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APPLYING THE FEDERAL RESERVE BOARD'S MARGIN LENDING RULES TO RESTRICT THE USE OF JUNK BONDS IN HOSTILE CORPORATE TAKEOVERS

High yield bonds, more commonly referred to as junk bonds, are high yield, below-investment-grade corporate securities.[1] Junk bonds offer investors a high yield or high rate of return in exchange for exposure to a higher risk of default than the risk of default associated with investment-grade bonds.[2] The below-investment-grade rating assigned to high yield bonds by

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1. *See The Financing of Mergers and Acquisitions: Hearing Before the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs,* 99th Cong., 1st Sess. 246 (1985) (supplemented by Winch and Braucato, Role of High Yield Bonds (Junk Bonds) in Capital Markets and Corporate Takeovers: Public Policy Implications 246, 254-58 (microfiche) (April 20, 1985) (defining and discussing junk bonds)) [hereinafter cited as *Junk Bonds*]; *The Financing of Mergers and Acquisitions: Hearing Before the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs,* 99th Cong., 1st Sess. 371 (1985) (supplemented by Drexel Burnham Lambert, Inc., High Yield Bonds 371, 373-75 (microfiche) (April 24, 1985) (defining and discussing junk bonds)) [hereinafter cited as *High Yield Bonds*]; Joehnk, *An Introduction to Fixed Income Securities,* in THE HANDBOOK OF FIXED INCOME SECURITIES 3, 9 n.6 (1983) (defining and discussing junk bonds); *see also infra* notes 18-29 and accompanying text (same). The term below-investment-grade derives from the ratings assigned to bonds by Moody's and Standard & Poor's, the major bond rating agencies. *See Junk Bonds, supra,* at 254 (discussing bond rating procedure). Moody's and Standard & Poor's assign ratings to corporate bonds based on an analysis of the credit worthiness of the company. *Id.* For example, the bond ratings assigned by Standard & Poor's result from an extensive investigation into not only the financial aspects of a company, but also other key elements of a company's business plan such as the company's objectives, strategies, and policies. *See* Hessol, *Debt Ratings Revisions: Aftermath of Mergers,* MERGERS AND ACQUISITIONS, 42 (1985) (cited in *Junk Bonds, supra,* at 255). Standard & Poor's assesses bonds on a scale descending from AAA to AA to A to BBB to BB to B to CCC to CC to C to D. *See* STANDARD & POOR'S BOND GUIDE, Jan. 1986, at 10 (explanation of bond ratings). A AAA rating designates bonds of the best quality, involving the smallest degree of investment risk. *Id.* At the lower end of the scale, D-rated bonds represent the lowest rated class of bonds. *Id.* Ratings decline with the bond analysts' view of the issuing company's ability to pay interest and repay principal. *See Junk Bonds, supra,* at 254 (explaining bond ratings). Similarly, Moody's Ratings provide investors with a system to evaluate the relative investment qualities of bonds. *See* MOODY'S BOND RECORD, Jan., 1986, at 1 (explanation of bond ratings). The scale of Moody's descends from Aaa to Aa to A to Baa to B to Cac to Ca to C. *Id.* Below-investment-grade bonds are those bonds rated below Baa by Moody's and below BBB by Standard & Poor's. *See Junk Bonds, supra,* at 254 (explaining meaning of bond ratings). Junk Bonds, therefore, are bonds that receive no rating or bonds that receive ratings below Baa from Moody's or BBB from Standard & Poor's. *Id.*

2. *See Introduction, supra* note 1, at 9 n.6 (explaining high yield and high risk exposure associated with junk bonds); *supra* note 1 (explaining that bond's rating is reflective of degree of risk associated with that bond). *See generally* D. DURST, THE COMPLETE BOND BOOK 22-28 (1975) (discussing yield and explaining formulas used in calculating yield). Most of the yield, or return, on junk bonds takes the form of interest payments. *See Latest Developments In Takeovers, Financing Methods Analyzed By Experts,* [July-Dec.] SEC. REG. & L. REP. (BNA) No. 44, 1973 (Nov. 8, 1985) (discussing high rates of return on junk bonds) [hereinafter cited

the major bond rating agencies[3] reflects the bond analysts' doubt concerning the issuer's ability to pay interest and, eventually, repay the principal to the investor.[4] Currently, junk bonds are most visible as a means of financing

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as *Latest Developments*].

Notwithstanding the high risk exposure associated with high yield bonds, studies reveal that, as compared to government or investment-grade bonds, the return on high yield bonds has more than offset high yield bonds' greater risk of default. *See High Yield Bonds, supra* note 1, at 384 (describing high net returns received by investors in junk bonds). For example, Marshall E. Blume and Donald B. Keim conducted a study of the risk and return characteristics of lower-grade corporate bonds for The Wharton School of the University of Pennsylvania. *See The Financing of Mergers and Acquisitions: Hearing Before the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs,* 99th Cong., 1st Sess. 298 (1985) (supplemented by Blume and Keim, Risk and Return Characteristics of Lower Grade Bonds 298, 299 (microfiche)) (Dec. 1984) [hereinafter cited as *Risk and Return Characteristics*]. Blume and Keim observed that during the period from January 1982 through May 1984, the annual rate of return on lower-quality bonds was 20.3% as compared to 15.0% on high-rated AAA bonds. *Id.* at 301-02; *see supra* note 1 (explaining meaning of bond ratings). Blume and Keim, therefore, concluded that from January 1980 through June 1984, in a well-diversified portfolio, lower-quality bonds posed no greater risk than higher-quality bonds. *Risk and Return Characteristics, supra,* at 305. Blume and Keim, however, warned against predicting similar results for the future because of the short time period involved in their study. *Id.*

