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REDEEMING SECURITIES THROUGH EQUITY FUNDING: THE SECURITY HOLDER'S DILEMMA

American corporations seeking to obtain capital for business investments may issue either long-term debt securities or shares of stock.[1] Corporate bonds and debentures are common long-term debt securities.[2] Generally, a corporation offering bonds and debentures for public sale must issue the debt securities under an indenture agreement[3] registered under the Trust Indenture Act of 1939.[4] The indenture agreement contains contractual provisions establishing

1. AMERICAN BAR FOUNDATION, COMMENTARIES ON IDENTURES 1 (1971) [hereinafter cited as COMMENTARIES]. Two types of securities that corporations issue to obtain capital are equity and debt securities. *Id.* The purchase of a share of stock creates an equitable ownership in a corporation. *Id.* An equity security holder has some rights of ownership and control over the corporation. *Id.* Holders of debt securities, however, possess no ownership interest in a corporation. *See id.* Debt security investors merely lend money to a company and receive in exchange a security evidencing the debt. *See id.* at 1-2. The security holder generally expects only periodic interest payments and the eventual return of his principal on the investment. *Id.* at 2. In addition to issuing pure debt and equity securities, corporations also may issue "hybrid securities" that contain both debt and equity features. *Id.* at 522-23. For example, a convertible debenture operates as a debt security but also provides the debenture holder with the right to convert the debenture into other securities, usually shares of stock, in the issuing company at a specified rate of exchange. *Id.*

2. *See id.* at 1. A bond is a long-term debt obligation secured by a mortgage, property lien, or other corporate asset. *Id.* at 7 n.3. Debentures, on the other hand, are unsecured long-term debt obligations. *Id.* Previously, mortgage bonds were a popular form of long-term financing because the mortgage evidenced security for the bond holder. *Id.* at 5. Mortgage bonds, however, are subject to several drawbacks. For example, a company can issue mortgage bonds only to the extent of the company's property. *See id.* at 6. To expand financing opportunities beyond the asset limitations in mortgage situations, companies began to issue debentures unsecured by either a mortgage or a lien. *See id.* at 7. To make debentures attractive to investors, issuing companies included covenants in their contracts with the debenture purchasers to afford protection to the debenture holders' investment and to assure that the issuer met his payment obligations. *Id. See generally* RODGERS, *The Corporation Trust Indenture Project*, 20 BUS. LAW 551 (1965) (general history of mortgage bonds and debentures).

3. *See* J. KENNEDY & R. LANDAU, CORPORATE TRUST ADMINISTRATION AND MANAGEMENT 19 (1975). An indenture agreement is a written document setting forth the rights and obligations of the debt security issuer, security purchaser, and an indenture trustee. *Id.* The indenture agreement designates an indenture trustee, usually a bank, who is responsible for protecting the rights of the debt security holders. *See id.* at 23-24. An indenture usually contains detailed contractual provisions with respect to the terms of interest payments, rights of redemption, and all other agreements affecting the parties' rights. *See id.* at 19-21.

4. 15 U.S.C. §§ 77aaa-77bbb (1982). The Trust Indenture Act of 1939 requires that most debt securities be "qualified" by the Securities Exchange Commission (SEC) before the issuing company may sell the security to the public. *See* Zeffiro v. Pennsylvania Banking and Trust, 623 F.2d 290, 293 (3d Cir. 1980), *cert. denied*, 456 U.S. 1005 (1982). SEC qualification of a debt security occurs when the security's registration takes effect. 15 U.S.C. § 77iii (1982). SEC qualification requires that a company issue a debenture under an indenture, designating a qualified indenture trustee, and the indenture must set forth the statutory substantive duties imposed on the indenture trustee. *See id.* §§ 77jjj-77rrr (1982); *see also Zeffiro*, 623 F.2d at 293. The indenture trustee is responsible for enforcing the indenture agreement in accordance with the terms contained in the agreement. *See* KENNEDY & LANDAU, *supra* note 3, at 27.

the rights and obligations of the security issuer and the security holder.[5] In addition to issuing debt securities, a corporation may issue shares of stock. Corporations issuing stock to raise capital generally classify the stock as either common or preferred.[6] A prospectus accompanying the stock sale usually sets forth any contractual agreements between the stock issuer and the stock purchaser.[7]

A provision present in virtually every indenture or preferred stock agreement[8] provides the issuing company with a right of redemption of the issued security.[9] If the indenture or stock agreement does not contain a provision allowing for redemption, the issuer has no right to redeem the securities prior to their maturity date.[10] A company issuing securities may desire to reserve the option to redeem the securities for various reasons. Redeeming securities before their stated maturity date may allow a company to complete business transactions such as a merger.[11] In times of fluctuating interest rates, the redemption of outstanding securities may end high interest rate payments to security holders that burden the company.[12] The security holder, on the other hand, does not want the issuing company to have unlimited redemption rights.[13] The investor who purchases debt securities or preferred stock bargains for a particular rate of return and would like to assume continued interest payments over an extended period of time.[14]

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5. *See supra* note 3 (indenture contains provisions with respect to rights of security purchaser and security holder); *see also supra* note 4 (indenture contains obligations of indenture trustee).

6. *See* 1 DEWING, FINANCIAL POLICY OF CORPORATIONS 123 (1953). (Corporate stock classified usually as common and preferred).

7. *See* Franklin Life Ins. Co. v. Commonwealth Edison Co., 451 F. Supp. 602, 605 (S.D. Ill. 1978) (prospectus set forth terms of preferred stock contract), *aff'd*, 598 F.2d 1109 (7th Cir.), *cert. denied*, 444 U.S. 900 (1979). A company issuing preferred stock usually amends its articles of incorporation to include the contractual agreements between the company and the stockholders. *See* BALLANTINE ON CORPORATIONS 501 (rev. ed. 1946) (redeemable provisions of preferred stock frequently placed in articles of incorporation to insure public availability of contractual terms).

8. *See* BALLANTINE, *supra* note 7, at 618-19 (stock agreements may permit redemption of preferred shares, but issuing company may not make common stock redeemable at its option).

9. *See* COMMENTARIES, *supra* note 1, at 475-76 (describing redemption provisions in debentures as "customary"); BALLANTINE, *supra* note 7, at 509 (redemption rights of corporations' preferred shares similar to redemption rights of bonds).

10. COMMENTARIES, *supra* note 1, at 475 (debenture issuer has no right to redeem debenture absent specific contractual provisions for redemption); *see* BALLANTINE, *supra* note 7, at 509 (preferred stock contract may include right of redemption to enable issuing company to redeem). Unlike debt securities, preferred stock normally has no maturity date. *Id.*

11. *See* COMMENTARIES, *supra* note 1, at 475 (possibility of merger is one of several reasons why issuing company may reserve privilege of redemption).

12. *See id.* (inability to redeem high interest loan may affect financial strength of issuing company adversely).

13. *See* KENNEDY & LANDAU, *supra* note 3, at 189 (discussing reasons why investor might want to prevent company from redeeming). During a period of fluctuating interest rates, a security purchaser may want to limit an issuing company's right to redeem so that if interest rates decline, the company may not redeem the outstanding securities and issue new securities at a lower rate of interest. *Id.* Such a redemption would force the investor to reinvest at a lower yield. *Id.*

14. *See* COMMENTARIES, *supra* note 1, at 1-2 (investors expect prescribed rate of return).

Agreements affecting an issuing company's rights to redeem its outstanding securities vary considerably. For example, an issuing company may reserve unlimited rights of redemption of its securities.[15] Alternatively, security purchasers could include a provision in their agreement with the issuer that the issuer has no right of redemption for a specific time.[16] A more common agreement between security holders and issuers, however, is a nonrefunding provision which provides that the security issuer may not redeem the outstanding securities with funds borrowed at an interest rate lower than the interest rate that the issuer initially paid on the security.[17] Accordingly, under a nonrefunding provision, the issuer maintains a limited right of redemption through nonborrowed funds while the security holder receives protection against redemption if interest rates fall and the issuer wants to redeem the securities and refinance the debt by issuing securities paying a lower interest rate.[18]

Redemption terms contained in an indenture or stock agreement are contractual and, therefore, courts considering disputes between security holders and security issuers with respect to redemption provisions generally apply contractual principles to resolve the disputes.[19] Thus, a company's right to redeem its outstanding securities will depend on the specific language of the redemption provision included in the issuer's agreement with the security holder.[20] By redeeming securities, an issuing company may violate the security's redemption provision, giving rise to a security holder's claim for breach of contract.[21] Courts considering whether an issuer's redemption of a security violated the security's redemption provision initially must examine the language of the contract.[22] If the language of a contractual provision is ambiguous, a review-

15. *See* Kennedy & Landau, *supra* note 3, at 188 (redemption provision may allow redemption of debt securities at option of company); Ballantine, *supra* note 7, at 509 (corporation may reserve right to redeem preferred shares).

16. Kennedy & Landau, *supra* note 3, at 189 (noncallable provision prohibits issuer from redeeming security for certain period of time).

17. *Id.; see* Commentaries, *supra* note 1, at 477 (nonrefunding provisions common in indenture agreements). The American Bar Foundation Model Debenture Indenture contains suggested language for a nonrefunding provision qualifying a company's option to redeem its securities. *Id.* at 483. The Model Debenture Indenture provides that, ". . . the Company may not, however, redeem any of the Debentures pursuant to such option prior to . . . directly or indirectly from or in anticipation of money borrowed having an interest cost to the Company . . . of less than ___ %."

Id. at 483-84. *see infra* notes 33, 67, & 99 (nonrefunding provisions focus of litigation).

18. Commentaries, *supra* note 1, at 477, *see supra* note 13 (security purchaser desires protection against redemption during period of fluctuating interest rates).

19. *See* Commentaries, *supra* note 1, at 2 (rights of debt security holders are matter of contract); Kennedy & Landau, *supra* note 3, at 25 (since trust indenture is contract, courts apply contractual principles to relationship between debenture holder and issuer); Ballantine, *supra* note 7, at 501 (rights and privileges set forth in preferred stock contract are contractual).

20. *See* Franklin Life Ins. Co. v. Commonwealth Edison Co., 451 F. Supp. 602, 612-16 (S.D. Ill. 1978) (language of stock agreement determined rights of parties), *aff'd*, 598 F.2d 1109 (7th Cir.), *cert. denied*, 444 U.S. 900 (1979).

21. *See id.* (preferred stockholders argued redemption of stock violated stock's nonrefunding provision).

22. *Id.* at 613.

ing court may resolve the ambiguity against the drafter of the language.[23] An ambiguity exists when the language of a contract permits more than one reasonable interpretation.[24] Mere disagreement over the meaning of a contractual provision, however, does not evidence an ambiguity.[25] When contractual language is clear, a court must enforce the contract as written.[26] A reviewing court may not change the interpretation of clear contractual language to agree with the court's sense of equity in a particular case.[27] To interpret correctly contractual language, a reviewing court must examine fully the precise wording of a contractual provision to give meaning to all of the terms within the provision.[28] The precise language of redemption provisions in indenture agreements and stock contracts, therefore, determines the redemption rights of the issuing company and the security holders.[29]

The language of a nonrefunding provision in a preferred stock contract governed the disposition of a breach of contract claim in *Franklin Life Insurance Co. v. Commonwealth Edison Co.*.[30] In *Edison*, the plaintiffs[31] purchased a portion of the Commonwealth Edison Company's (Edison or Company) issue of cumulative prior preferred stock.[32] A prospectus accompanying

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23. *See* 4 WILLISTON ON CONTRACTS § 621 (3d ed. 1961) (courts generally interpret contract language against party drafting language).

24. Harris v. Union Elec. Co., 622 S.W.2d 239, 247 (Mo. App. 1981) (ambiguity present if court can find more than one reasonable interpretation from contract language).

25. *See id.* (disagreement between issuing company and bond purchasers over meaning of bond provision did not make provision ambiguous).

26. Broad v. Rockwell Int'l Corp., 642 F.2d 929, 947 (5th Cir.) (court must enforce clear language of contract), *cert. denied*, 454 U.S. 965 (1981).

27. *Id.* (court may not rewrite contract when language is clear).

28. WILLISTON, *supra* note 23, at 731; *see, e.g.*, Thomas Hoist Co. v. William J. Newman Co., 365 Ill. 160, 166, 6 N.E.2d 171, 174 (1937) (court determined meaning of construction contract by giving effect to every clause and word in contract); Yamnitz v. Polytech, Inc., 586 S.W.2d 76, 80 (Mo. App. 1979) (court determined intent of parties to warranty contract by giving meaning to all contractual terms).

29. *See* Morgan Stanley & Co. v. Archer Daniels Midland Co., 570 F. Supp. 1529, 1542 (S.D.N.Y. 1983) (wording of indenture agreement permitted issuing company to redeem debentures); Franklin Life Ins. Co. v. Commonwealth Edison Co., 451 F. Supp. 603, 613-16 (S.D. Ill. 1978) (language of stock agreement allowed issuing company to redeem preferred stock). *aff'd* 598 F.2d 1109 (7th Cir.), *cert. denied* 444 U.S. 900 (1979).

30. *See* Franklin Life Ins. Co. v. Commonwealth Edison Co., 451 F. Supp. 602, 613-16 (S.D. Ill. 1978), *aff'd*, 598 F.2d 1109 (7th Cir.), *cert. denied*, 444 U.S. 900 (1979).

