's proposed buyout of RJR stock for $17 billion); Caprino, *Nabisco Breaks Off KKR Negotiations*, Washington Post, Oct. 17, 1988 at D9 (describing bidding war between RJR management and KKR for RJR's outstanding stock).

42. *See Courts Find No Implied Covenant To RJR Bondholders Not to Undertake LBO*, 21 Sec. Reg. & L. Rep. (BNA) 844 (June 9, 1989) (describing RJR shareholders acceptance of KKR's LBO bid). The pre-LBO price of RJR stock was $55 per share. Wallace, *supra* note 34, at cl.

43. *See* Wallace, *supra* note 31, at D1, col. 1 (stating that some RJR bonds fell as much

sequently lowered RJR bonds from an investment grade rating to a speculative grade rating.[44] Metropolitan Life Insurance Co. (MetLife), an institutional investor holding $340 million in RJR unsecured, investment grade bonds, suffered a $40 million paper loss as a result of the downgraded investment grade bonds.[45]

As a result of the drop in the market value of the RJR bonds, two institutional bondholders, MetLife and Jefferson Pilot Insurance Co. (Jefferson Pilot) jointly sued RJR and RJR's former Chief Executive Officer, F. Ross Johnson, in *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*[46] The plaintiffs brought nine causes of action.[47] To date, the United States District Court for the Southern District of New York, applying New York law, has ruled on five of the claims.[48] The court in *Metropolitan Life* addressed in detail the plaintiffs' claim of breach of implied covenant of

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as $160 per $1000 of face amount). Because of the LBO, RJR's debt payments rose from $549 million in 1988 to $3.38 billion in 1989. *See* Baker, *RJR Reports Losses, Strong Cash Flow*, Washington Post, Feb. 6, 1990, at D10 (describing RJR's increased debt payments due to LBO).

44. *See* Light, *Investors Are Developing a Taste for This Poison*, Bus. Wk., July 10, 1989, at 78 (stating that rating agencies downgraded RJR bonds from investment grade A to speculative grade BB after LBO announcement); *supra* note 17 and accompanying text (discussing how rating agencies rate bonds).

45. *See* Wallace, *Nabisco Sued Over Bond Drop*, N.Y. Times, Nov. 18, 1988, at D3, col. 4 (stating loss to MetLife if KKR's proposed buyout of RJR occurred). A paper loss is an unrealized capital loss. Barron's Dictionary of Finance and Investment Terms 282 (2d ed. 1987). Investors calculate a paper loss by comparing the current market price of the bond to the price at which the investor originally bought the bond. *Id.* The investor realizes paper losses upon selling the securities. *Id.*

46. 716 F. Supp. 1504 (S.D.N.Y. 1989).

47. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1507 n.6 (S.D.N.Y. 1989). Count I of the *Metropolitan Life* complaint alleged a breach of implied covenant of good faith and fair dealing (against both defendants); Count II alleged fraud (against both defendants); Count III alleged violations of Section 10(b) of the Securities Exchange Act of 1934 (against both defendants); Count IV alleged violations of Section 11 of the Securities Act of 1933 (only on behalf of plaintiff Jefferson Pilot against both defendants); Count V was labeled "In Equity" (against both defendants); Count VI alleged breach of duties (against defendant Johnson); Count VII alleged tortious interference with property (against defendant Johnson); Count VIII alleged tortious interference with contract (against defendant Johnson); and Count IX alleged violation of fraudulent conveyance laws (against defendant RJR). *Id.*

48. *See id* at 1526 (stating plaintiffs' claims which *Metropolitan Life* court dismissed). In *Metropolitan Life* Judge Walker of the United States District Court for the Southern District New York dismissed Count II (alleging fraud against both defendants), Count III (alleging violation of section 10(b) of the Securities and Exchange Act of 1934 against both defendants), and Count IX (alleging violation of fraudulent conveyance laws against RJR) for want of requisite particularity. *Id.* Judge Walker also granted defendants' motion for summary judgment on Count I (alleging breach of implied covenant of good faith and fair dealing against RJR) and Count V ("In Equity" claim against both defendants). *Id.* The claims, therefore, that remain are Count IV (only on behalf of plaintiff Jefferson Pilot alleging violation of section 11 of Securities Act of 1933 against both defendants), Count VI (alleging breach of duties against Johnson), Count VII (alleging tortious interference with property against Johnson), and Count VIII (alleging tortious interference with contract against Johnson). *Id.*

good faith and fair dealing and the plaintiffs' "In Equity" claim.[49]

In the plaintiffs' claim of breach of an implied covenant of good faith and fair dealing, MetLife and Jefferson Pilot contended that KKR's buyout of RJR deprived the plaintiffs of the "fruits" of their bond agreements with RJR and destroyed the value of the plaintiffs' investment grade bonds.[50] Once the holders of low risk, low yield securities, the plaintiffs involuntarily became holders of speculative junk bonds after KKR's buyout of RJR.[51] The plaintiffs further argued that, by engaging in the LBO, RJR drastically impaired the value of the plaintiffs' bonds by misappropriating the market value of the bonds to help finance the LBO.[52] Although conceding that the management of RJR had a great deal of discretion in operating RJR, the plaintiffs asserted that RJR's participation in an LBO was not within the management's discretion.[53] The plaintiffs claimed that RJR's management, by abusing its discretion, breached an implied basis of the parties' bargain, which was to maintain the high ratings of the investment grade bonds.[54]

The *Metropolitan Life* court granted RJR's motion of summary judgment against plaintiffs' claim of breach of an implied duty to maintain the ratings of the investment grade bonds.[55] In *Metropolitan Life* Judge Walker noted that courts will read an implied covenant into an indenture only if the explicit language of the indenture infers such a covenant.[56] Judge Walker

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49. *See id.* at 1514-24 (ruling on plaintiffs' claim of breach of implied covenant of good faith and fair dealing and "In Equity" claim).

50. *See* MetLife's Answering Brief, *supra* note 27, at 2-3 (contending that basis of plaintiffs' bargain with RJR was investment grade rating of bonds). By assuming a substantial amount of debt, the plaintiffs asserted that RJR intentionally destroyed the blue chip strength of the bonds. *Id.*

51. *See supra* notes 41-45 and accompanying text (describing impact of LBO on RJR bondholders).

52. MetLife's and Jefferson Pilot's Memorandum In Support of Summary Judgment at 26-32, Metropolitan Life Insurance Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989) (No. 88-8266) [hereinafter MetLife's Brief]. The plaintiffs in *Metropolitan Life* claimed that RJR advertised RJR investment grade bonds as historically secure investments. *Id.* Once RJR sold its bonds, however, the plaintiffs asserted that RJR subsequently sought to pay out a substantial portion of its equity, which was part of RJR's financial stability, to shareholders as part of the LBO. *Id.* The plaintiffs thus argued that RJR management misappropriated the value of plaintiffs' investment grade bonds by allowing KKR to buy RJR's outstanding stock at a premium and thereafter deplete the assets and earnings of RJR. *Id.*

53. *See id.* at 3 (explaining plaintiffs' claim). The plaintiffs in *Metropolitan Life* asserted that the RJR management did not have the discretion to engage voluntarily in a buyout that would destroy the investment grade ratings of RJR bonds. *Id.*

54. *See* MetLife's Brief, *supra* note 52, at 3 (contending that RJR bonds were attractive because of security). The plaintiffs in *Metropolitan Life* asserted that they bought RJR bonds because of the bonds' inherent security. *Id.* The plaintiffs argued that, by engaging in the LBO, RJR management destroyed that inherent security, the basis of the bargain between the plaintiffs and RJR. *Id.*

55. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1521-22 (S.D.N.Y. 1989).

