

The New Bond Workouts

Law Working Paper N° 356/2017

June 2017

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ECGI Working Paper Series in Law

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The article has benefitted from presentations at the Georgetown University Law Center Faculty Workshop, the University of Pennsylvania Law School Institute for Law & Economics Corporate Roundtable, and the Goethe/Penn Conference on Law & Finance. The authors wish to thank Philip Abelson, Martin Bienenstock, Tony Casey, Jill Fisch, Jesse Fried, Henry Hu, Marcel Kahan, David Kershaw, Frank Partnoy, Robert Rasmussen, Gabriel Rauterberg, and Eric Talley, for their comments on earlier drafts, and Joshua Kaufman, Emil Kleinhaus, and participants in the 2016 Financial Lawyers Seminar for sharing their practice experience, and the Georgetown University Law Library staff for research assistance.

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Abstract

Bond workouts are a famously dysfunctional method of debt restructuring, ridden with opportunistic and coercive behavior by bondholders and bond issuers. Yet since 2008 bond workouts have quietly started to work. A cognizable portion of the restructuring market has shifted from bankruptcy court to out-of-court workouts by way of exchange offers made only to large institutional investors. The new workouts feature a battery of strong-arm tactics by bond issuers, and aggrieved bondholders have complained in court. The result has been a new, broad reading of the primary law governing workouts, section 316(b) of the Trust Indenture Act of 1939 (“TIA”), which prohibits majority-vote amendments of bond payment terms and forces bond issuers seeking to restructure to resort to exchange offers.

This Article exploits the bond market’s reaction to the shift in law to reassess a long-standing debate in corporate finance regarding the desirability of TIA section 316(b). Section 316(b) has attracted intense criticism, with calls for its amendment or repeal because of its untoward effects on the workout process and tendency to push restructuring into the costly bankruptcy process. Yet section 316(b) has also been staunchly defended on the ground that mom-and-pop bondholders need protection sharp-elbowed issuer tactics.

We draw on a pair of original, hand-collected data sets to show that many of the empirical assumptions made in the debate no longer hold true. We show that markets have learned to live with section 316(b)’s limitations, denuding the case for repeal of any urgency. Workouts generally succeed, so that there is no serious transaction cost problem stemming from the TIA; when a company goes straight into bankruptcy there tend to be independent motivations. We also show that workout by majority amendment will not systematically disadvantage bondholders. Indeed, the recent turn to secured creditor control of bankruptcy proceedings makes them all the more attractive to unsecured bondholders.

Based on this empirical background, we cautiously argue for the repeal section 316(b). Section 316(b) no longer does much work, even as it prevents bondholders and bond issuers from realizing their preferences regarding modes of restructuring and voting rules. We do not know what contracting equilibrium would obtain following repeal, but think that the matter is best left to the market. Still, we recognize that markets are imperfect and that a free-contracting regime may result in abuses. Accordingly, we argue that repeal of section 316(b) should be accompanied by the resuscitation of the long forgotten doctrine of intercreditor good faith duties, which presents a more fact-sensitive and targeted tool for policing overreaching in bond workouts than the broad reading of section 316(b).

Keywords: Corporations, Bankruptcy, Corporate Finance, Securities, Bonds, Financial Distress, Reorganizations, Debt Restructuring, Trust Indenture Act, Collective Action Clauses, Unanimous Action Clause, Creditor Coercion, Exit Consents, Intercreditor Duty of Good Faith

JEL Classifications: G33, G38, K22

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RESEARCH PAPER NO. 17-9

The New Bond Workouts

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THE NEW BOND WORKOUTSWILLIAM W. BRATTON, JR.[†]ADAM J. LEVITIN[‡]**ABSTRACT**

Bond workouts are a famously dysfunctional method of debt restructuring, ridden with opportunistic and coercive behavior by bondholders and bond issuers. Yet since 2008 bond workouts have quietly started to work. A cognizable portion of the restructuring market has shifted from bankruptcy court to out-of-court workouts by way of exchange offers made only to large institutional investors. The new workouts feature a battery of strong-arm tactics by bond issuers, and aggrieved bondholders have complained in court. The result has been a new, broad reading of the primary law governing workouts, section 316(b) of the Trust Indenture Act of 1939 (“TLA”), which prohibits majority-vote amendments of bond payment terms and forces bond issuers seeking to restructure to resort to exchange offers.

This Article exploits the bond market’s reaction to the shift in law to reassess a long-standing debate in corporate finance regarding the desirability of TLA section 316(b). Section 316(b) has attracted intense criticism, with calls for its amendment or repeal because of its untoward effects on the workout process and tendency to push restructuring into the costly bankruptcy process. Yet section 316(b) has also been staunchly defended on the ground that mom-and-pop bondholders need protection sharp-elbowed issuer tactics.

We draw on a pair of original, hand-collected data sets to show that many of the empirical assumptions made in the debate no longer hold true. We show that markets have learned to live with section 316(b)’s limitations, denuding the case

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Based on this empirical background, we cautiously argue for the repeal section 316(b). Section 316(b) no longer does much work, even as it prevents bondholders and bond issuers from realizing their preferences regarding modes of restructuring and voting rules. We do not know what contracting equilibrium would obtain following repeal, but think that the matter is best left to the market. Still, we recognize that markets are imperfect and that a free-contracting regime may result in abuses. Accordingly, we argue that repeal of section 316(b) should be accompanied by the resuscitation of the long forgotten doctrine of intercreditor good faith duties, which presents a more fact-sensitive and targeted tool for policing overreaching in bond workouts than the broad reading of section 316(b).

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INTRODUCTION

Bond workouts are famously dysfunctional. When a firm is in financial distress, its stockholders and bondholders have every reason to negotiate a restructuring (or “workout”) of its obligations to produce a sustainable capital structure and avoid the costs of a bankruptcy. The reality is different. Bondholders hold out and free ride in response to restructuring offers from distressed debtors. Debtors respond with a host of coercive inducements and procedural maneuvers. The result is a destabilizing and potentially toxic mix of creditor opportunism and debtor coercion that can derail the workout process, forcing a bankruptcy restructuring.

Bond workouts exist in a space governed by neither corporate law nor bankruptcy law. While those regimes are designed to bring unruly investors together to settle matters by majority vote, in bond workouts the law actually stands in the way of majoritarian decisionmaking. The primary body of governing law is the Trust Indenture Act of 1939 (“TIA”), a hoary New Deal securities law that mandates terms in the contracts governing publicly-issued bonds. Section 316(b) of the TIA prohibits majority-vote amendments of bonds’ payment terms, foreclosing workout by direct contractual amendment.

But the TIA leaves open a second route to restructuring—the exchange offer, in which the debtor offers to exchange new, scaled-down bonds for the original bonds. Exchange offers are intrinsically susceptible to disruption by holdout bondholders and coercive tactics by issuers. Few of the process protections accorded by corporate and securities law to stockholders receiving tender and exchange offers apply to bond exchanges. There is no judicial oversight of the restructuring process, as would be the case in bankruptcy. Contract law provides little in the way of protection against distorted bargaining

in a financial context like this one.

The TIA itself bears much of the responsibility for the empty doctrinal toolbox. The TIA was a New Deal reaction to the excesses of a Depression-era out-of-court restructuring market in which insider equityholders and their favored creditors siphoned value away from bondholders. The statute's drafters wanted restructurings to proceed in bankruptcy under the eye of the court so as to prevent process abuses. They largely succeeded. The TIA's very success in shifting restructuring practice into bankruptcy resulted in the atrophying of the federal equity doctrine that policed earlier restructurings.

In recent years, however, the picture has changed quietly but markedly. Workouts have started to work. A substantial portion—around one fifth—of restructuring activity has shifted from bankruptcy court to out-of-court workouts effected through exchange offers made only to large institutional investors. The shift resulted from a temporary external shock—the brief disappearance in 2008-2009 of debtor-in-possession financing for bankrupt companies. But the altered pattern persists.

Coercive tactics figure more prominently than ever in the new workouts. Ugly facts and court challenges result. Thus confronted, but possessing no obvious doctrinal tool, courts in the Southern District of New York—the near exclusive forum for bond litigation—responded by adopting a new reading of TIA section 316(b) that would give courts broad power to police workouts. The Second Circuit Court of Appeals subsequently reversed the leading Southern District case, likely returning the law of bond workouts to its earlier posture, but the episode was the biggest jolt to the normally staid world of bond contracting since the leveraged takeovers and buyouts of the 1980s. While we are sympathetic to the policing impulse behind the broad reading of section 316(b), the broad reading went much too far. In a context where fact-sensitive policing is needed, the broad reading imposed bright-line mandates that overrode terms in bond contracts and threatened to choke off the new workouts altogether.

This Article exploits the bond market's reaction to these decisions to reassess a long-standing debate in corporate finance regarding the desirability of TIA section 316(b). Section 316(b) has attracted intense criticism in the past, with calls for its amendment or repeal because of

its untoward effects on the workout process and tendency to push restructuring into costly bankruptcy. Section 316(b) also has been staunchly defended on the ground that mom-and-pop bondholders need protection from strong-arm tactics.

We draw on a pair of original, hand-collected data sets to show that many of the empirical assumptions made in the debate over section 316(b) no longer hold true. First, we show that workouts are more tractable than thought heretofore. But for the recent intervention in the Southern District, the markets have learned to live with section 316(b), denuding the case for repeal of any urgency. Workouts generally succeed, so that there is no serious transaction cost problem stemming from the TIA; when a company goes straight into bankruptcy there tend to be independent motivations. Second, we show that workout by majority amendment will not systematically disadvantage bondholders. Indeed, the recent turn to secured creditor control of bankruptcy proceedings makes them all the more attractive to unsecured bondholders. Third, we show that bond workouts are more coercive than previously thought in some respects, but also less coercive in others.

Based on this empirical background we cautiously argue for the repeal section 316(b). Section 316(b) no longer does much work, even as it prevents bondholders and bond issuers from realizing their preferences regarding modes of restructuring and voting rules. We do not know what contracting equilibrium would obtain in the wake of repeal, but think that the matter is best left to the market. It follows that repeal should be complete and prospective. We also recognize that markets are imperfect and that a free-contracting regime may result in abuses. Accordingly, we argue that a repeal of section 316(b) should be accompanied by the resuscitation of a long forgotten, but still-valid doctrine of intercreditor good faith duties, which presents a more fact-sensitive and targeted tool for policing overreaching in bond workouts than the Southern District's broad reading of section 316(b).

This Article makes several contributions to the scholarly literature on corporate restructuring. First, the Article is the only comprehensive treatment of bond workouts. Section 316(b) is a central topic in the law of corporate finance, yet the field lacks a comprehensive treatment of the issue. The Article goes beyond anecdotal evidence to develop of working empirical picture while

simultaneously explaining the development of the applicable law against the background of a theoretical discussion of group decisionmaking by investors.

Second, the Article shows that there has been a marked change in the world of debt restructuring, and that a cognizable part of restructuring activity has moved outside of bankruptcy. We explain why the shift is occurring, looking to securities law compliance practice and incentive realignment in the wake of secured creditor control of Chapter 11 proceedings. We draw on an original data set to provide a first glimpse of the new workouts. The descriptive data show that contemporary workouts are flexibly structured and tend to succeed where those attempted before 2008 tended to fail. Specifically, we show that the holdout problem assumed by the previous literature has diminished in salience and that position of small bondholders, to the extent they still exist, also looks different because they are simply ignored in contemporary exchange offers, which are made only to large institutional investors.

Our third contribution to the literature is a second original data set that collects the process terms of contracts governing bonds issued under the Rule 144A exemption and thus not subject to the TIA. The data offer a glimpse at the preferences of bond issuers and bondholders, again upsetting settled assumptions. We show that contracts issued prior to the recent judicial opinions tend to adhere to the section 316(b) regime's broad outlines, but do introduce some significant modifications. Contracts issued after the recent cases show a new pattern, one group carrying on as before, but with another group affirmatively rejecting the Southern District's broad reading of the TIA. The contracts also take the surprising step of affirmatively sanctioning a coercive device, the exit consent, utilized in exchange offers.

We make a fourth contribution with an extended analysis of the recent flare up in TIA jurisprudence, showing deep structural problems in the broad reading. Courts have been grasping to find a way to address bad behavior in workouts, but the TIA provides a poorly suited tool. There resulted an overbroad and unpredictable standard likely to chill workouts garnering supermajority consent.

Finally, we play at legal archeology and rediscover a doctrinal tool better suited to the policing task, the intercreditor duty of good faith, an equitable tool that became irrelevant following the TIA's passage.

It sits on the books unremembered, but amenable to revival under the contractual duty of good faith. The recent turn to workouts points to the importance of reconsidering this doctrine. Indeed, it probably will become essential in the event section 316(b) is repealed.

The Article has five parts. The first four look at practice and law along parallel tracks, with the last part bringing them together. Part I lays out the bargaining framework in bond workouts, explaining the array of distortionary incentives and devices that come to bear and showing that, in theory, majoritarian amendment is the least distorted framework. Part II turns to the legal background, looking at the TIA, other provisions of the federal securities laws, and contract law, and comparing the treatment of collective decisionmaking by stockholders. It shows that there are precious few legal constraints other than section 316(b), setting the stage for a game of creditor opportunism and debtor coercion in connection with largely unregulated exchange offers. Part III presents the first empirical profile of new workouts, showing how it differs from the traditional picture of dysfunction. Part IV considers the broad reading of section 316(b) advanced in the Southern District, looking carefully at the facts of the cases and highlighting perverse effects. Part V turns to the ultimate policy question: what to do with section 316(b). We recommend outright repeal, but drawing on our empirical evidence of drafting practice, warn that the drafting could contract drafters' responses could be incomplete. We suggest that the intercreditor duty of good faith, once pulled out of the doctrinal wardrobe and given a good dusting, would hold out an effective solution to any resulting problems.

I. THE PROBLEM OF DISTORTED CHOICE IN BOND WORKOUTS

When corporate borrowers cannot pay, they seek to scale down (or “restructure”) their financial obligations. In the United States this tends to occur in one of two venues. First, restructuring can take place in bankruptcy court, under Chapter 11 of the Bankruptcy Code. Alternatively, the restructuring can take place out-of-court in what is known as a “workout.” A workout is simply a contractually concluded modification of debt effected either by amendment of the terms of the existing debt or an exchange of the existing debt for new obligations.

Bankruptcy can be set in motion by unilateral action by the debtor and, by staying enforcement of debt contracts,¹ forces creditors to the negotiating table. Workouts call for more in the way of creditor cooperation. For a company with a large number of individual, uncoordinated creditors—such as tort claimants, trade creditors, and tax authorities—it may not even be worth trying. Outside of bankruptcy, each individual creditor has a veto, at least in regard to its own debt, while inside bankruptcy creditors are grouped into classes within which a majority can bind a minority to a restructuring.²

Financial debt can be more tractable. Where there are multiple creditors under the same debt instrument—principally bondholders and syndicated lenders—the contract can provide for majoritarian amendment. Such provisions are known as “collective action clauses” (CACs) when they condition amendment of terms on a majority (or supermajority) creditor vote that binds dissenters. There is, however, a more preclusive alternative. Under a “unanimous action clause” (UAC), the common instrument requires each creditor individually to consent to an amendment of terms of its own obligation,³ preventing majoritarian amendment.

A UAC does not necessarily prevent out of court restructuring, however. There is another route. The debtor firm offers new, scaled-down obligations in exchange for the old obligations, which are not amended directly. Workout by exchange offer still presupposes creditor cooperation, for each creditor retains the choice of whether to exchange, and there is no legal mechanism outside of bankruptcy by which exchange can be compelled.

The concessions bound up in a workout, whether by direct amendment under a CAC or by an exchange offer, may enhance the

¹ 11 U.S.C. § 362(a).

² 11 U.S.C. §§ 1126(b), 1129(a)(8). In bankruptcy, and, in some situations, a debtor can bind creditors without any of them consenting. *See* 11 U.S.C. § 1124(2) (treating as unimpaired creditors whose debts are deaccelerated, cured, and reinstated). *See also* ADAM J. LEVITIN, *BUSINESS BANKRUPTCY: FINANCIAL RESTRUCTURING AND MODERN COMMERCIAL MARKETS* 542-43 (2015) (discussing “cramup”).

³ Technically, the reference to unanimity is a misnomer. UACs require a given bondholder to consent before an amendment can be binding; they do not prevent a majority from making non-binding concessions. The appellation does make sense as a practical matter, since UACs as a practical matter condition across-the-board application on unanimity and as a practical matter make disable workout by direct amendment.

creditors' collective interest. Publicly-traded bonds present the classic case. They trade at a discount to face value when the issuer gets into distress, reflecting the possibility of default and bankruptcy. Bankruptcy entails added costs—direct costs of administration and indirect costs due the proceeding's destabilizing effect on the company's customers, suppliers, and other constituents. A negotiated reduction of the company's debt burden potentially avoids those costs, keeping the company out of bankruptcy by refitting it with a sustainable debt load. The cost avoidance adds value to the company, making it possible that the bonds will be worth more net of the concessions.

This all sounds nice and neat, but the playing field is bumpy, ridden by problems of distorted consent-giving. The Part lays these problems out, applying a powerful theoretical analysis articulated by Professor Zohar Goshen, which we refer to as the “efficiency account.” Goshen's basic proposition is this: when corporate investors make collective decisions impacting their investments' value, the best available process is a binding simple-majority vote. Such a voting process must satisfy two further conditions: the investors must be well-informed, and they must vote sincerely, which means that they seek the outcome that maximizes the investment's value rather than seeking to maximize on an individual basis.⁴

There is also a corollary proposition: any other process for effecting a collective investor decision is presumptively infirm. The corollary does not follow because majority decision-making is possessed of some magical property that assures first-best results. Instead, the point follows from negative implication—all other processes carry a higher risk of distortionary influence.

With bonds, some distortions come from within the investor group, as when the consenting bondholders have private agendas and vote strategically, or, alternatively, hold out for a side deal. Other distortions come from the bond issuer, which can inject coercive elements into the decisional process. Section A describes distortions from within the bondholder group, while Section B turns to coercive

⁴ Zohar Goshen, *Controlling Strategic Voting: Property Rule or Liability Rule?* 70 S. CAL. L. REV. 741, 745-46 (1997).

tactics employed by bond issuers. Section C describes negative implications for successful out-of-court restructuring.

A. Distortion from other Bondholders

1. Voting Distortions: Self-Interest, Holding Out, and Misjudgment.

Some voting distortions arise because of bondholder self-interest, hold-out strategies, or simple misjudgment. To see how this works, assume that Company *ABC* has outstanding \$100 million 7% unsecured bonds—more properly known as “notes” or “debentures”—due in two years. (For the sake of consistency, we will refer to debt securities as “bonds” whether the credit instrument is a “bond,” “debenture” or “note” and to the investors as “bondholders.”) *ABC* has not yet defaulted on its interest payments but is experiencing severe business difficulties and default is a possibility. *ABC* does not expect to be in position to refinance the 7% bonds when they come due. The 7% bonds are trading for \$30, a deep discount from their \$100 face value. Assume that the bond contract contains a CAC permitting amendment, but only by a 90 percent supermajority of the bondholders. *ABC* has proposed a series of amendments to scale down the bonds’ interest rate to 5%, reduce their principal amount (a “haircut”) from \$100 to \$75, and extend their duration by three years. A bondholder will be better off having consented so long as the bonds emerge trading for more than \$40. In fact, the amendments will cause the bonds to trade at \$50, and the deal allocates all surplus value created by the shift to a sustainable capital structure to the bondholders. Consider the following three scenarios:

- (1) More than 10 percent of the bondholders either (a) have a more significant interest in Company *XYZ*, which competes with Company *ABC* and will be injured because the restructuring will make *ABC* stronger, (b) also own *ABC* stock which will lose value because to the bondholder-favorable surplus allocation, (c) hold a freely assignable put option on their bonds that will allow them to sell the bonds at an above-market price at a future date, or (d) hold credit default swaps on the bond that will pay off in aggregate more than the face amount of the bond if the issuer defaults. They vote no and the beneficial deal is lost. The problem here is self-interested, strategic voting activated by a conflict of interest.

- (2) Two hedge funds, both of which understand this to be the best deal available, each own 5.1% of the bonds and refuse to consent unless they receive consideration on the side, whether from the other bondholders or from *ABC*. No such consideration is forthcoming, they vote no, and the deal is lost. The hedge funds are voting strategically and self-interestedly, but here there is no conflict of interest as regards the transaction. The hedge funds are holding out to extract disproportionate consideration.⁵
- (3) The bondholders possess heterogeneous views about the amendments. Although it is the best deal available, more than 10 percent misjudge the situation, voting no because they believe that the surplus has been allocated to the equity. Although they are voting sincerely, they are still holding out, and their misjudgment kills the deal.⁶

The magnitude of each of the three problems, conflicted voting, holding out, and misjudgment, diminishes as the approval threshold decreases to a simple majority. If we could identify and disqualify conflicted voters and hold outs without incurring collateral costs, we should do so, for they detract from the collective good. We should at the same time distinguish sincere misjudgment from conflicts and holding out. Misjudgments about transaction quality are an inevitable incident of contracting under imperfect information against an uncertain future. One can ameliorate but not eliminate the problem by disclosing fully.

2. Free-Riding.

Let us now bring a UAC into the fact pattern and its block against majority or super-majority amendment of payment terms. It follows that *ABC* can only restructure by closing an exchange offer.

Exchange offers work only if enough bondholders accept them. Assume *ABC* authorizes \$75 million 5% unsecured bonds due in seven years and offers to exchange \$75 face value of the new bonds for each \$100 of old ones. If only a few bondholders refuse to exchange the new bonds still will trade for more than \$40. But supermajority acceptance will be necessary in order for the deal to make sense. An

⁵ *Id.* at 755.

⁶ *Id.* at 755-56.

exchange of 51% of the old bonds for the scaled-down bonds will not achieve a reduction in the debt load of a magnitude sufficient to avoid bankruptcy. Nor would the new bonds, with their reduced financial rights, trade for more than \$40. The offer accordingly will be conditioned on a 90% supermajority tender threshold.

The supermajority minimum tender creates the same potential for disruption from conflicts, holding out, and misjudgment as did the 90% supermajority vote. In addition, the shift from collective voting to bilateral contracting between Company ABC and individual bondholder-offerees opens up an additional distortionary possibility. A non-tendering bondholder cannot have its bonds amended. If the offer succeeds, there will emerge two groups of bondholders, one holding the old bonds and the other the new bonds. Holding out can make sense, even absent a side payment, because there is a potential free ride at the expense of the majority that tenders and takes the scaled down rights.⁷ If the offer closes and issuer emerges from distress, the unamended bond will be worth more than the amended bond. Furthermore, if the issuer emerges in stronger financial condition, the unamended bond is worth more ex post than ex ante.⁸ Add all of this up, and a successful restructuring effectuated by less than 100% effects a wealth transfer from the cooperative bondholders to the uncooperative bondholders. If enough bondholders try to free ride then the minimum tender threshold will not be not reached, and the offer will fail. All other things equal, amendment by a binding majority vote works better than does an exchange offer, because a majority vote leaves the bondholders in a single group with scaled-down rights, cutting off the free ride.

B. Distortion from Issuers

Now let us shift over to the other side and view the transaction from Company ABC's perspective, make the deal a bad one, and see what ABC can do to coerce the bondholders into taking it anyway.

Exchange offers are inherently coercive because they threaten the liquidity of the old bonds. The liquidity of a bond is a function of how widely it is held. A successful exchange inherently reduces the number

⁷ *Id.* at 751, 756-57.

⁸ *Id.* at 785-86.

of bondholders of the old bonds, and thus their liquidity, resulting in a loss of market value. Indeed, a listed issue can be delisted. This threat encourages bondholders to accept the exchange offer even without any deliberate coercion by issuers.

Issuers rarely rely on the implicit coercion of illiquidity alone, however. An exchange offer is a species of tender offer, and the tender offer form invites coercion because (1) it forces each member of the offeree group to act individually rather than by a collective decision-making procedure, and (2) it splits the offerees into two groups, permitting an offer can be structured so that opponents who refuse to consent are left in a worse off position. Issuers take advantage of these properties, deploying substantive and procedural sticks and carrots to encourage acceptance.

1. Sticks: Exit Consents.

Many protective provisions in bondholder contracts are open to majority amendment even when the payment terms are subject to a UAC. Issuers frequently condition bondholder tenders in exchange offers on the execution of a consent (an “exit consent”) to remove these provisions—business covenants (usually by a simple majority vote under the bond contract) and, in the cases of a secured bond, stripping collateral (usually a two-thirds vote).⁹ Thus, in an exit consent transaction, a bondholder is invited to exchange the old bond for a new one, but is allowed to do so only after first consenting to an amendment of the terms of the old bond. The move distorts the bondholder’s choice. Even if it would reject the offer based on its appraisal of its value, it might nonetheless accept to avoid being stuck with an old bond with diminished rights and no liquidity in the event the other bondholders accept and the offer succeeds.