31. *Id.* at 604. In *Franklin Life Ins. Co. v. Commonwealth Edison Co.*, the plaintiff Franklin Life Insurance Company filed suit against the Commonwealth Edison Company (the Company), individually and as representative of a class of preferred stockholders. *Id.* The Teacher Retirement System of Texas, purchasers of a significant number of the Company's preferred shares, later intervened. *Id.* at 605.

32. *Id.* Cumulative prior preferred stock is a special type of preferred stock providing that if the issuing company is unable to make interest payments to the preferred stockholders during any payment period, the company must pay any unpaid interest in subsequent payment periods before the company may declare any dividends for common stockholders. *See* BALLANTINE, *supra* note 7, at 505 (preferred stock dividends may be cumulative); DEWING, *supra* note 6, at 137 (cumulative preferred stock implies payment of lapsed interest payments to preferred stockholders before dividend payments to common stockholders).

the sale of the preferred stock stated that the issuer could not "redeem through refunding" the preferred stock by incurring debt if that debt had an interest cost to the Company less than the interest rate the issuer currently paid to the holders of the preferred stock.[33] Apart from the limitation of the nonrefunding provision, Edison maintained the option of redeeming any or all of the outstanding shares of preferred stock at any time, subject to the Company's payment of a premium to the preferred stockholders in the event of early redemption.[34] Because of the stock's high rate of interest and relying on the nonrefunding provision, the plaintiffs purchased the preferred stock.[35] The preferred stock prospectus also contained an economic forecast for the Company.[36] The forecast explained that Edison planned significant borrowings in addition to its preferred stock issuance to finance an expansive construction program.[37] In particular, the Company planned to raise a large portion of the funds needed for its construction program by issuing additional securities.[38]

Edison believed from the time it issued the preferred stock that the language of the nonrefunding provision did not prohibit the redemption of the preferred stock from the proceeds of a sale of common stock.[39] Accordingly, within two years following the sale of the preferred stock, the Company sold common stock and redeemed the preferred stock.[40] The plaintiff stockholders sued the

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33. *See Edison*, 451 F. Supp. at 605. The nonrefunding provision in *Edison* provided that:

> Prior to August 1, 1980 [ten years after issuance], none of the 9.44% Prior Preferred Stock may be redeemed through refunding, directly or indirectly, by or in anticipation of the incurring of any debt or the issuance of any other stock ranking prior to or on a parity with the Prior Preferred Stock, if such debt has an interest cost to the Company (as defined), or such shares have a dividend cost to the Company (as defined), less than the cost to the Company of the 9.44% Prior Preferred Stock.

Id.

34. *Id.* In *Edison*, the Company contracted to pay to preferred stockholders a premium at a varying rate depending on when the Company redeemed the preferred stock. *Id.* When a company issuing securities desires to reserve a right to redeem the securities prior to the securities' maturity date, the company generally must pay a premium for the privilege. *See* COMMENTARIES, *supra* note 1, at 477.

35. *Edison*, 451 F. Supp. at 605.

36. *Id.*

37. *Id.* In the Company's economic forecast, Edison predicted borrowing $2,225,000,000 over a five year period following the issuance of the plaintiffs' preferred stock. *Id.* The Company planned to obtain $1,150,000,000 of the debt through the issuance of additional securities. *Id.*

38. *Id.*

39. *Id.* at 606. The Company in *Edison* believed that its ability to redeem the outstanding preferred stock through the issuance of common stock did not depend on its plans to borrow funds for the Company's construction program. *Id.* A Company witness, an executive in an underwriting firm, testified at trial that indenture provisions contain nonrefunding provisions to prevent companies from redeeming securities by issuing low-interest bonds and not to restrict a company's right to redeem outstanding securities through the issuance of common stock. *Id.* at 609.

40. *Id.* at 606. Within the year following the sale of the preferred stock, the Company in *Edison* held its annual meeting. *Id.* A proxy statement the Company published for the meeting contained statements addressing the possibility of the Company redeeming its preferred stock by issuing common stock. *Id.* In the proxy statement, however, the Company declared that it had no definite plans to make a redemption at the time of the proxy statement. *Id.* Additionally,

Company claiming that the redemption of the preferred stock with the proceeds of a sale of common stock violated the preferred stock contract's nonrefunding provision.[41] The plaintiffs believed that the nonrefunding pro-

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at Edison's annual stockholders' meeting a Company spokesman stated that the Company planned to refund the outstanding preferred stock. *Id.* One year later, the company issued common stock and redeemed the preferred stock. *Id.*

41. *Id.* at 604. In addition to the breach of contract claim in *Edison*, the plaintiffs alleged that the Company violated §§ 11 and 17 of the Securities Act of 1933. *Id. See* 15 U.S.C. §§ 77k, 77q (1982). The plaintiffs also claimed that the Company violated § 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 promulgated thereunder, when the Company sold and redeemed the preferred stock. *Edison*, 451 F. Supp. at 604, 607; *see* 15 USC § 78j(b) (1982) (§ 10(b) of Securities Exchange Act of 1934); 17 C.F.R. § 240.10b-5 (1983) (text of rule 10b-5). Specifically, the plaintiffs alleged that a reading of the redemption provision contained in the prospectus accompanying the stock sale, in conjunction with Edison's forecast of additional borrowing to finance construction, gave the plaintiffs the impression that the Company could not redeem the preferred stock for a 10 year period following the stock's issuance. 451 F. Supp. at 606. The plaintiffs in *Edison* argued that the Company should have disclosed to investors, before the preferred stock issuance, both the Company's belief that it could redeem its preferred stock by issuing common stock and the Company's plan to redeem the preferred stock when economically feasible. *Id.* at 607. Because the Company failed to disclose its redemption intentions before the preferred stock's issuance, the plaintiffs argued that the Company misled the stockholder in violation of the federal securities laws by failing to clarify the Company's understanding of the redemption terms to the preferred stockholders. *See id.* The plaintiffs also contended that following the preferred stock's issuance, the defendant knew that the stockholders and the general investment community did not realize that the Company believed it could redeem its preferred stock by issuing common stock. *Id.* at 610. Since the Company continued to fail to disclose to the public its redemption intentions after the preferred stock's issuance, the plaintiffs argued that the Company recklessly failed to disclose material information and schemed to defraud the stockholders in violation of rule 10b-5. *Id.* at 610 n. 10.

Although the plaintiffs in *Edison* alleged several securities laws claims, the *Edison* court examined only those allegations under rule 10b-5 promulgated pursuant to § 10(b) of the Securities Exchange Act of 1934. *Id.* at 607. The court reasoned that §§ 11 and 17 of the Securities Act of 1933 either were coterminous with rule 10b-5 or provided a stricter standard for recovery than under rule 10b-5 so that a rejection of plaintiffs' rule 10b-5 claim necessarily would dispose of the other securities claims. *See id.* at 607 n. 1.; 15 U.S.C. § 77k (1982) (§ 11 of Securities Act of 1933 providing civil liability for false registration statement); § 77q (§ 17 of Securities Act of 1933 prohibiting fraudulent offer or sale of security through instrumentalities of interstate commerce); 17 C.F.R. § 240.10b-5 (1983) (rule 10b-5).

The *Edison* court separately considered the plaintiffs' rule 10b-5 claims with respect to the Company's duty to disclose its redemption intentions both before and after the preferred stock's issuance. 451 F. Supp. at 607. Initially, the court considered the plaintiffs' claim that the defendant should have disclosed, at the time of issuance, its beliefs regarding the preferred stock's redemption provision. *Id.* at 608. Although the court doubted that the Company had a duty to disclose the Company's opinions and beliefs under rule 10b-5, the court determined that the Company, in failing to disclose its beliefs concerning its redemption rights, had not acted with the requisite intent to deceive under rule 10b-5. *Id.* at 609; *see* Ernst and Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976) (defendant must act with scienter, which is "mental state embracing intent to deceive, manipulate or defraud" under rule 10b-5). The *Edison* court next addressed the plaintiffs' claim that the defendant learned after the preferred stock's issuance that the investment community and the plaintiffs were not aware of the defendant's plans to redeem and yet the Company still failed to disclose the redemption information. 451 F. Supp. at 609. The court determined that a Company proxy statement and a statement that a Company vice-president made at the Company's annual meeting were adequate to meet the Company's duty to disclose material information regarding its securities. *See id.* at 610-11.

As the holding in *Edison* exemplifies, a security holder seeking to establish that an issuing

vision, coupled with the Company's plans for significant borrowings to finance its construction program, prohibited the Company from redeeming the preferred stock.[42] The plaintiffs reasoned that as long as Edison was a "net borrower," borrowing more funds than it repaid, any redemption of the preferred stock would be "in anticipation of" incurring new debt having a lower interest rate than the rate the Company currently paid on the preferred stock.[43] Since Edison planned to borrow extensively for its construction program, it would have to replace the funds it used to redeem the preferred stock with additional funds that the Company could borrow at a lower interest rate.[44] The plaintiffs argued, therefore, that Edison's redemption of the outstanding preferred stock through the issuance of common stock violated the preferred stock contract's nonrefunding provision.[45]

Edison argued that the preferred stock's nonrefunding provision stated only that the Company could not redeem the preferred stock "through refunding."[46] Edison contended that this language prohibited the redemption of the preferred stock through low-cost borrowing, but did not prohibit the redemption of the preferred stock through the sale of common stock.[47] Edison reasoned that the issuance of common stock is not a refunding operation and that the preferred stock contract's redemption provision only prohibited the redemption of the preferred stock through refunding.[48]

To resolve the contract dispute, the United States District Court for the Southern District of Illinois examined the language of the preferred stock contract's nonrefunding provision.[49] Because a court construing a contract must try to give meaning to all of the contractual terms, the *Edison* court closely examined the language of the nonrefunding provision which provided that the Company could not redeem the preferred stock "through refunding."[50]

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company violated federal securities laws must establish that the company did not make an adequate disclosure and that even if the disclosure was inadequate, the issuing company acted with scienter. *See id.* at 608-09. Thus, any securities law claims that a security holder may have against a company redeeming securities will depend on what disclosures the company made and a factual determination of whether the issuing company acted with scienter in failing to disclose information.

42. 451 F. Supp. at 606. The plaintiff in *Edison* reasoned the prohibition on the redemption of the preferred stock extended to August 1, 1980, ten years after the preferred stock's issuance. *See id.; supra* note 33 (language of preferred stock's nonrefunding provision).

43. *See* 451 F. Supp. at 608.

44. *See id.* To finance a part of its construction, the Company in *Edison* issued short and long-term debt instruments at an interest rate of less than the interest rate payable on the preferred stock. *Id.* at 606.

45. *See id.* at 612-13. The plaintiffs in *Edison* argued that the sale of common stock was "in anticipation of" incurring new debt and, therefore, violated the preferred stock contract's nonrefunding provision because the Company could foresee borrowing funds at a lower interest rate than the rate payable on the preferred shares. *See id.*; *supra* note 33 (containing language of nonrefunding provision).

46. *See* 451 F. Supp. at 613-14.

47. *See id.*

48. *See id.* The Company in *Edison* reasoned that refunding involves incurring new debt to repay old debt, so that the issuance of common stock, involving the sale of an equitable interest in the corporation, would not constitute refunding. *See id.*

49. *See id.* at 612-15; *supra* note 33 (text of nonrefunding provisions).

50. *See* 451 F. Supp. at 613-15.

The court reasoned that this limiting language prohibited the Company's preferred stock redemption only if the Company obtained the funds necessary for the redemption through a refunding operation by which the Company incurred debt.[51] The *Edison* court agreed with the Company's conclusion that obtaining funds through a sale of common stock was equity financing, not a refunding operation, and, therefore, redeeming the preferred stock with the proceeds of a common stock sale did not violate the preferred stock's nonrefunding provision.[52]

The *Edison* court's holding may be significant to preferred stockholders faced with an issuing company's pending redemption of outstanding preferred shares. The stockholder must realize that, as the *Edison* court emphasized, an issuing company's right to redeem outstanding preferred stock depends on the language of the stock contract's redemption provision.[53] The *Edison* court based its decision that the Company could redeem its preferred stock through the proceeds of a common stock sale to a large extent on the "through refunding" language of the preferred stock contract.[54] The court added, however, that if the redemption provision had not contained the "through refunding" language, the plaintiffs' "net borrower" argument would have been persuasive.[55]

A preferred stockholder, confronted by an issuing company wishing to redeem the stock by issuing common stock, could argue that unless the nonrefunding provision in the stock agreement contains the "through refunding" language found in the agreement in *Edison*, then the issuing company who is a net borrower of funds, may not redeem the preferred stock by issuing common stock.[56] Accordingly, the stockholders could argue, like the

51. *See id.* at 614. The *Edison* court found support for its reasoning that the nonrefunding provision only prohibited a redemption of the plaintiffs' preferred stock if the Company obtained the funds through a refunding operation in the language of the preferred stock's prospectus which stated that the preferred stock was not redeemable "through certain refunding operations." *Id.* at 615. The court held that the nonrefunding provision only restricted the source of funds that the Company could use to redeem the preferred shares to funds that the Company obtained from a "refunding operation." *Id.* at 614. Additionally, the court noted that the preferred stock's redemption provision set a redemption price of $110 a share if the Company redeemed the stock prior to August 1, 1980. *Id.* at 615. The court reasoned, therefore, that this redemption price evidenced the Company's belief that it could redeem the preferred stock prior to August 1, 1980. *Id.*

52. *See id.* at 616.