56. *Id.* at 1517; *see also* Gardner & Florence Call Cowles Found. v. Empire, Inc., 589 F. Supp. 669, 673 (S.D.N.Y.) (refusing to grant relief to bondholder who claimed breach of implied covenant unless implied covenant derived its substance directly from language of indenture), *vacated on procedural grounds*, 754 F.2d 478 (2d Cir. 1985).

stated that the indentures did not contain any RJR guarantee to maintain the credit rating of the bonds held by the plaintiffs.[57] Because the indentures lacked any express covenants that referred to the downgrading of investment grade bonds, the court refused to imply a covenant and thereby create an indenture term for which the parties had not bargained.[58]

The plaintiffs "In Equity" claim stated that RJR's intentional distribution of equity to buy out the shareholders' outstanding stock was a "compelling example" of unjust enrichment and frustration of purpose.[59] The plaintiffs contended that RJR issued investment grade bonds to the plaintiffs with assurances that RJR would continue to be an economically strong company with a secure equity base.[60] By engaging in the LBO, however, RJR distributed a substantial amount of its equity to RJR stockholders to maximize the buyout price of the shareholders' stock.[61] The plaintiffs claimed that RJR's distribution of equity unjustly benefitted the RJR stockholders at the expense of the holders of RJR bonds and that the distribution of equity impeded RJR's ability to maintain an investment grade rating on its bonds.[62]

In addition to dismissing the claim of breach of implied covenant, the *Metropolitan Life* court granted RJR's motion for summary judgment on the plaintiffs' "In Equity" claim.[63] Judge Walker initially noted that the "In Equity" claim was similar to the plaintiffs' implied contract claim.[64] The *Metropolitan Life* court, consequently, rejected the plaintiffs' three general equitable claims of unjust enrichment, frustration of purpose, and breach of fiduciary duty.[65]

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57. *Metropolitan Life*, 716 F. Supp. at 1519. Judge Walker did state in *Metropolitan Life* that, while courts will use an implied covenant of good faith and fair dealing to ensure that the parties perform any bargained for rights, courts will not permit an implied covenant to shoehorn into an indenture any terms for which the parties did not bargain. *Id.*

58. *Id.* at 1522.

59. *See* MetLife's Brief, *supra* note 52, at 55 (explaining allegations of unjust enrichment and frustration of purpose in MetLife's "In Equity" claim). The plaintiffs in *Metropolitan Life* asserted that RJR's scheme to sell low risk, low yield bonds to help finance a subsequent takeover unjustly enriched both the defendants and RJR stockholders at the expense of holders of RJR investment grade bonds. *Id.* The plaintiffs argued that RJR, who sold investment grade bonds on the basis of a strong balance sheet, frustrated the plaintiffs' investment purpose by willfully depleting the assets of RJR that the plaintiffs assumed were secure. *Id.* at 57.

60. *Id.*

61. *Id.*

62. *Id.*

63. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989).

64. *Id.* at 1522.

65. *See id.* at 1523-24 (rejecting plaintiffs' "In Equity" claim). The *Metropolitan Life* court found that the plaintiffs' claim of unjust enrichment failed because the defendants did not violate any indenture term and, consequently, need not make restitution to the plaintiffs. *Id.* The *Metropolitan Life* court rejected plaintiffs' claim of frustration of purpose because the plaintiffs did not establish any of the three elements of such a claim. *Id.* Although the plaintiffs did not refer explicitly to a fiduciary duty owed by the management of RJR to RJR bondholders, the plaintiffs implicitly asserted that RJR management breached its fiduciary duty to the

Metropolitan Life admonishes investors that courts will not protect bondholders' interests by implying covenants into a bond indenture.[66] The *Metropolitan Life* court, however, did suggest ways in which future bondholders might protect their interests. Judge Walker repeatedly stated that some of the RJR indentures which MetLife originally accepted contained covenants that would have protected MetLife against their loss resulting from the buyout of RJR.[67] MetLife, however, agreed to exchange these specific protective covenants for alternative benefits.[68]

Knowing that courts are reluctant to imply protective covenants into indentures, many holders of investment grade bonds look to the government to protect investment grade bonds. These bondholders advocate two potential solutions. First, bondholders urge legislatures to extend the management's fiduciary duty to bondholders.[69] Second, bondholders propose that the Securities and Exchange Commission expand rule 13e-3 of the Securities Exchange Act of 1934 to require that companies give bondholders public evaluations of the fairness of an impending LBO.[70]

The traditional view of corporate law dictates that a corporation owes a fiduciary duty to its stockholders but not to its bondholders.[71] In the event of an LBO, therefore, management has a fiduciary duty to maximize

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plaintiffs. *Id.* The *Metropolitan Life* court relied on case law to reject summarily the breach of fiduciary duty claim. *Id.*; *see infra* notes 91-109 and accompanying text (describing lack of fiduciary duty owed by management of company to company's bondholders).

66. *See Metropolitan Life*, 716 F. Supp. at 1519 (contending that courts will not imply non-existant covenants into indenture to protect bondholders).

67. *See id.* at 1510, 1519, 1521 (noting that some original indentures protected RJR bondholders from LBO results). In its Amended Complaint MetLife listed six debt issues on which MetLife based its causes of action. *Id.* at 1510. The indentures for two of the six issues once contained covenants that expressly restricted RJR's ability to incur precisely the type of debt that RJR incurred when KKR bought out the RJR stock. *Id.*

68. *Metropolitan Life*, 716 F. Supp. at 1519, 1521. In 1985 MetLife voluntarily exchanged bonds that contained explicit covenants which would have protected the bonds against an LBO for bonds without such restrictions. Herzel & Shepro, *Bondholder Suits in the U.S.*, Financial Times, Dec. 21, 1989. The *Metropolitan Life* court also noted that, because an indenture is a private contract, courts should not alter an indenture before the company becomes insolvent or violates a covenant. *Id.* Such court intervention would inhibit the operation of a free market. *Id.* at 1508; *see* Bratton, *supra* note 39, at 102 (contending that, in debtor-creditor relationship, law holds to policy of non-intervention until debtor becomes insolvent).

69. *See infra* notes 73-103 and accompanying text (discussing possibility of legislatures extending management's fiduciary duties to bondholders).

70. *See infra* notes 104-25 and accompanying text (discussing possibility of SEC expanding security disclosure laws to apply to bondholder in LBOs).

71. *See* Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 593 n.5 (Del. 1986) (stating that relationship between corporation and its directors and bondholders is contractual and not fiduciary in nature). The traditional and still dominant view of corporate fiduciary duty is that management represents the shareholders; bondholders, creditors, suppliers, and employees create and protect their own particular interests through contracts with the corporation. Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117, 138 (1986).

shareholders' gains but has no similar obligation to bondholders.[72] Consequently, if bondholders suffer great losses in an LBO while stockholders profit, management can claim to have satisfied its legal duty by maximizing shareholder wealth.[73] Legislatures could protect bondholders from an LBO's damaging effects by extending management's fiduciary duty to bondholders and thereby forcing management to consider bondholders' interests in addition to shareholders' interests.[74] Management, consequently, would violate its fiduciary duty to bondholders if management agreed to an LBO that would weaken the value of bondholders' investment grade bonds.[75]

Twenty-one states have laws that allow the directors of a company to consider how management's actions affect the company's employees, suppliers,[76] and customers.[77] These laws, however, are purely permis-

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72. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (holding that management's concern for non-stockholder interests is inappropriate when company is target of takeover). No statute or case law protects bondholders, except in extreme situations, against a debtor's acts. *Commentaries*, *supra* note 2, at 2.

73. *See Revlon*, 506 A.2d at 182 (stating that when company is engaged in buyout, management's objective is to sell stock to highest bidder and thereby maximize shareholder wealth).