Note that this tactic is not injurious *per se*. The stripping of rights by the exiting bondholders lowers the free ride payoff from refusing to tender, discouraging self-interested holding out within the investor group and making it more likely that a fair offer succeeds. The exiting bondholders have every reason to consent to the amendment. Once the bondholder decides to cooperate with the issuer, the bondholder

⁹ See *infra* text accompanying note 238.

will see anything that lowers the value of old bonds left in circulation after the offer's conclusion as adding value to the new bonds.¹⁰

2. Sticks: Differential Consideration.

Issuers also can use procedural machinations to coerce acceptance of exchange offers. Absent regulation, an offer can be kept open only a short time, so as to discourage a coordinated response. Higher consideration can be added for earlier tenders toward the same end. Finally, disfavored bondholders can be excluded altogether from the set of offerees, facilitating side-deals with self-interested bondholders.

3. Carrots: Terms of the New Bonds.

Attractive terms can be included in the new bonds at the expense of the old. Suppose Company *ABC* offers to exchange the \$100 7% old bond due in two years for a \$75 face value 8% new bond due in seven years with a junior lien on its property. The 100 basis point interest step-up adds a little sugar without erasing the fact that the new bonds carry lesser financial rights. The lien does even more. Should bankruptcy follow for *ABC* despite a successful exchange offer, the new bonds will therein rank prior to the old bonds, making the lien a stick as well as the carrot. The same could be done by inserting a subordination provision into the old bonds via the exit consents, so that the old bonds would be explicitly subordinated to the new bonds.

4. Carrots: Consent Fees and Vote Buying.

Coercion also can occur in connection with a majority bondholder vote. The issuer can skew preferences by paying a consideration, known as a “consent fee” to those voting its way. The consent fee, like the exit consent, splits the bondholders into two groups and leaves the nonconsenting bondholders in a worse position. Given a 51% CAC, the issuer can pay a majority of bondholders to approve an amendment that makes the bonds as whole less valuable but leaves the payees better off net of the payment. If the bondholders cannot coordinate to resist, the issuer can even induce an amendment that leaves each consenting bondholder less well-off, but willing to vote yes and take the money for fear that a simple majority will do likewise.

¹⁰ Goshen, *supra* note 4, at 785.

C. Implications and Correctives

Exchange offers put bondholders in an unstable situation. They are forced to choose even as the value of the outcome depends on choices made by other members of the group as well as the issuer's prospects. Holding out and taking a free ride may look attractive, even given exit consents. But it is a dangerous game. If enough bondholders refuse to tender and the minimum condition is not met, then the offer fails. If a successful offer would have averted bankruptcy, everybody is worse off. Exit consents make this result less likely, but they too have a dark side. Suppose a successful restructuring does indeed create a surplus but the issuer has structured the terms of the new bonds such that the entire surplus redounds to the benefit of its stockholders. Here considered judgment counsels holding out. Unfortunately, given an exit consent, refusing to tender on the merits invites punishment in the form of impaired terms in the event the other members of the group buckle and accept. It is a game without an equilibrium solution as the bondholders choose between holding out and a high payoff and cooperation and a lower payoff against the threat of failure and a still lower payoff for everybody.

Meanwhile, all of the issuer "sticks" just described admit of a simple corrective. In order for group consents to be collected without coercion, each member must be allowed to register its preference without consequences tied to the outcome. This takes us back to the theoretical baseline—the best way to get the investor group from here to there is by simple majority vote conducted without side payments by the issuer. Such a vote also minimizes problems arising from holdouts, free riders, conflicts, and misjudgment. But problems will remain, particularly as regards the latter two. Conflicts that are difficult to detect can obtain among large segments of a voting population. Sound judgment depends on (but it not guaranteed by) complete information, a commodity not necessarily forthcoming from transactional proponents.

II. REGULATORY CONSTRAINTS

If corporate and securities law followed the efficiency account articulated in Part I, all collective decisionmaking by securityholders, whether stockholders or bondholders, would be subject to a norm of

sincere voting and a blanket prohibition of coercive tactics. But that's not how it works. There is a pattern. First comes a duty-driven state law base under corporate and contract law. Under this, absent a fiduciary or contractual duty to be solicitous of the interests of the corporate issuer or the other securities holders in a group, nothing prohibits either self-interested voting or coercive tactics. The base is modified by a hodgepodge of provisions in federal securities law pursuing the goal of undistorted investor choice. These constraints tend to take the form of bright-line rules.

The rules covering stockholders and bondholders differ markedly in their details, even as both follow the pattern. The comparison is instructive. Generally, stockholders are better protected than are bondholders because corporate law contains an overlay of fiduciary duty where contract law does not. Stockholders are also more likely to benefit from the regulatory solicitude of the Securities and Exchange Commission (SEC). But there also is a formative federal intervention on the bondholder side. Under section 316(b) of the Trust Indenture Act, payment terms in bond contracts may not be amended directly. Workouts accordingly proceed only by means of exchange offer. Ironically, both self-interested voting and issuer coercion come to forefront of the practice as a result. Courts have refused invitations to invoke the contractual duty of good faith against them

Section A outlines the treatment of stockholder decisionmaking. Section B moves up the right side of the balance sheet to bonds, focusing federal law, in particular on TIA section 316(b). Section C then looks at the contractual duty of good faith as applied to bonds. Section D explains the overall pattern. It shows that investor self-interest and issuer coercion present targets ill-suited to control under open-ended common law standards. No easily drawn lines distinguish "proper" from "improper" self-interest or coercion. The efficiency account, even as it works well taken as a whole, provides no assistance.

A. Stockholders

Corporate law's voting defaults are majoritarian and very few companies opt out, minimizing frictions from holdouts and other problems related to super-majority thresholds. But self-interested shareholder voting is not prohibited. Shareholders do not owe one another fiduciary duties and private agendas do not lead to disqualification. The only exception to the rule of self-interest

addresses vote buying, which breaks the overall regulatory pattern.¹¹ But only outright exchanges of cash for proxies clearly traverse the prohibition. Other arrangements, like side-deals that inject an element of self-interest into the tally, can pass if fully disclosed.¹²

Fiduciary scrutiny is triggered when a shareholder has voting control of the company. But the inquiry does not focus on the vote itself. It takes controlled boardroom action leading to unequal outcomes rather than self-interested voting *per se* to trigger scrutiny.¹³ That said, self-interested shareholder voting does arouse a response at a secondary level—the votes of a fiduciary seeking a shareholder ratification to shield a self-dealing transaction from fiduciary review are dropped from the tally.¹⁴

The federal securities laws, in contrast, do seek to assure undistorted consent-giving, although their coverage is intermittent. The primary contribution concerns information, the full production of which is mandated by the periodic disclosure system and the proxy rules.¹⁵ There is also process regulation of tender offers, which are subject to the same coercive tactics employed in distressed debt exchanges, except that here the coercer can be a third party offeror rather than the issuer. The Williams Act,¹⁶ added in 1968 to the Securities and Exchange Act of 1934 (the “1934 Act”), subjects tender offers to a package of bright-line rules designed to minimize coercion.

¹¹ See, e.g., *Chew v. Inverness Management Corp.*, 352 A.2d 426 (Del. Ch. 1976).

¹² The exception has been narrowing over time. See *Schreiber v. Carney*, 447 A.2d 17 (Del. Ch. 1982) (permitting a loan inducing a vote). What was once an open-ended standard generally directed to voting-for-consideration recently has taken on rule-like characteristics. See *Portnoy v. Cryo-Cell Int'l, Inc.*, 940 A.2d 43 (Del. Ch. 2008) (rejecting an intrinsic fairness test).

¹³ The classic case is *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971) (ruling that board control implies a duty against self-dealing defined as taking something to the exclusion or detriment of the minority shareholders).

¹⁴ See *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) (majority of minority required to protect cashout merger majority shareholder); *Lewis v. Vogelstein*, 699 A.2d 327 (Del. 1997) (majority of disinterested shareholders required for director self-dealing transaction).

¹⁵ Regulation 14A, 17 CFR 240.14a-1-240.14b-2. The federal securities laws now also mandate sincere voting on the part of institutional intermediaries. See SEC, Proxy Voting by Investment Advisors, 17 CFR Part 275, Release No. IA-2106 (March 10, 2003). Significantly, this innovation follows not from a revision of shareholder voting norms but of the norms governing the relationship between fund managers and their beneficiaries, and thus follows from fiduciary duty and conforms to the overall pattern.

¹⁶ 15 U.S.C. §§ 78m(e), 78n(d), 78n(e).

The rules control an offer's timing and require equal treatment of all members of the stockholder group.¹⁷

State corporate law also inhibits coercive tactics of tender offerors, but as an incident of fiduciary constraint of management defensive tactics.¹⁸ Coercion is thus deterred indirectly because it gives a management a justification for defensive barriers. Tender offers by majority shareholders also come in for special constraint against coercion, again as an incident of a fiduciary duty, in this case the control shareholder's duty.¹⁹ Under this, a majority of the minority must accept the offer, the independent directors of the target must get the chance to engage a banker and pronounce on price fairness, and the offeror must commit to go forward with a cashout merger at the same price and abjure retributive treatment of the holdouts.²⁰

B. Bondholders—Federal Law

With bondholders, we reverse order and begin with the federal overlay. The reversal follows from the magnitude of the federal intervention, which restricts the contracting space. The TIA mandates terms in the contracts, called “trust indentures” governing publicly-issued bonds, including terms facilitating workouts.²¹ The Bankruptcy

¹⁷ 17 C.F.R. §§ 240.13e-4(f)(8)(i)-(ii), 240.14d-10(a)(1)-(2) (2015).

¹⁸ See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Unitrin, Inc. v. Amer. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

¹⁹ The Delaware courts backed into this result, after the Delaware Supreme Court, as a matter of statutory construction, barred fiduciary review of minority shareholder cashout mergers in cases where the majority holds 90% or more of the shares. See *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001). Majority shareholders holding less than 90% thereafter evaded direct fiduciary scrutiny of their mergers by conducting antecedent tender offers to bring themselves up to the 90% threshold. The Delaware courts thereafter adjusted with an anti-coercion rule applied to the antecedent tender offer.

²⁰ See *In re Pure Resources, Inc. Shareholder Litigation*, 808 A.2d 421 (Del. Ch. 2002).

²¹ Bonds involve two separate contracts: a note, which is a promise from the bond issuer to repay the bond, and an indenture. The indenture creates a common enforcement mechanism for all of the bonds through an entity called an “indenture trustee,” who is to represent the interests of the dispersed bondholders. Although there need not be any actual trust corpus, the term is a holdover from older practice when bonds were generally secured and the collateral was held in trust. As a result, the indentures are often called “trust indentures,” so hence the name “Trust Indenture Act.” The term “indenture” refers to the contract itself—an indenture is merely a contract written with a primitive anti-fraud device consisting of two counterparts of the contract written on the same sheet of paper or parchment, which would then be cut in two, so as to divide the counterparts. The cut would be made with a set of zigzagged indents, hence the name indenture. The idea was that the two counterparts would have to fit together like Little Orphan Annie's locket or the Passover

Code goes on to block contract enforcement²² and channel restructuring into a judicially supervised process.

1. Amendment: TIA Section 316.

Section 316 of the TIA addresses bondholder waivers and amendments under trust indentures, seeking to prevent distorted decisionmaking by taking the decision itself off the table. Subsection (a) contains two provisions. One of them constrains majoritarian forgiveness of interest defaults by allowing only a payment moratorium not exceeding three years based on a 75% bondholder majority.²³ Subsection (a) also provides a limited prohibition against self-interested voting, requiring that votes of the issuer and anyone controlling, controlled by, or under common control with the issuer be disregarded.

Subsection (b) applies to amendments, providing as follows:

Notwithstanding any other provision of the indenture to be qualified, the right of any bondholder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder, except as to a postponement of an interest payment consented to as provided in paragraph (2) of subsection (a) of this section....²⁴

The section prevents majorities from binding minorities to amendments of terms implicating “the right to receive payment,” called “core” terms. It does not prevent unilateral consent-giving— if an issue is held by a large number of bondholders and 99% consent to remove a core term, the reduction still goes through, but only as to the consenting bondholders. The section in effect imposes a mandatory

afikomen, which would guaranty against fraudulent documents. Obviously such devices are not in use today, but the term has persisted.

²² See 11 U.S.C. § 362.

²³ 15 U.S. C. §77ppp(a). Subsection (a) also provides that bondholder majorities must be permitted to direct enforcement proceedings conducted by the indenture trustee.

²⁴ 15 U.S. C. §77ppp(b).

UAC that covers some but not all terms in the indenture. As to “non-core” terms there is no prohibition, and trust indentures tend to cover them with simple majority CACs. The promises to pay principal and interest clearly are in the “core.” Whether the words “impair” and “affect” imply further prohibitive reach recently has become a matter of interpretive dispute, as has the location of the line separating “core” from “non-core” terms. We will take up these matters in Part IV.

Section 316(b)’s blunt mandate against majority vote amendment is surprising. Indeed, the section makes no sense when viewed through lens of Part I’s efficiency account, which concludes that amendment by majority vote is the least distorted context for out-of-court restructuring. For an explanation, we need to look to the historical context.

The House and Senate reports accompanying the legislation offer the same (verbatim) statement of purpose for section 316(b): “Evasion of judicial scrutiny of the fairness of debt-readjustment plans is prevented by this prohibition.”²⁵ “Evasion” occurred when payment terms were amended in out-of-court workouts. The reasons for concern are set out in the SEC’s famous Report on protective and reorganization committees, supervised by an All-Star team of William O. Douglas, Abe Fortas, and Jerome Frank—two future Supreme Court justices and a future Second Circuit judge (as well as two future

²⁵ S. Rep. No. 1619, The Trust Indenture Act of 1938, S. 2344, 75th Cong., 3d Sess, Jan 5, 1938, at 19; S. Rep. No. 248, The Trust Indenture Act of 1939, S. 2065, 76th Cong., 1st Sess., Apr. 4, 18939, at 26-27; H. Rep. No. 1016, Trust Indenture Bill of 1939, S. 2065, 76th Cong. 1st Sess, June 30, 1939, at 56. There also was a purpose to synchronize the TIA’s regime of mandatory terms with state-based legal regimes that required an unconditional promise to pay in order to import negotiability. Negotiable Instruments Law § 1(2)-(3) (1900). Section 316’s rights-based language derives from this concern. The formulation came from contemporary trust indentures and was designed to assure negotiability. See AMERICAN BAR FOUNDATION CORPORATE DEBT FINANCING PROJECT, COMMENTARIES ON MODEL INDENTURE PROVISIONS 1965, MODEL INDENTURE PROVISIONS ALL REGISTERED ISSUES 1967, AND CERTAIN NEGOTIABLE PROVISIONS WHICH MAY BE INCORPORATED IN A PARTICULAR INCORPORATING INDENTURE 234 (1971). CACs applicable to payment terms were thought to undercut negotiability by interjecting uncertainty as to sum. But opinion was mixed. See De Forest Billyou, *Corporate Mortgage Bonds and Majority Clauses*, 57 YALE L.J. 595, 600-02 (1948). (arguing that a five-year postponement of principal and interest based on a three-quarters vote would not run afoul of the law). See also Robert T. Swaine, *Reorganization of Corporations: Certain Developments Over the Last Decade*, 27 COLUM. L. REV. 901, 927 (1927) (opining that a no action clauses precluding individual suit presented “a serious question whether they do not destroy the negotiability of the obligations affected by them”).

SEC Chairmen). The SEC Report detailed the recent appearance of CACs covering payment terms in new bonds issued in connection with workouts in the real estate sector. The provisions' express purpose was to substitute faster, cheaper workouts for bankruptcy proceedings.²⁶ The Report took a close look at the real estate bond indentures²⁷ along with CACs in bond documentation in Canada and Great Britain,²⁸ accurately stating the policy case in their favor.²⁹

For the SEC reporters, the problem was not that CACs were intrinsically distortionary, but that they would exacerbate distortionary influences in the then-prevailing institutional context. They had nothing against majoritarian concession-making, provided that it was exercised on a fair playing field.

The federal bankruptcy regime had only included corporate reorganization since 1934,³⁰ when Congress added section 77B to the Bankruptcy Act.³¹ Section 77B allowed creditor majorities to bind minorities, provided that certain minimum protections were met, with bankruptcy courts overseeing the process. The idea was to create a fair playing field and displace insider-driven judicial receiverships that had been the mode for corporate debt restructuring since the mid-19th century.

But the 1934 Bankruptcy Act failed to curb abuses, despite judicial supervision. The corporate insiders and investment bankers who had been stage-managing nonbankruptcy receiverships in the decades before 1934 transitioned to bankruptcy reorganization without missing a beat, continuing to use the process vehicle of protective committees to control every important aspect of bankruptcy proceedings. Unfortunately, protective committees were not very protective of their

²⁶ 3 SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 227 (1936).

²⁷ *Id.*, at 225-28; 6 SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, App. C., pp. 143-51 (1936).

²⁸ *Id.*, App. C., pp. 137-43.

²⁹ *Id.* at 147-48.

³⁰ For a description of the pre-1934 regime of equity receivership, see Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420, 1443 (2004).

³¹ Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911 (repealed 1938).

participating bondholders.³² There resulted out-of-control agency costs on the part of those responsible for framing restructuring plans and strategic distortion of consent-giving processes. The SEC Report devoted hundreds of pages to detailing the abuses.³³ A proliferation of CACs would have facilitated the protective committees' survival. Section 316(b)'s CAC prohibition followed.

Significantly, the TIA's progenitors knew both that their scheme implicated a trade-off in the form of additional bankruptcy costs³⁴ and that CACs prevailed in other systems.³⁵ They also knew that the buyers of new bond issues tended to be institutional investors and that mom-and-pop bondholders had more-or-less disappeared from the Depression-era market's buy-side.³⁶ They traded all of this off in pursuit of the ideal of a system in which investors make undistorted choices, an ideal they thought realizable only given some sort of supervision by an omniscient, neutral administrator.

2. Exchange Offers.

Section 316(b)'s protective purpose was never realized due to a critical omission. The TIA does not constrain exchange offers. They went on to emerge as the exclusive vehicle for out of court workouts after 1939, complete with almost every distortionary feature described in Part I—holdouts, exit consents, differential consideration, sweeteners, and consent fees. Federal law presents only a single anti-

³² The effect was ironic given the inclusion in section 77B of a provision allowing courts to disregard pre-bankruptcy protective committees' main tool for binding creditors, the depository agreement. Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911, 915 (repealed 1938).

³³ See, e.g., 1 SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 506-96 (1937) (describing coercive tactics employed against bondholders); id. at 863-83 (describing insider and underwriter control and rent-seeking motivations on the part of their opponents).

³⁴ See *supra* text accompanying note 26.

³⁵ See *supra* text accompanying note 28.

³⁶ See *Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce House of Representatives*, 76th Cong., 1st Sess., on H.R. 2191 & H.R. 5220, at 76-77 (1939) (testimony of John Starkweather, of the Investment Bankers' Association of America). In 1933, however, Jerome Frank, one of the drafters of the SEC report, infamously wrote, "Courts of equity have a tradition of aiding the helpless, such as infants, idiots and drunkards. The average security holder in a corporate reorganization is of like kind." Jerome Frank, *Reflections on Corporate Reorganizations*, 19 VA. L. REV. 541, 569 (1933).

coercive restraint, going to timing, as to which the Williams Act³⁷ applies. The issuer is required to hold open both offer and any exit consent for twenty days and an additional ten days in case of an extension.³⁸ But, because the Williams Act's other process protections do not apply to offers for debt securities,³⁹ exchange offers do not have to be made to all holders⁴⁰ and can address only a limited group of bondholders. Nor is the issuer required to pay the same and highest consideration under the offer to all tendering holders.⁴¹ Instead, the offer can be structured to pay more for early tenders, hustling the bondholders to accede.

C. Bondholders—Contract Law

State contract law adds little in the way of supplemental protection, apart from the possibility of containing exchange offers and coercive processes with explicit contract terms. It turns a blind eye to coercive tactics, even as it also holds out as black letter law an implied duty of good faith and fair dealing.⁴²

The good faith axiom generally receives only lip service from the courts in the context of bonds. The courts proceed from an assumption that the parties to these contracts are sophisticated and can

³⁷ 15 U.S.C. §§ 78m(e), 78n(d), 78n(e). The Williams Act requires that the offer stay open 20 days, 17 C.F.R. § 240.14e-1 (2015), that tenders may be withdrawn at any time prior to the offer closing, that the offer go to all holders, 17 C.F.R. §§ 240.13e-4(f)(8)(i), 240.14d-10(a)(1) (2015), and that all tenders be paid the highest consideration on offer. 17 C.F.R. §§ 240.13e-4(f)(8)(ii), 240.14d-10(a)(2) (2015).

³⁸ Rule 14e-1 under section 14(e) the 1934 Act requires that tender offers be held open for twenty business days, and an additional ten business days from the date of a change in terms. 17 C.F.R. § 240.14e-1 (2015). In a case where the exchange offer carries an exit consent, this requirement prevents the issuer from putting through the contract amendment ahead of closing the exchange offer.

³⁹ See 15 U.S.C. §§ 78m(e), 78n(d)(1) (20__); 17 C.F.R. §§ 240.13e-4(a)(2) (defining issuer tender offer as an offer for equity securities), 240.14d-1(a) (remitting tender offers to debt securities to Regulation 14E) (2015); *E. H. I., Inc. v. Insurance Co. of N. Am.*, 652 F.2d 310, 313-15 (3d Cir. 1981) (addressing 17 C.F.R. § 240.14d-1); Royce de R. Barondes, *An Economic Analysis of the Potential for Coercion in Consent Solicitations for Bonds*, 63 *FORDHAM L. REV.* 749, 762-65 (1994). The upshot is that an offer straight debt is subject to Regulation 14E, and Rules 14e-1, 14e-2, and 14e-3—the 20-day rule and the antifraud rules. However, exchange offers paying cash or debt convertible into equity must comply with the full-dress requirements in Rule 13e-4.

⁴⁰ 17 C.F.R. §§ 240.13e-4(f)(8)(i), 240.14d-10(a)(1) (2016).

⁴¹ 17 C.F.R. §§ 240.13e-4(f)(8)(ii), 240.14d-10(a)(2) (2016).

⁴² RESTATEMENT (SECOND) OF CONTRACTS, § 204.

bargain for the terms they want.⁴³ They accordingly have held that the implied duty of good faith derives directly from the language of the indenture. It follows that the good faith duty can be implied only when directly supported by an express term⁴⁴ and cannot provide bondholders with rights inconsistent with the indenture's express terms.⁴⁵ Thus formulated, the duty loses its gap-filling quality. This approach makes life simple and predictable for courts and comports with the courts' general approach to interpreting financial instruments.⁴⁶

The leading case taking this approach in connection with a debt restructuring is *Katz v. Oak Industries*,⁴⁷ in which Delaware's Chancellor William T. Allen rejected a good faith challenge to an exit consent attached to an exchange offer and directed to lifting business covenants. The device violated no express terms of the contract. Its coercive character was acknowledged, but not found to traverse any applicable norm—the bondholders were deemed to have a free choice between participating and holding out. Nor did the Chancellor see any problem with the issuer taking actions to benefit shareholders at the expense of creditors—that, after all is what directors are supposed to do.⁴⁸

⁴³ See, e.g., *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1049 (2d Cir. 1982); *Katz v. Oak Indus., Inc.*, 508 A.3d 873, 879 (Del. Ch. 1986).

⁴⁴ When the issuer acts in accordance with the indenture's express provisions, good faith claims are foreclosed. *First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co.*, 919, F.2d 510, 514 (9th Cir. 1990); *Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank*, 731 F.2d 112, 122 (2d Cir. 1984); *Banco Urquijo, S.A. v. Signet Bank*, 861 F. Supp. 1220, 1249 (M.D. Pa. 1994); *Banque Arabe et Internationale d'Investissement v. Md. Nat'l Bank*, 819 F. Supp. 1281, 1296 (S.D.N.Y. 1993); *Banco Español de Crédito v. Sec. Pac. Nat'l Bank*, 763, F. Supp. 36, 45 (S.D.N.Y. 1991).

⁴⁵ See e.g., *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 957 (5th Cir. 1981)(en banc); *Garner & Florence Call Cowells Found. v. Empire, Inc.*, 589 F. Supp. 669, 673 (S.D.N.Y. 1994); *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1517 (S.D.N.Y. 1989) ("In contracts like bond indentures, 'an implied covenant...derives its substance directly from the language of the Indenture and cannot give the holders of Debentures any rights inconsistent with those set out in the Indenture.'"); *Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co.*, 708 A.3d 989, 992 (Del. 1998) (bondholder must show from express terms that particular implied term would have been included if parties had negotiated for it).

⁴⁶ Cite Rule of Explicitness cases about subordination agreements.

⁴⁷ 508 A.2d 873 (Del. Ch. 1986).

⁴⁸ *Id.* at 879.

Chancellor Allen also is responsible for the leading decision on bondholder vote buying, *Kass v. Eastern Air Lines, Inc.*⁴⁹ This case concerned a \$35 per bond payment in exchange for a consent to waive a dividend covenant. The plaintiff, invoking a general public policy against vote buying, claimed a breach of the good faith duty stemming from the fact that the payment went only to consenting bondholders rather than on an equal basis to the group.⁵⁰ Chancellor Allen rejected the argument, seeing no reason to doubt that the payments lay within the expectations of the parties to the contract.⁵¹

D. Commentary

A comparison of Part I's efficiency analysis and this Part's sketch of the regulatory framework raises two questions. First, why do we have this incomplete, patchwork response to the distortion problem? Second, why is there a treatment differential between stockholders and bondholders? Stockholders enjoy full application of the Williams Act and a prohibition against vote-for-cash trading, and minority shareholders enjoy special anti-coercion rules that go beyond those held out under the Williams Act. Bondholders get none of this. This section suggests some answers to the questions.