53. *Id.* at 613.

54. *See id.* at 613-16; *supra* notes 45-52 and accompanying text ("through refunding" language allowed Edison to redeem preferred stock through common stock sale).

55. 451 F. Supp. at 614. The *Edison* court believed that a distinction existed between redemption in anticipation of debt and redemption through refunding in anticipation of debt. *Id.* If the redemption provision had not contained the "through refunding" language, then the nonrefunding provision might have prohibited the Company's redemption of its preferred stock with the proceeds of a common stock sale because the redemption would have been in anticipation of new debt. *Id.* The court suggested that the preferred stock's nonrefunding provision without the "through refunding" language would have barred redemption when the Company anticipated incurring new low-interest debt. *See id.* The actual redemption provision only prohibited redemption in anticipation of debt if that redemption was "through refunding." *See id.* at 614-15.

56. *See id.* A security holder faced with redemption also could attempt to distinguish *Edison* on the particular facts of the case. The *Edison* court stated that it interpreted the preferred stock

stockholders in *Edison*, that if a company plans significant borrowing, redeeming the preferred stock through the proceeds of a common stock sale would be in anticipation of incurring new debt because the company would have to replace the funds that the company would use to redeem the preferred stock with other funds that the issuing company may borrow at a lower interest rate.[57] Furthermore, the stockholder could argue that nonrefunding provisions should prevent an issuing company from redeeming outstanding securities through low interest borrowing if interest rates decline.[58] A stockholder could contend that allowing redemption with the proceeds of a common stock sale when the issuing company may replace the funds that the company used to

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contract's nonrefunding provision to prohibit redemption only with funds obtained through a refunding operation not merely because the stock contract contained the language "redeemed through refunding" but also because other language in the preferred stock prospectus stated that the stock was not redeemable "through certain refunding operations." *See id.* at 615. The court reasoned that this language limited the method the Company could use to redeem the preferred stock. *See id.* The court further reasoned, however, that this language indicated that the Company considered redemption of the preferred stock prior to 1980 a definite possibility as long as the method of redemption was not a refunding operation that violated the preferred stock contract's nonrefunding provision. *See id.* Additionally, the court realized that the plaintiffs' interpretation of the nonrefunding provisions only made the stock redeemable out of funds with an interest rate greater than the rate currently paid on the preferred stock, or if the Company ceased to be a net borrower of funds so that a redemption would not be in anticipation of incurring new debt. *See id.* The Company could not cease to be a net borrower of funds, however, unless it ended its plans for construction and expansion. *See id.* Since the Company would not borrow high interest money to redeem the preferred stock and undoubtedly would continue its construction program, the court felt the plaintiffs' interpretation of the nonrefunding provision made the stock uncallable for 10 years after issuance. *Id.* The court reasoned that if the Company had intended the preferred stock to be uncallable, the Company would have drafted a nonrefunding provision to that effect. *See id.*

The *Edison* court analyzed the nonrefunding provision considering that since the Company was a public utility, the Company would have to be a net borrower of funds to finance construction necessary to meet a growing demand for power. *See id.* Several other cases resolving disputes over nonrefunding provisions also have involved public utility companies, which because of a demand for continuous construction, traditionally are net borrowers of funds. *See, e.g.,* John Hancock Mut. Life Ins. Co. v. Carolina Power & Light Co., Civil No. 80-6960 (S.D.N.Y. Dec. 21, 1982) (available on LEXIS, Genfed Library, Dist. file) (public utility company allowed to redeem bonds under language of nonrefunding provision in indenture agreement); Harris v. Union Elec. Co., 622 S.W.2d 239, 248-50 (Mo. App. 1981) (public utility company allowed to redeem bonds under language of nonrefunding provision in indenture agreement). A holder of securities in a company other than a public utility might distinguish *Edison*, therefore, by arguing that while high fixed capital costs may assure that a public utility company will be a net borrower of funds, other corporations issuing preferred stock will not be necessarily net borrowers of funds. Investors in unregulated companies, unlike investors in a public utility company, could not expect, in most cases, the issuing company to be a net borrower of funds during the period that the nonrefunding provision is in effect. Therefore, if an issuing company other than a public utility includes a nonrefunding provision, similar to the provision in *Edison*, in a preferred stock contract and seeks to redeem the preferred stock by issuing common stock, the reviewing court should not allow the redemption if the company is a net borrower of funds because the redemption would be "in anticipation of" incurring new debt.

57. *See* 451 F. Supp. at 613-14.

58. *See supra* note 13 (nonrefunding provisions included in security agreement to prevent redemption by low interest money during periods of declining interest rates).

redeem the stock with low interest borrowed funds controverts the purpose underlying nonrefunding provision.[59]

The issuing company, on the other hand, my claim, as the defendant company in *Edison* claimed, that nonrefunding provisions similar to the provision used in *Edison* prevent a company from redeeming outstanding preferred stock through low-cost borrowings, but not through the proceeds of a common stock sale.[60] Accordingly, the company might contend that any nonrefunding provision containing language similar to that in *Edison* assumes that the redemption of the preferred stock may not be "through refunding" whether or not the redemption provision contains that exact language.[61] Furthermore, an issuing company could insist that any policy underlying nonrefunding provisions in general is not relevant. The right of the issuing company to redeem the company's preferred stock depends solely on the stock contract.[62] Therefore, if the language of the stock contract permits an issuing company to redeem its preferred stock, then the court must enforce the language of the contract and allow the company to redeem the stock.[63]

In determining the rights of debt security holders under an indenture agreement, reviewing courts generally apply the same contractual analysis to the indenture agreement as the *Edison* court used in examining the preferred stock contract.[64] Similar to the redemption provision in *Edison*, an indenture agreement's redemption provision may allow the issuing company to redeem debt securities against the wishes and expectation of the security holders.[65] For example, in *Morgan Stanley & Co. v. Archer Daniels Midland Co.*,[66] the Archer

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59. *See id.*

60. *See* 451 F. Supp. at 609; COMMENTARIES, *supra* note 1, at 477 (standard nonrefunding provisions recognize that issuing company may obtain funds from sources other than borrowing to redeem securities); KENNEDY & LANDAU, *supra* note 3, at 189 (nonrefunding provisions prevent redemption from low-interest borrowed funds).

61. *See* KENNEDY & LANDAU, *supra* note 3, at 188 (refunding involves issuance of debt securities); *see also supra* note 17 (language of model nonrefunding provision states that issuing company may not redeem securities with funds borrowed or obtained in anticipation of borrowing).

62. *See Edison*, 451 F. Supp. at 613; *supra* text accompanying notes 19-29 (disputes over redemption provisions are matters of contract). If a company issuing securities under a nonrefunding provision that does not contain *Edison's* "through refunding" language argues that redemption rights are solely dependent on the stock contract, then a reviewing court may conclude that the company may not redeem its outstanding stock with the proceeds of a common stock issuance. *See supra* notes 53-57 and accompanying text (absent "through refunding" language, issuing company arguably could not redeem securities from common stock sale if company contemporaneously is net borrower of funds).

63. *See infra* notes 25-26 and accompanying text (court must enforce clear language of contract).

64. *See* KENNEDY & LANDAU, *supra* note 3, at 25 (since indenture is contract, courts apply contractual principles to analyze indenture).

65. *See* John Hancock Mut. Life Ins. Co. v. Carolina Power & Light Co., Civil No. 80-6960 (S.D.N.Y. Dec. 21, 1982) (available on LEXIS, Genfed Library, Dist. File) (bond redemption allowed through use of special funds that indenture established); Harris v. Union Elec. Co., 622 S.W.2d 239 242-43 (Mo. App. 1981) (indenture created special funds that issuing company used to redeem bonds).

66. 570 F. Supp. 1529 (S.D.N.Y. 1983).

Daniels Midland Company (Archer Daniels) issued debentures under an indenture agreement containing a nonrefunding provision similar to the nonrefunding provision in the preferred stock contract in *Edison*.[67] The plaintiff, the Morgan Stanley & Company, Inc., (Morgan Stanley) purchased some of the debentures believing that the indenture agreement's nonrefunding provision provided protection from premature redemption.[68] Following the debenture issuance, Archer Daniels borrowed extensively by issuing debt securities paying an interest rate lower than the interest rate that it paid on the debentures.[69] Archer Daniels also raised significant capital by issuing common stock[70] and thereafter sought to use the funds that it obtained by issuing common stock to redeem the outstanding debentures.[71]

Morgan Stanley brought an action claiming that the proposed redemption violated the nonrefunding provision of the indenture agreement.[72] Similar

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67. *See id.* at 1539. In *Morgan Stanley & Co. v. Archer Daniels Midland Co.*, the indenture agreement between the debenture issuer, the Archer Daniels Midland Company, and Morgan Stanley & Company, provided that:

> The Debentures may be redeemed, . . ., at the election of the Company, as a whole or from time to time in part, at any time, subject to the conditions and at the Redemption Prices specified in the second paragraph on the reverse side of the form of Debenture hereinbefore set forth; provided, however, that prior to May 15, 1991, the Company may not redeem any of the Debentures pursuant to such option from the proceeds, or in anticipation, of the issuance of any indebtedness for money borrowed by or for the account of the Company . . . if, . . . the interest cost . . . shall be less than 16.08% per annum.

Id. at 1531 n. 1.

A prospectus announcing the debentures' issuance provided that the issuing company could not redeem the debentures "as part of a refunding or as part of a refunding operation by the application, directly or indirectly, of the proceeds of indebtedness for money borrowed which shall have an interest cost of less than 16.08% per annum." *Id.* n. 1.

68. *See id.* at 1533.

69. *See id.* at 1532. The issuing company in *Morgan Stanley* issued debt securities in May 1982, one year following the issuance of the debentures, and issued additional securities in March, 1983. *Id.* at 1530-31. There was a question whether the March 1983 securities were debt instruments, but the *Morgan Stanley* court assumed, for purposes of resolving the plaintiff's application for preliminary injunctive relief, that Archer Daniels' issuance of the securities resulted in the incurring of debt. *See id.* at 1532.

70. *Id.* at 1532. The issuing company in *Morgan Stanley* raised funds through two common stock offerings subsequent to the issuance of its debentures. *Id.*

71. *Id.* In *Morgan Stanley*, Archer Daniels deposited the proceeds of the common stock sales with the indenture trustee, the Morgan Guaranty Trust Company. *Id.* The trustee placed the funds in a special account to redeem the debentures. *Id.* The proceeds of the common stock sale were sufficient to redeem the debentures. *Id.*

72. *Id.* In addition to its claims for breach of contract, the plaintiff debenture holder in *Morgan Stanley* asserted that Archer Daniels violated federal and state securities laws similar to claims that the preferred stockholders made in *Edison. See id.* at 1532-33; *supra* note 41 (explaining *Edison* court's disposition of preferred stockholders' security claims). The court refused to grant the plaintiff preliminary injunctive relief on the basis of the securities claims and also denied the plaintiff's motion for summary judgment on the securities claims. *See* 570 F. Supp. at 1538, 1542-43 (ruling plaintiff failed to show sufficient likelihood of success on merits to entire plaintiff to preliminary injunctive relief and order denying Morgan Stanley's motion for summary judgment on securities claim).

to the plaintiff's argument in *Edison*, Morgan Stanley argued that because of Archer Daniels' significant low-cost borrowing, Archer Daniels' planned redemption of the debentures would be from funds that Archer Daniels obtained in anticipation of incurring debt bearing an interest rate less than the rate that Archer Daniels currently paid on the debentures.[73] Morgan Stanley believed that Archer Daniels' issuance of low-interest debt securities near the time of the redemption call proved that the funds for the redemption, at least indirectly, came from incurring low-cost debt in violation of the terms of the indenture agreement.[74] The plaintiff reasoned that Archer Daniels' proposed use of funds that it obtained by issuing common stock to redeem the debentures constituted a "juggling of funds" that Archer Daniels used to circumvent the indenture agreement's restrictions on debenture redemptions.[75] Morgan Stanley argued, as did the plaintiffs in *Edison*, that the court should not allow a company issuing securities under a nonrefunding provision prohibiting redemption from low cost borrowing, to redeem its outstanding securities from the proceeds of a common stock sale when the issuer contemporaneously borrows funds at a lower rate of interest than the rate the issuer currently pays on the outstanding security.[76]

The United States District Court for the Southern District of New York denied the plaintiff's application for preliminary injunctive relief to enjoin Archer Daniels from redeeming the debentures, ruling that Morgan Stanley failed to prove a sufficient likelihood of success on the merits to entitle the plaintiff to preliminary relief.[77] The court subsequently granted Archer Daniels'

73. *See id.* at 1532-33.