In addition to the Blume and Keim study, Edward I. Altman, Professor of Finance and Chairman of the MBA Program at New York University, and Scott A. Nammacher, both acting as consultants for the investment banking firm of Morgan Stanley, conducted a study on the default rate of high yield bonds. *See The Financing of Mergers and Acquisitions: Hearing Before the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs,* 99th Cong., 1st Sess. 335 (1985) (supplemented by E. Altman, and S. Nammacher, The Default Rate Experience on High Yield Corporate Debt 335, 335-56 (March 1985)) [hereinafter cited as *Altman Study*]. Altman and Nammacher found that from 1974 to 1984 the default rate on high yield bonds averaged 1.60%. *See Altman Study, supra,* at 337. The Altman Study, however, concluded that although a default rate of 1.60% represents an extremely risky situation, the "returns on low-quality debt portfolios have been very impressive, even after default." *Id.* at 337. Moreover, the Altman study explains further that the actual losses resulting from default are somewhat lower than the default rates simply because defaulted bonds do not become valueless. *Id.; see High Yield Bonds, supra* note 1, at 384 (explaining that default does not mean that bond becomes worthless). Rather than becoming valueless, defaulted bonds traded at an average rate of 41% of par value shortly following default during the 1974-84 period. *See Altman Study, supra,* at 337. *See generally* Yacik, *Roses in the Junkyard,* CREDIT MARKETS, April 8, 1985, at 9 (discussing Altman Study). Additionally, investors in junk bonds often diversify to reduce the risk of default. *High Yield Bonds, supra* note 1, at 385. Through diversification, investors spread the risk of default associated with junk bonds by investing in several different companies. *Id.; see Junk Bonds, supra* note 1, at 263 (noting risk-spreading through diversification); *Risk and Return Characteristics, supra,* at 299 (same).

3. *See supra* note 1 (discussing bond ratings).

4. *See* Joehnk, *supra* note 1, at 9 n.6 (explaining high risk exposure associated with junk bonds). Despite the higher risk of default associated with junk bonds, junk bonds comprise a growing sector of the corporate bond market. *See Latest Developments, supra* note 2, at 1973 (reporting rapidly growing market for high yield securities). *See generally,* Fabozzi and Sauvain, *Corporate Bonds,* in THE HANDBOOK OF FIXED INCOME SECURITIES 297 (1983) (defining and discussing corporate bonds). In addition to straight issues of corporate debt, the high yield market also includes municipal bonds, preferred stock, high premium convertible bonds, and

hostile corporate takeovers.[5] To raise the capital necessary to finance an acquisition, a corporate raider[6] creates a shell corporation[7] to issue debt securities.[8] A shell corporation has no assets or cash flow to service the debt created by the issuance of the high yield debt securities.[9] Consequently, if the corporate raider gains control of the target company, the raider may liquidate the acquired company's assets to pay the high yield to the purchasers of the junk bonds.[10] Although the issuance of high yield debt securities,

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private placements with registration rights. *See High Yield Bonds, supra* note 1, at 376 (describing scope of high yield market). A straight bond, as opposed to a convertible bond, is a bond that an investor cannot convert into another security. *See* A. PESSIN & F. MAITLAND, WORDS OF WALL STREET 249 (1983) (glossary of investment terms). The investment banking firm of Drexel Burnham Lambert, Inc. (Drexel), a leading underwriter of junk bonds, reports that in the eight year period from 1977 through 1984, more than 350 companies issued a total of $36.1 billion of high yield debt. *See High Yield Bonds, supra* note 1, at 378 (discussing growth of high yield market); *see also Few Jitters About Junk Bonds,* FORTUNE, April 29, 1985, at 337 (reporting that in 1984 junk bonds comprised 17% of new corporate bonds issued compared to 3.7% in 1980); *Junk Bonds, supra* note 1, at 274 (noting that Drexel received credit for underwriting 70% of high yield bonds issued in 1984).

The junk bond market consists primarily of institutional investors. *Junk Bonds, supra* note 1, at 273; *see Latest Developments, supra* note 2, at 1973 (reporting that insurance companies and pension funds purchase 65-70% of high yield securities offered). Junk bonds are not a suitable investment for a small individual investor because companies usually issue junk bonds in face amounts of $25,000 to $100,000. *See Junk Bonds Aren't Just For High Rollers,* BUS. WEEK, May 6, 1985, at 141 (describing individuals' role in junk bond market) [hereinafter cited as *High Rollers*]. Individuals, however, can participate in the junk bond market by purchasing shares in mutual funds for as little as $1,000. *Id.; see Junk Bonds, supra* note 1, at 288 (explaining how individuals participate in high yield bond market through mutual funds specializing in junk bonds).

5. *See FED Board Votes 3-2 to Restrict the Use of 'Junk' Bonds in Corporate Takeovers,* Wall St. J., Jan. 9, 1986, at 2, col. 3 (noting popular view of junk bond financing as significant driving force behind current wave of hostile takeovers) [hereinafter cited as *FED Board Votes 3-2*]; *Scrap Over Junk,* TIME, Jan. 20, 1986, at 43 (same); *see also infra* notes 7-11, 27-40 and accompanying text (discussing use of junk bonds in financing of hostile corporate takeovers); *cf.* Stewart and Hertzberg, *The Deal Makers, Investment Bankers Feed a Merger Boom and Pick Up Fat Fees,* Wall St. J., April 2, 1986, at 1, col. 6 (reporting that investment bankers are cause of takeover boom). Investment bankers receive large fees for underwriting junk bonds in a hostile acquisition. *See* Stewart and Hertzberg, *supra* at 1, col. 6; Schwartz, *Junk Bonds III* (pt. 3), INVESTMENT DEALERS' DIGEST, Jan. 27, 1986, at 50 (investment banking fees are high).

6. *See* Williams, *How 'Junk Financings' Aid Corporate Raiders In Hostile Acquisitions,* Wall St. J., Dec. 6, 1984, at 1, col. 6 (attaching term corporate raider to purchasers who seek to acquire companies in hostile takeovers).