74. *See* McDaniel, *supra* note 16, at 270 (contending that directors should consider interests of both bondholders and stockholders); Barkley, *supra* note 22, at 67 (arguing for extending management's fiduciary duty to bondholders). *But see* Dowd, *Washington's War Against LBO Debt*, FORTUNE, Feb. 13, 1989, at 91 (contending that neither SEC nor Congress will act in near future to protect bondholders by extending management's fiduciary duty to bondholders). Dowd notes that, although the RJR buyout caused Washington to take notice of bondholder losses, neither Congress nor the SEC has enacted any measures that directly would deal with the dilemma of bondholder losses caused by LBOs. *Id.*; *see also* Bratton, *supra* note 22, at 735 (asserting that, if legislatures extend management's fiduciary obligations to bondholders, other non-stockholder groups will ask legislatures to extend management's fiduciary duties to other non-stockholder groups as well). Bratton asserts that the possibility of management owing fiduciary duties to suppliers, customers, and creditors clearly undermines management's primary duty to maximize returns to common shareholders. *Id.*; *see also Bondholders Ponder Weapons in Era of Buyouts*, 21 Sec. Reg. & L. Rep. (BNA) 552 (Apr. 14, 1989) (noting that SEC's Chief Economist, Kenneth Lehn, is against expanding management's fiduciary duty to non-stockholders). Lehn states that any expansion of management's fiduciary duty to bondholders would set "very, very dangerous precedent" because such an expansion would necessitate extending the duty further to other corporate constituents, such as employees, suppliers, and creditors. *Id.*; *see also Brady Urges Curbs on LBO Tax Dividends Be Linked to Double Dividend Tax Relief*, 21 Sec. Reg. & L. Rep. (BNA) 153 (Jan. 27, 1989) (noting that Secretary of Treasury Nicholas Brady is against extending management's fiduciary duty to non-stockholders); Hector, *The Bondholders Cold New World*, FORTUNE, Feb. 27, 1989, at 83 (noting that recently retired SEC chairman David Ruder is against extending management's fiduciary duty to non-stockholders); Salwen, *SEC Should Get Authority to Monitor Brokers' Debt, Nominee Breeden Says*, Wall St. J., Oct. 2, 1989, at 17, col. 3 (noting that current SEC chairman Richard Breeden is against extending management's fiduciary duty to non-stockholders).

75. *See* McDaniel, *supra* note 16, at 247 (stating that, if management owes fiduciary duty to bondholders, any management decision that causes stock prices to rise and bond prices to fall would be prima facie evidence of management's breach of fiduciary duty to bondholders).

76. *See* Robertson, *supra* note 2, at 462 (explaining that bondholders are "suppliers" of capital to company).

77. *See* CONN. GEN. STAT. ANN. §33-313(e) (West 1988) (allowing management to consider

sive.[78] For example, the Indiana statute, which is a typical non-stockholder constituency statute, provides that the directors of a company may, but are not required to, consider the interests of non-stockholder corporate constituencies in deciding whether to engage in a takeover.[79] The permissive nature of the Indiana statute does not necessarily protect bondholders' interests.[80] For instance, even if New York law paralleled Indiana law at the time of KKR's buyout of RJR, RJR management still could have justified its actions despite the substantial loss to bondholders because RJR management did not owe a mandatory fiduciary duty to RJR bondholders.[81]

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interests of non-stockholder groups in corporate transactions); FLA. STAT. ANN. §607.111.9 (West 1989) (same); GA. CODE ANN. §14-2-205.5 (Harrison 1989) (same); IDAHO CODE, chap. 16, §30-1602 and chap. 17, §30-1702 (1988) (same); ILL. ANN. STAT. ch. 32, para. 8.85 (Smith-Hurd Supp. 1988); IND. CODE ANN. §23-1-35-1(d) (Burns Supp. 1988) (same); IOWA CODE §496A.34 (1989) (same);KY. REV. STAT. ANN. §271A.397(4) (Michie/Bobbs-Merrill 1989) (same); LA. REV. STAT. ANN. §12:92(G) (West 1988) (same); ME. REV. STAT. ANN. tit. 13A, §716 (1964 & Supp. 1988) (same); MASS. GEN. LAWS ANN. ch. 156B, §65 (West 1989) (same); MINN. STAT. ANN. §302A, 251 (West 1985 & Supp. 1989) (same); MO. ANN. STAT. §351.347 (Vernon Supp. 1989) (same); NEB. REV. STAT. §21-2035(i) (1988) (same); N.M. STAT. ANN. §53-11-35(d) (Supp. 1988); (same); N.Y. BUS. & CORP. LAW §717(b) (McKinney 1989) (same); OHIO REV. CODE ANN. §1701.59(E) (Anderson Supp. 1987) (same); OR. REV. STAT. §60.357 (1989) (same); 42 PA. CONS. STAT. ANN. §1721(c) (Purdon 1989) (same); TENN. CODE ANN. §48-35-204 (1988) (same); WIS. STAT. ANN. §180.305 (West Supp. 1988) (same).

78. *See* J. Grundfest, Remarks at Meeting of American Bar Association on the Impact of LBO's on Debtholders and Other Corporate Constituencies (1989 Honolulu) (asserting that statutes that expand management's fiduciary duties to non-stockholders are permissive).

79. *See* IND. CODE ANN. §23-1-35-1 (Burn Supp. 1989) (providing that directors may consider non-stockholder interests in change of control transactions). Section 23-1-35-1 provides that:. . .

> (d)
>
> A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers and customers of the corporation. . . .
>
> (f)
>
> Directors are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as a dominant or controlling factor. . . . Certain judicial decisions in Delaware and other jurisdictions, which might otherwise be looked to for guidance in interpreting Indiana corporate law, including decisions relating to potential change of control transactions that impose a different or higher degree of scrutiny on actions taken by directors in response to a proposed acquisition of control of the corporation are inconsistent with . . . this article.

80. *But see* McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 442 n.148 (1986) (providing example of effective potential legislation that would protect bondholders' interest). McDaniel states that, although no current law goes so far, the Articles of Incorporation for the Control Data Corporation provide adequate protection for bondholders. *Id.* Article Ten of Control Data's Articles of Incorporation states that the board of directors, in determining the best interests of the corporation and shareholders, shall give due consideration to the social and economic effects on employees, customers, suppliers, local communities and other constituents of the corporation and subsidiaries. *Id.* If New York had a statute similar to the provision in Control Data's Articles of Incorporation at the time of the RJR buyout, RJR management would have had difficulty justifying to the court management's decision to buy out the common stock in light of the resulting extensive losses to bondholders.

81. *See* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1508 (explaining RJR management's justification of LBO of RJR).

In addition to the legislative debate whether to expand the fiduciary duties of management, courts have considered whether to extend management's fiduciary obligations to bondholders. In *Pepper v. Litton*[82] the United States Court of Appeals for the Fourth Circuit granted the plaintiff, a controlling stockholder, a judgment which ensured that the insolvent company pay the plaintiff at the expense of the company's bondholders.[83] The United States Supreme Court, in overturning the Fourth Circuit's decision, held that the standard of fiduciary obligations should protect both stockholders' interests and creditors' interests in the company.[84] Although the language of the Supreme Court's decision in *Pepper* is broad, the facts of *Pepper* limit the imposition of a fiduciary duty on management to creditors only when a company becomes insolvent.[85] Courts after *Pepper* have extended the fiduciary duty of management to bondholders, but only in extreme circumstances such as fraud, insolvency, or a statutory violation.[86]

Despite these exceptions, case law stands unequivocally opposed to extending management's fiduciary duties to bondholders. In *Revlon, Inc. v. McAndrews & Forbes Holdings, Inc.*[87] Revlon management, combatting a hostile takeover attempt, sought a "friendly" investment firm that would take over Revlon in a leveraged buyout.[88] Revlon management chose the investment firm of Forstmann Little & Co. because Forstmann Little offered to protect Revlon bonds if the bonds lost market value because of the impending buyout.[89] The Delaware Supreme Court enjoined Revlon's choice of Forstmann Little and held that Revlon's management was not free to take non-stockholder interests into account when Revlon was the target of a buyout.[90] The *Revlon* court further found that management's central concern in a buyout should be to benefit stockholders by obtaining the highest possible price for the outstanding stock.[91] The *Revlon* court reasoned

82. 100 F.2d 830 (4th Cir. 1939).