74. *See id.*

75. *Id.*

76. *Id.*

77. *See id.* The *Morgan Stanley* court based its denial of the plaintiff's application for preliminary injunctive relief on three considerations. First, the court noted that in *Edison*, the only decision addressing the issue of the redemption of a security from the proceeds of a sale of common stock, the court construed the language of a similar nonrefunding provision to allow the issuing company to redeem. *See id.* at 1534-35. Second, the court observed that the redemption provision in *Morgan Stanley* was the same as the American Bar Foundation's suggested Model Debenture Indenture language. *See id.* at 1535. COMMENTARIES, *supra* note 1 at 483. (American Bar Foundation suggested Model Debenture Indenture language). The court noted that the Commentaries to the Model Debenture Indenture provisions state that the suggested nonrefunding provision may allow an issuing company to redeem its securities if it obtains funds from sources other than through borrowing. 570 F. Supp. at 1535; *See* COMMENTARIES, *supra* note 1, at 477 (funds issuing company obtains from sources other than through borrowing may be used to redeem securities under nonrefunding provision). Finally, the *Morgan Stanley* court noted that the restrictive language of the nonrefunding provision in the indenture agreement followed broad language granting Archer Daniels a right to redeem its debentures. *See* 570 F. Supp. at 1535. The redemption provision in *Morgan Stanley* also contained a table of redemption prices that Archer Daniels would pay to the debenture holders if Archer Daniels redeemed the debentures. *Id.* at 1531. This table covered the years that the nonrefunding prohibition would be in effect. *See id.* at 1535. The court reasoned that this language supported Archer Daniels' view that Archer Daniels could redeem the debentures while the nonrefunding provision was operative if it did not fund the redemption by or in anticipation of incurring indebtedness. *See id.*

Interestingly, the plaintiff in *Morgan Stanley* did not argue that once a company issuing

motion for summary judgment with respect to the contract claim.[78] The court noted that the language of the indenture agreement's nonrefunding provision was contractual and recognized that reviewing courts should construe language in indenture agreements according to contract principles.[79] While the court noted that the language of the indenture agreement's nonrefunding provision was "virtually identical" to the language of the preferred stock contract in *Edison*, the court held that the language was ambiguous.[80] Morgan Stanley argued that generally a reviewing court will resolve ambiguities in contract language against the drafter of the language.[81] The plaintiff also contended that a reviewing court should attempt to construe all the terms of a contract according to the "plain meaning" of the terms.[82] The court found, however, that these general principles of contract construction did not aid in resolving the dispute with respect to the indenture agreement's nonrefunding provision.[83] The court reasoned that the nonrefunding provision's language had no clear "plain meaning."[84] Additionally, through the contractual language was ambiguous, the court refused to construe the contract against Archer Daniels, the drafter of the language.[85] Since sophisticated bond counsel for both the

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securities under a nonrefunding provision borrows funds at a low rate of interest, then the company never may redeem the securities through equity funding. *See id.* The plaintiff instead suggested that a court reviewing the proposed redemption should consider the magnitude of the debt issuance and its proximity in time relative to the security's redemption call to determine if the issuing company, though it claims to redeem from equity funding, is funding the redemption, at least indirectly, by incurring debt. *Id.* The court reasoned that a case-by-case approach to determine the legality of a redemption transaction would present difficulties for reviewing courts and security holders. *Id.* at 1535-36. The court noted that under a case-by-case approach, a reviewing court would have to declare a redemption transaction unlawful merely if the issuing company appeared to fund the redemption through low-cost borrowing. *Id.* at 1536. Additionally, the court argued that such an approach would leave investors uncertain with respect to when a company could redeem its securities. *Id.*

78. *Id.* at 1542-43.

79. *See id.* at 1538-39; *supra* note 64 (reviewing courts generally apply contractual principles to resolve disputes with respect to indenture agreement provisions).

80. *See* 570 F. Supp. at 1541. While the redemption provision in the indenture agreement in *Morgan Stanley* did not contain the "through refunding" language, the prospectus announcing the debenture sale stated that Archer Daniels could not redeem the debentures "as part of a refunding or as part of a refunding operation" through low-cost borrowing. *See id.; supra* note 67 (text of indenture agreement and prospectus).

81. 570 F. Supp. at 1542; *See* Prescott, Ball and Turben v. LTV Corp. 531 F. Supp. 213, 218 (S.D.N.Y. 1981) (New York follows basic rule that reviewing court must resolve ambiguities in contract against party which drafted the agreement).

82. *See* 570 F. Supp. at 1542.

83. *Id.*

84. *See id.* at 1540-41. The *Morgan Stanley* court reasoned that both the plaintiff's and Archer Daniels' interpretation of the nonrefunding provisions language diluted the meaning of some of the contractual language. *See id.* at 1541. Archer Daniels' interpretation did not give full effect to the "indirectly or directly" "in anticipation of language" in the security agreement. *Id.* Morgan Stanley's interpretation of the nonrefunding agreement did not take notice of the "from the proceeds" and "as part of a refunding operation" language. *Id.; see supra* note 67 (nonrefunding language of indenture and prospectus).

85. *See* 570 F. Supp. at 1542.

underwriters and the issuing company negotiated the indenture terms, the court reasoned that no disparate bargaining power existed between the parties and, therefore, the court could not construe appropriately the contractual language against the drafter.[86] The court accordingly looked to the decision in *Edison* to resolve the contract dispute.[87] The court in *Morgan Stanley* found that the contractual analysis and reasoning in *Edison* was convincing with respect to the meaning of the nonrefunding provision and, therefore, granted Archer Daniels' motion for summary judgment.[88] The court emphasized that since the *Edison* decision preceded Archer Daniels' debenture issuance by several years, bond counsel for all of the parties should have been aware of the ruling in *Edison* in drafting the indenture agreement's nonrefunding provision.[89]

The holding in *Morgan Stanley* granting Archer Daniels' motion for summary judgment, thereby allowing Archer Daniels to redeem its debentures from the proceeds of a sale of common stock, supports but may not extend the holding in *Edison*. The language of the prospectus accompanying the debenture issuance in *Morgan Stanley*, as in the prospectus of the preferred stock issuance in *Edison*, contained language prohibiting redemption "through refunding."[90] Thus, a security holder whose security agreement does not include the "through refunding" language may still argue that the agreement between the security issuer and the security holder does not allow the issuing company to redeem the outstanding security with the proceeds of a common stock sale when the company contemporaneously borrows low-cost funds.[91]

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86. *See id.* at 1541. The court in *Morgan Stanley* agreed that under the circumstances of the case in which the underwriters actively negotiated the terms of the indenture agreement, the underwriter and, therefore, arguably the debenture purchasers, drafted the redemption provision's language. *See id.* at 1541-42; Broad v. Rockwell Int'l Corp., 642 F.2d 929, 947 n.20 (5th Cir.) *(en banc)* (debenture purchaser may stand in shoes of debenture underwriter who negotiated and drafted debentures), *cert. denied*, 454 U.S. 965 (1981).

87. *See Morgan Stanley*, 570 F. Supp. at 1541-42.

88. *See id.* at 1542. Illinois law governed the *Edison* decision and therefore, was not binding on the *Morgan Stanley* court, a federal court sitting in New York and applying New York's substantive law. *Id.* The *Morgan Stanley* court emphasized, however, that the *Edison* case was the only case addressing this nonrefunding provision issue, and that the *Edison* court resolved the dispute by applying universal contract principles. *Id.* at 1533-34, 1540. The court concluded that the *Edison* holding predictably should affect a decision in *Morgan Stanley*. *Id.* at 1541-42.

89. *See id.* at 1541. The *Morgan Stanley* court noted that actual unawareness of the *Edison* decision was irrelevant, since a contract automatically includes the law existing at the time of the contract's formation. *Id.; see infra* note 92 (New York law "presumes" parties had knowledge of law existing at time of contract's creation).

90. *See* 570 F. Supp. at 1535; *compare supra* note 33 (nonrefunding provision in *Edison*) *with supra* note 67 (nonrefunding provision in *Morgan Stanley*).

91. *See supra* notes 55-57 and accompanying text (absent "through refunding" language, security holders' net borrower theory may be persuasive). A security holder faced with a redemption of his securities through equity financing may note that in *Edison* and *Morgan Stanley*, the "through refunding" language appeared only in the prospectus accompanying the security's issuance. *See supra* note 33 ("through refunding" language in prospectus in *Edison*); *supra* note 67 ("through refunding" language in prospectus in *Morgan Stanley*). The reviewing court in each case regarded the prospectus language as a part of the security agreement between the issuing company and the security holder. *See Edison*, 451 F. Supp. at 613 (redemption terms of preferred stock issue part of preferred stock contract). *Morgan Stanley*, 570 F. Supp. at 1542. ("through

If the security agreement does contain the "through refunding" language, then it seems clear that the issuing company may redeem the outstanding securities from the proceeds of a sale of common stock[92] or from other equity financing.[93] The nonrefunding provision still would protect the security holders from a redemption with funds that the issuing company obtains from low-interest borrowing.[94] Thus, the security issuer's right to redeem its securities may depend on the precise language of the security's indenture agreement.[95]

Another case in which the precise language of a nonrefunding provision determined the rights of an issuing company to redeem its securities was *Harris v. Union Electric Co.*[96] In *Harris*, the defendant company issued mortgage bonds under an indenture.[97] The indenture stated that the issuer could not redeem the bonds before maturity, other than through the use of two special funds,[98] with money that the issuer would borrow at an interest rate lower

refunding" language of prospectus part of security agreement). If the "through refunding" language appears only in the prospectus accompanying the original security issue, however, later purchasers of the security would not know that the issuing company could redeem the securities by issuing common stock. Subsequent purchasers of the securities could argue that the security certificate did not contain the "through refunding" language, and thus the issuing company should not be permitted to redeem the securities through a common stock sale. *See supra* notes 55-57 (absent "through refunding" language in security agreement, issuing company may not be able to redeem securities through common stock sale).

92. *See Morgan Stanley*, 570 F. Supp. at 1542. Since both the *Morgan Stanley* and *Edison* decision allowed the issuing company to redeem their respective securities from a common stock sale despite the security agreements' nonrefunding provisions, reviewing courts resolving future disputes over nonrefunding provisions may also allow redemption reasoning that the negotiators of the security agreements' nonrefunding provisions should have been aware of the prior case law. *See* Skandia Amer. Reinsurance Corp. v. Schenck, 441 F. Supp. 715, 724 (S.D.N.Y. 1977) (under New York law, court presumes parties contemplated relevant law in drafting contract).

93. *See Morgan Stanley*, 570 F. Supp. at 1532 . (issuing company may use cash reserves or funds that it obtains from sale of assets, in addition to proceeds of sale of common stock, to redeem securities).

94. *See id.* at 1535. The *Morgan Stanley* court added that the reviewing court must be certain that the funds the issuer uses to redeem outstanding securities, even if the issuer obtains the funds by issuing common stock, do not come indirectly from incurring indebtedness. *See id.* at 1542 n.4. Thus, the court indicated that the court might not allow an issuing company to redeem outstanding securities from a common stock sale and subsequently incur low-cost indebtedness to repurchase the common stock. *Id.* The court reasoned that in such a case the issuing company arguably would have redeemed the stock in anticipation of incurring debt. *Id.* In *Morgan Stanley*, there were no allegations that Archer Daniels planned to repurchase the common stock that it had used to finance the debentures' redemption. *Id.* at 1532-33.

95. *See id.* at 1542.

96. 622 S.W.2d 239 (Mo. App. 1981).

97. *Id.* at 241.

98. *See id.* at 242-44. The issuing company in *Harris v. Union Elec. Co.* tried to redeem bonds that it had issued in 1975 under an indenture agreement that supplemented the bond indenture agreement of 1937. *Id.* at 241-42. The 1975 indenture established an Improvement Fund under which the issuing company had to pay cash to a trustee annually or satisfy the cash payment requirement with property addition credits. *Id.* at 243. The supplemental indenture stated that the trustee should use any cash that the company paid to the trustee to redeem the outstanding bonds at a special redemption price equal to the par value of the bond plus accrued interest. *Id.* Unlike the Improvement Fund, previous supplemental indentures to the original indenture of 1937 had established a Maintenance Fund. *Id.* As with the Improvement Fund, however, the

than the interest rate payable on the bonds.[99] The defendant company planned to borrow money at a low interest rate, place that money in the two special funds, and use the special funds to redeem the bonds.[100] The bondholders argued that the indenture agreement's redemption provision prohibited redemption from low-interest borrowed funds deposited into the special funds.[101] The bondholders sought injunctive and declaratory relief to prevent the bond issuer's redemption plans.[102] The Missouri Court of Appeals studied the language of the indenture agreement's redemption provision and concluded that the prohibition on bond redemptions did not apply to redemptions through the special fund even if the company borrowed money at a low interest rate to deposit into the funds.[103]

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company had to pay cash into the Maintenance Fund or use property addition credits. *Id.* at 244. The 1975 supplemental indenture continued the Maintenance Fund and stated that any cash that the company paid into the Maintenance Fund constituted part of the trust estate. *Id.* The 1975 indenture provided that the company could use cash in the trust estate to redeem outstanding bonds and that such a redemption would be at the special redemption price. *Id.*

99. *See id.* at 242-43. The nonrefunding provision in the supplemental indenture agreement in *Harris* provided that

> . . . Bonds . . . shall not be redeemable at the option of the Company at any time prior to March 1, 1985 (other than by the operation of the Improvement Fund or the Maintenance Fund provided in Article IV of this Supplemental Indenture or pursuant to Section 8 [allowing redemption from funds in trust estate] of Article VIII of the Original Indenture) if moneys for such redemption are obtained by the company directly or indirectly from or in anticipation of borrowings by or for the account of the Company at an effective interest cost . . . of 10.60% per annum.