7. *See* A. PESSIN & F. MAITLAND, WORDS OF WALL STREET 229 (1983) (defining shell company). A shell company or shell corporation is a corporation usually lacking assets and a legitimate business operation. *Id.; see infra* notes 30-36 and accompanying text (describing creation of and purpose of shell company).

8. *See* Williams, *supra* note 6, at 1, col. 6 (explaining junk financing as takeover tactic); *see also infra* text accompanying notes 26-32 (explaining use of junk bonds to raise capital to finance corporate acquisitions).

9. *See supra* note 7 (defining shell corporation).

10. *See* Rohatyn, *Junk Bonds and Other Securities Swill,* Wall St. J., April 18, 1985, at 30, col. 5 (explaining how target company's earnings and assets become vulnerable as sources

referred to as junk financing, may result in overburdening the acquired company with debt, junk financing permits a corporate raider to borrow 100 percent of the money necessary to finance the takeover of a target company.[11] On January 8, 1986, however, the Board of Governors of the Federal Reserve System (the Board) announced the adoption of an interpretative rule[12] (the rule) restricting the use of junk bonds in the financing of certain corporate takeovers.[13] Specifically, the Board voted to apply the margin lending rules of Regulation G to debt securities issued by a shell corporation to finance the acquisition of a target company.[14] The rule prohibits, in certain situations, shell corporations from issuing junk bonds in an amount that exceeds fifty percent of the purchase price of the target company.[15] The rule, therefore, imposes restraints on the ability of corporate raiders to obtain the financing necessary to take over major companies.[16]

Although the rule applies to junk bonds used in hostile corporate takeovers, junk bonds emerged in the marketplace for a different purpose.[17] The term "junk bonds" referred initially to the bonds of companies that

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of payment of return on junk bonds); *High Rollers, supra* note 4, at 141 (same); Drucker, *Corporate takeovers—what is to be done?*, THE PUB. INTEREST, Winter 1986, at 4 (explaining how hostile takeover forces acquired company to pay for its own execution); *see also infra* notes 27-40 and accompanying text (discussing concern surrounding use of junk bonds to finance hostile corporate takeovers).

11. *See* Williams, *supra* note 6, at 1, col. 6 (explaining junk financing as takeover tactic); *see also infra* text accompanying notes 27-37 (explaining use of junk bonds to raise capital to finance corporate acquisitions); *Junk Bonds, supra* note 1, at 279 (junk financing provides small entities with financial means to take over large companies).

12. *See* K. DAVIS, ADMINISTRATIVE LAW TREATISE § 7:8 (2d ed. 1979) (defining and explaining distinction between interpretative rules and legislative rules). An interpretative rule is a rule issued by an agency without exercising delegated authority to promulgate rules which have the force of law. *See id.;* Chamber of Commerce of United States v. Occupational Safety and Health Admin., 636 F.2d 464, 468 (D.C. Cir. 1980) (defining interpretative rule). A legislative rule, however, results from an exercise of delegated legislative authority to promulgate rules which have the force of law. *See* DAVIS, *supra*, at § 7:8 (defining and explaining distinction between interpretative rules and legislative rules); *Chamber of Commerce*, 636 F.2d at 468 (same). An interpretative rule is an agency's interpretation of an existing statute or rule. Batterton v. Marshall, 648 F.2d 694, 705 (D.C. Cir. 1980). *But see* General Motors Corp. v. Ruckelshaus, 742 F.2d 1561, 1565 (D.C. Cir. 1984) (agency action intended to formulate new law, rights, or duties is legislative rule), *cert. denied*, 105 S. Ct. 2153 (1985). While not binding on a court, interpretative rules provide guidance to agencies by clarifying statutory language. *See Chamber of Commerce*, 636 F.2d at 469 (explaining purpose of interpretative rules).

13. *See* 51 Fed. Reg. 1771 (Jan. 15, 1986) (to be codified at 12 C.F.R. § 207.112); *see also FED Board Votes 3-1, supra* note 5, at 2, col. 3 (interpreting Board's action).

14. *See* FED. SEC. L. REP. (CCH) ¶ 83,952 (Jan. 22, 1986) (discussing rule); 51 FED. REG. at 1771 (same); *see also* 12 C.F.R. § 207.1-207.112 (1985) (margin regulations).

15. 51 Fed. Reg. at 1771; *see Volcker Bends a Bit to Get His Junk Bond Rules*, BUS. WEEK, Jan. 20, 1986, at 25 (interpreting Board's actions); *see also infra* text accompanying notes 41-51 (explaining operation of rule).

16. 51 Fed. Reg. at 1771; *see FED Board Votes 3-2, supra* note 5, at 2, col. 3 (noting that 50% junk financing limit will force raiders to come up with more cash to finance acquisition); *Scrap Over Junk*, TIME, Jan. 20, 1986, at 43 (same).

17. *See infra* notes 18-23 and accompanying text (explaining origin of junk bonds).

entered the marketplace with investment-grade ratings,[18] but later began to experience financial difficulties.[19] As a result of a company's financial troubles, the major credit rating agencies[20] downgraded the company's bonds.[21] The investment community refers to a company whose bonds become downgraded as a fallen angel,[22] and to bonds of the fallen angel as junk.[23] In 1977, however, the investment banking firm of Drexel Burnham Lambert, Inc. (Drexel), introduced a new type of junk bond to the corporate bond market.[24] In 1977, Drexel, as a means of raising capital, began underwriting and trading bonds issued by small, emerging companies that received below-investment-grade ratings because of the companies' lack of a credit history.[25] The bonds issued by these small, emerging companies, like the bonds of the fallen angels, acquired the label junk bonds because of the bonds' below-investment-grade rating.[26] In 1983, Drexel expanded the concept of raising capital through original issues of junk bonds into the realm of corporate takeovers.[27] To avoid the difficulty involved in financing hostile corporate

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18. *See supra* note 1 (explaining meaning of bond ratings).