83. Pepper v. Litton, 100 F.2d 830, 832 (4th Cir. 1939).

84. 308 U.S. 295 (1939).

85. *See* Bratton, *supra* note 22, at 734 n.247 (noting that *Pepper* court extended fiduciary duty to bondholders only after corporation became insolvent).

86. *See* Harff v. Kerkorian, 347 A.2d 133, 133-34 (Del. 1975) (extending management's fiduciary duty to bondholders in case alleging management's intentional looting of corporation); Pittsburgh Terminal Corp. v. Baltimore Ohio R.R., 680 F.2d 933, 935 (3d Cir. 1982), (extending management's fiduciary duty to bondholders in case where bondholders proved that management improperly eliminated bondholders' conversion rights) *cert. denied*, 459 U.S. 1056 (1982). *But see* Simons v. Cogan, 542 A.2d 785, 790 (Del. Ch. 1987) (deciding contrary to *Pittsburgh Terminal*). The *Simons* court questioned Judge Gibbons's assertion in *Pittsburgh Terminal* that fiduciary obligations run to bondholders. *Id.* The *Simons* court noted that Judge Gibbons cited little authority to support his conclusion in *Pittsburgh Terminal. Id.*

87. 506 A.2d 173 (Del. 1986).

88. Revlon, Inc. v. MacAndrews & Forbes Holding, Inc., 506 A.2d 173, 175-76 (Del. 1986).

89. *Id.* at 179. The *Revlon* court noted that, after the announcement of the LBO of Revlon, the trading price of Revlon bonds dropped from $100 to $87.50. *Id.* at 178.

90. *Id.* at 182.

91. *Id.* The *Revlon* court acknowledged that a board of directors may have regard for

that, because the bond indentures contained all of the bondholders' rights and management did not violate any provisions of the indentures, the bondholders did not deserve any further protection from the court.[92]

In *Simons v. Cogan*[93] the plaintiff, a holder of convertible bonds, claimed that the management of the defendant corporation, Knoll International, Inc. (Knoll) violated its fiduciary duty to the plaintiff by eliminating the conversion feature on the bonds that the plaintiff held.[94] Under the original indenture the plaintiff could convert each $19.20 of principal amount of bonds into one share of Class A common stock of Knoll.[95] Subsequent to a merger, Knoll entered into a supplementary indenture to the indenture pursuant to which plaintiff's bonds were issued which stated that holders of convertible bonds could convert every $19.20 of principal amount of bonds into only $12 cash, the price of each share of common stock in the merger.[96] The plaintiff claimed that he lost the conversion feature of the bonds after the merger because no reasonable investor would convert $19.20 worth of bonds into $12 of cash.[97] After noting that the traditional approach to corporate law does not extend a fiduciary duty from management to bondholders, the *Simons* court refused to extend management's fiduciary obligations to bondholders.[98] The *Simons* court admonished future bondholders to protect against losses by only accepting indentures that contain explicit protective covenants.[99]

Finally, in *Katz v. Oak Industries*,[100] the plaintiff bondholder claimed a violation of fiduciary duty when the defendant corporation sought to exchange new securities and cash for a portion of the corporation's outstanding debt in an amount less than the face value of the debt.[101] In holding that the defendant did not breach any fiduciary duty to the plaintiff, the Delaware Chancery Court noted that management's relationship to bondholders is contractual, not fiduciary, and that bondholders' rights appear in the indenture.[102] The *Katz* court further found that directors have

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various corporate constituencies in discharging the board's responsibilities. *Id.* The court, however, stated that a board's sole concern in a buyout is to benefit the company's shareholders. *Id.*

92. *Id.*

93. 542 A.2d 785 (Del. Ch. 1987).

94. Simons v. Cogan, 542 A.2d 785, 787 (Del. Ch. 1987).

95. *Id.*

96. *Id.*

97. *Id.* at 788. The plaintiff in *Simons* asserted that twelve dollars per share is an unfairly low price and inadequate consideration for the loss of a right to receive Class A share. *Id.*

98. *Id.* at 791. The *Simons* court did not extend management's fiduciary duty to cover bondholders for fear of undermining the already established non-fiduciary relationship between bondholders and solvent corporations. *Id.*

99. *Id.* at 786-87.

100. 508 A.2d 873 (Del. Ch. 1986).

101. Katz v. Oak Indus., 508 A.2d 873, 878 (Del. Ch. 1986).

102. *Id.* at 879. The *Katz* court asserted that the rights and obligations of the board and the bondholders appear or should appear in the indenture. *Id.* The court further noted that the terms of the agreed upon contract, not broad concepts such as fairness, define the corporation's obligation to its bondholders. *Id.*

a duty to attempt to maximize the interests of shareholders and that, if management sometimes does so "at the expense of others," management will not have breached its duty.[103]

As an alternative to the legislative or judicial extension of management's fiduciary obligations to bondholders, bondholders also may seek protection under rule 13e-3 of the Securities Exchange Act of 1934.[104] Rule 13e-3 requires that companies who undertake certain transactions[105] provide material information[106] to shareholders to allow the shareholders to evaluate the particular transaction.[107] A company must disclose to shareholders a detailed analysis of the company's belief that a transaction will be fair to all equity shareholders.[108] If any shareholders conclude that the transaction is unfair, the company, before undertaking the transaction, must provide such shareholders with an outline of whatever remedies are available to the shareholders under applicable law.[109] Rule 13e-3, however, only requires disclosure to holders of equity securities[110] and, moreover, does not govern

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103. *Id.*

104. 17 C.F.R. §§ 240.13e-3, 100 (1989).

105. *See* 17 C.F.R. § 240.13e-3(a)(3)(i) (1989) (stating that rule 13e-3 covers such transactions as stock purchases, tender offers, mergers, consolidations, reclassifications, recapitalizations, reorganizations, sales of assets by company to affiliates, and reverse stock splits).

106. *See* 17 C.F.R. § 240.13e-100(1)-(15) (1989) (defining "material information"). Section 240.13e-100 provides that material information includes: (1) the issuer and the class of security subject to the transaction; (2) the details and background of the transaction participants; (3) the past contacts, transactions, and negotiations with the party; (4) the terms of the present transaction; (5) the proposed plans of the issuer; (6) the source and amounts of funds; (7) the purpose(s), alternatives, reasons and effects of the transaction; (8) the fairness of the transaction; (9) the reports, opinions, appraisals, and certain negotiations; (10) the interest in securities of the issuer; (11) the present intention and recommendations of certain persons with regard to the transaction; (12) the contracts, arrangements, or understandings with respect to the issuer's securities; (13) other provisions of the transaction; (14) financial information; and (15) a list of persons and assets employed, retained, or utilized in the transaction. *Id.*

107. 17 C.F.R. § 240.13e-3(a)(4) (1989) (stating that rule 13e-3 only applies to holders of equity securities).

108. 17 C.F.R. § 240.13e-3(d)(3)(e) (1989). Rule 13(e)-3(d)(3)(e) provides that:

> The issuer . . . engaging in the rule 13e-3 transaction . . . shall disclose to security holders . . . of equity securities . . . the information required by Item 8 (which provides that the company must):
>
> a) State whether the issuer . . . reasonably believes that the rule 13e-3 transaction is fair or unfair to . . . security holders. If any director dissented to or abstained from voting on the rule 13e-3 transaction, identify each such director and indicate, if known, after making reasonable inquiry, the reason for each dissent or abstention . . . [a blanket statement that a director has no reasonable belief as to the fairness of the transaction will not satisfy the requirement].
>
> b) Discuss in reasonable detail the material factors upon which the belief stated in [section a] is based and the weight assigned to each such factor.