Id. at 242-43.

100. *Id.* at 242. The issuing company in *Harris* made short-term borrowings of funds at less than 10.6% to deposit into the special funds to redeem the outstanding bonds. *Id.* The issuing company planned to issue a new series of bonds at 10.35% to replace the borrowed funds. *Id.* When the plaintiff bondholders filed suit against the issuing company to prevent redemption, the company withdrew the cash from the Maintenance and Improvement Funds and replaced it with property credits. *Id.*

101. *See id.* at 243.

102. *Id.* at 242.

103. *See id.* at 251. The trial court in *Harris* had granted the plaintiff bondholders' motion for summary judgment holding that the company could use neither the Improvement Fund nor the Maintenance Fund to redeem generally its outstanding bonds. *See id.* at 244. The trial court reasoned that the bonds' nonrefunding provision prevented redemption of the bonds from low-interest borrowings at a cost of less than 10.6%. *Id.* The Missouri Court of Appeals held, however, that the language of the nonrefunding provisions unambiguously allowed redemption of the bonds from Improvement Fund cash or from cash deposited with the trustee, as part of the trustee's estate, to satisfy the Maintenance Fund. *Id.* at 251. Furthermore, the issuing company could use cash held as part of the trustee's estate to redeem at the "special redemption price" of the par value of bonds plus accrued interest. *See id.*

Like the *Harris* court, other courts have recognized the possibility of redeeming bonds through the use of special funds. *See, e.g.*, Hanover Bank v. Commissioner, 369 U.S. 672, 679 (1962) (issuer could deposit idle cash into maintenance fund and redeem bonds); John Hancock Mut. Life Ins. Co. v. Carolina Power & Light Co., Civil No. 80-6960 (S.D.N.Y. Dec. 21, 1982) (available on LEXIS, Genfed Library, Dist. File) (issuing Company could deposit low interest cash into special funds to redeem bonds); Gourielli v. Commissioner, 289 F.2d 69, 74 (2d Cir. 1961) (possibility that issuing company could redeem outstanding bonds with cash deposited into special funds

The holdings in *Edison, Morgan Stanley*, and *Harris* allowing companies with outstanding securities to redeem those securities and thereby frustrate the expectations of the security holders[104] evidence the difficulties a security holder faces in trying to prove that an issuing company's redemption of securities breaches the contract between the security holder and the security issuer. If the language of a security's redemption provision is not ambiguous, a reviewing court must enforce the clear language of the provision.[105] Even if a provision's language arguable is ambiguous, a court construing a contract to give meaning to all the terms of a redemption provision, may allow the issuer to redeem its securities if the company follows the proper procedure.[106] More specifically, if a nonrefunding provision prohibits the redemption of securities "through refunding" in anticipation of debt, then the issuer still may redeem its securities from an equity financing even if the company contemporaneously borrows significant low-interest funds.[107] Because a security issuer's right to redeem its outstanding securities may depend on the precise language of its redemption agreement with the security holders, issuers wishing to reserve the right of redemption must draft redemption or nonrefunding provisions with care.[108] Similarly, underwriters and security purchasers should examine a security's redemption provision, in light of existing law, to be certain they understand under what circumstances the issuer may redeem the securities.[109]

In addition to simple breach of contract claims, a security holder faced with a redemption may raise several other arguments in contract to prevent redemption.[110] For example, the security holder could argue that a security

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affected tax rate); Parnell v. United States, 187 F. Supp. 576, 577 (M.D. Tenn. 1958) (redemption provisions allowing bond redemption from special funds are customary), *aff'd*, 272 F.2d 943 (6th Cir. 1959).

104. *See Morgan Stanley*, 570 F. Supp. at 1533 (plaintiff believed nonrefunding provision provided protection from premature redemption); *Edison*, 451 F. Supp. at 606 (plaintiffs believed nonrefunding provision made stock nonredeemable for 10 years following issuance); *Harris*, 622 S.W.2d at 248 (plaintiff bondholders felt nonrefunding provision in mortgage indenture afforded full protection against low-interest refunding of bonds).

105. *See* Broad v. Rockwell Int'l Corp., 642 F.2d 929, 947 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981) (court must enforce clear language of contract); *see also Harris*, 622 S.W.2d at 244 (although appeals court, like trial court, found indenture agreement was not ambiguous, appeals court's interpretation of contract differed from trial court).

106. *See Morgan Stanley*, 570 F. Supp. at 1541-43 (although court found nonrefunding provision ambiguous, court allowed issuing company to redeem securities).

107. *See id.; Edison*, 451 F. Supp. at 612-15 (issuer able to redeem preferred stock from proceeds of common stock sale).

108. *See Edison*, 451 F. Supp. at 616 (court emphasized that careful drafting could have alleviated need for litigation); *Harris*, 622 S.W.2d at 248 (court stated that if bondholders want absolute protection, security agreement must state clearly those intentions).

109. *See Morgan Stanley*, 570 F. Supp. at 1541 (underwriters and security purchasers must understand that court will interpret contract in light of existing law when contract formed).

110. *See Edison*, 451 F. Supp. at 604 (plaintiffs raised claims under breach of third party beneficiary contract theory, under adhesion contract theory, and under theory of Contra Proferentum).

agreement which allows a company to redeem constitutes an adhesion contract between the security issuer and the security holder.[111] Generally, an adhesive contract is a standardized contract formed between parties of unequal bargaining power containing unconscionable provisions that courts will not enforce as a matter of public policy.[112] A security holder could raise the argument that although the security holder rarely participates in the formulation of the security agreement provisions, the terms of the agreement bind the security holder.[113] Thus, since the security purchaser is in a bargaining position unequal to the issuing company, any unconscionable features of the security agreement should be unenforceable against the security holder.[114] The plaintiffs in *Edison* raised an adhesion contract argument contending that because they did not participate in drafting the preferred stock's redemption provision, the court should support the plaintiffs' interpretation of the provision.[115] While the *Edison* court noted that the Company drafted the nonrefunding provision without negotiating with the stockholders and agreed that unconscionable provisions of contracts between parties of unequal bargaining power are unenforceable, the court found that the preferred stock's redemption provision, in light of the Company's interpretation of the provision, was not unconscionable.[116]

Any security holder advancing an adhesion contract theory must show

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111. *See id.* at 616 (plaintiffs made claims that redemption provision was part of adhesion contract).

112. *See id. See generally* Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943) (general survey of adhesion contracts).

113. *See Edison*, 451 F. Supp. at 613 (although stockholders did not negotiate refunding provision, stock contract bound stockholders); *Harris*, 622 S.W.2d at 248 (bondholders who did not negotiate with bond issuer still bound by indenture terms when bond certificate refers to indenture terms); *see also* Erickson v. Winnebago Indus., Inc., 342 F. Supp. 1190, 1195 (D. Minn. 1972) (anyone accepting stock in Iowa corporation charged with knowledge of articles of incorporation); Rothschild v. Jefferson Hotel Co., 56 F. Supp. 315, 318 (E.D. Mo. 1944) (bondholders charged with knowledge of terms of trust indenture); KENNEDY & LANDAU, *supra* note 3, at 27 (although security purchasers do not bargain for terms of security agreement, it is essential that terms of agreement bind them).

114. *See Edison*, 451 F. Supp. at 616. *But see Morgan Stanley*, 570 F. Supp. at 1541 (sophisticated bond counsel represented both issuer and underwriter so no claim of disparate bargaining power possible).

115. 451 F. Supp. at 616.

116. *See id.* While discarding the adhesion contract theory, the *Edison* court stated that a corollary theory, Contra Proferentum, could aid courts in resolving disputes between security holders and issuing companies with respect to the redemption provisions of security agreements. 451 F. Supp. at 616. Contra Proferentum is a theory of contract construction which establishes that if one party drafts the language of a contract to which the other party assents without truly bargaining, a reviewing court may resolve any disputes against the drafter of the language. *Id.* Contra Proferentum is only helpful, however, to resolve ambiguities in contract language. *Id.*; *see* Hurd v. Illinois Bell Tel. Co., 136 F. Supp. 125, 154 (N.D. Ill. 1955) (court may invoke Contra Proferentum only as "last resort" when all other methods of contract construction fail to resolve ambituities), *aff'd*, 234 F.2d 942 (7th Cir. 1956). The court in *Edison* found that giving meaning to all the terms of the nonrefunding provision resolved any ambiguities and thus dismissed the applicability of Contra Proferentum. *See* 451 F. Supp. at 616. *But see Morgan Stanley*, 570 F. Supp. at 1541 (court found language ambiguous but did not construe against drafter).

that the issuing company's interpretation of the redemption provision is unconscionable and, therefore, a court should not enforce the provision as a matter of public policy.[117] A redemption provision is not unconscionable, however, merely because it allows the issuing company to redeem the outstanding securities.[118] Indeed, some redemption provisions allow an issuing company to redeem the issued securities without limitation[119] and some require the company to redeem.[120] Showing a redemption provision to be unconscionable and void as against public policy, therefore, would be difficult.

Another possible contractual claim that security holders may assert upon redemption of their securities is that the issuer failed to give appropriate notice of the redemption to the security holder. In *Van Gemert v. Boeing Company*,[121] holders of convertible debentures[122] claimed that although Boeing, the issuing company, redeemed its debentures in accordance with the terms of the debenture agreement, the defendant company failed to give reasonable notice of the redemption to the debenture holders.[123] The debentures in *Van Gemert* provided that Boeing could redeem the debentures in accordance with the procedure set forth in the indenture agreement.[124] In addition to setting forth provisions concerning redemption, the indenture agreement contained an explanation of what notice Boeing would give to the debenture holders in case of a redemption call.[125] The notice of redemption would enable the debenture holders to exercise their option to convert their debentures into Boeing common stock before Boeing could redeem the securities.[126] In accordance with

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117. *See Edison*, 451 F. Supp. at 616 (because nonrefunding provision was not unconscionable, plaintiffs could not rely on adhesion contract theory).

118. *See id.*

119. *See supra* note 15 (issuing company may reserve right to redeem preferred stock or debt security).

120. *See* COMMENTARIES, *supra* note 1, at 508-13. Some debt security indenture agreements establish a fund that the indenture trustee may use to redeem outstanding securities. *See id.* Redemption from the fund may be either mandatory or optional. *See id.* Companies also occasionally include compulsory redemption provisions in preferred stock contracts. *See* BALLANTINE, *supra* note 7, at 509. Companies include the provisions often to attract purchasers by providing the purchasers with a right to redeem the preferred stock and thereby assure the purchasers that they will receive a return of principal on their investment. *Id.*

121. 320 F.2d 1373 (2d Cir.), *cert. denied*, 423 U.S. 947 (1975).

122. *See* COMMENTARIES, *supra* note 1, at 522. A convertible debenture is a debt security that the holder may convert into another security of the issuing company, usually common stock. *Id.* Thus, convertible debentures are "hybrid securities" containing features of both a debt and an equity security. *Id.* at 523. *See generally* Katzin, *Financial and Legal Problems in the Use of Convertible Securities*, 24 BUS. LAW. 359 (1969) (overview of convertible securities).

123. *See* Van Gemert v. Boeing Co., 520 F.2d 1373, 1374 (2d Cir. 1975).

124. *Id.* at 1376.

125. *Id.* The indenture agreement in *Van Gemert v. Boeing Co.* provided that if the Boeing Company desired to redeem its debentures, Boeing would have to publish a notice of redemption at least twice in an "Authorized Newspaper" at least 30 days and not more than 90 days before the redemption. *Id.* An "Authorized Newspaper" under the indenture agreement included those newspapers published at least five days a week and generally circulated in Manhattan. *See id.* at 1376 n.6. The indenture also stated that if a debenture holder registered the debenture with Boeing, the debenture holder would receive mailed notice of the redemption. *Id.* at 1376.

126. *See id.* at 1375.

the indenture provisions, Boeing published a notice of redemption in several national newspapers.[127] Several debenture holders failed to see the newspaper notice Boeing published and, therefore, were unable to exercise their conversion rights.[128] The debenture holders brought suit claiming that Boeing provided inadequate notice of the debentures' redemption which deprived the debenture holders of their conversion rights.[129]

The United States District Court for the Southern District of New York held that the defendant company had complied with the notice provisions of the indenture agreement and therefore did not breach its contract with the debenture holders.[130] The Second Circuit reversed, holding that even though Boeing's notice of redemption conformed to the requirements of the indenture agreement, the notice did not apprise adequately the debenture holders of Boeing's intention to redeem the convertible debentures.[131] The *Van Gemert* court found that an implied duty exists in the contract between a debenture holder and issuer requiring the issuer to give the holder reasonable notice of what future notice the company will provide the debenture holders should the company decide to redeem the debentures.[132] In particular, the issuer must explain on the face of the debenture certificate the type of redemption notice the company will provide the holder.[133] The *Van Gemert* court reasoned that if a company does not explain sufficiently what redemption notice the debenture holder may expect, the issuer then must provide actual notice at the time of redemption that adequately informs the debenture holders of the pending redemption so that the debenture holder may have the opportunity to convert the debentures into common stock.[134]

In *Van Gemert*, the debenture certificates did not contain an explanation of what notice the issuing company would give in the event of redemption, but merely stated that the company would give notice in accordance with the terms of the indenture agreement.[135] The Second Circuit held, however, that

127. *See id.* at 1377. The issuing company in *Van Gemert* released the required notice of redemption to the *New York Times, New York Herald-Tribune* and the *Wall Street Journal* as well as to the major wire services. *Id.*

128. *Id.* at 1379.