19. *See High Yield Bonds, supra* note 1, at 373 (explaining origin of term junk bonds).

20. *See supra* note 1 (describing bond rating systems of Moody's and Standard & Poor's).

21. *See High Yield Bonds, supra* note 1, at 373 (explaining origin of term junk bonds).

22. *Id.* During the past five years, Ford Motor, Chrysler, and Montgomery Ward fell into the fallen angel category, but recovered and rose out of the high yield market. *Id.* at 377.

23. *Id.* at 373. The investment banking firm of Drexel Burnham Lambert, Inc. (Drexel), estimates that if all of the United States corporations with assets of more than $25 million applied for an investment rating, 99% of these corporations would receive below-investment-grade ratings and the investment community, therefore, would classify the bonds issued by these corporations as junk. *Id.* at 375; *see supra* note 4 (discussing Drexel's role in the junk bond market); *infra* notes 24-28, 30-33 and accompanying text (same).

24. *See High Yield Bonds, supra* note 1, at 374-75 (describing Drexel's role in development of junk bond market); *infra* text accompanying notes 25-27 (describing emergence of original issues of high yield, low-rated corporate bonds).

25. *See High Yield Bonds, supra* note 1, at 374-75 (describing Drexel's role in development of junk bond market). From an issuer's perspective, junk bonds provide companies with a means of financing that is more attractive than traditional financing available through banks and insurance companies. *See High Yield Bonds, supra* note 1, at 373-76. Drexel explained that beginning in the late 1970s, companies whose bonds received below-investment-grade ratings turned to junk bonds to raise permanent capital to avoid the restrictive covenants imposed by banking institutions and insurance companies. *See High Yield Bonds, supra* note 1, at 376. Additionally, Drexel reported that low-rated companies turned away from traditional financing through banks and insurance companies to become more visible in public markets, and to obtain greater institutional support from creditors. *Id.*

26. *Id.* at 375.

27. *See High Yield Bonds, supra* note 1, at 387-89 (explaining role of junk bonds as means of financing corporate acquisitions); *infra* notes 28-40 and accompanying text (same). Examples of recent takeover transactions involving the use of junk financing include Mesa Petroleum Company's bid for Unocal Corp., GAF Corp.'s offer for Union Carbide, Pantry Pride's bid for Revlon, Inc. and most recently, Turner Broadcasting System, Inc.'s bid for MGM/UA Entertainment Co. *See FED Adopts Junk-Bond Restrictions,* Wash. Post, Jan. 9, 1986 at E9, col. 6 (noting examples of recent takeover bids utilizing junk financing) [hereinafter cited as *FED Adopts*]; Schwartz, *supra* note 5, at 50 (discussing Turner-MGM/UA merger).

acquisitions through traditional financing methods, corporate raiders turn to junk financing to raise the capital needed to take over large companies.[28] A consideration of junk bonds, therefore, requires a distinction between junk bonds issued by fallen angels and original issues of high yield, low-rated corporate bonds, largely utilized as a means of raising capital for emerging companies, and, more recently, as a means of raising capital to finance hostile corporate acquisitions.[29]

Under Drexel's system of junk financing, a corporate raider creates a shell company[30] to issue junk securities.[31] The shell company then offers Drexel's corporate and individual investors the opportunity to buy the new junk bonds to help finance the takeover.[32] The shell company uses the proceeds from the sale of the junk bonds to acquire the shares of a target company.[33]

A shell company formed for the purpose of acquiring the shares of a target company has no other business operations and, therefore, has no

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Described as perhaps the ultimate junk bond financed acquisition, the Turner-MGM/UA merger was a $1.5 billion transaction with no cash provided by the acquirer. Schwartz, *supra* note 5, at 50 (discussing Turner-MGM/UA merger). Drexel arranged the financing for the Turner-MGM/UA Deal. *Id.*

28. *See High Yield Bonds, supra* note 1, at 388 (describing difficulty involved in raising capital for hostile takeovers through traditional financing techniques); *see also Takeovers, supra* note 10, at 8 (reporting that $1.5 billion represents the minimum amount necessary to attack a large company in a hostile takeover bid). Raising the large sums of money necessary for a hostile takeover through conventional lending institutions is difficult. *See High Yield Bonds, supra* note 1, at 388 (describing difficulty involved in raising capital for hostile takeovers through traditional financing techniques). Banks, for example, lack the flexibility to tailor financing features to suit the needs of particular large transactions. *Id.* Additionally, banks may refuse to make loans for acquisition activity to avoid the publicity and litigation often associated with hostile corporate takeovers. *Id.* at 388-89.

29. *See Junk Bonds, supra* note 1, at 255 (noting distinction between two categories of junk bonds).

30. *See supra* note 7 (defining shell corporation).

31. *See* Williams, *supra* note 6, at 1, col. 6 (explaining Drexel's system of junk financing of hostile corporate acquisitions).

32. *Id.* Drexel's clients include T. Boone Pickens, Jr., Mesa Petroleum Co.'s chairman; Sir James Goldsmith, a European financier; and Victor Posner of Miami. *Id.* at 20, col. 2. Drexel's investors include savings and loan associations, insurance companies, wealthy individuals, trust departments of banks, pension plans, and corporations. *Id.*

33. *See id.* at 1, col. 6 (describing role of shell company in corporate acquisitions); 51 Fed. Reg. at 1771 (same). To acquire the target company's shares, the shell company,using the proceeds from the sale of the junk bonds, offers to buy the target stockholders' shares of the target company's stock at a price greater than the current market price of the stock. *See* Drucker, *supra* note 10, at 4 (describing how raider acquires target's shares). Stock prices of target companies tend to rise when the investment community anticipates a takeover. *See The Financing of Mergers and Acquisitions: Hearing Before the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs,* 99th Cong., 1st Sess. 27 (1985) (statement of Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System). Consequently, even if the takeover bid fails, the corporate raider realizes a profit on the target company's shares purchased at the lower market price. *See* Drucker, *supra* note 10, at 4 (raider wins big even if takeover attempt is unsuccessful).