109. 17 C.F.R. § 240.13e-100(13)(a) (1989). Rule 13(e)-100(13)(a) provides that:

> [To] security holders who object to the transaction, [the company must] briefly outline the rights which may be available to such security holders under [state] law.

110. *See supra* note 107 and accompanying text (indicating that rule 13e-3 only applies to holders of equity securities).

the disclosure of information in third party transactions such as LBOs.[111]

Bondholders argue that the Securities and Exchange Commission (SEC) should adopt a disclosure rule that would require management to state whether management reasonably believes that an LBO is fair to all classes of security holders, including bondholders.[112] Such a rule would benefit bondholders in two respects. First, bondholders would gain access to information, including possible legal remedies, regarding the proposed transaction.[113] Second, because the company would have to provide bondholders with the company's predictions about the transaction, potential bondholder losses would be a matter of public record.[114] A company, consequently, might hesitate to proceed with an LBO that is unfair to the company's bondholders.[115] A transaction that is unfair to bondholders may tarnish the company's public image and may scare off potential investors in the company's bonds.[116]

Even if the SEC did expand the fairness aspect of rule 13e-3 to cover bondholders' interests in an LBO, such an extension would not necessarily protect bondholders.[117] Management properly could claim that an LBO is fair to bondholders as long as the surviving company satisfies the terms of the indentures.[118] For instance, if RJR maintains its ability to repay interest and principal to bondholders when due, then the LBO was fair to RJR

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111. *See supra* note 105 and accompanying text (noting that rule 13e-3 does not apply to transactions such as LBOs).

112. *See* McDaniel, *supra* note 16, at 312 (contending that, if SEC expanded coverage of rule 13e-3 to bondholders, rule 13e-3 would protect bondholders from losses in extraordinary transactions such as LBOs).

113. *See supra* note 106 and accompanying text (listing information that security holders are entitled to receive under rule 13e-3).

114. 17 C.F.R. § 240.13e-100(8)(b)(2) (1989). Section 240.13e-100(8)(b)(2) provides:

> Conclusory statements such as "the rule 13e-3 transaction is fair to unaffiliated security holders in relation to net book value, going concern value and future prospects of the issuer" will not be considered sufficient disclosure . . . [issuer must disclose reasonably detailed analysis of proposed transaction].

If § 240.13e-100(8) applied to the investment grade bondholders in the RJR takeover, RJR management would have had to assess publicly the effect on its pre-existing bonds of assuming billions of dollars of debt.

115. *See* McDaniel, *supra* note 16, at 312 (stating that company may hesitate before proceeding with transaction that harms bondholders if company must disclose information regarding harmful transaction).

116. *See id.* (describing undesirable future effects on surviving company if LBO harms bondholders).

117. *See Secretaries Group Urges SEC to Require Greater LBO Disclosure to Bondholders*, 21 Sec. Reg. & L. Rep. (BNA) 197 (Feb. 3, 1989) (noting SEC Commissioner Joseph Grundfest's opinion that expanding disclosure rules to bondholders would fail to protect bondholders' interests). Commissioner Grundfest maintains that a corporation could easily publish reports in good faith which stated that an LBO was "fair" to bondholders. *Id.* Commissioner Grundfest argued that bondholders still would suffer losses despite the disclosure of such fairness reports. *Id.*

118. *See* Salwen, *supra* note 74, at C3, col. 3 (reporting that SEC Chairman Richard Breeden asserted that corporations treat bondholders fairly as long as corporations meet indenture's terms).

bondholders.[119] Thus, despite the drastic drop in the value of the RJR bonds because of the LBO, RJR management could claim that the LBO was fair to bondholders.[120]

Market realities further diminish any protection bondholders could receive if the SEC expanded the scope of rule 13e-3 to include bondholders. The extensive publicity of the RJR takeover established two new concepts.[121] First, the publicity revealed that almost any company is susceptible to an LBO because of the widespread availability of debt financing.[122] Second, the RJR takeover demonstrated that investment grade bondholders take a substantial loss in highly leveraged transactions.[123] After the LBO of RJR, investors buy investment grade bonds with the knowledge of the risks of an LBO.[124] Bondholders, thus, cannot claim perfunctorily that bondholders are the victims of unforeseen LBOs which destroy the value of bonds.[125]

Because current statutory and case law does not protect bondholders sufficiently in the event of an LBO,[126] bondholders should use contractual provisions to protect the value of their investments.[127] Because of the

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119. *See supra* note 65 and accompanying text (contending that if RJR repays principal and interest to bondholder, LBO was fair). Because of the LBO, RJR's interest and debt expenses rose from $549 million in 1988 to $3.38 billion in 1989. Baker, *supra* note 43 at D10. Despite losing $144 million in the fourth quarter of 1989, RJR has kept current on its debt payments by selling off $5.5 billion in RJR assets. *Id.* Since the completion of the LBO, RJR has sold off Del Monte Foods, some European food units, Chun King Oriental foods, and Butter Finger and Baby Ruth candy bars. *Id.*

120. *See supra* notes 118-20 and accompanying text (proposing that company can assert fairness of LBO to bondholders if company meets terms of indenture after LBO).

121. *See* Wallace *supra* note 34, at C1, col. 2 (asserting that RJR takeover enlightened bondholder of dangers of LBO and vulnerability of large companies to LBOs).

122. *See, e.g.*, Farrell, *Bondholders are Mad as Hell—And They're Not Going to Take It Anymore*, Bus. Wk., Feb. 6, 1989, at 82 (contending that almost any industrial company is vulnerable to takeover); Knight, *supra* note 20, at D9 (reporting that investors in corporate bonds worry that RJR-type buyout may happen to any company); Wallace, *supra* note 31, at D1, col. 3 (asserting that, revelation of RJR LBO drove down price of Sears, Roebuck & Company's bonds for fear of similar takeover); Wallace, *supra* note 34, at C1, col. 2 (contending that, after RJR takeover, bond prices in consumer giants such as Ralston Purina, Proctor & Gamble, and Sara Lee dropped as these companies worried about takeover similar to RJR takeover). *But see* Bartlett, *The New Takeovers*, N.Y. Times, Dec. 17, 1989, at D1, col. 3 (contending that debt financing is no longer popular corporate practice).

123. *See* Herzel & Shepro, *supra* note 68 (contending that bondholders are big losers in highly leveraged deals); Hector, *supra* note 74, at 84 (stating that LBOs inherently hurt bondholders).

124. *See generally* Smith & Warner, *supra* note 31, at 260 (asserting that rational bondholders recognize market risk); Sloan, *The Rape of the Bondholder*, Forbes, Jan. 23, 1989, at 68 (contending that present bond market is very much "buyer-beware" market).

125. *See* Bratton, *supra* note 39, at 153 (claiming that holders of new debt issues can foresee and contractually control LBO-related injury and, thus, cannot easily claim to be victims of LBO).

126. *See* Robertson, *supra* note 2, at 484 (contending that neither courts nor legislatures has dealt with problem of bondholders' losses caused by leveraged transactions).