Note, first, that there is an across-the-board reluctance to imply protective, common law duties to assure undistorted consent-giving. The big statutory interventions—the TIA and the Williams Act—are the legislative results of moments in history in which their respective subject matters emerged as front-line policy concerns. In both cases, bright-line federal mandates supplemented the base of state law without influencing its normative coloration.

At the same time, the logic of Part I's efficiency account has not filtered into state law's normative framework. Absent such a policy focus there is little on which caselaw might build. Self-interested

⁴⁹ 1986 WL 13008 (Del. Ch.), *aff'd*, 518 A.2d. 983 (Del. 1986). See also *Drage v. Santa Fe Pacific Corp.*, 1995 WL 396370 (Ohio Ct. App.). Corporate law's anti-vote buying prohibition does not carry over to senior securities. New York, for example, relaxes a statutory prohibition against vote buying to permit the votes of preferred stockholders to be bought, provided the offer to purchase is made to all holders and left open for twenty days. N.Y. BUS. CORP. L. § 609(e). The same would seem to follow for bonds, which in any event lie outside the corporate law pale.

⁵⁰ 1986 WL 13008, at 1077.

⁵¹ *Id.* at 1091-82.

voting raises no hackles, absent a contrary duty on the voter's part. Were it otherwise, there would be difficult problem of sorting proper from improper self-interested motivation. No theory presents itself other than Part I's efficiency analysis, which signals a regime of sincere voting, an ideal result difficult to realize in the real world due to problems of verification. Unless a given voter has a duty to disclose, there may be no way to ascertain its motivations. The prohibition of votes-for-cash applied to common stock emerges more as an exception to the rule than a normative base point susceptible to expansion.

Coercive setups are easier to identify than voter self-interest. But, absent independent duty not to coerce, it once again is difficult identify a normative tool that draws a line between the proper and the improper. The efficiency analysis again provides no help in drawing the line. It signals that both tender and exchange offers should be banned outright, a result that makes no sense either as regards stock, as to which cash tender offers play an agency cost reductive role, or bonds, as to which the TIA makes the exchange offer the sole mode for out-of-court restructuring. When a court is asked to intervene against a coercive exit consent, nothing precludes the possibility that so doing would inhibit the closing of a beneficial deal. As we saw in Part I, coercion is not objectionable *per se* in practice, and can have a useful instrumental aspect when holdouts are present.

Such intervention as occurs is duty driven, and contract law offers very little with which to fill the gap. This is not only a function of the caselaw's *ad hoc* barriers to application of the good faith duty in financial contexts. There also are structural inhibitions. Coercion *per se* invalidates a contract only if it amounts to duress, which presupposes an improper threat and no reasonable alternative,⁵² extreme conditions not present in bond workouts. Coercive tactics and hard bargaining do figure into unconscionability avoidance. But, with the exception of one outlier case from a half-century ago that invoked the interest of helpless mom-and-pop bondholders in invalidating a bond contract term as adhesive,⁵³ the bundle of notions bound up in unconscionability have no traction in this big money context. Finally,

⁵² RESTATEMENT (SECOND) OF CONTRACTS, § 175(1).

⁵³ *Van Gemert v. Boeing*, 520 F.2d 1373 (2d Cir.), *cert. denied*, 423 U.S. 947 (1975).

the TIA itself defuses any sense of fact-driven urgency. As the Congress already has intervened here to assure protection, no further exertion in the form of an implied contractual duty is required.

Bankruptcy law provides an instructive contrast. Even though bankruptcy is an equitably-driven process explicitly devoted to creditor protection, it does relatively little regarding self-interested voting and coercive kickers. Under Chapter 11, (1) a reorganization plan's proponent must be in good faith⁵⁴ and (2) the votes of creditors that are not solicited or cast in good faith may be designated by the court (that is, cast as the court sees fit).⁵⁵ There is little caselaw, and neither provision has been read expansively. Thus claimants protesting coercive "death trap" reorganization plans that penalize non-consenting creditors have succeeded in invalidating them for failure to meet the "fair and equitable standard,"⁵⁶ but not as bad faith coercion.⁵⁷ The ban on bad faith voting applies only when a creditor casts its vote not to maximize the return on its claim, but rather to increase the value of other investments⁵⁸ or when a creditor has engaged in "obstructive tactics and hold-up techniques exact" better treatment for its individual claim, rather than for all similarly situated creditors with claims in the same class.⁵⁹ Merely amassing a blocking position for the purposes of preventing plan confirmation will not by itself result in designation.⁶⁰

We note that a court inclined to take self-interested voting or bond issuer coercion seriously could break with the foregoing pattern,

⁵⁴ 11 U.S.C. § 1129(a)(3).

⁵⁵ 11 U.S.C. § 1126(e).

⁵⁶ 11 U.S.C. § 1129(b).

⁵⁷ Cf. *In re MCorp Financial Inc.* 137 B.R. 219, 236 (Bankr. S.D. Tex. 1992) (holding that a death trap provision violated the "fair and equitable" requirement for cramdown plans) and *In re Allegheny Intern., Inc.*, 118 B.R. 282, 304 n.15 (Bankr. W.D. Pa. 1990) (finding that a death trap provision was not fair and equitable because it discriminated against classes of creditors who voted against the plan) with *In re Zenith Electronic Corp.*, 241 B.R. 92, 105-06 (Bankr. D. Del. 1999) (death trap plan permissible if it does not violate "fair and equitable" requirement) and *In re Drexel Burnham Lambert Group Inc.*, 138 B.R. 714, 715 (Bankr. S.D.N.Y. 1992), aff'd, 140 B.R. 346 (S.D.N.Y. 1992) (approving death trap plan).

⁵⁸ H.R. Rep. No. 95-595, at 411 (1977) (section 1126(e) is intended to overturn *Aladdin Hotel Co. v. Bloom*, in which the majority bondholders voted for an amendment because of the benefit to their equity interest in the debtor firm).

⁵⁹ COLLIER ON BANKRUPTCY (16th ed.), ¶ 1126.06[2]. See also *Young v. Higbee Co.*, 324 U.S. 204 (1945).

⁶⁰ *Figter Ltd. v. Teachers Ins. & Annuity Ass'n of Am.*, 118 F.3d 635 (9th Cir. 1997).

making two moves. First, process would be distinguished from substance. In the leading bondholder good faith cases the plaintiffs sought added substantive rights and the courts refused, hesitating to disturb settled allocations of risk and return. Objections to workouts ask for considerably less in the way of intervention, going not to the risk-return allocation but the bargaining framework for its modification. As such, a good faith claim falls into territory already problematized in contract law, which admits substantive review of modifications of executory contracts.⁶¹ Second, the court would intervene discretely so as to conform to the pattern of exception-by-rule. A different result in *Katz* called only for a rule against exit consents. *Kass* asked only for a cash-for-votes ban like that already in place for common stock.

Unfortunately, there is a powerful policy reason to refrain from such a process-based application of the good faith duty in the bond workout context. Workouts are hard to do precisely because TIA section 316(b) blocks majoritarian amendment of payment terms. Exchange offers are seen as likely to fail because they prompt holding out. In order to minimize the holdout problem, issuers attach high minimum tender conditions to the offer, which make success less likely. Issuers also resort to coercive exit consents and consent payments, in effect retaliating against holdouts in the service of a composition that just might make everyone better off. A different result in *Katz*, prohibiting exit consents, would make workouts still harder to do, implying cognizable opportunity costs. The same goes for vote buying. Return to the consent payment sanctioned in *Kass*, which concerned an amendment that relaxed a business covenant. Going concern modifications like these succeed without cash consideration only given cooperatively disposed lenders. “Relational” lenders such as banks in syndicated loans and insurance companies in classic private placements have the requisite cooperative incentives,⁶² where bondholders do not. Payment is expected when issuers seek waivers. Vote-buying, although suspicious when considered in the abstract, imports useful flexibility in this arm’s length context.

⁶¹ See RESTATEMENT (SECOND) OF CONTRACTS, § 89(1)(calling for changed circumstances and fairness review).

⁶² William W. Bratton, *Bond and Loan Covenants, Theory and Practice*, 11 CAPITAL MARKETS. L.J. 461, 477-81 (2016).

This policy case against judicial intervention against issuer coercion stems from a generally-accepted picture of uncooperative bondholders and dysfunctional exchange offers, a picture that in turn informs a long-standing policy case for repeal of section 316(b). Part III shows that the practice picture has changed in recent years. Today, exchange offers tend to succeed, so the case for judicial intervention looks different.

III. THE NEW RESTRUCTURING

Professor Mark Roe initiated a policy case against section 316(b) in an article published in 1987.⁶³ Roe saw section 316(b) as a source of avoidable costs. Workout by exchange offer was just too hard to do. Uncertainty and opportunism were combining to prevent value-enhancing exchange offers from closing where direct amendment would have succeeded, causing the agency costs of debt and the cost of bankruptcy to run to excess.⁶⁴ Bondholders who might otherwise support a deal of uncertain value withheld consent because they did not wish to be victimized by free riding holdouts.⁶⁵ Exit consents ameliorated the holdout problem without solving it.⁶⁶

Professor Victor Brudney countered a few years later, arguing for the status quo from what amounted to a polar opposite position. Like Roe, he assumed that holdouts tend to cause exchange to fail, but drew very different policy inferences. Brudney insisted on a process platform offering undistorted choice⁶⁷ and found that all proposals for majoritarian amendment came up short under that standard. Meanwhile, the contracting space was intrinsically distorted. Exchange offers were take-it-or-leave bids with no opportunity for negotiation. Bondholders labored under a collective action problem and issuers timed their offers to suit their own agendas; information asymmetries

⁶³ Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987).

⁶⁴ *Id.* at 243.

⁶⁵ *Id.* at 239.

⁶⁶ Roe argues (1) that many bonds are without significant covenants to strip away, (2) that exit consents are a factor only in a debt exchange and not in a deal involving cash or stock, and (3) that the courts might eventually suppress them. *Id.* at 250, 253, 256 (noting also that majoritarian amendment of payment terms no longer impaired negotiability).

⁶⁷ Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1828 (1992).

were intrinsic and irremediable.⁶⁸ Brudney also challenged the notion that restructuring failure necessarily triggers excess bankruptcy costs, asserting that in many cases the issuer was deteriorating so severely as to land in Chapter 11 even in the event of a successful workout.⁶⁹ Exchange offers had no significant cost reductive effect in such cases, and simply served to weaken the rights of those classes making concessions.⁷⁰

Roe, Brudney, and subsequent participants in this discussion work from a common bundle of assumptions. In the generally-accepted picture, section 316(b) makes out-of-court restructuring dysfunctional by foreclosing direct majority amendment of payment terms. Exchange offers come with 90% minimum tender conditions because bondholders insist that the holdout possibilities be minimized. This makes the offers likely to fail, prompting issuers to respond with coercive ploys like exit consents. Even so, failure is likely. It is a lose-lose outcome, with bankruptcy following and a surfeit of additional costs that make everyone worse off. With direct amendment by a two-thirds or three-quarters majority none of this would happen.

This Part shows that the practice has changed materially in recent years. First, bankruptcy itself has become cheaper with the proliferation of prepackaged, or “prepac” bankruptcy during the 1990s and the shift to creditor control after the turn of the century. Second, and more importantly, out-of-court restructuring activity has increased markedly during the past decade. Moreover, restructurings now tend to succeed—holdouts are much less of a problem. Today’s exchange offers are negotiated deals—the take-it-or-leave it ad in the paper has disappeared. At the same time, issuer coercion is more salient than ever. Where formerly it was merely common, now it is ubiquitous. We call these “the new workouts.”

Section A reconstructs the old picture of workouts, drawing on financial economic studies of datasets dating from before 2008. The studies provide support for both the Roe and Brudney positions, variously showing a high failure rate, issuer coercion, and holdout

⁶⁸ *Id.* at 1853-54.

⁶⁹ *Id.* at 1861.

⁷⁰ *Id.*

behavior but also detailing a long list of business reasons why a well-informed, uncoerced, and sincere bondholder might refuse to tender.

Section B turns to comparative costs. It shows that workouts are, indeed, the cheaper mode of proceeding, but shows that, quite apart from the section 316(b) barrier, circumstances often close off the out-of-court route. Discussion then turns to the cost of bankruptcy, detailing the proliferation of prepacks and a more recent trend toward faster, cheaper disposition in regular bankruptcies. The negative cost implications of a failed restructuring have dropped substantially.

Section C looks at workout volume. The uptick in out-of-court activity began as the result of an external shock, when financing sources dried up in 2008, but the change in the pattern has persisted. The shift occurred in the teeth of predictions that workouts would disappear altogether due to the proliferation of credit default swap protection, the purchasers of which have everything to gain from a bankruptcy filing.

We then turn, in Section D, to contemporary restructuring practice. We draw on a hand-collected data set of exchange offers made by SEC reporting companies from 2011 to 2016 to show that most workouts close. None of this goes to say that there are no holdouts or that holdouts no longer complicate matters. It just recharacterizes them as a secondary concern to issuer coercion.

Section E pursues parallel explanations for the change, narrow and broad. The narrow explanation concerns the federal securities laws: a shift in the basis for the exchange offers' exemption from section 3(a)(9) of the Securities Act of 1933 (the "1933 Act") to the Rule 144A exemption under the 1934 Act makes the field more receptive to negotiation. The broad explanation concerns the interplay between restructuring out-of-court and in bankruptcy. Previously, a bright line separated the alternatives. The choice between the two lay in the debtor and the debtor discretion was the rule even inside Chapter 11. Now, secured creditors tend to call the shots inside bankruptcy. These creditors also loom large in out-of-court negotiations. The result is a graying of the line between in- and out-of-court, with process choices emerging as incidents of a single, overall negotiating process.

A. The Dysfunctional Workout

There is considerable support for the assertion that workouts are dysfunctional. The empirical literature shows that restructurings tend to fail, with holdouts figuring prominently in the account. It also shows that bondholder opportunism prompts issuer coercion, which in turn enhances the chance of success. But the downward spiral of opportunism and coercion is not the only salient factor. Business fundamentals also figure prominently when workouts fail.

The studies, which cover the 1980s and 1990s, show that half or less of attempted exchange offers succeeded,⁷¹ although depending on the set of deals examined, success rates varied from 27%,⁷² to as high as 75%.⁷³ Putting aside the 75% outlier, the failure rate implies that holdouts, taken together with ancillary creditor co-ordination problems, impose an opportunity cost.⁷⁴ But it does so without foreclosing other, business-based explanations.

1. Holdouts.

The studies attempt to confirm a causal connection between holdouts and deal failure indirectly, by establishing a causal connection between the holdout threat and the exit consent, proceeding from the premise that a coercive device with the purpose and effect of targeting holdouts is arguably justified, whereas a coercive device with the

⁷¹ Stuart C. Gilson, Kose John & Larry H.P. Lang, *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315, 328 (1990) (studying distressed exchange offers 1978-87 and finding that 47% closed and 53% of the firms went into bankruptcy); Julian R. Franks & Walter N. Torous, *A Comparison of Financial Recontracting in Distressed Exchanges and Chapter 11 Reorganizations*, 35 J. FIN. ECON. 349 (1994) (tracking 161 distressed firms 1983-88 and finding that 76 restructured out-of-court and 78 went into bankruptcy); Lewis S. Peterson, *Who's Being Greedy? A Theoretical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers*, 103 YALE L.J. 505, 506 (1993) (taking a distressed sample 1990-92 and finding that 50% managed to restructure out of court). Salomon Brothers kept running totals, showing one-half or less completed on an annual basis, 1991-93. See also Salomon Bros., *Tender and Exchange Offers* 21 (1993), cited in Peterson, *supra* at 506.

⁷² Sris Chatterjee, Upinder S. Dhillon & Gabriel G. Ramirez, *Coercive Tender and Exchange Offers in Distressed High-Yield Debt Restructurings: An Empirical Analysis*, 38 J. FIN. ECON. 333, 339 (1995) (studying 46 exchange announcements by 40 firms, 1989-92).

⁷³ Christopher James, *Bank Debt Restructurings and the Composition of Exchange Offers in Financial Distress*, 51 J. FIN. 711, 717 (1996) (studying 68 proposed exchange offers 1980-90).

⁷⁴ See Edith S. Hotchkiss, Kose John, Robert M. Mooradian, Karin S. Thorburn, *Bankruptcy and the Resolution of Financial Distress* 32, working paper, Jan. 2008 available at <http://ssrn.com/abstract=1086942>.

purpose and effect of cramming down a bad transaction is not. The studies compare offers made with exit consents to offers made without—depending on the study, 46.6%,⁷⁵ 56%,⁷⁶ or 33%⁷⁷ of the offers include exit consents. The studies show, intuitively, that exit consents increase the number of tenders and the success rate.⁷⁸ They compare the two sets of offers on the assumption that exit consents will tend to show up where holdouts are more of a problem, using proxies to indicate holdouts.⁷⁹

2. Business Frictions.

A bondholder considering whether to accept an exchange offer worries about more than strategic holdouts. Some offers are bad on their own. A good offer meets two conditions. First, it has to cut deeply enough into the bondholders' contract rights to yield a sustainable capital structure,⁸⁰ and, second, it must not cut so deeply as to allocate to the common stockholders too much of the surplus arising from the achievement of sustainability. Threading this needle is not easy.

As Brudney pointed out, a workout can make the bondholders worse off if the issuer limps into bankruptcy anyway, for the old bond would entail a bankruptcy claim in the original face amount. Bond analysts cite post-exchange bankruptcy as a significant risk factor for bondholders taking exchanges. The studies confirm that creditors are

⁷⁵ Peterson, *supra* note 71, at 525.

⁷⁶ Kenneth Daniels & Gabriel G. Ramírez, *Debt Restructurings, Holdouts, and Exit Consents*, 3 J. FIN. STABILITY 1,2 (2007) (analyzing a sample of exchange and tender offers, 1986-97).

⁷⁷ Chatterjee *et al.*, *supra* note 72, at 339.

⁷⁸ *Id.* at 349; Peterson, *supra* note 71, at 526 (65% of offers with exit consent offers close, 59% of offers without, mixing a sample containing exchange and tender offers);

⁷⁹ Daniels & Ramírez, *supra* note 249, at 8 (associating exit consents with larger and riskier issuers); Chatterjee *et al.*, *supra* note 72, at 346 (associating senior debt with exit consents). The studies are marred by over-inclusion, because they include cash tender offers as well as exchange offers. Daniels & Ramírez, *supra* note 76, at 10, 15; Peterson, *supra* note 71, at 525; Chatterjee, *et al.*, *supra* note 72, at 339. Unsurprisingly, cash tender offers succeed more often. *Id.*; Peterson, *supra* note 71, at 526.

⁸⁰ Patrick McGeever, *An Introduction to Distressed Debt Exchanges 3* (2016) available at <http://www.aamcompany.com/insight/an-introduction-to-distressed-debt-exchanges/>.

less likely to support proposals as distress becomes more severe.⁸¹ Yet, according to the studies, bankruptcy eventually happens about half the time even when the offer succeeds—depending on the study, in 52%,⁸² 59%,⁸³ or 45.6% of the cases.⁸⁴ And, as Brudney also noted, the bankruptcy rate also implies a need to make a corresponding adjustment to the back-of-the-envelope estimate of the deadweight costs of failed workouts, for bankruptcy costs are not opportunity costs to the extent they were going to be incurred at all events.⁸⁵ Instead, the only issue is the time differential of when those costs are incurred.

Other business factors also figure into the causation picture. Assets matter—it has been found that a workout is more likely to succeed to the extent firm’s assets are intangible because the value of intangibles tends to erode in bankruptcy.⁸⁶ Capital structure complexity also figures in. The smaller the number of classes of creditors, the more likely a successful restructuring. Financial creditors are not the only pertinent players—a large and uncooperative population of trade creditors can force a company into bankruptcy.⁸⁷ The presence of a large bank lender also makes a difference, but the particular effect depends on the case.⁸⁸

⁸¹ Hotchkiss *et. al.*, *supra* note 74, at 29-30.

⁸² Chatterjee *et al.*, *supra* note 72, at 352.

⁸³ Paul Asquith, Robert Gertner, David Scharfstein, *Anatomy of Financial Distress: An Examination of Junk-Bond Issuers*, 109 Q.J. ECON. 625 (1994).

⁸⁴ Edward I. Altman & Brenda Karlin, *The Re-Emergence of Distressed Exchanges in Corporate Restructurings*, 5 J. CREDIT RISK 43, 51 2 (2009).

⁸⁵ This was Brudney’s point. Note that additional factors will come to bear on the resulting deduction from the opportunity cost ledger. Consider the following possibility. Maybe management put a low-ball haircut into the offer due to fear of holdouts; had management been free to set the haircut at the level needed for a sustainable capital structure, chapter 11 could have been avoided.

⁸⁶ Gilson *et al.*, *supra* note 71.

⁸⁷ Chatterjee, *supra* note 72, at 7.

⁸⁸ Banks tend to be secured, and a fully secured lender has little to fear regarding impairment of its interest in bankruptcy and so will be disinclined to make concessions outside of bankruptcy. James, *supra* note 73, at 712. At the same time, under-secured banks are more likely to make concessions out-of-court precisely because their recovery in a foreclosure—the alternative to concessions—would be limited. When an under-secured bank is willing to negotiate, the bank’s negotiation facilitates a parallel bondholder workout. *Id.* (finding that exchanges accompanied by bank concessions entail larger haircuts and junior claims and are more likely to succeed). Banks tend to make larger investments in information retrieval, so

B. Workouts versus Bankruptcy: Comparative Costs

We now turn to a cost comparison between out-of-court restructuring and bankruptcy. This confirms the point that constraints on the out-of-court route imply opportunity costs, but also shows that the cost differential has decreased substantially since Professor Roe problematized section 316(b) in 1987.

Exchange offers, when they do work, yield better cost numbers than do bankruptcies. Bondholder recovery rates are higher in out-of-court restructurings.⁸⁹ The deals close relatively quickly and without much additional cost. One study averages the cost of an exchange offer at 0.6% of pre-exchange asset book value, another at 2.5%.⁹⁰ In contrast, results of major studies of the direct costs of bankruptcy average out at 6.5% of book value.⁹¹ Indirect costs of bankruptcy, while difficult to measure, are thought to be higher still, at 10% or more.⁹² A *caveat* still should be noted. Indirect cost incurrence tends to be concentrated during the period after distress sets in, but prior to bankruptcy.⁹³ It follows that some of these costs also befall distressed firms that succeed in closing a workout.

Even with the caveat, the cost and recovery numbers suggest that workouts would predominate over bankruptcies in a perfect world. Real world frictions prevent that, quite apart from bargaining instability and regulatory constraints. If the debtor's problems are due to tort, tax, or trade debt or if the debtor has a complicated capital structure, then exchanges have little to offer. Moreover, if the debtor lacks a viable business model and a liquidation makes more sense than a restructuring, there is no point to an exchange, and Chapter 11 offers a high-octane federal sales power that facilitates liquidation.⁹⁴ Severe liquidity problems also can make bankruptcy the only alternative.⁹⁵

bank participation also imports a reduction in information asymmetry, which also is facilitative. Hotchkiss, *supra* note 74, at 27.

⁸⁹ See Altman & Karlin, *supra* note 84, at 50, tbl. 2 (showing an average recovery rate, 1984-2009, on exchanges of 50.8 cents on the dollar compared to 37½ cents on the dollar for other defaults. See also Hotchkiss, *et al.*, *supra* note 81, at 50.

⁹⁰ Altman & Karlin, *supra* note 84, at 29.

⁹¹ *Id.* at 44.

⁹² *Id.* at 48.

⁹³ *Id.* at 49.

⁹⁴ 11 U.S.C. § 363(f).

⁹⁵ Hotchkiss *et. al.*, *supra* note 81, at 27.

Finally, bankruptcy has special advantages for some companies, like disaffirmance of onerous contracts,⁹⁶ and the nationwide service of process.⁹⁷

Managers may balk at the suggestion of an early exchange offer because an exchange offer takes a distressed but non-defaulting company across the line separating performance and default in the eyes of the credit rating agencies.⁹⁸ An exchange offer announcement tends to prompt a drop in the price of the company's common stock, even though economic theory holds that the offeror is trying to unlock a surplus.⁹⁹ Apparently, the offer by itself imports negative informational content. The bonds themselves also are likely to lose value in the wake of an announcement,¹⁰⁰ even as they can be expected to increase in value if the offer succeeds.¹⁰¹ There is also a negative tax result at some companies: the difference between the face value of the old bond and the principal amount for which it is exchanged amounts to cancellation of indebtedness income.¹⁰²

Meanwhile, bankruptcy has gotten cheaper, reducing the policy stakes surrounding section 316(b). Prepack bankruptcy processes,¹⁰³

⁹⁶ 11 U.S.C. §§ 365, 1110, 1113, 1114.

⁹⁷ FED. R. BANKR. PROC. 7004.

⁹⁸ Albeit in a separate subcategory. McGeever, *supra* note 80, at 2.