assets or cash flow, other than the margin stock[34] the shell company has acquired or intends to acquire from the target, to support the credit obtained through the sale of the debt securities.[35] Consequently, once the corporate raider accomplishes the takeover, the target company becomes responsible for payment of the high rate of interest to the investors who purchased the junk bonds to help finance the takeover.[36] If the earnings of the target company are inadequate to meet the high interest rates demanded by the high yield bonds, the new management must sell the target company's assets to pay interest to purchasers of the bonds.[37] The liquidation of the target company's assets to service the debt created through the issuance of junk bonds raises serious economic concerns about the use of junk bonds to finance hostile corporate acquisitions.[38] In addition to economic concerns,

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34. *See infra* note 41 (defining margin stock).

35. *See* 51 Fed. Reg. at 1771 (describing role of shell company in corporate acquisition).

36. *See* Rohatyn, *supra* note 10, at 30, col. 5 (explaining how target company's earnings and assets become vulnerable as sources of payment of return on junk bonds).

37. *Id.; see High Rollers, supra* note 4, at 141 (noting that target company's assets become vulnerable as sources of payment of return on junk bonds).

38. *See* Rohatyn, *supra* note 10, at 30, col. 5 (expressing concern over tearing apart of corporation to service high yield debt); *see also Junk Bonds, supra* note 1, at 279-80 (citing Rohatyn's comments as articulation of concern that certain financiers do not engage in corporate takeover attempts for purpose of furthering best interests of target company). Drexel refutes the argument that acquisitions financed by junk bonds require a sale of the target's assets to repay the debt to investors. *See High Yield Bonds, supra* note 1 at 389. Drexel asserts that liquidation of assets may result from a business decision by management to sell certain assets to enable the company to operate more effectively and competitively. *Id.* at 389-90. Moreover, Drexel states that the acquirer may have decided to sell certain assets prior to the acquisition. *Id.* at 390.

Another area of concern involves the association of financiers' use of junk financing with the technique of "greenmail." *See Junk Bonds, supra* note 1, at 285. Greenmail describes the process in which a raider threatens a potential target with a junk financed takeover attempt for the sole purpose of forcing the target to repurchase at a premium the shares of a target company already owned by the raider. *Id.* Repurchasing the raider's shares leaves the target in a very weakened position and suggests that the raider intended to acquire short term profits rather than the operation of the company. *Id.* at 279-80; *see id.* at 277-78 (illustrating association of junk financing with greenmail). Moreover, combatting a raider's greenmail techniques by repurchasing the raider's shares at a premium, diverts corporate funds from technological research and development which may weaken the competitiveness of the United States economy. *See* Drucker, *supra* note 10, at 13 (explaining how defending against hostile takeovers has become dominant force in corporate management). Consequently, some commentators fear that the corporate raiders are altering the structure of the American economy by forcing management to sacrifice long-term, business planning, which includes expenditures for research and development, for short-term defensive decisionmaking focused on protecting the company against hostile takeovers. *Id.; cf.* Schwartz, *supra* note 5, at 50 (junk bond issue must be viewed as part of larger transition occurring in American economy). In response to the growing concern surrounding the use of junk bonds, several congressmen introduced legislation in the 99th Congress aimed at junk bonds. *See, e.g.,* H.R. 2476, 99th Cong., 1st Sess. (1985) (to amend tax laws related to acquisitions, junk bonds and greenmail); S. 1286, 99th Cong., 1st Sess. (1985) (to limit amount of junk securities federally insured institutions hold); S. 1016, 99th Cong., 1st Sess. (1985) (to amend Federal Deposit Insurance Act and National Housing Act with regard to junk bonds).

the liquidation of a corporation solely to repay debt raises questions of public policy.[39] The disassembling of a corporation to repay debt overlooks the interests of the corporation's employees and customers, as well as the community in which the company operates.[40]

Amidst the concern surrounding the use of junk bonds to finance hostile corporate acquisitions, the Board of Governors of the Federal Reserve System (the Board), on January 8, 1986, announced the adoption of an interpretative rule applying the margin lending rules of Regulation G[41] to debt securities issued by shell companies for the purpose of acquiring the margin stock[42] of

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39. *See* Rohatyn, *supra* note 10, at 30, col. 5 (raising public policy questions surrounding tearing apart of corporation to service high yield debt); *supra* note 36 (discussing concern surrounding junk bonds).

40. *See* Rohatyn, *supra* note 10, at 30, col. 5 (raising public policy questions surrounding tearing apart of corporation to service high yield debt); *cf.* Sugg, *The Threat of Merger Mania,* Roanoke Times & World-News, Feb. 24, 1986, at A 9, col. 3 (concern over takeovers extends beyond corporate boardroom to plant employees and families whose lives center around plant floor); W. Baxter, Baxter World Economic Service, 9 (Bulletin 12, March 21, 1986) (discussing disassembling of going corporation).