127. *See supra* notes 67-68 and accompanying text (discussing *Metropolitan Life* court's repeated references to benefits to bondholders of contractual protection in indentures).

heightened awareness of bondholder losses caused by LBOs, many prospective bondholders insist on the inclusion of highly elaborate protective covenants in indentures.[128]

One such protective covenant is the poison put.[129] Poison puts allow investors to cash in bonds before maturity if the company that issued the

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128. *See* Bratton, *supra* note 39, at 155-57 (discussing bondholders who formed lobbying groups to advocate for contractual protection). In late 1986 bondholder investment groups lobbied the federal government to create laws that protected all investors in the event of an LBO. *Id.* at 155. The lobbying efforts failed. *Id.* at 156. After the RJR buyout, however, new lobbying groups emerged and urged issuers and underwriters to include protective covenants in bond indentures. *Id.* at 157; *see* Grant, *Bondholders Begin Struggle for Rights*, CRAIN'S N.Y. BUS., July 4, 1988 (discussing lobbying efforts of Institutional Bondholders' Rights Association that call for reemergence of protective covenants); Light, *supra* note 44 (reporting that bondholders request inclusion of protective covenants in indentures); Farrell, *supra* note 122, at 83 (reporting that bondholders are pushing companies to issue new bonds with protective covenants).

129. *See* Vlahakis & Nussbaum, *supra* note 37, at 66 n.15 (describing poison put provision in indentures of Harris Corporation and Northwest Pipeline, Inc.). The poison put in Harris Corporation's indenture provides:

> 4.01. In the event that (i) a Designated Event shall occur at any time on or prior to the tenth anniversary of the date on which the Debentures are first issued under this Indenture and (ii) on any date within 90 days after a public filing has been made with the Securities and Exchange Commission or other general public disclosure has been made indicating the occurrence of such Designated Event, the then current rating of the Debentures by Standard & Poor's Corporation or its successor ("S&P") or by Moody's Investor's Service, Inc. or its successors ("Moody's") is downgraded to lower than BBB, in the case of S&P, or lower than Baa3, in the case of Moody's (or an equivalent successor rating) (the occurrence of the conditions specified in both (i) and (ii) being a "Put Event"), then each registered holder of Debentures shall have the right, at such holder's option, and subject to the conditions of this Article Four, to put all or part of its Debentures to the Company for purchase by the Company at a purchase price of 100% of the principal amount thereof, together with interest accrued to the date fixed for such purchase (provided that if the date fixed for such purchase is on or subsequent to the date on which interest is otherwise payable to Debentureholders pursuant to Section 2.03 hereof, such interest shall be payable to the registered holder of Debentures as of the applicable record date for such interest payment). Any such put of Debentures for purchase by the Company shall be irrevocable.
>
> The term "Designated Event" means any one or more of the following events which shall occur subsequent to the date of issuance of the Debentures:
>
> (A)(1) the Company shall consolidate with or merge into any other corporation or convey, transfer, or lease all or substantially all of its assets to any person (other than a wholly owned subsidiary of the company) or (2) any corporation shall consolidate with or merge into the Company, in either event pursuant to a transaction in which any common stock of the Company outstanding immediately prior to the effectiveness thereof is changed into or exchanged for cash, securities or other property;
>
> (B) any person (other than the Company or any Subsidiary) shall purchase or otherwise acquire directly or indirectly the beneficial ownership of securities of the Company and, as a result of such purchase or acquisition, such person (together with its associates and affiliates) shall directly or indirectly beneficially own in the aggregate (1) twenty percent (20%) or more of the common stock of the Company, or (2) securities representing twenty percent (20%) or more of the combined voting power

bonds is the subject of a successful takeover.[130] Poison puts increase the cost to a bidder of buying the target company because the bidder must pay off both the shareholders and the bondholders to consummate the takeover.[131] Bondholders who cash in their bonds benefit from a poison put if a takeover spawns a new, more leveraged, high risk company.[132]

The basic provisions of a poison put give bondholders the right to require the issuing company to repurchase the bonds within a specific, short time period after the occurrence of a "designated event" and "qualifying downgrade." A designated event may consist of: (1) a merger or transfer of all or substantially all of the company's assets to another company; (2)

> of the Company's voting securities, in each case under clause (1) or (2) outstanding on the date immediately prior to the date of such purchase or acquisition (or, if there be more than one, the last such purchase or acquisition);
>
> (C) the Company or any Subsidiary shall purchase or otherwise acquire, directly or indirectly, beneficial ownership of capital stock of the Company if, after giving effect to such purchase or acquisition, the Company (together with all Subsidiaries) shall have acquired, during any period of 12 consecutive months, beneficial ownership of an aggregate of thirty percent (30%) or more of the capital stock of the company outstanding on the date immediately prior to the first such purchase or acquisition during such period; or
>
> (D) on any date (a "Calculation Date") (1) the Company shall make any distribution or distributions of cash, securities, or other properties (other than regular periodic cash dividends at a rate which is substantially consistent with past practice, including with respect to increases in dividends and other than common stock, or rights to acquire common stock or preferred stock substantially equivalent to common stock) to holders of capital stock, whether by means of dividend, reclassification, recapitalization or otherwise, or (2) the company or any Subsidiary shall purchase or otherwise acquire, directly or indirectly, beneficial ownership of capital stock, and the sum of the Applicable Percentages of all such distributions, purchases and acquisitions which have occurred on the Calculation Date and during the 365-day period immediately preceding the Calculation Date shall exceed thirty percent (30%).

Id.

130. *See* Winkler, *Wall Street Is Devising The Takeover Proof Bond*, Wall St. J., Nov. 3, 1988, at C1, col. 3 (discussing history of poison puts). Winkler states that early poison puts, drafted in the mid-1980s, were ineffective because the contractual provisions did not protect bondholders from responses to "friendly" management buyouts. *Id.*; Light, *supra* note 44, at ____(explaining drawbacks of early poison puts). Another drawback of the early poison puts was the provisions' inability to allow bondholders to sell bonds back to the company for profit if the bonds were trading at a premium. *Id. But see* Vlahakis & Nussbaum, *supra* note 37, at 68 (describing modifications on poison puts that allow bondholders to sell bonds back to company at premium). Vlahakis and Nussbaum assert that, if a bond was trading at a premium over its market price when a designated event and qualifying downgrade occurred, the bondholder would collect either a stated premium or an amount determined by comparing the bond to a U.S. Treasury bond. *Id.* Corporate bonds are priced in relation to U.S. Treasury bonds of comparable maturity. McDaniel, *supra* note 16, at 238. McDaniel states that, Treasury bonds are risk-less and reflect the market rate of interest. *Id.* Because corporate bonds have a degree of risk, the higher the degree of risk, (as compared to Treasury bonds), the higher the interest rate (as compared to Treasury bonds). *Id.*

131. *See* Laderman, *How Megadebt Shakes Up Banks and Bonds*, Bus. Wk., Nov. 14, 1988 (contending that poison puts will increase cost of LBOs).

132. *See id.* (contending that bondholders can avert risk by selling bonds back to more leveraged, surviving company).

any change or exchange of a majority of the common stock of the company; (3) any purchase or acquisition by any person of thirty percent (or some other specified amount) or more of the company's common stock; (4) a purchase by the company or one of its subsidiaries of thirty percent (or some other specified amount) or more of its own common stock; or (5) a change on the board of directors in which the continuing directors cease to constitute at least a majority of the board.[133] A qualifying downgrade occurs if the bond rating by Standard & Poor's is at least BBB (or Baa by Moody's) twenty days prior to the occurrence of a designated event and subsequently falls to a rating lower than BBB (or Baa).[134]

In addition to poison puts, credit sensitive provisions may protect the value of bonds from the consequences of an LBO.[135] Unlike poison puts, credit sensitive provisions allow investors to retain their bonds after an LBO.[136] The credit sensitive provisions provide for an adjustable interest rate that compensates bondholders for any increased risk which results when a designated event, such as an LBO, and a qualifying downgrade occur.[137] Bondholders, therefore, will profit when interest rates on the bonds escalate to reflect the increased risks to the bonds after an LBO.[138] By including poison put and credit sensitive provisions in an indenture, bondholders faced with a potential LBO will be able either to sell bonds back to the issuer at face (or at a premium) value or retain the bonds and receive increased interest payments.[139]

Some investors contend that the effectiveness of any protective covenants is dubious because bondholders will be unable to convince issuing companies or underwriters[140] to include such provisions in an indenture.[141] Management

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133. *See* Macey, *supra* note 31, at 188 (describing provisions of designated event).