⁹⁹ Chatterjee *et al.*, *supra* note 72, at 352 (showing a negative announcement period return of -3.28%). Gilson *et al.*, *supra* note 71, at 342 report a return of -1.6% for firms whose exchange offers succeed and -6.3% for firms whose offers go on to fail.

¹⁰⁰ See Chatterjee *et al.*, *supra* note 72, at 17 (showing an announcement negative return of -0.98% for private workouts and -0.54% for public workouts).

¹⁰¹ Peterson, *supra* note 71, at 528-30.

¹⁰² 28 U.S.C. § 108. To the extent that the company has taxable income and lacks loss carryovers to offset it, this tax tab has a cognizable downside, see Altman & Karlin, *supra* note 221, at 44, particularly given the fact that the same haircut, if effected in Chapter 11, creates no taxable income. 28 U.S.C. § 108(a)(1)(a).

¹⁰³ Chapter 11 debtors are generally prohibited from soliciting consents on a Chapter 11 plan prior to the court approving a plan disclosure statement. There is an important exception to this rule, however: if the consents are solicited prior to the filing of the bankruptcy, then no disclosure statement is required. 11 U.S.C. §§ 1125(b), (g), 1126(b). This facilitates a much faster bankruptcy process in two ways. First, the plan can be filed with the bankruptcy petition, enabling a plan confirmation hearing in as little as 28 days. FED. R. BANKR. PROC. 2002(b), 3020(b)(2). Second, because there is no requirement of a court-approved disclosure statement, there is less ability for dissident creditors to hold up the process. The solicitation of votes on a prepack must still comply with any relevant nonbankruptcy law—such as federal or state securities laws—but these disclosure regimes only create ex-post liability. In contrast, bankruptcy has a merits-based disclosure regime that

which have proliferated during the past quarter century, ask the court to confirm what amounts to a workout approved by at least two-thirds of the amount and over one half of the number of each impaired class of creditors. The entire prepac process can, in theory, result in plan confirmation in 28 days and a plan going effective in 42 days. Prepacs are more expensive and time consuming than workouts, but not by all that much. Studies variously find average (median) direct costs of prepacs at 2.8% (2.4%)¹⁰⁴ and 1.8% (1.4%)¹⁰⁵ of pre-bankruptcy assets, putting them between workouts and full-dress bankruptcies on the cost scale, but much closer to workouts. Prepacs, while slightly more expensive, they also offer powers not available in workouts: amendment of core payment terms based on majority consent, redemption of nonredeemable debt, cure and reinstatement of accelerated debts without creditor consent, the ability to get new, super-priority financing, and the asset sale power.

Time is an important factor—costs go up as debtors linger in Chapter 11.¹⁰⁶ Classic studies from before the turn-of-this-century put the average duration of a bankruptcy reorganization proceeding at 2.5 years,¹⁰⁷ 2.3 years,¹⁰⁸ and 2.2 years.¹⁰⁹ But the most recent set of numbers, covering 1981 to 2013, shows a notable reduction to a median of 1.04 years. Prepacs, which are much quicker, have a lot to do with this, averaging 0.34 years over the same period, while regular bankruptcies take an average of 1.53 years.¹¹⁰ In 1990, prepacs made

allows for the injunction of the dissemination of a disclosure statement that has not been pre-approved by the court, which in turn enables hold-up objections. 11 U.S.C. § 1125(b), (g).

¹⁰⁴ Brian L. Betker, *The Administrative Costs of Debt Restructurings: Some Recent Evidence*, 26 FIN. MGT. 56 (1997).

¹⁰⁵ Elizabeth Tashjian, Ronald C. Lease & John J. McConnell, *Prepacs: An Empirical Analysis of Prepackaged Bankruptcies*, 40 J. FIN. ECON. 135 (1996).

¹⁰⁶ Hotchkiss *et al.*, *supra* note 74, at 47.

¹⁰⁷ Lawrence A. Weiss, *Bankruptcy Costs and Violation of Claims Priority*, 27 J. FIN. ECON. 285 (1990).

¹⁰⁸ Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization*, 61 J. FIN. 1253 (2006).

¹⁰⁹ Franks & Touros, *supra* note 71.

¹¹⁰ Edward I. Altman & Brenda J. Kuehne, *Defaults and Returns in the High-Yield Bond and Distressed Debt Market: Review and Outlook*, in *Contemporary CHALLENGES IN RISK MANAGEMENT: DEALING WITH RISK, UNCERTAINTY AND THE UNKNOWN*, at 212 (T. Anderson & Stanley Mayes, eds., 2014).

up 3.3% of public company bankruptcy filings, in 2012, they made up 33.3%.¹¹¹

Regular bankruptcies, taken by themselves, also have gotten faster. Since 2000, performance terms attached to debtor in possession financing agreements (“DIP loans”) caused power to shift from the debtor’s managers to its creditors.¹¹² Where once we had endless petitions by debtors for extensions of plan exclusivity, there are now frequently timetables for asset sales or plan confirmation and other performance metrics.¹¹³ We also have more dispositions by sale of going concern assets than by conventional reorganization by renegotiated capital structure.¹¹⁴ In 1990, the average non-prepac took 2.21 years, a duration that shortened to 0.71 years for the class of 2012.¹¹⁵ As yet, no exhaustive new study of bankruptcy costs covers these recent years. We predict that when such a study is conducted, it will show a substantial reduction.

We note one further factor. Debt contracting has itself evolved so as to reduce the risk of default. The debt incurred in connection with the private equity wave of 2003-2007 came to maturity without a hint of an insolvency crisis. The terms of the deals had something to do with this—many omit financial covenants and contain “pay-in-kind” (PIK) interest terms allowing distressed managers to postpone cash payments.¹¹⁶ Efficiency enhancements in chapter 11 practice also surely played a role. But, very much contrary to expectations, out-of-court restructurings also figure in.

¹¹¹ Edward I. Altman, *The Role of Distressed Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations*, 22 AM. BANKR. INST. L. REV. 75, 92, fig. 7 (2014). The prepack percentage varies widely. In this century the low was 3.4% in 2001 and the high was 76.9% in 2013. The average since 1988 is 11.6%. *Id.*

¹¹² Altman & Karlan, *supra* note 84, at 52.

¹¹³ Since late 2005, debtors also face a hard cap on the period in which they have the exclusive right to propose a plan. Pub. L. 109–8, title IV, §§ 411, Apr. 20, 2005, 119 Stat. 106–07 (codified at 11 U.S.C. § 1121(d)).

¹¹⁴ See *infra* text accompanying note 147.

¹¹⁵ Altman, *supra* note 111, at 92, fig. 7.

¹¹⁶ Bratton, *supra* note 62, at [19].

C. The Shift to Workouts

1. Volume.

Restructuring practice shifted abruptly in 2008 due to a temporary absence of financing. It is impossible to reorganize a firm in Chapter 11 without adequate financing for on-going operations. The financing comes from DIP loans. But the DIP lending market all but disappeared during the credit crunch of 2008, precisely at the moment when demand for financing spiked.

Without a viable bankruptcy option, distressed borrowers turned to exchange offers.¹¹⁷ The number of distressed exchanges effected in 2008 was double that of any year since 1984, the first year when data are available, and the total amount exchanged (\$30.3 billion) exceeded twice the total amount exchanged in all years from 1984 to 2007.¹¹⁸ The issues implicated comprised 59% of issues in default at the time, compared with 10% of issues in default across the period 1984-2007.¹¹⁹ Although DIP financing only disappeared temporarily, the percentage of workouts remained large in 2009 and 2010, at 18.5% and 36%, respectively.¹²⁰ For these two years there was a tax explanation—a temporary deferral of taxation of cancellation of indebtedness income until 2014.¹²¹ The tax deferral ended after 2010, and in 2011 exchange defaults constituted a more normal 9.5% of total defaults.¹²² In 2012 and 2013, however, the number of restructuring exchange offers picked up again to 21% of issues.¹²³ Overall, debt exchanges made up 29% of all issuer defaults during the period 2008-2013, compared to 10% for 1984-2007.¹²⁴

Chapter 11's continued dominance is not surprising. As we have noted, restructuring by exchange makes sense for only a subset of debtors. We are not able to say what percentage of debtors meets this description. The point is merely that with around one-fifth of all defaulting public company debtors turning to exchanges and only a

¹¹⁷ Altman & Karlin, *supra* note 84, at 46.

¹¹⁸ *Id.*, at 46.

¹¹⁹ *Id.*

¹²⁰ Altman & Kuehne, *supra* note 110 at, 226, tbl. 8.7.

¹²¹ See 24 U.S.C. § 108(i)(4)(B).

¹²² Altman & Kuehne, *supra* note 110, at 226.

¹²³ *Id.*

¹²⁴ *Id.*, at 225; Altman & Karlan, *supra* note 84, at 46.

subset of the group well-suited to the exchange alternative in the first place, workouts now vie with bankruptcy as a restructuring option within the subset. This is an important change.

2. The Empty Creditor Problem.

The workout uptick is doubly surprising in view a lengthening list of inhibiting frictions. A so-called “empty creditor” problem has spilled over from the proliferation of credit default swaps (CDSs).¹²⁵ In a CDS, a protection seller promises to pay a protection buyer a certain sum in the event of a defined credit event on a reference asset in exchange for a periodic fee. When a bondholder purchases CDS protection, the CDS hedges the bondholder’s default risk with the protection seller’s promise to pay in the event of a default. Significantly, credit events, as defined under the International Swaps & Derivative Association’s (ISDA) Master Agreement, include payment defaults and bankruptcies but not voluntary debt exchanges.¹²⁶ It follows that a bondholder with swap protection has no incentive to tender into an exchange offer, good or bad. As between a successful restructuring paying, say, 75 cents on the dollar, and a bankruptcy proceeding which will result in the CDS protection seller paying 100 cents¹²⁷ (or more) under the swap, the bondholder wants the latter. It follows that where a substantial subset of a distressed issuer’s bondholders are paying for swap protection, an exchange offer with a super-majority tender condition should be impossible to bring about. In fact, an ex ante subset of protected bondholders is not even a necessary prerequisite. Financial punters who don’t hold the bonds buy credit protection as a way of betting on a default. Once a distressed issuer puts out an exchange offer, such a “naked” protection buyer has an incentive to buy the bonds in order to prevent their being tendered.

So goes the story, and it makes a great deal of sense. But, until recently, supporting evidence was entirely anecdotal, a shortcoming sharply highlighted by a spokesman for the ISDA, which controls the

¹²⁵ Bernard Black & Henry Hu, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PENN. L. REV. 625 (2008).

¹²⁶ At least since the International Swaps and Derivative Association’s “Big Bang” Protocol of 2009. See Credit Suisse, Fixed Income Research, *A Guide to Credit Events and Auctions* 4-5 (2011).

¹²⁷ The difference amount paid under the swap plus the value of the defaulted bond.

documentation for the standard swap contract and manages the process of settling up.¹²⁸ The spokesman also pointed to the upsurge in successful workouts¹²⁹ as contrary evidence and set out some arithmetic demonstrating that the naked swap arbitrage play just hypothesized really does not work.¹³⁰

A couple of empirical studies have appeared, reaching conflicting results. One takes a sample of distressed exchanges from 2006 to 2011 and compares bondholder participation rates as between those issuers as to whose debt CDS contracts had been written and those whose debt was uncovered, and found a 29 point reduction in participation in the former group.¹³¹ The other study takes a sample from 2008 to 2009, and finds that the factors already identified in the literature drive the results¹³² with no difference resulting from the availability of swap protection.

The salience of empty creditors in distressed exchanges remains an unresolved question. We do note that none of our empirical findings undercuts the claim that empty creditors prevent restructurings, for it is possible that issuers and their advisors screen for them in advance, directing capital structures with extensive CDS coverage to prepack bankruptcy. If, as seems likely, CDS coverage does limit the class of companies suited to out-of-court restructuring, the rise in the numbers of restructurings is doubly impressive.

D. The New Practice

The transactional profile of workouts also has changed. This Section shows prevailing picture of dysfunctionality no longer obtains, drawing on hand-collected data on workouts commenced since 2010. The data show a notable increase in flexibility and success. We also

¹²⁸ David Mengle, ISDA Research Notes, *The Empty Creditor Hypothesis* 1 (2009) available at <https://webcache.googleusercontent.com/search?q=cache:VbuxIrfbdPcJ:https://www2.isda.org/attachment/MTY4Mg%3D%3D/ISDA-Research-Notes3.pdf+&cd=2&hl=en&ct=clnk&gl=us>.

¹²⁹ *Id.*, at 7-9.

¹³⁰ *Id.*, at 9-12.

¹³¹ Andras Danis, *Do Empty Creditors Matter? Evidence from Distressed Exchange Offers* 16-18 (2015) (specifically, leverage and short term debt, bank secured creditor presence) working paper available at <https://ssrn.com/abstract=2001467>.

¹³² Mascia Bedendo & Lara Cathcart, *In-and Out-of-Court Debt Restructuring in the Presence of Credit Default Swaps* 3 (2014), working paper available at <http://ssrn.com/abstract=1666101>.

note a shift in the position of household bondholders: now that issuers rely on the Rule 144A exemption from registration, bondholders with assets under \$100 million are entirely excluded from the process.

1. New Data: Distressed Exchange Offers, 2010-2016.

None of the empirical surveys of workout practice looks solely at the period since shift of 2008. To fill this gap, we collected data from a search of EDGAR Form 8-K files, using “exchange offer” and “indenture” as required terms and “consent solicitation” as an optional term.¹³³ The search covered the period from January 1, 2010 to June 30, 2016. We narrowed the results to a group of 46 exchange offers made by distressed issuers.¹³⁴ The offers in the data set all entail either a reduction of principal amount, an extension of time without an increase of interest, or a reduction of interest, and frequently a combination of the three. We do not claim the data set to be complete. With EDGAR as the mode of data collection, distressed issuers owned by private equity partnerships and not reporting publicly, are not included.

The terms of the workouts in the data set span a wide range of possibilities: 50% offer new debt, 17.4% offer new debt and cash, 19.6% offer new debt and equity (preferred or common stock), 6.5% offer new debt, equity and cash, and 6.5% offer all equity. Within the subset offering debt only, the new bonds extend duration in 91.3% of the cases, reduce the interest rate in 34.8%, increase the interest rate in 47.8%, and implicate a principal haircut in 56.5%. The average (median) proposed haircut is 43.5% (32.7%). The average (median) number of days between the announcement of the offer and its completion or termination is 65.4 (42). Stated as a portion of a year, the average duration is .18, which compares favorably with prepack bankruptcy’s average duration of .34. Workouts are almost twice as fast on average.

¹³³ We ran the search through the Wharton Research Data Services SEC Analytics Suite.

¹³⁴ We excluded offers paying all cash at a premium over market price and offers that shifted obligations to different entities within a corporate group without modifying core financial terms. This left us with 44 issuers. We added two issuers whose exchange offers have been the subject to litigation—Education Management Corp. and Chesapeake Energy Corp. and worked the details up with press releases.

The new data also displace old picture in which the holdout problem always leads to a 90% minimum tender condition that causes around one half of the offers to go on to fail. Our data yield a more flexible and successful picture.

Minimum tender requirements take a wide range. The 90% minimum remains the modal approach. In this sample, 17 of 46 offers (40%) specify a super-majority minimum tender (90% or more in 16 cases, 85% in 1 case). In 8 cases (17.4%) the minimum drops to either a simple, two-thirds, or three-quarters majority. One offer split the difference, specifying 90% for a senior issue and a simple majority for junior issues. Fifteen offers (33.3%) had no minimum tender requirement. There were an additional five offers (10.9%) without a minimum, but as to which either a supermajority of bondholders signed onto a formal support agreement with the issuer or such a high subscription rate (99%) resulted as to implicate a high level of organized support. In other words, no minimum tender condition was needed because the necessary support already had been lined up. In the final tally, only one-half of the offers proceeded on condition of 90% supermajority support.

Once the issuer makes the offer, things get even more flexible. Only 40% of the offers closed with subscriptions having met a stated minimum condition. In 17.4% of the cases a stated minimum was waived in connection with the closing, while 32.6% of the offers were completed with no minimum having been stated. Extensions of time also are common, occurring in 22 (47.8%) of the cases, often multiple times. Minimum tender conditions were relaxed as the offer was extended in five cases. Only five of the offers were sweetened.

The new data also dispel the image of failure. Overall, 87% of the offers closed. Two of the closings occurred in respect of a prepack bankruptcy solicitation run concomitantly with the out-of-court offer, where the two-thirds of dollar amount tender threshold for the prepack was met but the exchange offer's higher threshold was not met. If those two cases are omitted from the success column, the proportion goes down to 82.6%. Either way, the success rate is higher than in the

previous studies of distressed offers—only the outlier study registering 75%¹³⁵ even comes close.

There were six complete failures. They are worth a closer look. Bankruptcy followed the offer's failure in 5 of the 6 cases, suggesting that the issuer was too far gone to be an appropriate company for a workout. Indeed, in two cases, the issuers were so close to bankruptcy's door as to make the exchange offer a nonevent, yielding tenders of only 7.2% of the bonds in one case (Dynergy) and only 5.1% in the other case (Colt). As to the other four cases, the tenders came close to the minimum in only one (Angiotech), which involved two issues with minimums of 90% and 98% and tenders of 76% and 85%. In the first of the other two cases (Penson), subscriptions of 51% and 70% failed against a minimum of 95%; in the second (Goodrich), 62% came in against a minimum of 95%. The implication is that exchange offers fail on the merits, rather than due to decisional instability due to holdouts, at least in this sample.

Increased coercion accompanies the picture of increased success. Consent solicitations stripping covenants from the old bonds accompanied 82.6% of the offers in our sample, much in excess of the 33% to 46.6% range found in earlier studies.¹³⁶ The thing that needs explaining, then, is not why the issuers included exit consents but why 9 issuers omitted them. In 4 of those 9 cases, the explanation is easy. Two were exchanges with no minimum condition subject a cap on the number of new bonds, with proration to occur in the event of over subscription. In both cases, the maximum number of old bonds to be accommodated fell short of the number of consents necessary to amend the indentures. Two were exchanges concluded pursuant to side deals without a further solicitation of non-signatory bondholders. All of the remaining five offers fit the general profile. Significantly, all of them failed to close, confirming the effectiveness of coercive tactics.

Coercion did not stop with exit consents. There was an “upstream” feature in 59.6% of the offers, with the new bond offering junior secured status in exchange for an unsecured old bond (65.2% of the debt-only offers had this feature). As noted above, secured status

¹³⁵ See *supra* text accompanying note 74.

¹³⁶ See *supra* text accompanying notes 75-77.

has a negative effect on the value of untendered old bonds and discourages holdouts.

There is also timing coercion. Fifty percent of the offers took advantage of Williams Act exclusion of debt exchanges from the operation of the all holders rule to offer better terms for acceptances received by an early tender date. Typically, this comes in the form of a new bond with a principal amount \$20 to \$50 higher than on the new bond received for late tenders. There were also five cases of vote buying in the form of a fee (typically \$2.50) paid separately for the exit consent.

Finally, there is also a factor that at least nominally counterbalances coercion—negotiation. There is concrete evidence that many issuers pre-negotiate the offer with large bondholders. A formal “restructuring support agreement” between the issuer and (usually) a majority of the bondholders preceded the offer in 45.8% of the cases. We suspect that the number of negotiated deals was actually higher. Issuers hire advisors whose job it is to manage relationships with the large bondholders. The fact that no formal agreement is reached does not imply that discussions did not proceed in the ordinary course.

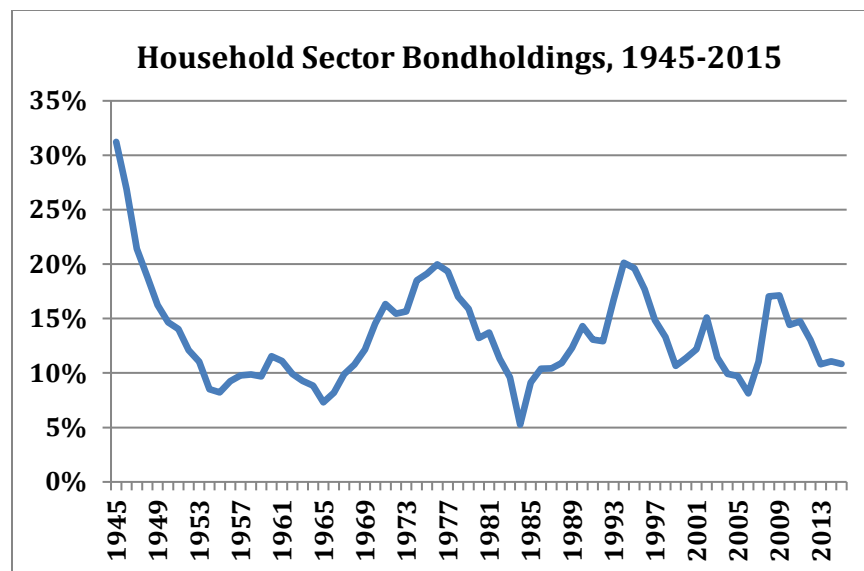
Finally, the new data confirm the older picture is one important respect. Eventual bankruptcy remains salient. Across the entire sample, 34.8% of the issuers eventually went into bankruptcy reorganization or liquidation; 10.9% were acquired by other companies; and 54.3% remain as independent operating companies. Although the percentage is lower than in the earlier studies, our sample includes some very recent closing dates. In the subset of workouts commenced before January 1, 2016, 44.4% went bankrupt. We expect the bankruptcy rate to continue to rise over time.

2. Institutional and Household Bondholders.

Another change in the workout pattern should be noted. This one concerns the treatment of household bondholders, but not their numbers. With bonds, institutions rose to the fore in the bondholder population more than six decades ago. Figure 1 draws on the Federal Reserve Board’s Statistical Release Z.1 to break out the percentage of bonds held by households since 1945. A notable shift to institutions occurred at the beginning of the period—by 1953 household holdings

had fallen from 31% to 11%. Since then the household share has risen and fallen with surprising volatility, but has never exceeded an upper 20% (1976 and 1994) and never fallen below a low of 5% reached in 1984. In 2015, the figure was the same 11% as in 1953 (which may itself be surprisingly large to some).

Figure 1



Today the question concerning the bondholder population goes less to institutions versus households than to status under the federal securities laws. Today's issuers rely on the Rule 144A exemption from registration for the securities offered in the exchange, an exemption requiring that only "qualified institutional buyers"(QIBs) be solicited.¹³⁷ QIBs are defined as substantial institutions or trust funds that own at least \$100 million of securities on behalf of unrelated parties.¹³⁸ The offer process starts with the identification and pre-certification of the QIBs in the bondholder group.¹³⁹ Once the offer goes forward, any mom-and-pop bondholders *don't even receive it*. They in effect are written off as statutory holdouts. It is a complete reversal

¹³⁷ See Morrison & Foerster, *Debt Repurchases and Exchanges* 57, Nov. 8, 2012, available at <http://www.mofo.com/files/Uploads/.../121108-Debt-Repurchases.pdf>.

¹³⁸ See 17 C.F.R. § 230.144A(a)(i)-(iv).

¹³⁹ See Morrison & Foerster, *supra* note 137, at 48.

of the old picture of the coerced, small investor. Rather than being coerced, the moms-and-pops are ignored as too small to matter.

E. Explaining the Changes

Clearly, something other than the temporary disappearance of DIP financing in 2008-2009 and the 2009-10 tax deferral is at work. We offer two explanations, one keyed to the federal securities laws, and the other to the power allocations within Chapter 11.

1. Registration Exemption.

There has been a shift in securities law compliance strategy. The contemporary bond workout took shape in the early 1980s, when investment bank Drexel Burnham Lambert promoted exchanges that made use of the registration exemption in 1933 Act section 3(a)(9).¹⁴⁰ Section 3(a)(9), however, places unwelcome constraints on the debtor's investment bankers and other financial advisors. Under section 3(a)(9), financial advisors must be paid for the advice itself and may not be paid success fees. They are also prohibited from soliciting consents or advising offerees, even though they may negotiate with the bondholders, deliver fairness opinions, and circulate disclosed information. Old school section 3(a)(9) exchange offers were, as a result, often un-negotiated offers done by advertisement in the newspaper.

Today Rule 144A provides a cheaper, more user-friendly alternative. Rule 144A allows for exchanges without constraining the conduct of investment bankers and other advisors engaged by the issuer. The bankers line up the bondholders and take the lead in negotiating restructuring support agreements. Hands-on management by restructuring specialists is complemented by enhanced price discovery, which facilitates evaluation of the value on offer in the exchange.¹⁴¹ The result is that restructuring market has increasingly come to resemble the mergers and acquisitions market, a space in which intermediaries guide managers and investors toward closing. The day of the un-negotiated exchange offer has passed.

¹⁴⁰ Altman & Karlan, *supra* note 84, at 44.

¹⁴¹ *Id.*, at 79.