41. 12 C.F.R. §208.1-207.12 (1985). The margin lending rules of Regulation G govern the extension of credit by persons other than banks, brokers or dealers. *See* 12 C.F.R. §207.1(b) (1985) (defining purpose and scope of Regulation G); *see also* A. PESSIN & F. MAITLAND, WORDS OF WALL STREET 199 (1983) (defining Regulation G). The margin lending rules apply to lenders who extend credit for the purpose of buying securities when those securities serve as collateral for the credit extended. *See The Financing of Mergers and Acquisitions: Hearing Before the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs,* 99th Cong., 1st Sess. 27 (1985) (statement of Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System). For purposes of Regulation G, a lender is any person required to meet the registration requirements of Regulation G. 12 C.F.R. § 207.2(h) (1985). Under Regulation G, every person who extends or maintains credit in the amount of $200,000 or more during any calendar quarter that is secured, directly or indirectly, by any margin stock must register with the Board. *Id.* at § 207.3(a) (1985). Additionally, a person whose credit outstanding equals $500,000 or more during that calendar quarter must also register. *Id.* The Board concluded that purchasers of debt securities may qualify as lenders under Regulation G because they buy the debt securities in very substantial quantities. 51 Fed. Reg. at 1773. Specifically, Regulation G provides that "[n]o lender. . . shall extend any purpose credit, secured directly or indirectly by margin stock in an amount that exceeds the maximum loan value of the collateral securing the credit. . . ." 12 C.F.R. § 207.3(b) (1985). Purpose credit is credit extended for the purpose of buying or carrying margin stock. 12 C.F.R. § 207.2(l) (1985). The Board concluded that the debt securities issued by a shell company clearly constitute purpose credit under Regulation G. 51 Fed. Reg. at 1773. Section 207.2(b) of Regulation G describes two situations that fall within the meaning of indirectly secured, including any arrangement involving a restriction on the disposition of the margin stock. 12 C.F.R. § 207.2(b) (1985). Section 207.2(i) of Regulation G defines margin stock as any equity security registered or having unlisted trading privileges on a national securities exchange. 12 C.F.R. § 207.2(i) (1985). Under Regulation G "[t]he maximum loan value of any margin stock. . . is fifty percent of its current market value." 12 C.F.R. § 207.7(b) (1985). The Board promulgated Regulation G pursuant to Section 7 of the Securities Exchange Act of 1934. *See* 15 U.S.C. § 78g(a) (1982) (providing for regulation of extension of credit); 12 C.F.R. § 207.1(a) (1985) (citing Section 7 of Securities Exchange Act of 1934 as authority for Regulation G). Section 7 of the Securities Exchange Act of 1934 gives the Board authority to prevent the excessive use of credit extended for the purchase or carrying of securities. 15 U.S.C. § 78g(a) (1982).

42. *See supra* note 41 (defining margin stock).

a target company in a takeover attempt.[43] The Board concluded that debt securities issued by a shell corporation, for the purpose of acquiring the margin stock of a target company, are indirectly secured[44] by the margin stock acquired in the limited situation in which the other assets of the shell company are insufficient to support the credit extended by the purchasers of the debt securities.[45] The margin lending rules of Regulation G prohibit a lender[46] from extending purpose credit[47] indirectly secured[48] by margin stock in an amount that exceeds fifty percent of the market value of the collateral securing the stock.[49] Consequently, the margin lending rules of Regulation G limit the amount of credit a lender can extend through the purchase of debt securities to fifty percent of the purchase price of the target company.[50] Regulation G provides further that indirectly secured includes any arrangement with the purchaser involving a restriction on the disposition of the margin stock.[51] The Board cited Mesa Petroleum Company's bid for Unocal Corporation as a situation involving a restriction on the disposition of margin stock so that the debt securities purchased to finance the acquisition were indirectly secured by the margin stock for purposes of Regulation G.[52]

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43. *See* 51 Fed. Reg. at 1771; *see also* FED. SEC. L. REP. (CCH) ¶ 83,952 (Jan. 22, 1986) (discussing rule).

44. *See supra* note 41 (defining indirectly secured).

45. *See* 51 Fed. Reg. at 1774 (explaining rule). Although the rule speaks generally in terms of debt securities, and not specifically in terms of junk bonds, the applicability of the rule to high yield debt securities is clear. *See FED Board Votes 3-2, supra* note 5, at 2, col. 3 (interpreting Board's action as restriction on use of junk bonds in financing of certain corporate takeovers); *FED Adopts, supra* note 27, at E1, col. 6 (same); *Scrap Over Junk, supra* note 5, at 43 (same). Stated in junk bond terms, the Board concluded that junk bonds issued by a shell company to purchase the margin stock of a target company are indirectly secured by the margin stock in the limited situations in which the other assets of the shell company are insufficient to pay the high interest rates to the purchasers of the junk bonds. *See FED Board Votes 3-2, supra* note 5, at 2, col. 3 (interpreting Board's action as restriction on use of junk bonds in financing of certain corporate takeovers); *FED Adopts, supra* note 27, at E1, col. 6 (same); *Scrap Over Junk, supra* note 5, at 43 (same).

46. *See supra* note 41 (defining lender).

47. *See id.* (defining purpose credit).

48. *See id.* (defining indirectly secured).

49. 12 C.F.R. § 207.3(b) (1985); *see supra* note 41 (explaining Regulation G).

50. *See* 12 C.F.R. §§ 207.3(b), 207.7(a) (1985) (explaining credit limitations); *FED Board Votes 3-2, supra* note 5, at 2, col. 3 (interpreting Board's action as restriction on use of junk bonds in financing of certain corporate takeovers); *FED Adopts Junk-Bond Restrictions, supra* note 27, at E1, col. 6 (same); *Scrap Over Junk, supra* note 5, at 43 (same).

51. *See* 12 C.F.R. § 207.2(f) (1985) (defining indirectly secured); *supra* note 41 (same).