129. *Id.* at 1374.

130. *Id.* at 1375.

131. *See id.* at 1383-86. The Second Circuit stated that the notice Boeing gave to the debenture holders did conform to the requirements of the indenture agreement. *See id.* at 1383. The court held, however, that the notice was not reasonable or fair to the debenture holders because the notice did not apprise adequately the debenture holders of the pending redemption. *Id.*

132. *See id.*

133. *See id.* The *Van Gemert* court stated that if the issuing company does not give adequate notice on the face of the debenture concerning the type of notice the company will give in the event of a redemption call, the company must inform the debenture holders what redemption notice the company expects to give in "some other way." *Id.* The court did not explain in what other way a company could give notice but it is clear that including the notice only in the indenture agreement would be insufficient. *See id.* at 1383-84.

134. *See id.* The *Van Gemert* court felt that the issuing company had a duty to its security holders to provide notice that would meet an investors' reasonable expectations regarding appropriate notice of the debentures' redemption. *Id.* at 1383.

135. *See id.* at 1376.

placing a notice agreement only in a complicated indenture was tantamount to no notice at all.[136] The court reasoned that the company could not expect unsophisticated investors to send for, read, and understand the indenture.[137] As a result, Boeing should have given the debenture holders actual notice at the time of redemption sufficient to apprise the holders of the pending redemption so that the debenture holders could convert their debentures into common stock of the company.[138] Since the *Van Gemert* court found that Boeing's newspaper notice was insufficient to inform the debenture holders of the redemption call, the court found that Boeing breached its duty to the debenture holders to provide a reasonably adequate notice of redemption.[139]

Relying on *Van Gemert*, the security holder might have several arguments against a company redeeming securities. The security holder could allege a breach of an implied contract to give notice of redemption if the issuing company neither explains the agreement's redemption provision on the face of the certificate evidencing the security nor gives adequate notice of the security's redemption.[140] Secondly, by analogy, a security holder could argue that an issuing company must explain any agreements affecting the security holders' rights on the face of the certificate evidencing the security.[141] Just as the debenture holders in *Van Gemert* successfully argued that the issuing company should have placed notice provisions on the face of the debentures, any security holder could argue that an issuing company must include, on the face of the certificate evidencing the security, explicit statements with respect to the manner

136. *Id.* at 1383.

137. *Id.* at 1383-84.

138. *Id.* at 1384. The *Van Gemert* court noted that Boeing easily could have provided better notice to the debenture holders in several ways. Boeing could have published a more understandable notice of redemption or mailed notice to the debenture holders. *Id.* At the time of redemption, Boeing mailed proxy statements to Boeing security holders regarding an upcoming annual meeting. *Id.* The court reasoned that Boeing could have provided notice of redemption with the proxy materials. *Id.* While the court stated that mailed notice and a more detailed published notice might have been sufficient notice, the court did not explain in detail what notice a company must provide in case of a redemption call. *See id.*; c.f. Kaplan v. Varando, Inc., 341 F. Supp. 212, 216 (N.D. Ill. 1971) (press release in addition to publication satisfied requirement of providing notice of debenture's redemption).

139. *See Van Gemert*, 520 F.2d at 1383.

140. *See id.* The *Van Gemert* court stated that a company issuing securities has a duty to give reasonable notice of a redemption by virtue of the contract between the security issuer and the security holder. *Id.* The duty to give notice of redemption in *Van Gemert* did not arise from a specific contractual provision, but rather was inherent in the contractual relationship between the security issuer and the security holder. *See id.* A purchaser of convertible debentures bargains for a right to convert his debenture into stock of the issuing company so that if the company fails to give the debenture holder reasonable notice of the redemption, the debenture holder will not receive the benefit of his bargain. *See id.* at 1385; *see generally* Note, *Convertible Securities: Holder Who Fails to Convert Before Expiration of the Conversion Period*, 54 CORNELL L. REV. 271 (1969) (remedies for security holder who is unable to convert his securities).

141. *See* KENNEDY & LANDAU, *supra* note 3, at 188 (substantive provision affecting rights of security holders must be in text of security). *But see* Broad v. Rockwell Int'l Corp., 642 F.2d 929, 942 (5th Cir. 1981) (redemption terms only summarized on security itself while issuer places details in indenture agreement); cases cited *supra* note 113 (language of security agreements bound security holders when security certificates referred to terms of security agreements).

in which an issuing company may redeem a security despite any nonrefunding provision.[142] Security holders could rely on the *Van Gemert* court's reasoning that an issuer could not expect an unsophisticated investor to read intelligently indenture provisions regarding notice and, accordingly, contend that an issuer similarly could not expect security holders to discern from redemption provisions in complicated indenture agreements the actual situations in which an issuing company might redeem its securities.[143] The issuing company, therefore,

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142. *See* KENNEDY & LANDAU *supra* note 3, at 188 (substantive provisions affecting rights of security holders must be in text of security). A security holder also may argue that an issuing company should include explicit statements with respect to how redemption provisions operate on the face of a security to satisfy a court-implied contract of good faith. *See* Broad v. Rockwell Int'l Corp., 642 F.2d 929, 957 (5th Cir. 1981). In *Broad v. Rockwell Int'l Corp.*, the Fifth Circuit applied New York law under which every contract contains an implied provision that the parties will act fairly and in good faith. *Id.* A security holder might argue that to deal fairly and in good faith, a security issuer should make clear to the security holders exactly how a company will redeem outstanding securities. For example, on facts similar to *Edison* and *Morgan Stanley*, a security holder could contend that the company should have explained on the face of the preferred stock certificates or the debentures that the company could redeem the securities by issuing common stock. At the very least, the company should include the "through refunding" language, on the face of the security instrument instead of merely in a prospectus accompanying the security issuance. *See supra* note 33 (nonrefunding provision containing "through refunding" language in preferred stock prospectus); *supra* note 67 ("through refunding" language in debenture prospectus). The *Broad* court, however, stated that the mere exercise of a company's contractual rights would not constitute necessarily a breach of an implied convenant of good faith. 642 F.2d at 957. The *Broad* court, discussing *Van Gemert,* reasoned that *Van Gemert* relied in part on the notion of a breach of an implied covenant of good faith. *See id.* (citing *Van Gemert* principle that covenant exists that neither party will act to destroy rights of other party under contract). The court in *Broad* reasoned that in *Van Gemert*, the failure to publish proper notice deprived the convertible debenture holders of one of the fruits of their contract, the right to convert the debentures into common stock. *See id.* The *Broad* court concluded, however, that a security holder could not use an implied covenant of fair dealing to gain more rights than the contract provides nor could an implied covenant change the clear intent of the parties to the contract. *See id.* at 957.

Thus, on the facts of *Edison* and *Morgan Stanley*, the security issuer could contend that the failure to explain how the security's nonrefunding provision operated would not constitute a breach of an implied covenant of fair dealing as the issuers, by redeeming their securities, did nothing to deny the security holders the fruits of their contract. *See Morgan Stanley*, 570 F. Supp. at 1532 (debenture holders received contractual redemption price); *Edison*, 451 F. Supp. at 606 (stockholders received redemption price of par value plus 10% premium). Unlike the debenture holders in *Van Gemert*, the security holders in *Morgan Stanley* and *Edison* arguably received all of their contractual rights. *See Morgan Stanley*, 570 F. Supp. at 1335; *Edison*, 451 F. Supp. at 613-15. *But see Harris*, 622 S.W.2d 239, 242-51 (court allowed issuer to redeem bonds at special redemption price of par value of stock instead of regular redemption price of par value plus premium).

143. *See Van Gemert*, 520 F.2d at 1383-84. In *Harris* for example, the bonds provided that the company could not redeem with low-cost borrowing except through the Maintenance and Improvement Funds. *See Harris*, 622 S.W.2d 239, 242 (Mo. App. 1981). The Maintenance Fund, however, operated under a provision of an old indenture agreement incorporated by reference into the indenture agreement for the plaintiffs' bonds. *See id.* at 242-44. Relying on *Van Gemert*, plaintiff security holders in a situation similar to the security holders in *Harris* could argue that an issuing company could not expect the security holders to read both the indenture agreement for their series of bonds and also all former indenture agreements incorporated by reference.

should make clear on the face of a security certificate exactly how a redemption could operate.[144]

In addition to relying on various contract claims with respect to the contract between a security holder and an issuing company, security holders faced with a premature redemption of securities could assert a contract claim on the basis of a third party beneficiary theory by arguing that a redemption violated the New York Stock Exchange (Exchange or NYSE) listing agreement between the Exchange and the security issuer.[145] In *Edison*, the plaintiffs claimed to be third party beneficiaries of the listing agreement contract between the Exchange and Edison, which Edison allegedly had breached by failing to provide to the security holders appropriate notice of its intentions to redeem.[146] The plaintiffs argued that the NYSE Company Manual interpreting the listing agreement between Edison and the Exchange required Edison to make a general news release when Edison's stockholders voted to increase the number of common shares the Company could sell to the public because this was action which "looked toward" redemption.[147] The *Edison* court found, however, that the Company released information to the press with respect to the Company's possible intentions to redeem, although the wire services did not publish the release.[148] The court found this release adequate to satisfy any duty established by the listing agreement between the Company and the Exchange.[149]

In addressing the plaintiffs' reliance on the listing agreement between the Exchange and the Company, the *Edison* court set forth the requirements that a security holder must satisfy to establish liability under a third party beneficiary theory.[150] Initially, a security holder must show that the listing agreement vests in the security holder third party beneficiary rights.[151] Furthermore, the security holder must show that the issuing company violated the listing agreement.[152]

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144. *See supra* notes 141-42 and accompanying text (issuing company should place provisions that affect security holders substantive rights on face of security).

145. *See, e.g.*, Van Gemert v. Boeing Co., 520 F.2d 1373, 1378-80 (2d Cir. 1975) (debenture holders claimed to be third party beneficiaries of listing agreement); Pittsburgh Terminal Corp. v. Baltimore & O.R.R., 509 F. Supp. 1002, 1015 (W.D. Pa. 1981) (no liability under third party beneficiary theory for issuing company's failure to give notice to convertible debenture holders of dividend payment), *modified*, 680 F.2d 933 (3d Cir.), *cert. denied*, ___ U.S. ___ (1982); Franklin Life Ins. Co. v. Commonwealth Edison Co., 451 F. Supp. 602, 611-12 (issuing company made news release arguably required by listing agreement).

146. *See Edison*, 451 F. Supp. at 611.

147. *See id.* at 611-12. The plaintiffs in *Edison* contended that § A10 of the New York Stock Exchange Manual (NYSE Manual) required any listed company to make a general news release when the company took any action which "looked toward" redemption. *Id.* at 612. The stockholders in *Edison* claimed that the Company anticipated redemption when it decided to issue common stock and, therefore, should have made the required news release. *Id.*

148. *Id.*

149. *Id.*

150. *See id.*

151. *Id.*

152. *See id.* The *Edison* court stated that on the facts of the case the stockholders needed to show that the listing agreement incorporated § A10 of the NYSE Manual, which required

Since the *Edison* court found that the Company made the required news releases and therefore did not violate the listing agreement, the court did not reach the question of whether the listing agreement between the Exchange and the Company vested the security holders with third party beneficiary rights.[153]

In *Pittsburgh Terminal v. Baltimore & Ohio Railroad*,[154] however, the United States District Court for the Western District of Pennsylvania discredited the third party beneficiary theory on the grounds that a listing agreement between the Exchange and a member company issuing securities did not exist for the benefit of the security holders.[155] In *Pittsburgh Terminal*, holders of convertible debentures claimed that the issuing company's failure to inform the debenture holders that the company would pay a dividend on its common stock violated the NYSE listing agreement under which the company sold the debentures.[156] The plaintiffs argued that the defendant company, in accordance with the listing agreement, should have published notice[157] of the proposed dividend to enable the plaintiffs to make an informed investment decision whether to convert their debentures into common stock and receive the dividend or to await redemption.[158] The plaintiffs argued that the issuing company's failure to provide notice of the dividend payment violated the listing agreement between the issuer and the Exchange.[159] The plaintiffs claimed to be third party beneficiaries of the agreement between the issuing company

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a general news release upon action looking toward redemption, and that the Manual required the Company to make a release even if the Company's redemption plans were only tentative. *See id.* The court's finding that the Company made the required release obviated the need to discuss the other requirements. *See id.*

153. *See id.* The *Edison* court concluded that the Company made the news release the NYSE Manual required even though the wire services did not publish the release. *Id.* In contrast, the court in *Van Gemert* indicated that an issuing company would have to publish a news release to satisfy § A10 of the NYSE Manual. *See Van Gemert*, 520 F.2d at 1377, 1378. The *Van Gemert* court found that although the issuing company published notices sufficient to meet the precise requirements of the issuing company's indenture agreement with its bondholders, the release did not satisfy the listing agreement requirements because the release in *Van Gemert* did not detail the rate of conversations and the exact date and time when the conversion privilege would expire. *See id.* at 1378.