2. Creditor Control in Chapter 11.

The second explanation lies in the power shift to the creditor side in Chapter 11. Chapter 11 has increasingly become a creditor-controlled process, specifically a process controlled by the senior secured lender, which is often also the DIP financier.¹⁴² Whereas public firms filing for bankruptcy in the 1980s and 1990s often had significant unencumbered assets, most public firms that file for bankruptcy now have few, if any assets not subject to liens.¹⁴³ The lack of unencumbered assets gives the secured creditor a pervasive veto over the bankrupt company's business decisions—even use of cash generated by operations falls into the zone of creditor consent.¹⁴⁴ In addition, an amendment of the Bankruptcy Code in 2005 limited the time during which the debtor has the exclusive right to propose a plan, thereby diminishing a key negotiating lever for management—the threat of interminable delay.¹⁴⁵

Secured creditors usually agree to act as DIP lenders, and DIP financing agreements present a second, even more potent power source. DIP loans come with not only super-priority status but highly invasive promises and conditions—*inter alia*, detailed budgets,

¹⁴² Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STANFORD L. REV. 751 (2002); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STANFORD L. REV. 673 (2003); David A. Skeel, *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 UNIV. PA. L. REV. 917 (2003); Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's 'The End of Bankruptcy'*, 56 STANFORD L. REV. 645 (2003); Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, AM. BANKR. INST. J. 12, 52-53 (Sept. 2003); Barry E. Adler, Vedran Capkun, & Lawrence A. Weiss, *Value Destruction in the New Era of Chapter 11*, 32 J. L. ECON. & ORG. (2012).

¹⁴³ Greg McGalun, *Lender Control in Chapter 11: Empirical evidence*, Feb. 5, 2007, at <https://ssrn.com/abstract=961365>; Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 523 (2009). A revision of Article 9 of the Uniform Commercial Code that went into effect in 2001 facilitated this change. Prior to 2001, creditors had jurisdictionally spotty and uncertain right to take and maintain a security interest in deposit accounts. Since 2001, the Uniform Commercial Code has expressly permitted security interests in deposit accounts. UCC § 9-104.

¹⁴⁴ The cash is likely to be the proceeds of a secured creditor's collateral and thus also subject to the lien. UCC § 9-315; 11 U.S.C. § 552. Bankruptcy law prohibits the debtor from using this "cash collateral" unless it either provides the secured creditor with "adequate protection" of its interest in the collateral, something that is usually impossible given debtor's the lack of unencumbered assets, or obtains the consent of the secured creditor for the use of the cash. 11 U.S.C. §§ 361, 363(c)(2).

¹⁴⁵ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, § 411, *codified at* 11 U.S.C. § 1121(2).

timelines, and the right to approve the appointment of a “Chief Restructuring Officer.”¹⁴⁶ DIP lenders often use their control to buy the company, either by forcing a sale of the debtor’s assets (at which the lender has the advantage of credit bidding) or pushing through a cramdown restructuring in which the lender ends up with a controlling stake in the equity.¹⁴⁷ Such processes effectively sidestep many of the key protections for other, more junior creditor constituencies in Chapter 11, even while complying with the literal terms of the Bankruptcy Code.¹⁴⁸

Chapter 11, then, often becomes a vehicle for the senior secured creditor to carry out a foreclosure sale, either of specific assets or of the entire firm, often to itself. Debtors have little wiggle room, evasive maneuvers having come to naught in the bankruptcy courts.¹⁴⁹

¹⁴⁶ See, e.g., LEVITIN, FINANCIAL RESTRUCTURING AND MODERN COMMERCIAL MARKETS 797-99 (2015); Sris Chatterjee, Upinder S. Dhillon & Gabriel G. Ramirez, *Debtor-in-Possession Financing*, 28 J. BANK. & FIN. 3097 (2004) (detailing terms of DIP loans). See also Sreedhar T. Bharath, Venky Panchapegasan, & Ingrid Werner, *The Changing Nature of Chapter 11*, Fisher College of Business Working Paper No. 2008-03-003, at <http://ssrn.com/abstract=1102366> at 22 (finding a 65% increase in management turnover rates in bankruptcy between 1990 and the early 2000s, with a 200% increase in the turnover rate for managers with significant equity holdings).

¹⁴⁷ An increasing percentage of plan distributions appear to comply with the absolute priority rule, a marker of diminished managerial power in bankruptcy. Cf. Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 523 (2009) (APR violations in 12% of Chapter 11 plans, and payments to equityholders in 18% of plans for cases filed in 2001) and Vedran Capkun & Lawrence A. Weiss, *Bankruptcy Resolution and the Restoration of Priority of Claims*, Am. L. & Econ. Ass’n 18th Annual Meeting, Working Paper 43 (2008) (APR violations in 37% of recent cases) with Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747-69 (1989) (APR violations in 70% of cases in the 1980s) and Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285-314 (1990). (199) (APR violations in 78% of cases).

¹⁴⁸ Neither the best interest test, which guaranties that creditors receive at least as much value in Chapter 11 as in a Chapter 7 liquidation, nor absolute priority rule, which protects unsecured creditors from value being diverted to equity, matter because creditors receive their liquidation rights, and nothing more. 11 U.S.C. §§ 1129(a)(7) (best interest test), 1129(b)(2)(b)(ii)-(b)(2)(c) (absolute priority rule). Likewise, plan feasibility, 11 U.S.C. § 1129(a)(11), does not matter because in this new world, the Chapter 11 plan does not promise to pay junior creditors anything. And the Chapter 11 good faith requirement, 11 U.S.C. § 1129(a)(3), has little bearing on such a plan.

¹⁴⁹ These include “new value” plans that would let old equityholders retain the equity in the reorganized company in exchange for a non-market-tested contribution of new value, “gift plans” in which seniors agree pay off out-of-the-money equity in order to facilitate a quick plan confirmation, and restrictions on credit bidding at asset sales designed to prevent senior secured lenders from purchasing assets. Courts, however, have held that these ploys violate

Increased secured creditor control implies incentive adjustments for the other members of the cast of characters. Certainly, bankruptcy is less attractive than heretofore for the debtor's managers.¹⁵⁰ The same will be the case for its unsecured financial creditors. Their interests often do not favor asset sales and other fast track strategies, making them more amenable to an out-of-court settlement, even a flawed one, so long as it provides a significant reduction in bankruptcy costs and averts the possibility of a settlement skewed to the interests of a the secured class. This does not go to say that an out-of-court composition somehow imports unilateral power evade the secured creditor and injure its interests,¹⁵¹ just that the other players see things differently than heretofore. Where bankruptcy used to offer a comfort zone, today's managers have every reason to avoid it. Meanwhile, bondholder calculations will have shifted in the direction of cooperation.

Indeed, the new restructuring also reflects the presence of dominant secured creditors, which is evidenced by the proliferation of second liens in the new bonds in our data sample. Restructuring support agreements are ubiquitous in bankruptcy as well as in workouts. They set out constraints and timetables similar to those in DIP financing agreements, but go farther, lining up support for a stated outcome.¹⁵² Nothing stops the issuer and a secured creditor from getting the negotiating process going before a bankruptcy filing. An exchange offer can figure in at this point, posing a cost-effective alternative to a prepack filing. What matters is less the venue of composition than the negotiating framework, which proceeds in much

various provisions of the Bankruptcy Code. See *Bank of America, Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle Street P'ship*, 526 U.S. 434 (1999) (prohibiting cramdown confirmation of new value plans that violate absolute priority when there is not a market test); *In re DBSD Nor. Am., Inc.*, 634 F.3d 79 (prohibiting cramdown confirmation of gift plans); *In re Armstrong World Indus.*, 432 F.3d 507 (3d Cir. 2005) (prohibiting cramdown confirmation of gift plans); *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2013) (prohibiting restriction of credit bidding under 11 U.S.C. § 1129(b)(2)(A)(iii)).

¹⁵⁰ Adler, et al., *supra* note 142, at 479 (showing that the shift to creditor control causes management to delay filing).

¹⁵¹ Such a case would exist where there is no secured creditor or the where the secured creditor has a limited claim and lien. The unsecured creditors would take the downsides of DIP financed Chapter 11 into account in evaluating the present give-ups bound up in a workout designed to return issuer to sustainability.

¹⁵² See Douglas G. Baird, *Bankruptcy's Quiet Revolution*, Coase-Sandor Working paper Series in Law & Economics No. 755 (2016) available at <https://ssrn.com/abstract=2767057>.

the same mode whether the context is a workout, a prepack, or a full-dress Chapter 11.

This, then, is the new restructuring of financial debt: exchange offers as an incident of the new politics of Chapter 11 bankruptcy.

F. Summary

Our review of restructuring practice has important implications for the policy discussion directed to section 316(b). The recent developments undercut the polar positions of both Professors Roe and Brudney.

As to Roe, any opportunity costs stemming from distortions related to section 316(b)'s restructuring barrier have ameliorated substantially. Holdouts no longer systematically prevent deals from closing. This is not just a matter of across-the-board issuer coercion. Many offers proceed successfully without a 90% tender condition. When substantial tenders come in but do not reach 90%, the issuer tends to waive the condition and close anyway. If bondholder retribution in the wake of such bait-and-switch maneuvers were a problem, issuers would be forced to make minimum tender condition unwaivable so as to make their offers credible. In cases where the out-of-court route is unfeasible or undesirable, bankruptcy affords a faster, cheaper alternative than heretofore. To the extent that section 316(b) has a potential to do harm, the markets have figured out how to minimize it.

The problems that concerned Brudney also have lost salience. Mom-and-pop bondholders already had largely disappeared from the holding group at the time he wrote. Any disabling coordination problems on the part of bondholding institutions are much diminished as well, to the extent they exist at all.

To say that the markets can live with section 316(b) does not also say that they would be better off with it than without it. Even as the force has gone out of the case for outright repeal, it also has gone out of the case for retention. Coercive tactics are more salient than ever. There are also new factors in the policy calculus. To the extent that secured creditor control (along with restructuring support agreements that follow from it) is skewing bankruptcy into undesirable directions, the new workouts' negotiated aspect, rather than being an ameliorating

factor, becomes subsumed in a larger problem. But it is a problem for bankruptcy courts to address.

IV. THE NEW WORKOUTS GO TO COURT: THE RISE AND FALL OF THE BROAD READING OF SECTION 316(B)

The new workout is a hardball game. Dissatisfied bondholders have pushed back in court, seizing on a reading of TIA section 316(b) set out in a 1999 case called *Federated Strategic Income Fund v. Mechala Group*.¹⁵³ In *Mechala*, a court in the Southern District of New York disregarded the traditional reading of section 316(b), substituting a broader interpretation that potentially extended the section's scope. Under the traditional reading, the reader takes the statutory language—"the right ... to receive payment of the principal of and interest on such ... security ... shall not be impaired or affected without the consent" of the holder—and interpolates the contract's promise to pay as the "right" and interprets "impair" and "affect" to refer to amendment or waiver of the promise.¹⁵⁴ It follows that section 316(b) only applies amendments and waivers of payment terms. A thin caselaw confirmed the reading,¹⁵⁵ which guided practice in financial markets and law firms. Under the broad reading, the impairment of the right to be paid encompasses any unconsented action under the trust indenture that compromises the issuer's ability to pay, even if the bond is not amended. "Impair" and "affect" are, under this interpretation, any unconsented change that makes it less likely that a bondholder will be repaid.

¹⁵³ No. 99 Civ. 10517(HB), 1999 WL 993648 at *7 (S.D.N.Y. Nov. 2, 1999)(concerning a restructuring effected by an exchange offer and exit consents that moved assets out of obligor entities and lifted guaranties of the bonds).

¹⁵⁴ See *Opinion White Paper*, Apr. 25, 2016, available at <https://www.ropesgray.com/newsroom/alerts/2016/April/Opinion-White-Paper-on-Recent-Judicial-Opinions-Relating-to-TIA-Section-316b.aspx> (statement of interpretation of section 316(b) joined by 28 law firms).

¹⁵⁵ *In re Nm. Corp.*, 313 B.R. 595,600 (Bankr. D. Del. 2004); *YRC Worldwide Inc. v. Deutsche Bank Trust Co. Am.*, No. 10 Civ. 2106(JWL), 2010 WL 2680336, at *7 (D. Kan. July 1, 2010). See also *UPIC & Co. v. Kinder-Care Learning Ctrs., Inc.*, 793 F.Supp. 448, 455 (S.D.N.Y.1992)(opining that section 316(b) guaranties the procedural right to sue on the promise but does not "alter the substance of a noteholder's right to payment of principal and interest under the Indenture and, in particular, cannot 'override' the Indenture's subordination provisions").

No one paid much attention to *Mechala* until the Southern District decided a trio of workout cases in 2014 and 2015, *Marblegate Asset Management v. Education Management Corp.*,¹⁵⁶ *Meehancombs Global Credit Opportunity Funds, LP v. Caesars Entertainment Corp.*,¹⁵⁷ (*Caesars I*) and *BOKF, N.A. v. Caesars Entertainment Corp.*¹⁵⁸ (*Caesars II*). The court found that all three restructurings potentially violated the TIA, relying on the broad reading. The rulings disrupted practice assumptions going back three-quarters of a century and triggered more litigation. Uncertainty resulted for bond counsel regarding opinion letters on the validity and enforceability of trust indentures, prompting representatives of 28 prominent law firms to issue a joint interpretive statement.¹⁵⁹ Industry representatives even slipped a clause retroactively overruling the cases into an (un-enacted) appropriations bill.¹⁶⁰

In January 2017, a panel of the Second Circuit reversed the *Marblegate* ruling in a two-to-one decision over a strong dissent.¹⁶¹ The reversal consigns the broad reading to history unless continued litigation in the case or a contrary decision in another circuit keeps it alive. Whatever the outcome, the distorted playing field in out-of-court restructurings returns to the front burner as an unsolved policy problem.

This Part looks closely at the rise and fall of the broad reading of section 316(b). Two issues are implicated. The first concerns the TIA and its legislative history. The broad reading draws purposive inferences from the historical origins of the TIA while the Second Circuit's reinstatement of the narrow reading follows from a closer look at the historical evidence. We show that the appellate court has

¹⁵⁶ 75 F.Supp.3d 592 (S.D.N.Y. 2014), *rev'd* __ F.3d__ (2d Cir. 2017), 2017 WL164318.

¹⁵⁷ 80 F.Supp. 3d 507 (S.D.N.Y. 2015).

¹⁵⁸ 144 F.Supp.3d 459 (S.D.N.Y. 2015)

¹⁵⁹ See Opinion White Paper, *supra* note 154.

¹⁶⁰ See Matt Jarzemsky, *Caesars Takes Aim at Law Aiding Creditors*, WALL ST. J. (Dec. 6, 2015); Liz Moyer, *Wall Street's Debt Restructuring Fight Heads to Washington*, N.Y. TIMES: DEALBOOK (Dec. 7, 2015), <http://www.nytimes.com/2015/12/08/business/dealbook/wall-streets-debt-restructuringfight-heads-to-washington.html>. We note that we both were signatories to a legal scholar's letter to Congressional leadership opposing the proposed amendment of the TIA through the appropriations process.

¹⁶¹ *Marblegate Asset Management, LLC v. Education Management Finance Corp.*, __ F.3rd __, (2d Cir. 2017), 2017 WL164318.

much the better of the argument. The second issue concerns the terms of the broad reading and its application on workout fact patterns. We show that the broad reading is ill-suited to the task assigned, disrupting settled allocations of risk without targeting the problem of distorted choice at its source. That said, everything set out in Parts I to III of this Article goes to show that distorted consent-giving in workouts proceeding under the traditional reading does indeed present a cognizable problem. The facts of the *Marblegate* and *Caesars* underscore this point, but teach an additional lesson. These situations are extremely complicated and fact insensitive judicial intervention does more harm than good.

Section A looks at *Marblegate*, laying out the facts, the Southern District's disposition, the grounds for the Second Circuit's reversal, and our critical analysis of the broad reading as applied on the facts of the case. The round trip leaves the discussion in an awkward place, for the Second Circuit put paid to the broad reading solely on the ground of legislative history without also considering its practical merits and demerits. Section B focuses the broad reading's merits, comparing its application on the facts of *Caesars*, where it can be defended as common sense policing. We go on to show that a similar result can obtain on a more nuanced basis under contract law, even given the limited application of the good faith duty to financial contracts.

A. Marblegate

1. Facts.

In 2014, Education Management Corporation (“EDMC” or the “Parent”), the owner and operator of eighteen for-profit higher educational institutions,¹⁶² sought to restructure its debt.¹⁶³ EDMC faced an unusual challenge: it could not credibly threaten to file for bankruptcy in order to force a restructuring because a filing meant loss of eligibility to receive revenue from federal student aid programs.¹⁶⁴

¹⁶² *Marblegate Asset Mgmt. v. Ed. Mgmt. Corp.*, 75 F.Supp.3d 592, 596 (S.D.N.Y. 2014), *rev'd* ___ F.3d ___, (2d Cir. 2017), 2017 WL164318.

¹⁶³ *Id.* at 598.

¹⁶⁴ *Id.* at 595-96.

EDMC's debt consisted of \$1.3 billion in secured debt (the "bank loans") and \$217 million in unsecured notes (the "bonds") issued by its subsidiary Education Management LLC ("Operating Sub") and guarantied by the Parent.¹⁶⁵ The bonds were issued pursuant to an indenture qualified under the TIA. The indenture limited the Parent's guaranty with a "tag-along"; under this, the guaranty automatically terminated upon a release of a parallel parent guaranty of the bank loans.¹⁶⁶

The Parent negotiated a restructuring support agreement with a subset of lenders holding approximately 81% of the bank loans and 81% of the bonds. They agreed to support two alternative transaction structures, which we will call Plan A and Plan B. Under Plan A, the Parent would undertake a pair of linked exchange offers conditioned on 100% participation of all creditors (the "Exchange Offers"). The Exchange Offers held out \$400 million in new loans and convertible preferred stock for the banks and up to \$71 million of worth of common stock for the bondholders, which amounted to 55 cents on the dollar for the banks and 33 cents on the dollar for the bondholders.¹⁶⁷

Plan B was triggered in the event that Plan A failed due to less than 100% participation.¹⁶⁸ Under Plan B the bank lenders undertook to enforce against their security as follows:

- (1) the bank lenders would release the Parent guaranty on their credit agreement, which, under the tag-along, automatically released the Parent guaranty on the bonds;
- (2) the bank lenders would foreclose on "substantially all" of Operating Sub's assets;
- (3) the bank lenders would immediately sell the foreclosed assets back to a new subsidiary of the Parent ("New Sub") that would

¹⁶⁵ *Id.* at 597.

¹⁶⁶ The guaranty also could be released with the consent of the holders of a majority of the outstanding principal of the bonds *Id.* at 597-98.

¹⁶⁷ *Id.* at 601. The Parent's current shareholders would be diluted to 4% or less of the common stock. *Id.* at 600-01.

¹⁶⁸ *Id.* at 600. Given that a majority of bank lenders supported the restructuring plan, the others were undoubtedly bound through their loan syndication agreements' majority rule provisions.

distribute its debt and equity to the creditors who had consented to support the restructuring and had tendered their debt instruments.

Plan B implicated no amendment of the bonds, leaving the bondholders' rights in place. But, because Plan B moved all of Operating Sub's valuable assets to New Sub and eliminated the Parent's guaranty, the bonds retained by non-tendering bondholders represented worthless claims against an obligor that had been stripped of all ability to pay without any backup. Thus the choice for the bondholders was 33 cents on the dollar under Plan A or nothing under Plan B, which, strictly speaking, was not a choice at all. Ninety-nine percent of the bank lenders and 90% of the bondholders agreed to Plan A.

2. Southern District of New York.

Among the non-participating bondholders was a distressed debt hedge fund, Marblegate, which held \$14 million (6.4%) of the bonds purchased in the secondary market, presumably at a large discount from face value. Marblegate unabashedly pursued maximum holdout value from its position,¹⁶⁹ taking the broad reading to the Southern District of New York for a preliminary injunction preventing the restructuring's consummation.

The court faced a double-sided problem of distorted consent weighted at both extremes—a holdout among holdouts on one side and a crammed down restructuring on the other. Navigating between the extremes, it declined the injunction on equitable grounds,¹⁷⁰ but concluded that the restructuring likely would violate section 316(b). The Parent was ordered to continue guarantying the bonds held by Marblegate,¹⁷¹ even as it was left free otherwise to conclude the restructuring.

The court fairly characterized the language of section 316(b) as ambiguous. There followed a cursory look at the legislative history limited to the “evasion of judicial scrutiny” line from the committee

¹⁶⁹ *Id.* at 605-06.

¹⁷⁰ *Id.* at 605-610.

¹⁷¹ Judgment, Marblegate Asset Mgmt., LLC v. Ed. Mgmt. Corp. No. 14cv-8584, (S.D.N.Y. June 25, 2015).

reports.¹⁷² Effectuation of the purpose, said the court, meant reading the section to protect “the *ability*, and not merely the formal right, to receive payment in some circumstances.”¹⁷³

The Court had two problems with which to deal in getting from here to there. First came a line-drawing exercise. Clearly, some modifications of rights are unobjectionable even though they nonetheless impair the obligor’s ability to pay. For example, bondholders routinely assent to majoritarian amendments relaxing non-core terms like business covenants, even though loosening constraints on dividends, asset sales, and additional borrowing increases the risk of default. As we saw in Part II, there is a strong case in favor of such concessions even when extracted by the payment of a (potentially) coercive fee—flexibility is enhanced and rights relaxation can avoid default and bankruptcy. The court, looking to the TIA’s legislative history seized the notion of “restructuring” and drew the line as follows:

[p]ractical and formal modifications of indentures that do not explicitly alter a core term “impair[] or affect[]” a bondholder’s right to receive payment in violation of the Trust Indenture Act only when such modifications effect an involuntary debt restructuring.¹⁷⁴

Thus could majority amendment of many terms, even when effected through coercive exit consents, pass TIA muster, while a majority vote “restructuring . . . seeking to involuntarily disinherit” the minority could not.¹⁷⁵ Plan B was such a “restructuring.”¹⁷⁶ What exactly might amount to a similar prohibited restructuring in another case was left open.

The second problem concerned the guaranty. The court, in addition to reclassifying a guaranty as an unamendable core term (at least when released in connection with a “restructuring”), was overriding the indenture’s built-in guaranty release provision. No one was trying to amend this “core” right out of existence. The right was

¹⁷² See *supra* text accompanying note 25.

¹⁷³ *Id.* at 612.

¹⁷⁴ *Id.* at 614.

¹⁷⁵ *Id.* at 614-15.

¹⁷⁶ *Id.* at 615.

contingent, and the contingency had failed. The issuer had even warned the bondholders not to rely on it in the Notes' offering documents.¹⁷⁷ But a statutory right was a statutory right:

Section 316(b) “prohibit[s] nonconsensual amendments to contractual payment rights.” Yet if the Trust Indenture Act protects only those rights that are enshrined in an indenture, subject to whatever limitation contained therein, and nothing prevents an ex ante limitation on the right to receive payment (including through majority vote), then the Trust Indenture Act would fail to prohibit indentures allowing for majority modification of payment terms. . . . The Trust Indenture Act, then, must protect *some* rights against at least *some* ex ante constraints.¹⁷⁸

3. Second Circuit Court of Appeals.

The appellate panel drilled down into the legislative history and came up with a very different story. Yes, the Congress wanted to push restructuring into bankruptcy. But Congress took only a limited step in pursuing the goal, to wit, prohibiting “non-consensual amendments of core payment terms (that is, the amount of principal and interest owed, and the date of maturity).”¹⁷⁹ The Court reviewed the famous SEC Report¹⁸⁰ and found no mention of an objective to require unanimous consent to all out-of-court “restructurings.” Furthermore, the Report acknowledged more than once that foreclosure (the technique used in *Marblegate*) was a separate path to restructuring, evidencing no intent to interfere with it.¹⁸¹ The Court went on to the Congressional committee process, focusing on the testimony of SEC chair William O. Douglas in 1938 and the assistant director of the SEC's reorganization division, Edmund Burke, Jr. in 1939.¹⁸² This was the pay dirt. Douglas had stressed that the section covered only

¹⁷⁷ *Id.* at 616.

¹⁷⁸ *Id.* at 613.

¹⁷⁹ *Marblegate Asset Management, LLC v. Education Management Finance Corp.*, ___ F.3d ___, ___ (2d Cir. 2017), 2017 WL164318, at *5.

¹⁸⁰ See *supra* text accompanying note 26.

¹⁸¹ 2017 WL164318, at *6-8, *10. Here the Court drew on the detailed historical argument in Harald Halhuber, *Debt Restructurings and the Trust Indenture Act*, 25 AM. BNKR. INST. L. REV. ___, ___ (forthcoming 2017).

¹⁸² 2017 WL164318, at *8-9.

amendment and waiver of payment terms,¹⁸³ and Burke has noted that the barrier went only to an unconsented “variation from [the] contract.”¹⁸⁴

That decided the case. The Second Circuit panel did not go farther to consider the *Marblegate* rule’s practical application.¹⁸⁵ We find the absence of substantive discussion telling. Perhaps the panel did not want to go there because the traditional reading does leave the door open to egregious self-dealing and coercion, as our review of the facts *Caesars* shortly will show.

4. Analysis.

The Second Circuit panel was right about the legislative history. We reviewed it too, and found nothing supporting the assertion that section 316(b) prohibits actions other than majoritarian amendments and waivers.¹⁸⁶ The TIA’s objective was less a categorical requirement of judicial supervision, than achievement of the more immediate goal of putting bondholder protective committees out of business.¹⁸⁷ The context was fact-driven and emphasized administration rather than judging. Douglas, explaining the objectives of the new scheme in a pair of speeches delivered in 1937, noted that the missing oversight capability was administrative expertise and rather than neutral decision of litigated issues.¹⁸⁸ The new system imported it in the form of a mandatory trustee for bankrupt public companies and mandatory SEC

¹⁸³ *Id.* at *8.