52. *See* 51 Fed. Reg. at 1772 (explaining purpose of rule). The interpretative rule resulted from petitions submitted to the Board by Unocal Corp. (Unocal) and Revlon, Inc. (Revlon). *See* 51 Fed. Reg. at 1771-72 (explaining origin of rule). In May 1985, Unocal requested a determination that the margin lending restrictions of Regulation G governed the issuance of debt securities by a shell corporation controlled by Mesa Petroleum Co. to acquire Unocal's stock. *Id.* at 1771. Similarly, in September 1985, Revlon requested a determination that the margin lending restrictions of Regulation G governed Pantry Pride's issuance of debt securities as part of Pantry Pride's takeover bid for Revlon. *Id.* at 1772. Additionally, several members of Congress requested the Board to address the applicability of the margin lending rules to the

In the Mesa/Unocal transaction, a shell corporation controlled by Mesa issued debt securities to finance a tender offer for Unocal's stock.[53] The shell corporation held no assets other than the margin stock acquired from the target.[54] In May, 1985, Unocal requested a determination from the Board that the debt securities issued by the shell corporation to acquire Unocal's stock were subject to the margin lending restrictions of Regulation G.[55] The Board observed that opposition to the merger by the target company, Unocal, could delay or prevent the consummation of the acquisition, forcing the shell company to hold the stock for a significant period of time.[56] The Board reasoned that during the period of indefinite delay caused by opposition to the takeover, lenders could rely on only the margin stock, and not the assets of the target company, for repayment of the credit.[57] The Board stated that a reasonable lender would not extend credit to a shell corporation without an understanding that the shell corporation would hold the stock during the period of indefinite delay.[58] The Board reasoned that this understanding would discourage the shell company from disposing of the stock, thus constituting a restriction on the shell company's right to dispose of the stock.[59] The Board, therefore, concluded that the debt securities issued by the shell company were indirectly secured by the margin stock the shell company intended to acquire and, therefore, the debt securities were subject to the margin lending restrictions of Regulation G.[60]

The Board, however, emphasized that even if a restriction on the disposition of the target company's stock exists, the presumption of indirect security does not arise unless the lender, in good faith, relies on the margin stock as collateral for repayment of the debt.[61] Consequently, the Board delineated four situations in which the interpretative rule will not apply

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use of debt securities to finance corporate takeover attempts. *Id.* The Board considered the requests of Unocal, Revlon, and the legislators in meetings in September and November 1985. *Id.* On December 6, 1985, the Board released a proposed interpretation of Regulation G. *Id.; see* 50 Fed. Reg. 50606 (Dec. 10, 1985). After issuing the proposed interpretation, the Board allowed a short period for public comment. 51 Fed. Reg. at 1772. After receiving 87 comments, the Board adopted the proposal with clarifications and limited modifications. *Id.* The final interpretative rule became effective on January 10, 1986. *Id.* at 1771.

53. 51 Fed. Reg. at 1773 (describing Mesa/Unocal transaction).

54. *Id.*

55. *Id.* at 1771.

56. *Id.* at 1773.

57. *Id.*

58. *Id.*

59. *Id.; see* 12 C.F.R. § 207.2(f) (1985) (indirectly secured includes any restriction on borrower's ability to dispose of margin stock).

60. 51 Fed. Reg. at 1773. *But see generally The Financing of Mergers and Acquisitions: Hearing Before the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs,* 99th Cong., 1st Sess. 165 (1985) (supplemented by Memorandum for Board of Governors of the Federal Reserve System by Davis Polk & Wardwell; Baker & Botts; Skadden, Arps, Slate, Meagher & Flom 165, 166-67 (microfiche) (April 30, 1985) (advising Board that Regulation G did not apply to Mesa/Unocal transaction)).

61. 51 Fed. Reg. at 1773.

because the lender could not rely reasonably on the target company's assets for repayment.[62] Specifically, the Board's presumption that the debt securities are indirectly secured by margin stock will not apply if the shell's parent company, or another company possessing substantial non-margin stock assets or cash flow, guaranteed the debt securities issued by the shell company.[63] Additionally, the presumption will not apply if a merger agreement existed between the acquiring and target companies which the parties entered into at the time investors agreed to purchase the debt securities or at a time before investors advanced the loan funds.[64] Moreover, the presumption will not apply to short form mergers,[65] or to debt securities issued by an operating company with sufficient assets to support the debt.[66]

The Board's delineation of the numerous situations in which the rule will not apply is reflective of the narrow scope of the rule.[67] The narrow scope of the rule is indicative of the minimal impact the rule is likely to have on corporate takeover activity.[68] The Board has acknowledged that the rule will not substantially alter the level of merger activity.[69] The Board emphasized that the interpretative rule applies to a very narrowly defined class of acquisition financing transactions in which shell corporations issue debt securities.[70] Although Wall Street's reaction to the Board's action has been

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62. *Id.* at 1772-74.

63. *Id.* The Board permits lenders to rely in good faith on assets other than margin stock as collateral for repayment of the credit if the parent company or another company guarantees the debt securities. *Id.*

64. *Id.* at 1773.

65. *Id.* Short form merger refers to a merger resulting from the shell company's acquisition of a number of shares necessary pursuant to state law to accomplish a merger without the approval of the shareholders or directors of the target company. *Id.*

66. *Id.* at 1772. In its explanation of the rule, the Board cited the recent Pantry Pride/Revlon and GAF/Union Carbide transactions as illustrations of situations in which the rule would not apply. *See id.* (describing Pantry Pride/Revlon transaction); *id.* at 1772 n.3 (describing GAF/Union Carbide transaction). In the Pantry Pride/Revlon transaction, Pantry Pride, an operating company possessing substantial assets other than margin stock, issued debt securities to finance a tender offer for Revlon's stock. *Id.* at 1772. Pantry Pride successfully completed its acquisition of Revlon after Revlon unsuccessfully attempted a leveraged buy-out of Revlon. *Id.* at n.3; *see* MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1247-52 (Del. Ch. 1985) (Delaware court invalidated Revlon's attempted "friendly" leveraged buy-out), *aff'd*, 506 A.2d 173, 180-85 (Del. 1986); 51 Fed. Reg. at 1772 n.3 (discussing *Revlon*). In GAF's bid for Union Carbide, GAF, as the parent of the shell company would guarantee either the debt securities issued by the shell to finance the tender offer for the shares of Union Carbide, or issue the debt securities itself. 51 Fed. Reg. at 1772 n.2. GAF, however, on January 8, 1986, abandoned its attempt to takeover Union Carbide. *See GAF Drops Bid For Carbide,* Wash. Post, Jan. 9, 1986, at E1, col. 6 (detailed coverage of GAF's pursuit of Union Carbide); Schwartz, *Junk Bonds II: Victory in Defeat,* INVEST. DEALERS DIGEST, Jan. 20, 1986 (discussing GAF's hostile bid for Union Carbide including financing summary).