134. *See id.* (discussing provisions of qualifying downgrade).

135. *See* Dazzo, *Corporate and Mortgage Securities*, THE BOND BUYER, June 2, 1989, at 2 (describing first fixed rate corporate bond issue that contained "credit sensitive" provisions in indenture that protected bondholders from LBOs). Dazzo states that the interest rate in credit sensitive bonds will adjust to changes in the bonds' investment grade rating. *Id.* For instance, if Standard & Poor's and Moody's raise their ratings on a particular bond, the interest rate payment on that bond will drop. *Id.* Conversely, if either Standard & Poor's or Moody's lowers its rating on the bond, the interest rate payable on the bond will increase. *Id.*

136. *See id.* (asserting that bondholders may retain credit sensitive bonds after LBO and receive compensation for additional risk caused by increased debt).

137. *See* Macey, *supra* note 31, at 188 (defining credit sensitive provisions that provide for adjustable interest rates on bonds depending on bonds' credit rating); *supra* note 137 and accompanying text (discussing how interest rate in credit sensitive bond adjusts when bond's rating changes).

138. *See* Dazzo, *supra* note 135, at 2 (asserting that company will compensate holders of credit sensitive bonds for any downgrading of bonds caused by increased risk to company).

139. *See* Macey, *supra* note 31, at 188 (illustrating effect of using dual protective clauses of poison put and credit sensitive provisions).

140. *See* BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 452 (2d ed. 1987) (defining underwriter as investment banker who, singly or as member of underwriting group, agrees to purchase new issue of securities from issuer and distribute securities to investors).

141. *See* Robertson, *supra* note 2, at 464 (contending that underwriters and issuers preclude

of the issuing company usually negotiates the terms of the indenture with the underwriters, who then purchase the securities for immediate resale to the public.[142] The issuing company seeks to draft an indenture that provides for a low interest rate and contains few restrictive covenants.[143] The underwriters, in contrast, argue for an indenture with sufficient protection so that the issue is marketable.[144] Individual bondholders typically do not participate in the negotiation of the indenture.[145]

Although individual bondholders usually do not participate in the indenture negotiations, individual bondholders indirectly may influence the drafting of the indenture. Since the RJR takeover, bondholder lobbying groups and an increasing number of bond investors now request that issuers and underwriters include protective covenants in indentures.[146] Issuing companies have been receptive to the input of bondholders because of the tax advantages of debt to the issuers.[147] Underwriters also have become more sensitive to bondholders' concerns after underwriters have had increased difficulty selling covenant-free bonds since the buyout of RJR.[148] Thus,

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individual bondholders from participating in indenture negotiations and, thus, individual bondholders cannot demand inclusion of terms in indenture). *But see infra* note 153 and accompanying text (asserting that institutional bondholders have direct influence in indenture negotiations).

142. *See* Robertson, *supra* note 2, at 464 (asserting that issuing company typically negotiates indenture's terms with underwriters).

143. *See id.* (stating terms that issuers want in indentures).

144. *See id.* (declaring what underwriters want in indentures).

145. *See id.* (asserting that individual bondholders usually do not negotiate indenture terms). Robertson states that institutional investors like MetLife play a significant role in the bond market and frequently purchase whole issues of publicly issued bonds. *Id.* Because of the financial importance of the institutional investor to the bond market, issuing companies make certain that publicly issued bonds have the minimal protection necessary to ensure institutional sales. *Id. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.* signaled to issuing companies that institutional investors now demand that indentures contain more protective covenants. Wallace, *supra* note 34, at C1, col. 2.

146. *See* Grant, *supra* note 128 (discussing plan of Institutional Bondholders Rights Association to protect bondholders by developing and advocating for inclusion of protective covenants in indentures); Farrell, *supra* note 122, at 82 (reporting that bondholders push companies to issue new bonds with covenants that limit losses in future restructuring of company); Light, *supra* note 44 (contending that, since RJR takeover, more bond buyers have issuers include protective covenants in indentures).

147. *See* Farrell, *supra* note 122, at 82 (reporting that influence of bondholders on United States companies is growing because, increasingly, debt is replacing equity as America's risk capital). Corporations favor debt because a company can deduct from its taxes the interest that a company pays on its debt. *Brady Urges Curbs on LBO Tax Deductions Be Linked to Double Dividend Tax Relief*, 21 Sec. Reg. & L. Rep. (BNA) 152 (Jan. 27, 1989). Conversely, companies must pay taxes on their earnings, including the portion distributed as dividends to holders of equity in the company. *Id.* Because companies prefer debt to equity, bondholders may convince issuers to include protective covenants in indentures by refusing to buy issues that lack adequate protections. *See* Grant, *supra* note 128 (citing examples of bond issues that did not sell because of lack of protective covenants).

148. *See* Laderman, *supra* note 131 (discussing underwriters' difficulties in selling bonds after buyout of RJR). Laderman explains that, after RJR management announced the proposed takeover of RJR, underwriters could sell only about one-third of a $300 million offering of

despite the absence of individual bondholders at indenture negotiations, several issuers and underwriters have complied with bondholder wishes and issued bonds that contain protective covenants such as poison puts and credit sensitive provisions.[149]

While effectively protecting bondholder interests, poison puts and credit sensitive provisions greatly restrict the flexibility of management to run a company by constraining management's ability to take risks.[150] These provisions impede management's ability to finance, invest, and distribute assets.[151] Management, however, may derive some benefits from including protective covenants in an indenture.[152] For instance, management can demand that bondholders who want protective covenants pay a higher price for the bonds.[153] Alternatively, a company may pay bondholders a lower yield on bonds that contain protective covenants.[154]

Critics of contractual remedies assert that protective covenants do not address adequately the inequities that an LBO inflicts on bondholders.[155] In light of an LBO's devastating effect on bondholders and conversely beneficial effect to management and stockholders, some commentators demand

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Eastman-Kodak Co. bonds before the underwriters had to cut prices and raise interest rates on the bond issue. *Id.* The trading of many companies' bond issues simply dried up when investors saw the companies as vulnerable to swift changes in credit quality. *Id.* Bond issues of corporate giants, such as Sara Lee, Ralston Purina, and Sears Roebuck & Co., practically stopped trading after the RJR takeover. *Id.*

149. *See* Farrell, *supra* note 122, at 83 (listing Harris Corporation, Northwest Pipeline, and Grumman Corporation as companies that issued bonds with poison puts after RJR). Farrell believes that Grumman Corporation is an example of a company that needed working capital immediately and, therefore, included a poison put in its bonds to ensure that underwriters could sell the bonds quickly and smoothly. *Id.* The Grumman bonds, in fact, did sell quickly. *Id.* Northwest Pipeline bonds with poison puts also sold well. *See* Kelly, *Northwest Pipeline Deal Well Received*, THE BOND BUYER, Nov. 23, 1988, at 78 (noting that Northwest Pipeline's poison put bonds received warm welcome from market). Manufacturers Hanover Corporation, Mellon Bank Corporation, Ford Motor Credit Corporation, and General Electric Capital Corporation all have issued bonds with credit sensitive provisions in their respective indentures. *Id. See supra* note 136-39 and accompanying text (explaining credit sensitive provisions).

150. *See* Light, *supra* note 44, at 79 (contending that covenants that protect bondholders severely limit management's flexibility to restructure company).

151. *See* Bratton, *supra* note 39, at 162 (discussing debtor corporation's need to manage assets without creditor interference); Vlahakis and Nussbaum, *supra* note 37, at 63 (noting that tension between restrictive financial covenants and business flexibility has made some issuers shy away from contractual provisions).