¹⁸⁴ *Id.* at *9.

¹⁸⁵ It paused only to charge the Southern District, in prohibiting restructurings “designed” to eliminate the ability to received payment, carried bond contract interpretation into forbidden subjective territory. *Id.* at *11. We think the comment was unfair. The inquiry contemplated was an objective one. The problem concerned not subjectivity but lack of specification and overbreadth.

The dissenter stressed the text of passage, taking the position that it unambiguously dictated the broad reading, making resort to the legislative history unnecessary. *Id.* at *13-15. We prefer to read the test as ambiguous, joining the Southern District and the panel majority on the point.

¹⁸⁶ See *supra* text accompanying notes 25-30.

¹⁸⁷ See 15 U.S.C. § 77bbb(a) (TIA preamble regarding necessity for regulation and enumeration of practices adversely affecting the public). The drafters also sought to reinvent the indenture trustee as an effective agent of bondholder protection, both in and out of bankruptcy.

¹⁸⁸ DEMOCRACY AND FINANCE: THE ADDRESSES AND PUBLIC STATEMENTS OF WILLIAM O. DOUGLAS 194-95 (James Allen, ed., 1940).

review of reorganization plans,¹⁸⁹ features that have been swept away by history and replaced by negotiating investors with economic stakes in the outcome.

It is no wonder that the post-war appearance and tolerance of restructuring by out-of-court exchange raised no TIA-generated hackles. Simply, the TIA was not intended to create a permanent, one-size-fits-all, bankruptcy-forcing regime based on contract-overriding bondholder rights. The better characterization is that Congress intended to corner and eliminate bondholder committees by blocking CACs. As to that it succeeded quickly and completely.

Marblegate would present intractable problems even if the legislative history had held out something more in its favor. The broad reading's contract-overriding aspect disrupts considered allocations of risk effected in bond contracts. The reading also is overly broad, sweeping in unobjectionable as well as objectionable transactions.

The *Marblegate* court took a drastic step in deploying its new 316(b) right so as to nullify the tag-along contingency on the Parent guaranty. Its explanation—well, that's what mandates do—was incomplete, omitting to point out that the override hands the bondholders something for which they did not bargain, disrupting the contract's risk allocation. The court also failed to explore the override's technical implications. A payment term can be contingently framed as well, as occurs with variable interest rates, income-only interest provisions, payment-in-kind (PIK) options, and mandatory debt-to-equity conversions. Yet no one would suggest that the contingencies in these types of provisions traverse section 316(b).

Nor was it enough to say that the new mandate effectuated the intent of the enacting Congress. For even if Congress had intended the broad reading, pursuing a general purpose of forcing resort to bankruptcy, invalidation of the *Marblegate* restructuring would not have followed. Simply, bankruptcy was not a plausible alternative in *Marblegate* and, strictly speaking, the *Marblegate* bonds lay outside of the intended protected class.

¹⁸⁹ *Id.*, at 180-88, 191-92.

Finally, the term overridden was not “just boilerplate.” We surveyed 109 trust indentures (49 executed in 2011 before *Marblegate* and 60 executed thereafter in 2016) and found that most (82%) but not all of the indentures containing guaranties (76%) took steps to include the guaranty in their UACs, even though the TIA does not necessarily require inclusion.¹⁹⁰ The inclusion makes sense—guaranties can figure critically in the structure of promises creating a given issue’s borrowing base. At the same time, 98% percent of the guaranties had release provisions and accordingly contingent status, even as the most of them could not be amended. Only 28% of the guaranties contained a tag-along condition, implying specific focus, deal-by-deal. The override of guaranty release in *Marblegate* raises a serious policy question accordingly.

The broad reading also suffers from insensitivity to context. It aspires to follow the overall pattern of legislative intervention respecting distorted investor choice and lay down an easily administered rule. It thus poses two categorical questions: is a “core” term being amended, and, if not, is the debt being “restructured” without the holder’s consent? If either question is answered yes, unanimous consent will be necessary to complete the transaction. The *Marblegate* rule thereby prohibits without ever asking whether self-interested investor voting or issuer coercion materially distorted the decisionmaking context, and if so, whether any cognizable wrong resulted. This is a fatal shortcoming.

To see why, all one has to do is go back to the *Marblegate* facts. It is true that the *Marblegate* restructuring involved a coercive exchange offer and a restructuring crammed down on one creditor group by another. Even so, it raises no red flags when viewed through the theoretical lens set out in Part I. The deal, which traversed no contract rights, was negotiated and garnered supermajority support. Everybody took a haircut. From a contractual point of view, it was no more coercive than a majoritarian amendment. Indeed, the only material difference between it and a prepackaged Chapter 11 proceeding is the absence of formal judicial approval of the restructuring. In that

¹⁹⁰ We note, however, that the TIA defines “obligor” to include “guarantor,” suggesting that if the right to payment is from an obligor, it includes a guaranty of that payment as well. 15 U.S.C. § 77ccc(12). TIA section 316(b) does not use the term “obligor,” however. 15 U.S.C. § 77ppp(b).

context, the only possible friction impeding plan confirmation would have been the question whether the restructuring was done in good faith, which doubtless would have answered in the affirmative. Given that bankruptcy was not an option, EDMC had nowhere else to go but out-of-court restructuring, and the plaintiff was looking for holdout value pure and simple. All equities lay on the side of the issuer and the supporting creditors, as the court duly found when refusing an injunction. Any substantive prohibition should display similar flexibility.

The *Marblegate* rule was so broad that it threatened to shut down 144A-based restructuring altogether. To see how, return to the sweetened ABC exchange offer hypothesized in Part I—the offer of new bond with a \$75 face value but with givebacks in the form of a junior lien and an interest rate hike to 8%. Recall that the junior lien served as a stick as well as a carrot by possibly detracting from the value of the old bond in a subsequent bankruptcy. It is thus at least possible that the new bondholders come out better off at the old bondholders' expense. Now recall that in 144A exchange offers non-QIB bondholders are excluded from the process. It follows that the closing of the exchange offer could injure to the excluded moms and pops.

Plaintiffs' lawyers picked up on this in the wake of *Marblegate*, bringing class actions on behalf of excluded bondholders and alleging that the exclusion and resulting impairment of position violates section 316(b) under the broad reading.¹⁹¹ The issuers, they argue, have “restructured” without the non-QIB bondholders' consent. The theory has been rejected in the single decided case, *Waxman v. Cliffs Natural Resources Inc.*¹⁹² The court ruled that the plaintiffs had suffered no injury and hence had no standing to challenge the offer, and that in any event no “restructuring” was in process as regarded excluded

¹⁹¹ Along with the covenant of good faith and fair dealing and unjust enrichment. *See, e.g.,* Complaint, Chesapeake Energy Corp., *available at* _____.

We also note the possibility that Chancellor Allen's *Kass* opinion, see *infra* text accompanying note 219, read broadly, could import grounds for a finding of bad faith stemming from the selective offering. But we also note a point of distinction. *Kass* looked only to selective vote buying only; here there is a class of offeree defined and excluded for extraneous regulatory reasons.

¹⁹² 2016 WL 7131545 (S.D.N.Y., Dec. 6, 2016).

bondholders whose rights were left untouched.¹⁹³ The Second Circuit's *Marblegate* reversal moots the question as to the soundness of that analysis even as it probably puts paid to the remaining mom-and-pop complaints.

We see no reason to question the result, for any injury is at best *de minimis*. The “impairment” of the non-QIBs seems more theoretical than real, for the new bond's second lien in all likelihood is out of the money. The plaintiffs, moreover, are literally biting the hand that gives them a free-ride. Finally, mandated inclusion of non-QIB bondholders would have forced issuers back a section 3(a)(9), chilling out-of-court restructuring across-the-board.

B. Caesars Compared

Nothing in the foregoing goes to say that the broad reading didn't also do some good, sweeping in egregious fact patterns as well as inappropriate ones. To see such a case, we turn to *Caesars*. Like *Marblegate*, *Caesars* involved asset-stripping. The bond issuers in both cases were operating subsidiaries controlled by holding company guarantors. In both cases, the parent effected a transfer of the operating subsidiary's assets to a new unencumbered subsidiary simultaneously with a release of its own guaranty, leaving the obligor subsidiary without means to pay the bonds. Both cases resulted in intervention under the broad reading of section 316(b). But similarities fade on close inspection, and the policy concerns implicated by section 316(b) come to bear differently. Where *Marblegate* raised no red flags, *Caesars* raised a whole collection.

1. Facts.

We once again have a parent, here Caesars Entertainment (“Caesars” or the “Parent”), one of the world's largest casino owners and operators, and an operating subsidiary, Caesars Entertainment Operating Company, Inc. (“Operating Sub”), which owned and operated the casinos. We also have new subsidiaries organized to receive stripped assets.

¹⁹³ Id. at *3-*7.

In January 2008, Caesars was acquired by two private equity funds, Apollo Global Management, Inc., and TGP Capital, LP, in a \$30.7 billion leveraged buyout (LBO).¹⁹⁴ The LBO was funded by approximately \$23.2 billion of new debt issued by Operating Sub.¹⁹⁵ The section 316(b) litigation related to two different sets of Operating Sub bonds, one issue from before the LBO for \$1.5 billion due in 2016 and 2017 (the “Pre-LBO Bonds”) and the other issue from after the LBO for \$6.3 billion due in 2017 and 2018 (the “Post-LBO Bonds”). Both issues were under TIA qualified indentures and were guaranteed by the Parent.¹⁹⁶

The guaranties had similar but not identical termination provisions. With the Pre-LBO Bonds the termination kicked in if Operating Sub ceased to be Parent’s “wholly owned subsidiary.” The term “wholly owned subsidiary” was defined by reference to an SEC regulation¹⁹⁷ as a subsidiary “substantially all of the outstanding voting shares [of which] are owned by its parent and/or the parent’s other wholly owned subsidiaries.”¹⁹⁸ The Post-LBO Bonds’ guaranty similarly depended on wholly-owned status, but defined “wholly-owned” as 100% ownership.¹⁹⁹ The Post-LBO Bonds’ guaranty also was subject to a tag-along clause triggered by a guaranty release under

¹⁹⁴ *MeehanCombs Global Credit Opportunities Master Fund, LP v. Caesars Entertainment Corp.*, 80 F.Supp.3d 507, 510-11 (S.D.N.Y. 2015); *BOKF, N.A. v. Caesars Entertainment Corp.*, 144 F.Supp.3d 459 (S.D.N.Y. 2015).

¹⁹⁵ Complaint, *MeehanCombs Global Credit Opportunities Master Fund, LP v. Caesars Entertainment Corp.*, No. 14-cv-7091, Sept. 3, 2014, at ¶ 45.

¹⁹⁶ \$137 million of the outstanding Pre-LBO Bonds were alleged to have been held by individual investors at the time of the litigation. *MeehanCombs Global Credit Opportunities Master Fund, LP v. Caesars Entertainment Corp.*, 80 F.Supp.3d 507, 510 (S.D.N.Y. 2015).

¹⁹⁷ Memorandum of Law of Caesars Entertainment Corp. in Support of Its Motion for Summary Judgment, *Trilogy Portfolio Co. LLC v. Caesars Entertainment Corp.*, No. 1:14-cv-07091, May 10, 2016 at 5 (referencing 17 C.F.R. § 210.1-02(aa)).

¹⁹⁸ 17 C.F.R. § 210.1-02(aa).

¹⁹⁹ Complaint, Exhibit 1, *UMB Bank, N.A., v. Caesars Entertainment Corp.*, No. 1:15-cv-04634, June 15, 2015 (S.D.N.Y.) (Indenture, dated as of June 10, 2009, 11 ¼% Senior Secured Notes due 2017, Harrah’s Operating Escrow LLC, Harrah’s Escrow Corp. as Issuer, Harrah’s Entertainment, Inc. as Parent Guarantor, § 1.01 (definition of “Wholly Owned Subsidiary”). There was also an ambiguity: the subparagraphs that listed the guaranty termination events were not separated by an “or”, but instead joined with an “and”, raising the possibility that even if Operating Sub ceased to be a wholly-owned subsidiary (however defined), the cessation would not itself terminate the guaranty.

any of a number of defined Operating Sub debt issues, including the Pre-LBO Bonds.²⁰⁰

Casino revenues took a hit in 2008 and never really recovered. Perhaps seeing the handwriting on the wall, in 2010, Apollo and TGP began stripping Operating Sub's assets, causing it to enter a series of transactions that transferred valuable properties to new non-guarantor affiliates in exchange for questionable consideration.²⁰¹ By 2014 Operating Sub was struggling to service its debt.²⁰²

The scheme depended on getting the Parent off the hook on Operating Sub's debt. This meant triggering the guaranty terminations. Apollo and TGP pursued multiple means to this end. First, Operating Sub refinanced some debt by taking out \$1.75 billion in new term loans,²⁰³ also guaranteed by the Parent.²⁰⁴ In connection with this deal, the Parent sold five percent of Operating Sub's common stock to certain institutional investors.²⁰⁵ This permitted the Parent to claim that Operating Sub was no longer its "wholly owned" subsidiary, automatically terminating its guaranty of the Post-LBO Bonds.²⁰⁶ The Parent took the position that the stock sale was necessary because the term loan lenders required elimination of the guaranty of the Post-LBO Bonds in order to provide enhanced credit support for the term loan.²⁰⁷

Shortly after the stock sale, Operating Sub also adopted an equity incentive plan that enabled it to grant shares of its stock to its directors

²⁰⁰ Complaint, Exhibit 5, UMB Bank, N.A., v. Caesars Entertainment Corp., No. 1:15-cv-04634, June 15, 2015 (S.D.N.Y.) (Second Supplemental Indenture, amending section 12.02 of the Indenture); Complaint, Exhibit 1, UMB Bank, N.A., v. Caesars Entertainment Corp., No. 1:15-cv-04634, June 15, 2015 (S.D.N.Y.) (defining "Existing Notes" to include the Pre-LBO Notes).

²⁰¹ *BOKF, N.A. v. Caesars Entertainment Corp.* 144 F.Supp.3d 459 (S.D.N.Y. 2015); Complaint, MeehanCombs Global Credit Opportunities Master Fund, LP v. Caesars Entertainment Corp., No. 14-cv-7091, Sept. 3, 2014, at ¶49.

²⁰² *BOKF, N.A. v. Caesars Entertainment Corp.* 144 F.Supp.3d 459 (S.D.N.Y. 2015); MeehanCombs Complaint, ¶ 47; BOKF Complaint, ¶ 49.

²⁰³ *BOKF, N.A. v. Caesars Entertainment Corp.* 144 F.Supp.3d 459 (S.D.N.Y. 2015).

²⁰⁴ Caesars Entertainment Corp., Form 8-K, May 9, 2014 ("the borrowings under the Credit Agreement will be guaranteed by Parent...").

²⁰⁵ *BOKF, N.A. v. Caesars Entertainment Corp.* 144 F.Supp.3d 459 (S.D.N.Y. 2015).

²⁰⁶ *Id.*

²⁰⁷ *Id.*

and officers.²⁰⁸ The subsequent stock grants amounted to another 6% of its shares (together with the term loan stock sale, the “equity placements”).²⁰⁹ Thus did 11% of Operating Sub’s stock come into hands other than the Parent’s, perhaps lifting the guaranty under the Pre-LBO Bonds’ “substantially” wholly-owned test as well as the Post-LBO Bonds’ 100% test.

The Parent also proceeded on another front, procuring a direct amendment of the Pre-LBO Bonds by buying off a majority of the bondholders (the “Amendment”). Operating Sub offered to repurchase the Pre-LBO Bonds held by some but not all of the bondholders at face value plus accrued interest and transactional fees and costs—a 100 cents-on-the-dollar offer at a time when the Pre-LBO Bonds were trading at 48 cents.²¹⁰ A trio of exit consents was attached to the offer. The tendering Pre-LBO bondholders had to agree (1) to a forward-looking restructuring support agreement, (2) to modify a covenant restricting disposition of “substantially all” of Operating Sub’s assets so as to measure future asset sales based on the assets as of the date of the amendment, and (3) to release the Parent guaranty. In Parent’s view, the guaranty release covered not only its guaranty of the Pre-LBO Bonds but its guaranty of the Post-LBO Bonds because the release of the Pre-LBO Bonds was a release within the Post-LBO Bonds’ tag-along clause.

2. Southern District of New York

We are concerned with two of four separate lawsuits filed in response, both in the Southern District.²¹¹ A suit brought by Pre-LBO bondholders (*Caesars I*) alleged, *inter alia*, that the Amendment constituted an impairment of right under TIA section 316(b). The Court followed *Marblegate* and refused to dismiss the complaint, ruling that the Amendment plausibly could be deemed “an impermissible

²⁰⁸ Memorandum of Law in Support of Plaintiffs’ Joint Motion for Partial Summary Judgment, *Trilogy Portfolio Co. LLC v. Caesars Entertainment Corp.*, No. 1:14-cv-07091, May 10, 2016 at 21.

²⁰⁹ *Id.* at 2-3.

²¹⁰ Complaint, *MeehanCombs Global Credit Opportunities Master Fund, LP v. Caesars Entertainment Corp.*, No. 14-cv-7091, Sept. 3, 2014, at ¶ 72.

²¹¹ Certain of Operating Sub’s second-lien creditors then filed an involuntary bankruptcy petition against it in the Bankruptcy Court for the District of Delaware. Immediately thereafter, Operating Sub filed a voluntary bankruptcy petition in the Bankruptcy Court for the Northern District of Illinois.

out-of-court debt restructuring achieved through collective action. This is exactly what TIA section 316(b) is designed to prevent.”²¹²

The indenture trustees for the Post-LBO Bonds (*Caesars II*) sued the Parent,²¹³ seeking to enforce its guaranty.²¹⁴ The Parent invoked contract interpretation as a first line of defense. The guaranty, it argued, was inserted solely to economize on compliance costs; with the Parent on the hook, Operating Sub, as issuer, could satisfy its SEC reporting requirements by filing Parent’s audited financials. The Court rejected this by reference to the plain words of the indenture under which the guaranty, although conditional, also was “irrevocable” and “unconditional.”²¹⁵ There was no further discussion regarding the meaning of “wholly-owned” or the operation of the tag-along.

The *Caesars II* court then turned to section 316(b) and *Marblegate*.²¹⁶ No amendment of a core term was involved, for even if guaranties were not core terms, no one was attempting to amend the guaranty in the Post-LBO Bonds. So the question was whether a debt “restructuring” had occurred, a matter under factual dispute. Findings were needed on the questions whether (1) the transactions involved the “restatement of assets and liabilities,” (2) Operating Sub had entered into “talks with creditors in order to make arrangements for maintaining repayments,” and (3) the transaction extended the life of a company otherwise facing bankruptcy.²¹⁷ Defendant’s motion for summary judgment was denied accordingly.

3. Analysis

Caesars I confirmed something implied in *Marblegate*—that guaranties now were included in the set of core terms whether or not a “restructuring” is proceeding (a result also overturned by the Second Circuit panel). Like *Marblegate*, *Caesars I* involved a coercive exchange

²¹² *MeehanCombs Global Credit Opportunities Master Fund, LP v. Caesars Entertainment Corp.*, 80 F.Supp.3d 507, 516 (S.D.N.Y. 2015), *rev’d* ___ F.3d __ (2d Cir. 2017), 2017 WL164318.

²¹³ See *Caesars Entm’t Operating Co. v. BOKF, N.A. (In re Caesars Entm’t Operating Co.)*, 808 F.3d 1186 (7th Cir. 2015).

²¹⁴ *BOKF, N.A. v. Caesars Entertainment Corp.*, 144 F.Supp.3d 459 (S.D.N.Y. 2015); Complaint, *UMB Bank, N.A., v. Caesars Entertainment Corp.*, No. 1:15-cv-04634, June 15, 2015 (S.D.N.Y.)

²¹⁵ *BOKF, N.A. v. Caesars Entertainment Corp.*, 144 F.Supp.3d 459, 464-69 (S.D.N.Y. 2015).

²¹⁶ *Id.* at 468 (2015).

²¹⁷ *Id.*

offer and the imposition of a restructuring on one group of creditors by another group of creditors. *Caesars II* resembled *Marblegate* in a different respect, for it involved neither the amendment nor the violation of a term in the indenture. It as a result turned on the question whether the transactions amounted to a “restructuring.”

The similarities ended there. The coercive threat in *Caesars I* emanated not from a transaction effected by a separate creditor, but from a guaranty release effected by exit consents granted by bondholders of the same bonds, bondholders who were receiving a separate consideration from the issuer. The deal, moreover, was never offered to the dissenting minority. Bondholder opportunism and issuer coercion worked in tandem to exclude and exploit a disfavored bondholder group—a classic case of selective vote buying.

The *Caesars I* exit consents spill over into *Caesars II* due to the knock-on effect on the post-LBO Bonds’ tag-along guaranty. *Caesars II* otherwise did not implicate bondholder consent-giving at all. It instead concerned the issuer’s equity placements and their impact on the Parent guaranty, conduct ordinarily actionable only to the extent implicating a breach of contract.

Between the vote buying and the equity placements, there was ample cause for judicial intervention. *Caesars* thus poses facts that display the advantages held out by the broad reading of section 316(b). It thereby problematizes the Second Circuit’s reversal of *Marblegate*, raising the question whether there was a narrower way to proceed, an analysis that opened up a distinction between *Marblegate* and *Caesars*. For instance, the Court could have held open the question whether guaranties should be included in the class of “core” terms.

But there is another way to distinguish *Marblegate* from *Caesars*—contract law. *Marblegate* is an easy contract case. No terms were violated and the actors behind Plans A and B, while indeed throwing hardballs, were just trying to muddle through in a bad situation. All the bad faith lay on the plaintiff’s side. *Caesars* is very different, raising serious questions of interpretation and bad faith.

The vote-buying scam in *Caesar’s I* is highly vulnerable to invalidation as bad faith, despite the fact that solicitation fees paid to bondholders by issuers seeking to amend indentures survived scrutiny

under *Kass*.²¹⁸ In a dictum in that case, Chancellor Allen suggested that there are limits to what the good faith duty will tolerate when it comes to vote buying. The offer in *Kass* was open to all bondholders. An offer open only to a select few would present a different case:

[S]ome instances may permit a plaintiff to satisfy the applicable [good faith] test For example, had Eastern not made its offer to all bondholders on the same terms, but had it privately paid money to sufficient holders to carry the election, one would, without more, feel some confidence in concluding, provisionally at least, that such conduct was so inconsistent with the concept of voting implied by the amendment provision that it constituted a violation of what must have been the reasonable expectation of the contracting parties.²¹⁹

Restating, the fact that the indenture's voting provisions said nothing about vote buying did not by itself determine the outcome, and the good faith duty supported an implied interdiction under the contract against selective offers of payment.²²⁰ The burden thus would lie on the issuer to show that an indenture contemplated selective vote buying, something which indentures do not sanction explicitly.

The *Caesars II* equity placements also raise a contract law issue, a question of interpretation. To wit, whether a guaranty condition tied to the obligor's wholly-owned status can fail as a result of any placement of equity made for any reason. *Caesars* tried to persuade the court to answer this question affirmatively, arguing that the guaranty was solely for the obligor's benefit and in effect at will. Under this reading, the Operating Sub's CFO could make the guaranty go

²¹⁸ See *supra* notes 49-51 and accompanying text.

²¹⁹ 1986 WL 13008 (Del. Ch.), at 1082. Interestingly, Chancellor Allen stopped short of this reading in *Katz*, finding that exit consents were within the contemplation of the indentures' voting provisions. 508 A.3d at 881.

²²⁰ See *In re Loral Space and Communications Inc.*, 2008 WL 4293781 (Del. Ch.) (permitting unequal consideration on the ground that the question had come up during negotiations and a prohibitive term rejected). The law of the UK works differently, vote buying through consent payments is permitted so long as the payments are disclosed, even when the payments are not made to all bondholders. *Azevdo and another v. Imcopa Importação, Exportação e Indústria de Óles Ltda and others*, [2012] EWHC 1849 (Comm), *aff'd* [2013] EWCA Civ. 364. See also *Brit. Am. Nickel Corp. Ltd v MJ O'Brien Ltd* [1927] AC 369; *Goodfellow v. Nelson Line Liverpool, Ltd.*, [1912] 2 Ch. 324.

away simply by transferring one share of the company's stock to any down and out gambler hanging around on the Las Vegas strip. The tradition of literalism in interpretation of financial contracts backs this position.

But it by no means concludes the matter, particularly as regards a term in a contract subject to a public offering. Other inferences can be drawn. There is an additional reason why a drafter might condition a parent guaranty on 100% ownership. The appearance of a minority shareholder interest at the subsidiary makes the guaranty the source of an actionable conflict—enforcement of the guaranty against the subsidiary by parent creditors is an unequal outcome at the subsidiary for the parent's sole benefit implicating a potential breach of fiduciary duty by the parent. The release provision holds open the possibility of bringing the parent into the subsidiary's borrowing base without ancillary problems. Such a provision leaves the parent bondholders bearing considerable risk. But we think it highly unlikely that the risk included of subsidiary common stock issuance undertaken for the sole purpose of bringing about the guaranty's termination in connection with an asset stripping program and that a court—particularly a court otherwise suspicious about the opportunism apparent in the fact pattern—would have no difficulty characterizing the equity placements as subterfuge. After all, what sorts of investment institutions go long in the equity of 89% owned subsidiaries whose assets are being stripped? And what kind of an incentive does such an equity interest import to the subsidiary's officers and directors?