67. *See* 51 Fed. Reg. at 1774 (noting narrow scope of interpretative rule); *supra* notes 63-66 and accompanying text (describing situations in which rule would not apply).

68. *See infra* text accompanying notes 69-71 (explaining that rule will not likely reduce merger activity).

69. 51 Fed. Reg. at 1776.

70. *Id.* at 1778.

mixed, a frequent response is that potential corporate raiders likely will tailor takeover attacks to conform to the situations described by the Board as not falling within the applicable scope of the rule, or will devise new ways to avoid the rule.[71]

Opponents of the Board's action include the Securities and Exchange Commission, the Justice Department, and Drexel.[72] Much of the criticism charges that the Board's action failed to comply with the rulemaking procedures set forth in the Administrative Procedure Act (APA).[73] The Board defended the charges on the ground that the rule was not legislative, but was merely interpretative and, as such, the Board's action falls within the exemption from the rulemaking procedures of the APA.[74] The purpose of the interpretative rule is to guide the investment community in determining whether debt securities issued to finance the acquisition of the margin stock of a target company come within the scope of the margin lending restrictions in Regulation G in certain takeover situations.[75] The rule, therefore, is not new law, but is the Board's interpretation of the application of an existing provision of Regulation G in certain takeover situations.[76] The Board concluded that equitable and consistent administration of existing law requires application of the margin regulations in situations in which purpose credit extended is indirectly secured by margin stock.[77] Unless successfully challenged on APA or other grounds, raiders, financiers, and investors involved in hostile corporate takeover transactions must comply with the Board's

71. *See FED Adopts, supra* note 27, at E1, col. 4 (suggesting that bidders could get around rule by selling preferred stock rather than debt to finance acquisitions or by having companies with substantial assets guarantee takeover financing); *FED Votes 3-2 to Limit Use of Junk Bonds,* AMERICAN BANKER, Jan. 9, 1986, at 18, col. 4 (reporting suggestion that bidders might try to avoid label of shell by establishing company with nominal business operations); *see also Scrap Over Junk, supra* note 5, at 43 (reporting Drexel's assertion that creativity of financial sector will avoid rule).

72. *See Justice, SEC Criticize Rule on Junk Bonds as Hasty, Costly,* SEC. REG. & L. REP. (BNA) No. 1, 3 (Jan. 3, 1986) (commenting on proposed interpretation); 51 Fed. Reg. at 1775-78 (analysis of public comments received on proposed interpretation).

73. *See* 51 Fed. Reg. at 1778 (discussing charges that rule violates Administrative Procedure Act). The Administrative Procedure Act (APA) establishes administrative rulemaking guidelines. *See* 5 U.S.C. § 551-53 (1982) (regulation of rulemaking procedure). The APA requires an agency formulating a rule to give notice of the rulemaking, provide for an opportunity for public comment, state the rule's basis and purpose, and provide a delayed effective date. 5 U.S.C. § 553(a)-(d); *see* 51 Fed. Reg. at 1778 (interpreting APA). The APA exempts expressly interpretative rules from the rulemaking regulations. 5 U.S.C. §§ 553(b)(A), (C)(2); *see* 51 Fed. Reg. at 1778 (interpreting APA).

74. 51 Fed. Reg. at 1778 (rebutting charge that rule violates APA). The Board concluded that because the rule is interpretative, the Board does not intend the rule as an exercise of the Board's statutory rulemaking power, as binding on reviewing courts, nor as subject to the APA. *Id.* at 1772; *see also supra* note 12 (distinguishing between legislative and interpretative rules).

75. *See* 51 Fed. Reg. at 1772 (explaining purpose of rule).

76. *See* 51 Fed. Reg. at 1779 (Board defending rule as interpretative); *supra* note 12 (distinguishing between legislative and interpretative rules).

77. 51 Fed. Reg. at 1776.

action restricting the use of junk bonds in certain hostile takeover situations.[78]

Although corporate raiders will turn away from junk financing or devise ways of sheltering junk financing from the narrow scope of the rule, the Board has achieved its modest goal of limiting the issuance of junk bonds by shell corporations in only specifically defined acquisition situations.[79] Junk financing that falls outside the narrow scope of the rule, however, will continue to impede the vitality of American corporations by forcing management to divert funds away from expenditures that increase productivity and economic competitiveness to service high yield debt.[80] Moreover, as corporate raiders turn away from junk financing, a further question arises as to what impact, if any, the rule will have on the junk bond market outside the realm of corporate takeovers.[81] Since the rule applies only to shell companies involved in corporate acquisitions it is plausible to assume that companies that turn to junk financing as a means of raising operating capital will continue to provide a viable market of junk for those investors attracted by high yield.[82]

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78. *See supra* note 74 and accompanying text (discussing interpretative rule); *supra* note 12 (same).

79. *See supra* notes 67-71 and accompanying text (discussing minimal impact of rule). Felix Rohatyn, a critic of junk financing of hostile corporate takeovers, praises the Board's action as "a sound step to curb the most extreme uses of junk bonds." *Scrap Over Junk, supra* note 5, at 43.

80. *See* Baxter, *supra* note 40 (discussing concern surrounding junk bonds).

81. *See infra* note 82 and accompanying text (discussing impact of rule outside realm of corporate takeovers).

82. *See supra* notes 17-26 and accompanying text (explaining that companies issue junk bonds to raise capital); *supra* note 4 (discussing current growth of junk bond market); *cf.* Television interview with Ed Brown, President, Brown Capital Management Company, on *Wall Street Week with Louis Rukeyser*, Jan. 17, 1986 (encouraging investors to hold on to junk bond fund).