154. 509 F. Supp. 1002 (W.D. Pa. 1981), *modified*, 680 F.2d 933 (3d Cir.), *cert. denied*, ___ U.S. ___ (1982).

155. *See id.* at 1015-17. *But see* Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12, 25 (1966) (investors are third party beneficiaries of some provisions of listing agreements and accordingly should have redress for agreements' violations); Note, *Theories of Liability Under Convertible Debenture Redemption Notice Requirements*, 44 FORDHAM L. REV. 817, 832-34 (1976) (investors may have third party beneficiary claims because design of some listing agreement provisions is to protect investors); Note, *Private Actions as a Remedy for Violations of Stock Exchange Rules*, 83 HARV. L. REV. 825, 839-41 (1970) (suggesting third party beneficiary theory valid because parties to listing agreement make agreements for benefit of investors).

156. *See Pittsburg Terminal*, 509 F. Supp. at 1015-16.

157. *See id.* (listing agreement requires stock issuers to publish notice of any action taken with respect to dividends to security holders and Exchange).

158. *See id.* (court held that issuing company gave no notice to the convertible debenture holders of dividend payments).

159. *See id.* at 1014.

and the Exchange, and, accordingly, asserted a private cause of action against the issuing company based on the company's breach of the listing agreement.[160]

The *Pittsburgh Terminal* court held that the debenture holders lacked a private cause of action under a third party beneficiary theory, reasoning that the listing agreement only regulated the relationship between the Exchange and the issuing company.[161] The parties to the listing agreement did not intend to create a third party cause of action in favor of the plaintiff debenture holders.[162] Since the listing agreement only regulated the relationship between the Exchange and the issuing company, the court held that the plaintiffs had failed to establish that the plaintiffs were third party beneficiaries.[163]

While the *Pittsburgh Terminal* court held specifically that the NYSE listing agreement does not provide security holders with third party beneficiary rights, other courts have rendered decisions supporting the possibility that security holders may have a cause of action under a third party beneficiary theory.[164] The decision in *Edison*, for example, indicated that the listing agreement theory was attractive.[165] In *Van Gemert*, the author of the majority opinion stated that he could have based the issuing company's liability on a third party beneficiary theory.[166] Security holders will be able to prevail on the theory,

160. *See id.* at 1015-16.

161. *See id.* at 1016.

162. *See id.* The listing agreement between the New York Stock Exchange (Exchange) and the listed company exists to benefit the Exchange and the listed company. *See* F. ZARB & G. KEREKES, THE STOCK MARKET HANDBOOK 98 (1970). Listing provides the listed company with a means to gain wider recognition in the financial community, broaden the company's base of ownership, and lower financing costs. *See id.* at 92. Listing agreements aid the Exchange by assuring an orderly market for securities. *See id.* at 98. Many of the provisions in listing agreements, however, also aid the investors, such as the requirement that companies annually distribute to security holders financial information concerning the company. *See id.*

163. 509 F. Supp. at 1018 (court held plaintiffs failed to show private cause of action under listing agreement).

164. *See, e.g.*, Weinberger v. NYSE, 335 F. Supp. 139, 143 (S.D.N.Y. 1971) (investor may recover on third party beneficiary theory against national stock exchange if exchange contract created for benefit of investors); Mackubin v. Curtiss-Wright Corp., 190 Md. 52, 57 A.2d 318, 321 (1948) (investor may recover under third party beneficiary theory if he shows he was intended beneficiary of contract). In reaching its decision in *Pittsburg Terminal v. Baltimore & O.R.R.*, the court noted that the NYSE Manual specifically provided that the listing agreement did not give rise to any third party rights so that the debenture holders were not intended beneficiaries of the listing agreement. *Pittsburg Terminal*, 509 F. Supp. at 1016.

165. *See Edison*, 571 F. Supp. at 612.

166. *See Van Gemert*, 520 F.2d at 1382-83 n.19. The author of the *Van Gemert* decision, Judge Oakes, believed that a debenture holder could be a third party beneficiary to a listing agreement between a listed company and the Exchange. *See id.* Judge Oakes contended that debenture holders are creditor beneficiaries of a corporation. *Id.* Since a listed company has a duty to treat its security holders fairly by virtue of the listing agreement contract, Judge Oakes reasoned that the security holders could be third party creditor beneficiaries of the listing agreement and recover for a breach of the agreement. *See id. But see* Mackubin v. Curtiss-Wright Corp., 190 Md. 52, 57 A.2d 318, 321 (1948) (security holder suing for breach of listing agreement as third party beneficiary is not creditor beneficiary); *Theories of Liability, supra* note 155, at 833-34 & n.124 (arguing that security holders may recover under third party beneficiary theory as creditor beneficiaries only when issuing company makes promises to security holder, as opposed to Exchange).

however, only if the security holders can show that they are beneficiaries of the listing agreement.[167]

In addition to asserting breach of contract claims, and depending on the circumstances surrounding a redemption and the type of security outstanding, a security holder may have a claim that the issuing company violated a fiduciary duty to the security holder. While the rights of holders of pure debt securities[168] are a matter of contract, corporations owe equity security holders a duty of fairness and good faith because of the equity security holders' ownership interest in the corporation.[169] Convertible debentures, possessing features of both debt and equity, present questions with respect to whether companies owe fiduciary duties to the holders of the debentures.[170] The existence of a fiduciary duty, however, will not provide necessarily the security holder with any protection against redemption other than that provided by the security contract.[171]

Security holders raised a claim of breach of fiduciary duty in *Broad v. Rockwell International Corp.*[172] In *Broad*, the plaintiffs purchased convertible debentures in the Collins Corporation. Collins merged with the Rockwell International Corporation and, under the terms of the merger agreement, Collins stockholders received cash for their Collins stock.[173] Under a supplemental indenture addressing the effects of the merger on the rights of the convertible debenture holders, the debenture holders received the amount of cash for their debentures that they would have received had they converted their debentures into common stock immediately before the merger.[174] Holders of the convertible debentures brought suit claiming, among other things,[175] that Rockwell breached its fiduciary duty owed to the debenture holders by depriving the

167. *See Pittsburg Terminal*, 509 F. Supp. at 1016 (one requirement of third party beneficiary doctrine is that plaintiff must show drafters of contract intended plaintiff to benefit from contract).

168. *See supra* note 1 (explaining distinction among debt, equity, and hybrid securities).

169. *See* Singer v. Magnavox Co., 380 A.2d 969, 976-77 (Del. 1977) (corporate directors owe high duty of care and good faith to stockholders).

170. *See* Green v. Hamilton Int'l Corp., Civil No. 76-5433 (S.D.N.Y. July 14, 1981) (available on LEXIS, Genfed library, Dist. file) (issuing company owed fiduciary duty to convertible debenture holders); Harff v. Kerkorian, 347 A.2d 133, 134 (Del. 1975) (fiduciary duty owed to convertible debenture holders in special circumstances).

171. *See, e.g.*, St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 562 F.2d 1040, 1055 (8th Cir. 1977) (no breach of fiduciary duty when corporation only acted within its rights under stock contract by repurchasing stock); Ryan v. J. Walter Thompson Co., 453 F.2d 444, 446 (2d Cir.) (stockholders rights under stock contract limited to terms of contract), *cert. denied*, 406 U.S. 907 (1971); Fershtman v. Schectman, 450 F.2d 1357, 1360-61 (2d Cir. 1971) (limited partnership agreement controlled duty), *cert. denied*, 405 U.S. 1066 (1972).

172. 614 F.2d 418 (5th Cir. 1980), *aff'd in part, rev'd in part*, 642 F.2d 929 (*en banc*), *cert. denied*, 454 U.S. 965 (1981). *See generally* Comment, *Corporate Law—Bondholders Rights—Trustee Under An Indenture, Issuing Corporation, and Successor Corporation Did Not Breach Indenture or Fiduciary Duties To Holders of Convertible Subordinated Debentures By Eliminating Bondholders' Conversion Rights Pursuant to a Merger*, 30 EMORY L.J. 1167 (1981) (discussion of *Broad v. Rockwell Int'l Corp.*).

173. 642 F.2d 929, 934. (5th Cir.) (*en banc*), *cert. denied*, 454 U.S. 965 (1981).

174. *See id.* at 936.

175. *See id.* at 932 (debenture holders alleged that Rockwell breached terms of indenture agreement, breached implied convenant of good faith, and violated several federal securities laws).

debenture holders of the option to convert into common stock of either Collins or Rockwell.[176]

The Fifth Circuit[177] assumed that Rockwell owed a fiduciary duty to the holders of the convertible debentures.[178] The *Broad* court noted that while corporations generally owe fiduciary duties to their stockholders, some courts have established the existence of a fiduciary duty that controlling stockholders owe to corporate debenture holders and creditors.[179] The *Broad* court reasoned, however, that the corporation had no duty to expand the rights of the debenture holders beyond the right provided in the indenture contract.[180] Since the court held that Rockwell did not breach the indenture agreement and that the debenture holders received all of the rights owed to them under the indenture agreement, Rockwell satisfied its fiduciary duty obligations.[181]

Applying the *Broad* reasoning, a security holder will be able to establish that a company redeeming securities violated its fiduciary duty to the security holder only if the security holder did not receive his contractual rights due under the indenture agreement.[182] Circumstances could exist, however, in which a corporation acts in accordance with its strict obligations under a security agreement and yet may breach its fiduciary duty to its security holders.[183] For example, in *Green v. Hamilton International Corp*,[184] convertible debenture holders filed suit against the Hamilton International Corporation alleging a

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176. *See id.*

177. *See* 642 F.2d 929 (5th Cir. 1981) (*en banc*), *aff'g in part and rev'g in part Broad*, 614 F.2d 418 (5th Cir. 1980). The United States District Court for the Northern District of Texas in *Broad v. Rockwell Int'l Corp.* considered the plaintiffs' breach of duty claim and held that since Rockwell did not breach the terms of the indenture agreement, the plaintiff debenture holders did not have a claim for breach of fiduciary duty. *See id.* at 939 (explaining district court's holding that Rockwell's compliance with indenture agreement foreclosed claims of breach of fiduciary duty). On appeal of the district court's ruling, a panel of the Fifth Circuit held that the indenture agreement between Rockwell and the debenture holders was ambiguous, presenting a jury question whether Rockwell had acted in accordance with the intent of the parties to the agreement or had breached the agreement. *See* 614 F.2d at 426-29. The panel reasoned that Rockwell could have met its fiduciary duty to the debenture holders if Rockwell either complied with the intent of the parties to the indenture agreement or acted in good faith despite its breach of the terms of the indenture agreement. *See id.* at 430-31. The Fifth Circuit subsequently granted a rehearing *en banc*. Broad v. Rockwell Int'l Corp., 618 F.2d 396 (5th Cir. 1980).

178. *See Broad*, 642 F.2d at 958.

179. *See Broad*, 614 F.2d at 430; *see also* Superintendent of Ins. v. Bankers Life and Casualty Co., 404 U.S. 6, 12 (1971) (under federal law, controlling stockholders owe fiduciary duty to creditors as well as other stockholders); Pepper v. Litton, 308 U.S. 295, 306-07 (1939) (under federal law majority stockholders' obligation of fiduciary duty protects creditors and other stockholders).

180. *See Broad*, 642 F.2d at 918; *supra* note 171 (no duty owed to security holders beyond performance of contract).

181. *See* 642 F.2d at 918.

182. *See supra* notes 148-49 and accompanying text (no fiduciary duty beyond bounds of contract).

183. *See infra* notes 184-202 and accompanying text (fiduciary duty may extend beyond strict limits of contract).

184. Civil No. 76-5433 (S.D.N.Y. July 14, 1981) (available on LEXIS, Genfed library, Dist. file).

breach of fiduciary duty for Hamilton's failure to inform the debenture holders of a possible merger with the Household Finance Corporation.[185] Hamilton had discussed the sale of a subsidiary to Household Finance but negotiations had failed and Hamilton subsequently issued a press release to that effect.[186] The plaintiffs, relying in part on the press release, redeemed their debentures instead of converting them into common stock.[182] Hamilton and Household Finance, however, thereafter decided to merge.[188] After the merger, the value of Hamilton common stock rose significantly.[189]

The United States District Court for the Southern District of New York charged the jury that Hamilton had a fiduciary duty to the convertible debenture holders to make disclosures and correct misleading information to enable the debenture holders to make informed investment decisions.[190] Furthermore, the court stated that failure to divulge material facts that could influence a convertible debenture holder's investment decision would constitute a breach of the company's duty of good faith and fair dealing owed to the debenture holders.[191] After the jury found that Hamilton had breached its fiduciary duty to the debenture holders, Hamilton moved for summary judgment, judgment notwithstanding the verdict, and a new trial.[192] The court denied the motions holding that under Delaware law, holders of convertible debentures, under "special circumstances,"[193] could have a claim for breach of fiduciary duty against the corporation in addition to any other claims arising under the express terms of the indenture agreement.[194] According to the *Green* court, one

185. *Id.*

186. *Id.* In *Green v. Hamilton Int'l Corp.*, the Hamilton Corporation issued a press release stating that Hamilton had broken off negotiations with the Household Finance Corporation with respect to the sale of Hamilton's subsidiary corporation. *Id.* The press release, however, did not explain that Hamilton had ended negotiations partly due to tax problems with the sale, and partly because Hamilton was considering the possibility of a merger. *Id.*

187. *Id.* The plaintiffs in *Green* testified that information concerning a possible merger would have affected materially their decision to redeem. *Id.*

188. *Id.*

189. *Id.* Under the terms of the indenture agreement between the plaintiffs and Hamilton, the plaintiffs in *Green* could have converted their debentures into common stock at $2.25 per share. *Id.* Under the terms of the merger agreement, Household Finance bought Hamilton common stock at $4 per share. *Id.*

190. *Id.*

191. *Id.*

192. *Id.*

193. *See id.* In addressing the possibility of breach of fiduciary duty claims for convertible debenture holders, the *Green* court relied on *Harff v. Kerkorian*, 324 A.2d 215 (Del. Ch. 1974), *aff'd in part, rev'd in part*, 347 A.2d 133 (Del. 1975). In *Harff*, the Delaware Court of Chancery specifically held that under Delaware law, convertible debenture holders were not equity owners of a corporation and therefore the debenture holders indenture agreement with the issuing company determined the debenture holders' rights. *See* 324 A.2d at 219. The *Harff* court held, however, that under certain "special circumstances" such as fraud, insolvency or a violation of a statute, the rights of convertible debenture holders extended beyond the bounds of the indenture agreements to encompass fiduciary obligations. *See id.* at 222.