The good faith duty comes to bear to make the subterfuge argument as base for breach of contract. Here the leading citation is another one of Chancellor Allen's cases, *HB Korenvaes Investments, L.P. v. Marriott Corp.*,²²¹ which involved an issue of convertible preferred stock. The Chancellor opined that the good faith duty would block a large spin off otherwise permitted by the contract if the value of the included assets was of a magnitude sufficient to cause the adjustment formula in the issue's antidilution clause to cease to operate arithmetically, causing the clause to fail to achieve its intended purpose.

²²¹ 1993 WL 257422 (Del. Ch.)

We think the strategic and apparently uneconomic equity placements in *Caesars II* fall could into this category.

Thus, contract interpretation under the good faith rubric could yield the right results in both *Marblegate* and *Caesar's* where the broad reading of TIA 316(b) does not. Our analysis will surprise many, for, as we have saw in Part II, courts have a longstanding habit of refusing to apply contract good faith to financial contracts. Indeed, the result surprises us too. We put it down to chance—it just happens that the few doctrinal odds and ends that retain vitality within the narrow band of good faith constraint of financial contracts come to bear on the facts of *Caesars*. It bears noting that our contract law theories do not amount to a sure thing. But at least they direct the inquiry where it ought to go, to the allocation of risk bound up in the contract.

C. Conclusion

The broad reading of section 316(b) is the logical result of the corrosion of good faith duties in financial contracts. The new workouts can present disturbing facts. With good faith off the table, something needed to be done to fill the gap and the Southern District used section 316(b) and a very, very broad reading its legislative history as the means to the end. Alternative theories could suffice. Meanwhile, the Second Circuit correctly rejected the broad reading as a matter of legislative history.

V. RETAIN OR REPEAL?

The *strum and drang* surrounding the broad reading's rise and fall awakens the dormant policy question regarding repeal of section 316(b). The broad reading threw a wrench into today's workout machinery, making section 316(b) even more counter-productive. The issue will persist even if it turns out that the Second Circuit panel opinion definitively reestablishes the traditional reading. *Marblegate* and *Caesars* together cast an unflattering light on the distortionary tactics that drive the new restructuring, suggesting a need for a revised approach.

The repeal question returns in a policy context very different from that prevailing at the time Professors Roe and Brudney debated the matter decades ago. As we saw in Part III, bankruptcy is less costly, the dysfunctional restructuring is a thing of the past, and negotiated

workouts now present a viable alternative. There may be power imbalances on the fact patterns, but bondholder collective action problems no longer contribute to them. Now that the broad reading is off the table, it would seem that issuers and bondholders can continue to live with section 316(b) without excess discomfiture. But, at the same time, coercive tactics have assumed greater salience. Maybe it is time to put CACs back on the process table.

The literature describes two contrasting means to that end—qualified repeal with continuing SEC control and outright repeal that leaves the future process regime in the hands of indenture drafters. The primary point of difference lies in the observer’s view of the efficacy of bond contracting.

Professor Roe makes the case for qualified repeal. He projects that contractual adjustment will be slow and rigid, with issuers resisting CACs due to worries about negative bond market signals.²²² In addition, self-interested bondholder voting will remain a problem under CAC indentures—separate lending relationships between issuers and bondholders will result in side payments.²²³ He accordingly suggests that the SEC exercise its exemptive power under TIA section 304²²⁴ to allow indentures to include two-thirds majority CACs on

²²² Roe, *supra* note 63, at 273-74.

²²³ *Id.* at 270.

²²⁴ Trust Indenture Act section 304(d), amended in 1990, 15 U.S.C. 77ddd, provides as follows:

The Commission may, by rules or regulations upon its own motion . . . exempt conditionally or unconditionally any person, security or transaction, or any class or classes of persons, securities or transactions, from any one or more of the provisions of this title, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by this title.

The section’s legislative history also allows this on a literal read, although the examples stated therein are of a considerably lesser magnitude than exemption Roe proposes. The reports and testimony variously describe the amendments to section 304(d) as facilitating adjustments to new developments in debt security design and underwriting, citing in particular the appearance of securitization. See Trust Indenture Reform, Hearing on H.R. 1786 before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce House of Representatives, 101 Cong. 1st Sess. 28, 30, 35, 54 (1989).

condition that the provisions bar coercive transactions and disqualify conflicted votes.²²⁵

Professor Marcel Kahan counters with a case for outright repeal.²²⁶ For Kahan, there is no justification for any mandated terms in bond contracts. Between good information diffusion, robust pricing,²²⁷ and almost universal institutional holding, bondholders can protect themselves.²²⁸ He does not deny that coercive devices play an important role in workouts, but takes the position that coercion by itself does not justify a preclusive mandate such as that embodied in section 316(b).²²⁹

This Part looks into these alternatives, taking a position in the middle. That is, we favor outright repeal but enter a doctrinal *caveat*—outright repeal would work best against a background threat of judicial intervention. Standard trust indentures do address process matters related to amendment and exchange offers. Indenture drafters also adjust indenture forms in response to external shocks. But the process is indeed slow and the results are variable—some indentures do a better job of addressing process contingencies than do others. Meanwhile, depending on the drafting, a CAC indenture can expand the list of coercive possibilities. We think the drafters will be more likely to focus on the process issues and treatment alternatives with a judicial officer on patrol.

In Section A we explain our doubts about further SEC involvement in workouts and go on to show that trust indenture drafters are more responsive to the stresses of restructuring than some

²²⁵ Mark J. Roe, Commentary, *The Trust Indenture Act of 1939 in Congress and the Courts in 2016: Bringing the SEC Back to the Table*, 129 HARV. L. REV. F. 360, 372 (2016). This is the second iteration of the proposal. In the 1987 paper, he suggested an SEC rulemaking pursuant to which core indenture terms could be amended by a two-thirds vote and exit consents would be prohibited. In addition, conflicted voting would be addressed through the interpolation of the Bankruptcy Code's rules on voting disqualification, and second, by self-reporting of insider status by the bondholders. Roe, *supra* note 63, at 270-71.

²²⁶ Kahan, *supra* note **Error! Bookmark not defined.**

²²⁷ *Id.* at 578.

²²⁸ Kahan cited his own study of covenant amendments, which found that less than half of the solicitations succeeded as originally proposed, that in 42% of the cases bondholder resistance resulted in improved terms, and that 17% of the solicitations failed altogether. *Id.* at 604, citing Marcel Kahan & Bruce Tuckman, *Do Bondholders Lose from Junk Bond Covenant Changes?*, 66 J. BUS. 499 (1993).

²²⁹ Kahan, *supra* note **Error! Bookmark not defined.**, at 628-620.

observers have conceded heretofore. Indentures contain an elaborate set of process rules operating against the background of section 316(b). We surveyed the terms of two sets of indentures governing bonds issued under 144A, one set issued in 2011 and the second in 2016. The findings are surprising: first, UACs cover considerably wider ground than required under section 316(b), and, second, a majority of the contracts explicitly sanction exit consents. We also show that indenture drafters adjust to background shocks, in this case, *Marblegate*—a subset of the 2016 indentures draft out from under section 316(b). That said, the dataset does not support a prediction that the drafters will manage to respond comprehensively to the process questions that would arise in the wake of section 316(b)'s repeal.

Section B lays out our doctrinal suggestion. The contractual good faith duty, as we have seen, only rarely comes to bear against bond issuers, amounting to considerably less than a threat. Given this, we project that in the event section 316(b) repeal resulted in anything short of comprehensive revision of trust indentures, that CACs could be combined with exchange offers and exit consents with devastatingly coercive effect. Further, given repeal, exit consents would lose the expedient attractiveness they currently enjoy as a weapon against holdouts. We project that pressure for judicial intervention would build up accordingly, and describe a robust basis for justifying it—a revived intercreditor duty of good faith.

A. The Case for Outright Repeal

1. Federal Mandate.

Professor Roe conditions repeal on the institution of a protective layer of federal law, proposing that the SEC by rule promulgate a broad standard directed to any and all distortionary influences. As a theoretical proposition the suggestion has everything to recommend it—it amounts to a mandate embodying the policy bottom line described in Part I. But we worry about implementation. *Marblegate* shows that single-minded pursuit of undistorted choice can have perverse effects. Although existing law is far from perfect, its overall pattern is instructive—rules, not standards, and reticence respecting the advisability of pushing toward the theoretical ideal in arm's length contexts. Conflicts are hard to smoke out and it would take an invasive disclosure regime to get them on the table. And then there's

the flood of suits. An SEC rule would presumably fall within the existing private right of action under the TIA.²³⁰ As such, it would not be subject to the lawsuit baffle that is universal in trust indentures—a “no action provision” requiring that a group holding at least 25% of the bonds coalesce to pursue a contract claim when the trustee declines to do so.²³¹

We also question whether it makes sense to leave the process regime’s terms up to the SEC. The agency has been out of the bondholder protection business for decades and has a lot of other things on its plate. Once it put through a 66 2/3 CAC alternative, one doubts that it would monitor investor preferences regarding further particulars on a going concern basis even as experience accumulated in the marketplace.

Finally, and most importantly, the proposal follows from theory and makes no reference to the preferences of bondholders. We will see below that it is not safe to assume that they would agree to a ban on issuer coercion, or indeed, that they would prefer a CAC regime in the first place.

2. Contracting Practice.

Trust indentures are famously unresponsive to change. This is partly because the TIA locks in a number of their provisions. Even outside of the TIA’s purview, standardization (wherein lies a part of the value of these contracts) inhibits innovation. For policy purposes, trust indentures tend to be written off as expressions of the bondholder preferences.

We think that’s a mistake, as least regards the practice respecting indenture terms governing amendments and waivers. To support our point, we collected a sample of indentures governing new issues of bonds issued during the second quarter of 2011, well before the *Marblegate* decision, and the second quarter of 2016, after understanding of *Marblegate* and its implications had a chance to diffuse through the bond market. Our sample is restricted to offerings pursuant to the 144A registration exception because 144A indentures

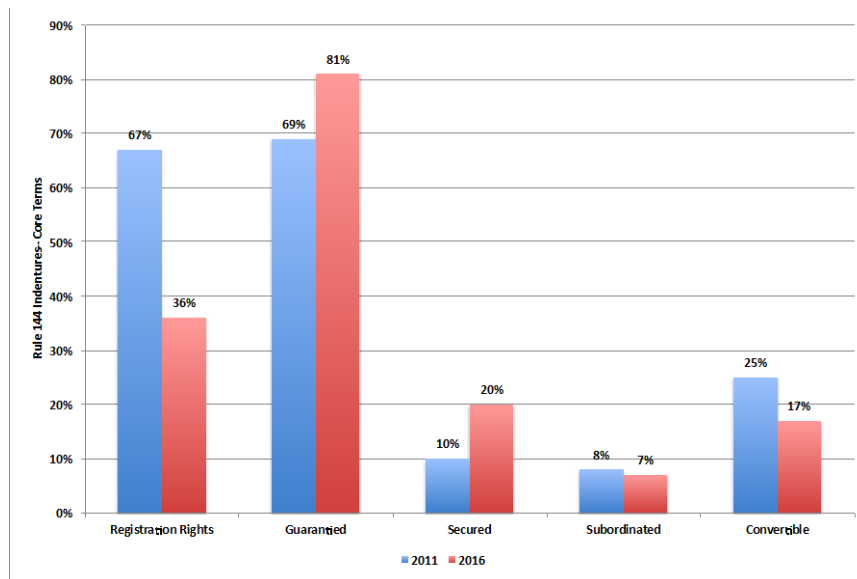
²³⁰ The action dates back to *Zeffiro v. First Pa. Banking & Trust Co.*, 623 F.2d 290 (3d Cir. 1980).

²³¹ AMERICAN BAR FOUNDATION, *supra* note 25, at ____.

do not need to be qualified under the TIA. Some issuers scrupulously conform to the TIA nonetheless—it is common in the 144A market to give the purchasers a concomitant option to exchange for a registered bond, an exercise entailing ex post TIA qualification of the indenture. Other issues are “144A for life” and, once their transfer restrictions lift after six months, trade in a QIB market. The territory thus is open to heterogeneous responses to developments under the TIA—nothing prevents a drafter of a 144A for life issue from including an across-the-board CAC. The sample is culled from EDGAR’s Form 8-K files, pursuant to a request requiring “144A,” “indenture,” and “notes” and the relevant item and exhibit designations.²³² The 2011 sample includes 49 indentures and the 2016 sample includes 59.

Figure 2 describes basic terms of the transactions in the data set. In 2011, two-thirds of the deals included registration rights, a percentage that declined to 36% in 2016, reflecting the diminishing relevance of trading restrictions in the 144A market. Most of the bonds were guaranteed by other entities in the issuer’s corporate group. Most of the bonds also were straight senior debt, but there were large subsets of secured and convertible bonds along with a smaller subset of subordinated issues.

²³² The search was run through the Wharton Research Data Services SEC Analytics Suite.

Figure 2. Core Terms of Rule 144A Indentures

a. Drafting Out from Under Marblegate.

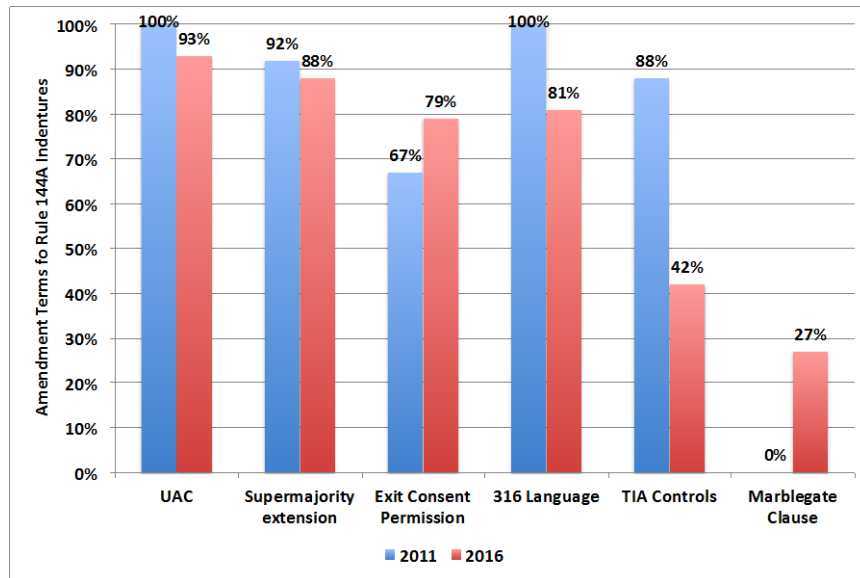
Bond counsel reacted negatively to *Marblegate* and responded in 144A-for-life issues by contracting out from under section 316(b), changing a drafting pattern dating back at least to the TIA.

Figure 3 depicts the appearance of amendment provisions. In 2011, 100% of the issues contained a classic trust indenture UAC operating as a proviso to a CAC. The CAC permits amendment of any terms by a simple majority but is qualified by a limitation prohibiting changes to core terms without the consent of each bondholder affected thereby.²³³ In 2016, the classic UAC proportion declined to 93.2%. Four of the indentures in the 2016 group drop the unanimous consent requirement for core terms and substitute supermajority provisions (90% in three, 75% in one). The declines suggests resistance to *Marblegate* in 144A-for-life issues, with the choice of a

²³³ A simple majority is employed across-the-board. A half century ago the rule of thumb was two-thirds. See AMERICAN BAR FOUNDATION, *supra* note 25, § 9-2, at 305-6 (including a two-thirds CAC and commenting that the two-thirds threshold is “required generally”).

90% CAC in three out of four further suggesting that the relaxation of the unanimity requirement specifically targets holdouts.

Figure 3. Amendment Terms of Rule 144A Indentures



The implication of resistance becomes stronger when we look at section 316(b) clauses. Trust indentures customarily add a term that repeats the language of section 316(b) in addition to including an explicit UAC. In 2011, 100% of the indentures contained a provision that replicated section 316(b) without substantive variation. In 2016, that number had dropped to 81%.

The section 316(b) clause has become the platform for getting out from under the broad reading, and is utilized as such in 17% of the 2016 indentures. It is a less drastic approach than that taken in the four CAC indentures. The drafter rephrases the section 316 clause to narrow the scope of the “right.” Thus do we see a prohibition of impairment of “the contractual right to bring suit.”²³⁴ This indicates an intent to block broader readings emanating not from the contract but from the TIA. The “contractual” right is further defined as a right “to bring suit” and a right against application of unconsented amendment, more concretely blocking interpolation of a transcendent

²³⁴ Realogy Group, CIK 1355001, June 3, 2016, §5-8, at 234.

right to be paid. Another drafter simply states an affirmative “right to bring suit” for principal and interest,²³⁵ eliminating the separate right “to receive payment” entirely.

Eight of the indentures proceed this way. Another three leave the section 316(b) clause out entirely. An additional four contain a clause that blocks application of the TIA even as they also contain a classic section 316(b) clause.²³⁶ The apparent objective is to block the broad reading of the clause by blocking application of the statute. By one or another means, 23.7% of the indentures block the broad reading.

There is also a more drastic decline in inclusion of a standard backstop clause specifying that the TIA controls the indenture whatever else the indenture says—down from 88% of the 2011 indentures to 42% of the 2016 indentures.

b. Unanimous Action Expanded; Exit Consents Permitted.

The belt-and-suspenders drafting approach—explicit UAC plus 316(b) clause—has important implications for section 316(b) repeal. If repeal occurred tomorrow, the 316(b) clauses would still be in the indentures. Even if repeal had the effect of removing 316(b) clauses from existing bonds, the separate UACs would remain, thereby limiting the legislative shift to majority consent to future indentures.

Three additional drafting patterns should be noted, these appearing in common in both 2011 and 2016. The drafters effectively endorse the current framework of restructuring, both extending the UAC beyond the mandate of 316(b), leaving the section 316(a) mandate as is, and sanctioning exit consents.

The UAC extensions go beyond the traditional core payment terms to pick up redemption terms, guaranties, conversion provisions, and subordination language.²³⁷ Amendment terms on liens split the difference, permitting security to be released on a two-thirds or three-quarters vote. Further extensions appear frequently but not

²³⁵ PVH Corp. Indenture, U.S. Bank National Ass’n, Trustee, June 20, 2016, § 6.07.

²³⁶ Still four more employ this clause in addition to employing the other techniques.

²³⁷ The correspondences are not quite perfect, more indicating sloppy use of forms than intentional omission. For example, out of 22 convertible issues, one omits to put the provisions under the UAC. The numbers respecting guaranties are less thorough-going, 88.2% in 2011, 77% in 2016, and conceivably could support an inference of issuer push-back.

consistently—48.6% of the indentures extend the UAC to “priority;” 21.1% pick up their poison put provision. In effect, the drafter is broadening the set of “core” terms.²³⁸

Movement toward bondholder protection is not thorough-going, however. The drafters might also have extended the reach of TIA section 316(a), which disqualifies votes of bonds held by the issuer and its affiliates.²³⁹ The indentures in our sample track 316(a) closely, where they might have defined additional classes of prohibited self-interest. For example, consent payments also could be barred in specified situations, and empty voting could be addressed. This probably is a considered result, for a more expansive reading of section 316(a) directed to exit consents has been mooted in the law reviews²⁴⁰ and also litigated without much success.²⁴¹

Most indentures also sanction exit consents, confounding the expectations of academics. Professors Coffee and Klein, writing in the wake of *Katz v. Oak Industries*, suggested that all it would take is a little

²³⁸ The parameters have widened since the drafters of the Model Indenture reported in 1971. Their amendment clause includes payment terms only, with the note mentioning practice extension only to redemption, conversion, and liens. See AMERICAN BAR FOUNDATION, *supra* note 25, § 9.02, at 305-9.

²³⁹ See *supra* text accompanying note 23.

²⁴⁰ Professors Coffee and Klein suggested that bonds submitted with exit consents could be deemed “owned” or “controlled” by the bond issuer, falling afoul of both the trust indenture’s voting provisions and TIA section 316(a). John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1257 (1991). The idea was to read “owned” in 316(a) “owned” broadly to include control and suggested an economic reality test looking to beneficial interest, not just legal ownership, thereby sweeping exit consents into the prohibition. *Id.* at 1258.

²⁴¹ The theory that the issuer owns bonds tendered with exit consents worked in a UK case, *Assénagon Asset Management S.A. v. Irish Bank Resolution Corp. Ltd.*, [2012] EWHC 2090 (Ch) (2012). The indenture provision in question provided that “Neither the Issuer nor any Subsidiary shall be entitled to vote at any meeting in respect of Notes beneficially held by it for its account.” *Id.* at ¶ 16. Taking a formalist approach, the High Court of Justice ruled that by the time the votes garnered under the exit consents were cast at a later bondholders’ meeting, the bonds were beneficially held by the issuer because the contract of sale contained a specific performance provision and a refusal to deliver the bond would not be adequately compensated by monetary damages. *Id.* at ¶¶ 62-67.

The *Caesars I* plaintiffs tried this out, arguing that the issuer either owned or controlled the bonds redeemed from the favored bondholders and thus could not vote those bonds. 80 F.Supp. 3d 507, at 516-17. The court rejected the theory, taking the same formalist tack as did the earlier *Assénagon* court. But this time the background was different, for the consents were delivered before the issuer took ownership of the bonds. Hence, there were no “owned” votes. Nor were the votes under issuer “control,” for the voters were “unaffiliated, independent third parties” acting at arm’s length. *Id.* at 517.

nudge and indenture drafters would wake up and shut down exit consents by requiring that amendments and exchange offer tenders be unbundled.²⁴² But precisely the opposite occurred. Express sanction of amendments by exiting bondholders are widespread without being ubiquitous—67.3% of the 2011 indentures and 79.6% of the 2016 indentures include them.

The bond issuers' interest in assuring the validity of exit consents is clear enough. Significantly, it concerns more than the reservation of freedom of action in distress situations. The primary value of an exit consent is lies on the upside, when the issuer of an unredeemable bond seeks to pay down early. The means to the end is a premium cash repurchase tender offer. An exit consent tie in gives the offer a kick. Issuers like the flexibility imported by the play—they get to shave a few basis points off the interest rate in exchange for issuing an unredeemable bond and at the same time keep their options open.

The bondholder position presents a bit of a puzzle, for bondholders are supposed to be the victims here. Why would they sanction their own coercion? Indeed, the preferences suggested appear contradictory—in favor of both unanimous action (retarding workouts) and coercive exchange offers (encouraging workouts).

Here is our attempt to make the pattern intelligible. The bondholders do not trust one another to vote sincerely on amendments of core terms and are jealous of their holdout privilege, hence the UAC expansion. At the same time, they understand that holding out can lead to problems and want to give issuers a reasonable shot at an out-of-court restructuring. Restating, make me an offer, and I'll look at it. In addition, they are happy to pick up a little added yield when an issuer makes a premium cash tender offer, and have no trouble handing an issuer a stick to help such a deal along.

If that is a fair characterization, follow-up questions arise: Can we go a step farther and conclude that bondholders prefer unanimous action; that they are unconcerned about coercive issuer tactics; and that

²⁴² Coffee & Klein, *supra* note 240, at 1257 (1991). Klein and Coffee also suggested that the contractual duty of good faith, long somnolent in the area of relationships between issuers and bondholders and within groups of bondholders, could come to bear effectively if only courts would wake up and bring it to bear. *Id.* at 1256-59.

left to their own devices they would leave workout practice as is? We can suggest these possibilities but cannot go farther. We do not know how large of a role path dependence plays in bond indenture drafting.

It is also can be projected that, given a blank slate, bondholders would herd to CACs. The UAC versus CAC question has been exhaustively discussed in the sovereign bond market since the spectacular Argentine default of 2001. Sovereign debt tends to be issued in New York and London. Historically, New York issues were covered by UACs (despite the inapplicability of the TIA), while London issues were governed by CACs. Argentina had a significant amount of debt outstanding under UACs. Default led to a fractious workout by exchange offer. Related litigation only finally settled in 2016.²⁴³ The public side of the international financial community (which has never been able to come up with a sovereign bankruptcy regime), blamed the mess on the UACs. CACs became part of a policy push for orderly restructuring.²⁴⁴ Sovereign borrowers were pressured to insist on CACs,²⁴⁵ and a widespread shift of preferences followed. Two points emerge, bondholder preferences regarding CACs and UACs are mutable and boilerplate amendment terms can indeed change in response to events.

It should be noted that our data also suggest a counter-projection. *Caesars* and *Marblegate* did not precipitate a widespread shift to CACs, implying that there is no pent up demand for collective action. If there

²⁴³ Argentina effected a take-it-or-leave-it exchange offer implicating a substantial haircut, but left outstanding a sizable population of holdout bonds. A years'-long standoff followed as the holdouts, led by hedge funds, pursued their US law remedies where they could, finally vindicating their right to payment in the United States Court of Appeals for the Second Circuit in 2012. See *NML Capital, Ltd. v. Republic of Argentina*, 699 F. 3d 246 (2d Cir. 2012). Only in 2016 (when execution of the federal court judgment threatened to disrupt Argentina's payments to its cooperative creditors) did Argentina come to the table and settle, giving the holdouts the last laugh. But by then the contracting practice had changed substantially, with super-majority CACs becoming the sovereign debt standard. See, e.g., Alexandra Stevenson, *How Argentina Settled a Billion Dollar Dispute with Hedge Funds*, N.Y. TIMES, Apr. 25, 2016, available at <http://www.nytimes.com/2016/04/25/business/dealbook/how-argentina-settled-a-billion-dollar-debt-dispute-with-hedge-funds.html>.