152. *See* Herzel & Shepro, *supra* note 68 (concluding that management can obtain alternative benefits by placing protective covenants in indentures).

153. *See id.* (concluding that bondholders have to pay price for protection in bonds). Safer bonds pay lower interest rates. *Id.* The increased price for bonds containing protective covenants has not reduced the demand for protective covenants. *Id.* From January 1989 to June 1989, bond investors purchased $14 billion worth of bonds containing protective covenants, almost as much as bond investors purchased in all of 1988. Light, *supra* note 44, at 78.

154. *See* Lehn, Blackwell, *supra* note 17, at 185 (asserting that bondholders pay price for protective covenants by receiving lower interest rates on bonds).

155. *See* McDaniel, *supra* note 16, at 209 (contending that many investors accept bondholder losses caused by LBOs as inherent investment risk).

action, albeit judicial, legislative or regulatory, to alleviate bondholder losses.[156] Bondholders, however, should not receive protection for which they did not bargain simply because LBOs cause bond values to drop.[157] Bondholders who deal with corporations should be able to protect bondholders' interests.[158] Neither a governmental agency nor a court should alter an indenture that bondholders accepted by providing added protection to the bondholders.[159]

One commentator also criticizes the effectiveness of explicit protective covenants because such provisions do not cover every conceivable contingency.[160] Many investors believe that management hires skilled counsel to obfuscate the intended effects of any protective language in an indenture.[161] While creating the perfect contract is impossible, protective covenants can protect bondholders from LBOs.[162] Judge Walker in *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.* repeatedly referred to the original MetLife-RJR indentures that contained restrictive covenants which would have protected MetLife had the covenants been in effect at the time of the RJR takeover.[163] In fact, after RJR accepted KKR's buyout offer, holders of some RJR bonds demanded that RJR buy back almost $500 million of the bondholders' bonds because RJR had incurred such a large amount of LBO-generated debt.[164] The indentures governing these bonds contained

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156. *See id.* at 237 (contending that contractual remedy does not effectively protect bondholders in event of LBO); H. Kamen, Remarks at Meeting of American Bar Association on the Impact of LBOs on Debtholders and Other Corporate Constituencies (1989 Honolulu) (same); *supra* notes 70-132 and accompanying text (describing possible governmental solutions to bondholder losses caused by LBO).

157. *See* Bratton, *supra* note 39, at 145 (asserting that law should not compensate "irrational" bondholders who fail to protect themselves by buying bonds with protective covenants); Robertson, *supra* note 2, at 466-67 (stating that rational bondholders are aware of dangers of company issuing more debt and can obtain contractual protection against this type of management activity).

158. *See* Bratton, *supra* note 39, at 101 (contending that idea of bondholder self-protection dominates real world corporate debtor-creditor relationships).

159. *See id.* at 110 (asserting that legal intervention to protect creditor rarely is justified). Bratton contends that, prior to insolvency, the law holds to a policy of non-intervention in the debtor-creditor relationship. *Id.* at 102.

160. *See* McDaniel, *supra* note 16, at 235 (contending that indenture never can be complete because indenture cannot contain covenants that cover every contingency).

161. *See* Longa, *UAL Shares Soar But Bonds Sink on Possible Takeovers*, REUTERS, Aug. 11, 1989 (describing many investors' belief that highly paid lawyers can interpret special legal covenants to benefit of corporation and to detriment of investors); Farrell, *Takeovers and Buyouts Clobber Blue Chip Bondholders*, BUS. WK., Nov. 11, 1985, at 114 (quoting statement of Drexel Burnham, Lambert, Inc.'s CEO Fred Joseph that, "There's no protective covenant that a good lawyer can't get around.").

162. *See infra* notes 164-67 and accompanying text (noting that holders of RJR Swiss bonds had effective protective covenants that shielded holders from risks of RJR takeover).

163. *See supra* notes 67-68 and accompanying text (describing RJR-MetLife indentures that would have protected bondholders from LBO).

164. *See* Dazzo, *Court Order Blocks RJR Nabisco Buyout In Responses to Lawsuit by Swiss Investors*, THE BOND BUYER, May 20, 1989, at 3 (describing efforts by holders of RJR Swiss-Franc bonds to sell bonds back to RJR because RJR incurred LBO-related debt).

provisions allowing the bondholders to put the bonds back to RJR if RJR reorganized.[165] Instead of exercising the put option, the bondholders and RJR, as a result of negotiations, took out letters of credit to assure the bondholders that RJR had sufficient equity to maintain RJR's payments on the bonds.[166] Despite the bondholders' decision to refrain from exercising the put option in the indenture, the RJR bondholders effectively protected their interests against the consequences of the LBO of RJR.[167]

Investment grade bondholders can protect their bonds from the adverse ramifications of an LBO through contractual provisions.[168] These bondholders do not need, nor do they deserve, legislative or regulatory protection.[169] Protective covenants, such as poison puts and credit sensitive provisions, allow bondholders to avoid the consequence of an LBO decreasing the value of bonds.[170] Poison puts negate the debilitating effects of an LBO by allowing bondholders to sell bonds back to the issuer at a pre-LBO price if the LBO decreases the value of the bonds.[171] Credit sensitive provisions enable bondholders to retain bonds and possibly profit from an LBO by requiring the issuer to raise the interest rate on the bonds to reflect the increased risk of the newly leveraged surviving company.[172] As a cost of obtaining a more protective indenture, bondholders undoubtedly will have to accept lower yields from the bonds and pay a higher price for the bonds.[173] Individual bond investors will bear an additional burden because, as outsiders to the negotiations of the indenture, individual bondholders cannot demand that the indenture contain protective covenants.[174] Individual bond investors thus should purchase solely from issuing companies that already provide contractual protection in the indenture.[175] Protective cove-

165. *See, e.g.*, Winkler, *Two Underwriters Demand RJR Call Swiss Franc Bonds*, Wall St. J., Feb. 7, 1989, at C1, col. 3 (describing protective covenants in indenture that allowed bondholders to put bonds back to RJR); *Swiss Investors Create Hurdles for RJR*, BONDWEEK, March 27, 1989 (same); Fanning, *Bonds that Bind*, FORBES, May 1, 1989, at 48 (same).

166. *See* J. Grundfest, Remarks at Meeting of American Bar Association on the Impact of LBO's on Debtholders and Other Corporate Constituencies (1989 Honolulu) (describing RJR's actions to appease RJR bondholders who were irate over LBO of RJR).

167. *See id.* (asserting that RJR's obtaining letters of credit to ensure security of Swiss-Franc bonds proves that contractual provisions can protect bondholders).

168. *See supra* notes 127-67 and accompanying text (describing effective contractual measures by which investors may protect bonds in event of LBOs).

169. *See supra* notes 69-125 and accompanying text (contending that bondholders should not receive governmental protection from LBOs).

170. *See supra* notes 127-67 and accompanying text (contending that protective covenants in indenture can protect bondholders from losses due to LBO).

171. *See supra* notes 128-34 and accompanying text (discussing beneficial aspects of poison puts).

172. *See supra* notes 135-39 and accompanying text (explaining beneficial aspects of credit sensitive provisions).

173. *See supra* notes 152-54 and accompanying text (asserting that bondholders will receive less profit from bonds as compensation for added security of protective covenants).

174. *See supra* notes 146-47 and accompanying text (noting that individual bondholders typically cannot demand that indenture contain protective covenants).

175. *See supra* notes 148-49 and accompanying text (asserting that individual bondholders must buy bonds from companies that include protective covenants in indenture).

nants will prevent both individual bondholders and institutional bondholders from suffering the horrendous losses that may result from an LBO.[176]

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176. *See supra* notes 162-67 and accompanying text (illustrating that protective covenants in indenture can prevent bondholder losses caused by LBO).