194. *See Green*, Civil No. 76-5433 (S.D.N.Y. July 14, 1981) (available on LEXIS, Genfed library, Dist. file). The *Green* court noted that under Delaware law, the fiduciary duty a corporation and its majority stockholders owe to minority stockholders also extends beyond the terms

circumstance in which a convertible debenture holder could raise a fiduciary duty claim is when the issuing company's actions adversely affect the conversion option of the convertible debenture.[195] In such a case, a reviewing court should treat the debenture as in the nature of an equity security and should impose a fiduciary duty on the corporation for the benefit of the debenture holders.[196] The *Green* court reasoned that Hamilton's issuance of a misleading press release affected the debenture holders' conversion option and thus gave rise to a fiduciary duty imposed on Hamilton.[197] The court concluded that if the defendant company violated its fiduciary duty, the jury could find the company liable under the court's special circumstances theory for constructive fraud.[198]

In *Green*, Hamilton, like the issuing company in *Broad*, argued that it

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of the stock agreement. *See* Roland Int'l Corp. v. Najjar, 407 A.2d 1032, 1034 (Del. 1979) (majority stockholders owe duty to minority that majority cannot satisfy always by full compliance with corporate procedures); Singer v. Magnavox Co., 380 A.2d 969, 979-80 (Del. 1977) (controllers of corporation owe fiduciary duty to minority stockholders and may not use position to perpetuate control).

195. Green v. Hamilton Int'l Corp. Civil No. 76-5433 (S.D.N.Y. July 14, 1981) (available on LEXIS, Genfed library, Dist. file).

196. *Id.* The *Green* court noted, however, that an action for breach of fiduciary duty under special circumstances only applied to holders of convertible debentures. *See id.* The court distinguished nonconvertible debenture holders, who the court termed mere creditors of the issuing company, and to whom the issuing company did not owe a fiduciary duty beyond the bounds of the indenture agreement. *Id.*

197. *See id.*

198. *Id.* The defendant company in *Green* argued that any fiduciary duty it owed to the debenture holders only extended to an obligation not to commit common-law fraud. *Id.* The defendant contended that the plaintiffs must show the existence of common-law fraud, including a showing that the defendant company acted with scienter, to establish a claim of breach of fiduciary duty. *Id.* The court in *Green* held that the plaintiffs did not have to prove that the defendant company intentionally breached its covenant to act fairly. *Id.* The court distinguished common-law fraud, which requires proof of scienter, from constructive fraud, which requires only a showing of deceptive action and the existence of a fiduciary duty. *Id.* Since the issuing company in *Green* owed a fiduciary duty to the convertible debenture holders, and since a jury found that the issuing company had not dealt fairly with the debenture holders by publishing a misleading press statement, the court affirmed the verdict that the defendant company breached its fiduciary duty to the debenture holders. *Id.*

The *Green* court's holding that, under Delaware law, a convertible debenture holder may have a claim against an issuing company for breach of a fiduciary duty under a theory of construction fraud, arguably surpasses the holding in *Harff. See id.* In *Harff*, a Delaware court interpreting Delaware law determined that under special circumstances, such as fraud, a convertible debenture holder may have a claim against an issuing company for violation of a fiduciary duty outside the limits of the indenture agreement. *See Harff*, 347 A.2d at 134. The *Harff* court reasoned that declaring a dividend only for the financial benefit of the controlling stockholders was a special circumstance allowing the debenture holders to assert a claim of breach of a fiduciary duty because the controlling stockholders were intentionally looting the corporation. *See id.* The *Harff* court seemed to base its decision to allow a claim for breach of fiduciary duty on the existence of an actual common-law fraud. *See id.* In contrast, the *Green* court was a federal court applying Delaware law. *Green*, Civil No. 76-5433 (S.D.N.Y. July 14, 1981). The court in *Green*, claiming to rely on *Harff*, allowed convertible debenture holders to claim a breach of fiduciary duty by the issuing company based on constructive fraud. *See id.* Thus the federal court in *Green* may have read Delaware law more broadly than would a Delaware court.

had not breached the security agreement between Hamilton and the debenture holders, and thus had not breached a fiduciary duty.[199] The *Green* court distinguished *Broad* on the basis that in *Broad*, the merger did not extinguish the rights of the convertible debenture holders.[200] In contrast, the debenture holders in *Green* did not receive sufficient advance notice of the merger to allow them to convert their debentures into common stock and receive the benefits of an increased stock price.[201] The *Green* court concluded that while the issuing company allowed the debenture holders to exercise the right to convert their debentures into common stock, the issuing company did not treat the debenture holders fairly when the company issued misleading information material to the debenture holders' decision to convert.[202]

To raise a claim of breach of fiduciary duty against an issuing company with respect to the redemption of a security, the security holder first must prove the existence of a fiduciary relationship.[203] While a corporation owes a fiduciary duty to its equity security holders, and possibly to its debt security holders, a corporation may satisfy the duty by allowing the security holders

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199. *Green*, Civil No. 76-5433 (S.D.N.Y. July 14, 1981).

200. *Id.; see supra* notes 173-81 and accompanying text (since debenture holders received same rights as common stockholders, issuing company did not breach either indenture agreement or fiduciary duty).

201. *See* Green v. Hamilton Int'l Corp., Civil No. 76-5433 (S.D.N.Y. July 14, 1981) (available on LEXIS, Genfed library, Dist. file).

202. *Id.* In addition to a possible claim for breach of fiduciary duty against the issuing company, a holder of a bond or debenture issued under an indenture may have a claim of breach of fiduciary duty against the indenture trustee. *See* Broad v. Rockwell Int'l Corp., 642 F.2d 929 (5th Cir.) (*en banc*) (plaintiff debenture holders alleged breach of fiduciary duty against indenture trustee), *cert. denied*, 454 U.S. 965 (1981). In *Broad* the debenture holders claimed that the indenture trustee violated a fiduciary duty by failing to divulge information regarding the merger. *See id.* The plaintiffs claimed first that the Trust Indenture Act of 1939 (Act) created a fiduciary duty for the trustee in addition to the duties specified under the Act. *See id.*.; U.S.C. § 77ooo(a) (1976) (duties of indenture trustee). The *Broad* court dismissed the plaintiffs' claim, holding that the Act creates no duties beyond the specific duties set forth in the indenture agreement. *See Broad*, 642 F.2d at 959; *see also* Browning Debenture Holders' Comm. v. DASA Corp., 560 F.2d 1078, 1083 (2d Cir. 1977) (claim that trustee violated fiduciary duty under Act by failing to negotiate better conversion price for debenture holders held frivolous); 15 U.S.C. § 77ooo(a)(1) (1976) (trust indenture agreement may include provision that trustee has no duties beyond those duties specifically set forth in indenture agreement).

The *Broad* court held, however, that a trustee may be liable for violations of a fiduciary duty under state law. *See Broad*, 642 F.2d at 959. The Fifth Circuit assumed without deciding that under New York law, a trustee may have a fiduciary duty to debenture holders extending beyond the strict bounds of the indenture contract. *Id.* (citing panel's conclusion that trustee did have duties outside contract); *see* Dabney v. Chase Nat'l Bank, 196 F.2d 668, 670 (2d Cir. 1952) (trustee's obligation under New York law exceeds contractual duties and includes fiduciary duties). The *Broad* court reasoned that had the contract been ambiguous, a question would have arisen whether the trustee did all that he could have done to protect the rights of the debenture holders. *Broad*, 642 F.2d at 959. Since the indenture agreement was clear and the debenture holders did receive all of their rights under the agreement, the trustee had not violated his fiduciary duty. *Id.* The court concluded that a trustee has no duty to procure for debenture holders rights that exceed what the holders are due under the indenture agreement. *See id.*

203. *See Broad*, 614 F.2d at 418.

to exercise all of the security holders' contractual rights.[204] In *Green*, the court found a breach of a fiduciary duty because the issuing company materially mislead the convertible debenture holders and thus affected their rights to exercise their contractual conversion rights.[205] With respect to an issuing company's right to redeem its securities, however, if the issuing company reserves in the indenture agreement or stock contract the right to redeem a debt security or preferred stock, then the company's exercise of that right probably will not violate its fiduciary duty to the security holders.[206] In *Edison*, for example, the company merely exercised its contactual rights by redeeming the plaintiffs' preferred stock.[207] While the issuing company undoubtedly owed the stockholders a fiduciary duty, no fiduciary claim was possible because the issuing company's redemption of the preferred stock did not affect the contractual rights of the shareholders.[208] Similarly in *Harris*, even if the issuing company owed a fiduciary duty to its bondholders, redeeming the bonds in accordance with the terms of the bond indenture agreement would not have constituted a breach of a fiduciary duty.[209]

Depending on the facts of the case, a security holder may have several claims against a security issuer when the issuer tries to redeem the securities.[210] If the language of a redemption provision provides the issuer with a right of redemption, however, the holder can do little to prevent redemption.[211] The security holder will not be able to establish an issuer's liability for breach of contract because the issuing company, by redeeming, merely will be asserting its rights under the contract.[212] The security holder also may raise claims under theories of adhesion contract, third party beneficiary, and implied contract.[213] These theories, however, probably will not provide the security

204. *See supra* notes 180-81 and accompanying text (fiduciary duty satisfied if security holders receive all of their contractual rights).

205. *See supra* note 198 and accompanying text.

206. *See Broad*, 642 F.2d at 959 (company may have no liability for breach of fiduciary duty if it complied with obligations under indenture agreement). The plaintiffs in *Morgan Stanley, Edison*, and *Harris*, unlike the plaintiffs in *Green*, did not hold convertible securities. In *Morgan Stanley, Edison*, and *Harris* since the security holders did not have a conversion option, any misleading statements or omissions regarding a redemption of the securities were less likely to affect adversely the security holders' contractual rights.

207. *See supra* notes 49-59 and accompanying text (Edison's redemption did not violate the plaintiffs' stock contract).

208. *See supra* notes 180-81 (fiduciary duty satisfied if security holders receive all their contractual rights).

209. *See id.*

210. *See supra* note 110 and accompanying text (plaintiffs may have claims against issuer for breach of contract and claims under adhesion contract, Contra Proferentum, and third party beneficiary theories); *supra* note 41 (possible claims under securities laws).

211. *See supra* notes 19-29 and accompanying text (since courts apply contract principles to redemption disputes, if contract provides right of redemption then issuer may redeem).

212. *See id.*

213. *See supra* note 110 (claims against issuer under adhesion contract, and third party beneficiary theories); *supra* notes 140-44 and accompanying text (claim under implied contract to give reasonable notice of redemption and to explain redemption rights on face of security).

holder with an adequate basis for a claim unless the security issuer has acted unfairly.[214] The security holder also could make a claim of breach of fiduciary duty against the issuing company.[215] If the security holder received all of his rights under the security contract,however, the security holder will be able to show breach of a fiduciary duty in only limited situations.[216]

The solution to redemption problems lies only in better drafting.[217] If a security holder wants protection from redemption, he must draft the security agreement to reflect those desires.[218] For example, the security agreement could provide that the securities could not be redeemed through refunding or through the proceeds of equity financing. While the security purchaser does not participate in the actual drafting of security agreement provisions, the purchaser may exert influence by refusing to purchase until the contract reads as he desires. Once an investor purchases a security, however, he should be bound by its terms.

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214. *See supra* notes 112-18 and accompanying text (redemption provisions not unconscionable so claims under adhesion contract theory difficult); *supra* notes 145-67 and accompanying text (third party beneficiary theory); *supra* notes 140-44 and accompanying text (implied contract to give reasonable notice of redemption and explain redemption features of security on face of security).

215. *See supra* notes 168-209 and accompanying text (claims against security issuer for breach of fiduciary duty).

216. *See id.; supra* notes 193-97 and accompanying text (special circumstances, including fraud, in which debt security holder may have claim for breach of fiduciary duty outside bounds of contract).

217. *See supra* note 108 (better drafting could reduce litigation over redemption rights).

218. *See id.* To prevent redemption of securities from the proceeds of a sale of common stock, for example, the security purchaser could include in the security agreement with the issuer prohibitions on redemptions through equity financing.