²⁴⁴ William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. 1, 45-48 (2004).

²⁴⁵ The borrowers had assumed that, given issuance in New York, bondholders', marked preference for UACs entailed a beneficial give back in the form of a lower interest rate.

were, it is not implausible to suggest that a cascade would have occurred in the 144A market in *Marblegate's* wake.

3. Conclusion.

We see, then, that present arrangements could reflect considered preferences and would be replicated unchanged in future contracts. It is also possible that preferences would adjust if Congress opened the door for CACs, and that the shock might break the drafting pattern in other respects as well. There is no certain prediction. What we can say is that bond contracting is sensitive to workout process questions and does register the preferences of issuers and bondholders, and that as between bond contract drafters and SEC staffers, the former are better equipped to accomplish the task.

B. CACs—the Worst Case

1. The Drafting Task in the Wake of Repeal.

Outright repeal of section 316(b) would clean the slate, raising a series of questions for indenture drafters. First comes the CAC/UAC choice. A choice for CAC raises a subsidiary question about acceptance percentages, not only the number set for payment terms, but whether to incorporate percentage differentials for different categories of contract term. There would also be a critical additional question: whether to bar exit consents; indeed, whether to bar exchange offers altogether. Arguably, with a 66 2/3% or 75% CAC, exchange offers no longer would serve a legitimate purpose in workout contexts. A prohibition would close off a whole avenue of coercive possibilities. Finally, conflicted bondholder voting and vote buying could and should be reconsidered.

The adjustment process could be slow and messy. The *Marblegate* adjustment presents a case in point. If we assume, as seems sensible, that preferences lie against the broad reading, the fact that 37.5% of the 144A-for-life indentures in the sample opted out one year to 18 months after the decision does not bespeak highly focused drafting. Why not all of them? Perhaps preferences differ from issue to issue. More likely, there is inattention. Alternatively, let us assume that bondholders generally are happy to sanction exit consents, an assumption that seems reasonable in view of the fact that 68% and 80% of the indentures in the samples did just that. The same question arises.

The lack of focus follows from the deals' underwritten character. The bondholders are represented at the drafting table only by a proxy, counsel for the underwriter, whose client is interested in bondholder protection only to the extent that it imports marketability. There is no marching order to assure that the lender's perspective informs all fine points, as would be the case in a negotiated bank loan. Risk allocation conventions evolve, but with incomplete coverage. Imperfections creep in.

2. The Worst Case.

Let us assume that section 316(b) is repealed, the drafters insert 75% CACs, but do not follow up by blocking exchange offers and exit consents. Instead, they follow the practice that evolved with European sovereign bond issues and raise the threshold percentage for covenant amendments from 51% to 75%. The operative notion is that the increase in the threshold makes exit consents less user friendly for the issuer, making direct amendment more attractive than an exchange offer.

This sets the stage for the worst case, a case that has arisen under the law of England and Wales. *Assénagon Asset Management S.A. v. Irish Bank Resolution Corp. Ltd.*²⁴⁶ involved an exchange offer featuring new bonds with a face value of €20 and an exit consent that amended the principal amount of the old bonds from €100 to €0.01.²⁴⁷ The issuer was an insolvent bank subjected to a government takeover, and the offer derived from a government policy decision. There was disputed evidence that the bonds had been trading for €20, but no evidence of negotiation. Presumably, none was needed, given the high octane coercive possibilities that result when a drafter combines an across-the-board CAC without simultaneously barring exchange offers and exit consents. Ninety-two percent of the bondholders knuckled under.

There is a notable similarity to *Marblegate*, the choice between €20 and €0.01 being no different from the choice between \$33 and \$0. But the cases are otherwise sharply distinguishable. *Marblegate* was a negotiated deal amongst creditors who had nowhere else to go and

²⁴⁶ [2012] EWHC 2090 (Ch).

²⁴⁷ *Id.* at ¶ 32. The amendment inserted a right to redeem for €0.01. Procedurally, *Assénagon* was on a Part 8 claim, the England and Wales equivalent to a motion for summary judgment in which there is no material dispute as to facts.

acute vulnerability to holdouts due a UAC. *Assénagon* was a take-it-or-leave-it offer embodying the issuer's notion of an appropriate price where a CAC otherwise would have facilitated amendment without coercion.

The moral of the story is that a CAC regime, even as it nominally serves the purpose of reducing distortion, opens up wildly coercive possibilities unless the drafting is thorough-going. Current drafting practice promises responsiveness but not completeness, inserting an element of risk.

C. Backstop Policing: An Intercreditor Duty of Good Faith

Given repeal of section 316(b) and CACs, exit consents would lose their expedient attractiveness and emerge as an instrument of pure coercion. Absent a contractual prohibition, the judiciary would be called on to intervene. In this section we show how that can be done, looking to the intercreditor duty of good faith.

The intercreditor duty responds to a good faith claim asserted by one bondholder in response to an action taken by other bondholders. The posture is different from that the limited good faith duty described in Part II, which involves claims asserted in suits by bondholders against issuers. The duty is articulated in a largely forgotten line of cases antedating the TIA, cases showing strong grounds for a robust implied duty in workout contexts. Not coincidentally, this duty led to an outcome in the plaintiff's favor in *Assénagon*. It also would have provided an alternative basis for blocking the *Caesars I* amendment, an approach which would not also have implied invalidation for the *Marblegate* restructuring.

An intercreditor duty would do more than just provide a basis for the right result in an extreme case. It would also improve the drafting environment. Most observers assume that the burden to draft an explicit contract provision should fall on the party asserting the right, on the sensible ground that this is the party with the correct incentive and possibly superior information. Trust indentures are different because the deals are underwritten. Incentives on the bondholder side are diffuse and influence is indirect. To get a contract-forcing result, it makes much more sense to put the burden on this issuer, at least so far as concerns process terms in the wake of section 316(b)'s repeal.

1. Intercreditor Good Faith Cases.

A bondholder duty constraining self-interested unilateral or majority action not in the best interests of the bondholders as a group can be seen in a pair of nineteenth century Supreme Court cases. In the 1874 case of *Jackson v. Ludeling*, the Supreme Court was faced with the problem of an individual bondholder who foreclosed on the collateral securing the bond and artificially depressed the price in the foreclosure sale so that his associate could purchase a \$2 million railroad for \$50,000. The Court noted that the foreclosing bondholder

was not a partner with [the other bondholders], nor strictly a tenant in common, but the relation into which he introduced himself by his purchase [of the bonds] imposed on him some duties.... [I]t was a duty which he owed the other bondholders not to destroy [the mortgage's] value. When two or more persons have a common interest in a security, equity will not allow one to appropriate it exclusively to himself, or to impair its worth to the others. Community of interest involves mutual obligation.²⁴⁸

The Court commented similarly in *Shaw v. Railroad Co.*:

If there are differences of opinion among the bondholders as to what their interests require, it is not improper that [the indenture trustee] should be governed by the voice of the majority, acting in good faith and without collusion, if what they ask is not inconsistent with the provisions of his trust.²⁴⁹

A similar approach can be found in the 1896 case of *Hackettstown National Bank v. D.G. Yuengling Brewing Co.* In *Hackettstown*, the bond issuer—the famous brewery—had defaulted on its interest payments. The company's principal shareholder arranged for a friendly party to buy enough of the bonds in order to amass (together with bonds held by other Yuengling family members) the three-quarters majority necessary to amend the bonds' indenture to defer the interest payments. The principal shareholder personally agreed to repay the friendly party's investment with interest. A minority bondholder sued over the indenture amendment. The Second Circuit Court of Appeals

²⁴⁸ *Jackson v. Ludeling*, 88 U.S. 616 (1874).

²⁴⁹ *Shaw v. Railroad Co.*, 100 U.S. 605, 612 (1879).

nullified the amendment, noting that a vote “made collusively...for the purpose of defeating the remedy of the minority, and not in the exercise of an honest discretion in the general interest, is not a consent within the meaning of the indenture.”²⁵⁰ The court’s ruling was based on a “community of interest” that “creates mutual obligation, and imposes upon all persons occupying that position the duty of acting in good faith toward the interests of their associates.”²⁵¹

In the nineteenth century, then, majority rule was always subject to a requirement of good faith and a prohibition on collusion with the debtor. It is important to note that the courts did not think of this as an imposition of fiduciary duty, even as they analogized to partners. It was a situation-specific duty springing not from the overall relationship but from the vested power to vote or enforce. While a fiduciary-like duty of self-abnegation did result, there were no further implications for the relationship.²⁵²

The good faith constraint on majority bondholder voting power retains vitality in English caselaw, perhaps because there is no statutory equivalent to the TIA and bonds are governed by across-the-board CACs.²⁵³ *Assénagon* is an exemplar of its application. A nonexchanging

²⁵⁰ *Hackettstown National Bank v. D.G. Yuengling Brewing Co.*, 74 F. 110, 112 (2d Cir. 1896).

²⁵¹ *Id.* While duty qualified the principle of majority rule, it did not prevent majorities from binding minorities. *Shaw v. R.R. Co.*, 100 U.S. 605, 611-612 (1880); *First Nat'l Bank v. Shedd*, 121 U.S. 74, 86-87 (1887); *In re Schommer*, 112 F.2d 311, 314-315 (7th Cir. 1940). See also *Crosswaith v. Moline Plow Co.* 298 F. 466, 469 (D.N.Y. 1924) (denying minority bondholder’s suit in contravention of collective action clause to challenge equity reorganization). The duty went together with a requirement that the benefits the majority’s decision be shared by all the holders of the same security. *Crosswaith v. Moline Plow Co.* 298 F. 466, 469 (D.N.Y. 1924).

²⁵² Comment, *Modification of Corporate Mortgages and Trust Indentures*, 38 MICH. L. REV. 57, 67 (1939) (“But granted an exercise within the explicit power of the majority, still the courts will inquire into the manner and circumstances of its exercise before holding the minority bound by their irrevocable assent to the alterations. The approach of the courts is that the majority are in a fiduciary relationship to the minority, with a power in trust to be used only for the common good of all.”).

²⁵³ The English principle derives from partnership and majority-minority shareholder cases. See *Blisset v. Daniel* (1853) 10 Hare 493, 523-24 (partnership); *Re Westbourne Galleries* [1973] AC 360, 381 (shareholders in limited company); *O'Neill v. Phillips* [1999] 1 WLR 1092, 1098-1101 (shareholders in limited company); *Allen v. Gold Reefs of West Africa* [1900] 1 Ch 656, 671 (shareholders). It imposes a good faith limitation on the power of a creditor majority to bind a minority. *Brit. Am. Nickel Corp. Ltd. v. M. J. O'Brien* [1927] AC 369, 371; *Redwood Masterfund Ltd. v. TD Bank Europe Ltd* [2006] 1 BCLC 149 (majoritarian amendment of the terms of a syndicated loan facility). Any votes not cast in good faith are to be disregarded. *In re Wedgwood Coal & Iron Co.*, 6 Ch. 627 (1877); *In re Empire Mining Co.* 44 Ch. D. 403 (1890).

minority bondholder, whose €17 million were forcibly redeemed for a mere €170,²⁵⁴ brought suit challenging the validity of the majority's exit consents. The High Court of Justice applied the intercreditor duty:²⁵⁵

The exit consent is, quite simply a coercive threat...[the] only function [of which] is the intimidation of a potential minority....This form of coercion is ... entirely at variance with the purposes for which majorities in a class are given power to bind minorities.... [O]ppression of a minority is of the essence of exit consents of this kind, and it is precisely that at which the principles restraining the abusive exercise of powers to bind minorities are aimed.

Assénagon is cut from the same cloth as were this country's nineteenth century intercreditor cases, but carries them a step into new territory. In the old cases, the voting infirmity arises in respect of bondholder conflicts of interest independent of issuer action. In *Assénagon* the conflict stems from bondholder responses to issuer coercion. Indeed, it delivers the good faith constraint at the issuer's doorstep by indirection, nominally in conflict with the result in *Katz v. Oak Industries*. The High Court acknowledged the point, noting that the exit consent is an invitation from the issuer for the "majority to levy against the minority." But a bondholder not an issuer duty was under consideration: "it is no answer for [the majority] to say that it is the issuer which has required or invited them to do so."

As noted in Part II, the intercreditor good faith tradition also lives on within bankruptcy, which provides that any votes not cast in good faith in Chapter 11 may be "designated" and cast in the judge's discretion.²⁵⁶ Although this is not a blanket bar against self-interested voting,²⁵⁷ it covers much the same territory as did the intercreditor cases.

²⁵⁴ *Assénagon*, ¶ 37.

²⁵⁵ *Id.* ¶¶ 40-47.

²⁵⁶ 11 U.S.C. § 1126(e).

²⁵⁷ *In re Adelpbia Communic. Corp.* 359 B.R. 54, 60-61 (Bankr. S.D.N.Y. 2006).

2. The Disappearance of Intercreditor Good Faith Cases in the United States.

The idea that express contract rights given to majority bondholders must be equitably exercised was black letter law on the eve of the enactment of the TIA.²⁵⁸ An evolutionary dead end followed. Why did the line of cases die out? First and foremost, the TIA had the effect of shifting a substantial portion of restructuring activity into bankruptcy, where it occurred under judicial supervision and with express good faith duties. As a result, intracreditor duties slipped out of the collective memory, so much so that they were not cited in the *Marblegate* and *Caesars*.

Secondly, intercreditor duties simultaneously lost their framework of application—the equity receivership in which federal courts applied federal equity jurisprudence—a body of law that looks much like a federal common law—in umpiring corporate restructuring. While federal equity receiverships are still possible, they have largely been supplanted by bankruptcy proceedings. Moreover, the merger of law and equity in the 1938 Federal Rules of Civil Procedure and the Supreme Court’s 1938 holding in *Erie Railroad Co. v. Tompkins* that there is no general federal common law²⁵⁹ rendered further confusion about the role and continued viability of federal equity jurisprudence. As a result, the old equity receivership cases endure as homeless precedents, strictly speaking binding no one.²⁶⁰ But, they are also not thereby deprived of persuasive status—the late twentieth century good faith duty can be seen as a vessel that picks up in legal contexts notions that formerly took shape on the courts’ equitable side. Meanwhile, out-of-court restructuring is returning to real world salience. It makes

²⁵⁸ *Hackettstown* was featured in leading corporate finance texts in the 1930s and was favorably cited in Congressional debates on the Trust Indenture Act. Coffee & Klein, *supra* note 240, at 1262, n. 158; Roe, *supra* note 63, at 252. The *Hackettstown* case received extended treatment in a treatise written the year after the opinion came out. See EDWARD LYMAN SHORT, THE LAW OF RAILROAD BONDS AND MORTGAGES IN AMERICA, WITH ILLUSTRATIVE CASES FROM ENGLISH AND COLONIAL COURTS 50-51 (1897). See also *In re Georgian Hotel Corp.*, 82 F.2d 917, 919 (7th Cir. 1936); *Vogelstein v. Ath. Mining Co.*, 192 S.W. 760, 763 (Mo. Ct. Appl. 1917); *Sage v. Cent. R.R.*, 99 U.S. 334, 341 (1878).

²⁵⁹ 304 U.S. 64 (1938).

²⁶⁰ We do not venture a theory here for the dormancy of intercreditor good faith cases in England and Wales in the decades prior to *Assénagon*.

eminent sense to look back to pre-Depression caselaw for doctrinal guidance.

Thirdly, as the bond market shifted from mom-and-pop bondholders to institutional investors, courts likely became less concerned about intercreditor voting conflicts. Consider in this regard of *Aladdin Hotel Co. v. Bloom*,²⁶¹ which has been used in generations of corporate finance textbooks as an illustration of the evils that can befall minority bondholders in the absence of the TIA.²⁶²

As in *Hackettstown*, the chicanery afoot in *Aladdin Hotel* involved equityholders who also held a majority of the bond issue. The Aladdin Hotel Corp. built and operated the Aladdin Hotel (now a Holiday Inn) in downtown Kansas City, Missouri, issuing bonds to finance the construction and operation. The bonds came due and Aladdin Hotel Corp. wanted to extend the maturity date on the bonds by ten years, and amendment which had the knock-on effect of decreasing the interest rate from 8% to 5% if earned. The indenture had a two-thirds majority CAC²⁶³—the bonds had been issued in 1938 and the TIA did not apply.²⁶⁴ Critically, the members of bondholder majority that approved the amendment also happened to own a majority of the issuer's common stock.²⁶⁵ A minority bondholder challenger won in the district court, only to lose in the Eighth Circuit.

Although *Aladdin* was not precisely framed in intercreditor terms, it admits of the characterization. The 8th Circuit posed it as an equitable inquiry. The plain language of the indenture gave the plaintiff no case at law—the indenture explicitly permitted majority amendment—so all plaintiff had was an equitable claim about the amendment's unfairness. The 8th Circuit proved blind to the operative incentives, astoundingly proclaiming that “it is inconceivable that the

²⁶¹ 200 F.2d 627 (8th Cir. 1953).

²⁶² See WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 548-52 (8th ed. 2016); MARK J. ROE & FREDERICK TUNG, BANKRUPTCY AND CORPORATE REORGANIZATION: LEGAL AND FINANCIAL MATERIALS 470-74 (4th ed. 2016); ADAM J. LEVITIN, BUSINESS BANKRUPTCY: FINANCIAL RESTRUCTURING AND MODERN COMMERCIAL MARKETS 157-61 (2015). Curiously, despite its academic canonization, *Aladdin Hotel* received no notice in the legal press when it came down. The case has only been cited a few times since in other decisions, and the scholarly literature did not start citing to it until the 1980s.

²⁶³ *Id.* at 628.

²⁶⁴ *Id.*

²⁶⁵ *Id.* at 628-29.

[equityholders] should deliberately act to the prejudice or detriment of the bondholders when they held and owned some 72 per cent of the entire outstanding bond issue.”²⁶⁶ Extreme though this language may be, the case should not be read as a wholesale repudiation of the earlier intercreditor cases. The court, even as it doubted that there was a conflict of interest, also noted that it did not matter in any event. The plaintiff had purchased the bonds after the completion of the amendment, and under Missouri law, equitable rights were not assignable. It followed that plaintiff’s purchase included only the express legal rights in the bond.²⁶⁷

So, while *Aladdin* denied a good faith remedy to the plaintiff, it held open the possibility of such a remedy for other plaintiffs who held at the time of the amendment. Back in the 1950s, good faith was still understood as an equitable matter requiring clean hands from the party seeking relief and in those days distressed debt investors apparently did not meet the requirement.²⁶⁸ The contrast with the decorous treatment of the holdout plaintiff in *Marblegate* is instructive for how attitudes toward distressed debt investing have changed.

Aladdin, then, does recognize an intercreditor good faith duty. As with the older precedents, it reaches the duty in the framework of equity, rather than in the “legal” framework of an implied contractual covenant of good faith and fair dealing under contract law, but a transfer to the modern framework is easily effected.

3. Scope.

We now address the intercreditor duty’s scope of application in exchange offer contexts. We note first that, as a good faith duty, it would operate as a default. Explicit process rulemaking would be left to the drafters. The duty would easily replicate the result in *Caesars I*,

²⁶⁶ *Id.* at 630.

²⁶⁷ One wonders if there might have been more going on in *Aladdin Hotel Corp.* The plaintiff, Mrs. Bloom, was not some little old widow who had put her retirement savings into the Aladdin bonds. Instead, she was the sister of a pair of corporate raider brothers who owned, among other things, Trans World Airlines (at the time still headquartered in Kansas City), and she purchased the bonds after the amendment. Given the era of the case, it’s plausible to surmise that Mrs. Bloom was serving as a front for her brothers’ new money interests. (One also suspects that being Jewish did not help Mrs. Bloom’s cause as it may have reinforced antisemitic stereotypes of distressed debt investors.)

²⁶⁸ The same approach can be seen in the case cited by *Aladdin Hotel Co., Monticello Bldg. Corp. v. Monticello Inv. Co.*, 330 Mo. 1128 (Mo. 1932).

for it plainly constrains the giving of consents in exchange for selective redemptions. The question is whether the duty does a great deal more than that, for, as articulated in *Assénagon*, it could be read to imply a categorical prohibition of exit consents. Given 316(b), it thereby would throw a wrench into out-of-court restructuring, at least under indentures not explicitly permitting exit consents.²⁶⁹ Contrariwise, categorical prohibition of exit consents would make perfect sense in a CAC regime.

There is a further question regarding *Marblegate*: whether the duty, having come to bear to self-interested voting in *Caesars I*, responds similarly to the *Marblegate* bank lender's self-interested enforcement action. We think a solid line of containment can be drawn.

Marblegate involved *two* issues of debt, invalidating a judicial enforcement action by a secured bank lender at the behest of an unsecured bondholder, thereby applying a duty on creditors under one instrument to refrain from imposing what amounted to a restructuring on the creditors under the other. The intercreditor good faith cases, in contrast, arise from disputes among creditors under common instruments. We see no reason to extend it to creditors under multiple instruments, for, in our view, creditors under different instruments are necessarily competitors who have not impliedly bound themselves to share a recovery from what might be a limited pool of assets.

Some gray areas complicate the line-drawing exercise. Consider first conflicts arising among different classes of creditors under the same instrument, such as the senior-subordinate structure created in securitizations and also in multi-facility syndicated loans. We think these should be included within the zone of good faith. Such creditors have bound themselves to share a recovery from a potentially limited pool, but have structured the sharing as something other than pro rata. We think that the particular allocation is irrelevant; these creditors should still have a duty to each other to attempt to maximize the

²⁶⁹ The solution to the problem, in the present context, would be to bring forward the 19th century cases, but leave *Assénagon* behind—a bad faith action would be a self-interested action not in the best interests of the bondholders as a group but not an action undertaken for self-preservation and not otherwise for private gain in response to a coercive offer made by the issuer.

overall recovery to which their internal division of proceeds applies. The same outcome should hold for creditors under separate instruments who have bound themselves together through an intercreditor agreement, an arrangement that voluntarily moves the two classes from the zone of self-interested independence into the zone of mutual obligation.

Now consider situations involving creditors under separate instruments who are connected not through an intercreditor agreement, but through either (1) a senior/subordinate structure in which bondholders under one instrument acquire senior status by taking an assignment of the junior claim, or (2) a tag-along right, such as a tag-along guaranty or negative pledge clause. We do not think that intercreditor good faith duties should reach these relationships. Creditors on a junior note necessarily have a potential conflict with those on a senior note, a conflict voluntarily assumed. Likewise, tagalong rights might appear solely in one instrument; the parties to the other instrument might not even be aware of the tagalong rights. It would seem that other doctrines, such as tortious interference with contract, might be better suited to policing any manipulative behavior, rather than a general duty of good faith.

4. Conclusion.

Looking forward to a repeal of section 316(b), we believe that the intercreditor good faith duty, taken together with the good faith duty's limited constraints against bond issuers, presents a viable framework for policing coercion and opportunism in restructuring. It also would focus the drafters' attention. And, as a default rule, would work better in the long run than an open-ended federal anti-distortion mandate.

CONCLUSION

The practice picture respecting workouts has changed dramatically, but not so much as to solve a number of longstanding problems. There is no perfect regulatory solution, leaving us in a zone of imperfections and trade-offs. We draw five more particular conclusions.

First, although the broad reading of section 316(b) was laudably motivated, it was overly broad and followed from an incomplete review of the legislative history. The Second Circuit was

amply justified in reversing *Marblegate*. Despite this, stepped up judicial policing under the good faith rubric on an intercreditor basis would be useful and would have the advantage of respecting risk allocations in contracts.

Second, increased workout activity, taken together with changes in bankruptcy practice, denude the case for repeal of section 316(b) of policy urgency. Markets have shown that they can muddle through with the status quo.

Third, section 316(b) can be repealed prospectively without undue risk to the bondholder interest. Take-it-or-leave-it exchange offers no longer present a serious problem, for issuers now negotiate solely with bondholders who know how to evaluate deals and say no. Even the section's bankruptcy-forcing purpose now rings hollow, given reality of secured creditor control, which comes at the expense of unsecured bondholders.

Fourth, any repeal should be outright so as to leave the matter over to the drafters and the market. The theory signals a CAC regime with ancillary process protections. But it is not clear that investors prefer a theoretically correct regime. Moreover, their preferences will be dynamic in time, evolving in response to events. At the same time, the verification problem respecting bondholder conflicts would make a theoretically correct regime difficult to implement. Trade-offs would have to be made, trade-offs best left to the contracting parties.

Finally, a backstop default regime incorporating an intercreditor good faith duty would assist the transition process in the wake of repeal by focusing the issuers' attention and spurring indenture forms in the direction of a complete set of process rules.

The restructuring business has changed in recent decades, such that its New Deal-derived legal paradigms no longer fit market realities. It is time to consider a reform of restructuring law that facilitates fair and efficient workouts.

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