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HEDGE FUND ACTIVISM IN THE ENFORCEMENT OF BONDHOLDER RIGHTS

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INTRODUCTION

Hedge funds have caused some of the most significant recent changes in financial markets. Like mutual funds, hedge funds are pooled investment vehicles that invest primarily in publicly traded securities. But unlike mutual funds, hedge funds are open only to rich individuals and institutional investors, and are therefore exempt from most regulations. That most individuals cannot invest in hedge funds, however, has not hurt their popularity. The assets managed by hedge funds have grown at stratospheric rates, from $40 billion in 1990 to more than $1.7 trillion in 2007.[1]

But the mere growth in hedge funds' assets is only part of the reason why hedge funds have become so influential. Even at $1.7 trillion, hedge funds remain much smaller than mutual funds or pension funds.[2] What distinguishes hedge funds from other investors is that hedge funds tend to pursue active and aggressive investment strategies. Thus, hedge funds use leverage, sell short, and invest in derivatives. They trade much more frequently than other investors. And once they have taken a stake, they often initiate changes rather than wait for changes to happen on their own.

In an earlier article, we examined the involvement of hedge funds, as shareholders, in corporate governance and in corporate control transactions. We argued that hedge fund activism differs in quantity and quality from the activism of traditional institutional investors. Hedge fund activism is more strategic, directed to more significant changes, and entails greater expenses than traditional institutional activism. We further analyzed the reasons for these differences and their normative implications.[3]

In this Essay, we turn to a different facet of hedge fund activism: hedge funds' engagement as holders of corporate bonds. We show that the rise of hedge funds and other activist investors has led to a transformation in the

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[1] *See* NOVARE INVS. LTD., THE GROWTH AND REGULATION OF HEDGE FUNDS (2004), *available at* http://www.novare.co.za/uploads/files/File/Novare%20News%20-%20Growth%20and%20regulation%20of%20Hedge%20Funds%2030%20July%202004.pdf; Aureliano Gentilini & Ferenc A. Sanderson, *Hedge Fund Asset Flows 3Q07: Event-Driven Strategies Growing Fastest*, SEEKING ALPHA, Dec. 21, 2007, http://seekingalpha.com/article/58097-hedge-fund-asset-flows-3q07-event-driven-strategies-growing-fastest.

[2] BD. OF GOVERNORS OF THE FED. RESERVE SYS., FEDERAL RESERVE STATISTICAL RELEASE: FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS THIRD QUARTER 2007, at 75 tbl.L.118, 76 tbl.L.119, 77 tbl.L.122 (2007) [hereinafter FLOW OF FUNDS] (reporting $5.8 trillion, $3.2 trillion, and $8.0 trillion in assets for private pension funds, public pension funds, and mutual funds, respectively).

[3] Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007).

way bondholder rights are enforced.[4] In the past, many violations of bondholder rights have remained undetected and unsanctioned. This historic underenforcement problem was rooted in the collective action problems facing bondholders, in the lack of substantial incentives for the indenture trustee—the supposed bondholder representative—to represent bondholder interests vigorously, in contractual provisions in the bond indenture—the document that governs most bondholder rights—that provide little help in detecting violations and impose barriers on the ability of bondholders to enforce their rights, and in the relatively accommodating attitude of insurance companies and mutual funds—the traditional holders of corporate bonds.

With the rise of hedge funds, however, this historic underenforcement problem has given way to a new enforcement paradigm. Unlike traditional investors, activist hedge funds look for bonds where companies have violated, have arguably violated, or are about to violate some contractual provisions; buy up a large quantity of the issue; and then aggressively enforce their rights. Hedge funds have been able to greatly ameliorate the historic underenforcement problem because they have the sophistication to detect potential violations, the financial resources to acquire substantial amounts of a single bond issue, and the willingness to take on issuers; perhaps most importantly, they have decided to pursue, and become experienced in pursuing, this strategy.

Yet not all is peachy-keen, and not just for the companies that find themselves the unexpected targets of activism. Hedge funds are obviously motivated by the desire to make money, and how much money they make from this strategy depends on the remedy afforded to bondholders for violations of their rights. But as we show, this remedy scheme entails its own imperfections. In particular, the standard remedy for covenant violations—acceleration—can, depending on extraneous circumstances, result in payoffs that are significantly larger or significantly smaller than the harm related to the violations.

In those circumstances where the payoff exceeds the harm, and thus produces a windfall, activist bondholders have incentives to enforce their rights aggressively, leading to overenforcement. Therefore these bondholders may devote excessive resources to the detection of violations and pursue claims that have limited merit. Companies have corresponding excessive incentives to avoid (actual or potential) violations and to fight even meritorious claims. But when the payoff is less than the harm, bondholders will often be better off ignoring violations of their contractual rights even if they suffered harm. In these cases, bondholder rights will remain underenforced: not even activist bondholders will bother to investigate whether a violation

[4] In addition to hedge funds, some private investment managers have also pursued activist strategies as bondholders. For the remainder of this Essay, references to hedge funds as being activist also encompass these private investment managers.

has occurred and expend resources to pursue claims. Companies thus lack proper incentives to comply with their contractual obligations.

We refer to this recent enforcement paradigm—where some claims are aggressively enforced and others are virtually ignored—as one of selective enforcement. We argue that, compared to underenforcement, selective enforcement has benefited not just hedge funds, but bondholders at large. Less clear, however, is whether selective enforcement has generated additional value when one considers both bondholders and companies. In the short run, it is likely that selective enforcement has resulted in a disequilibrium between indenture covenants—which were drafted with the expectation that they would be underenforced—and the actual, much higher level of selective enforcement. In the long run, we would expect the market to adjust to reach a new equilibrium that is likely to be more efficient than the old underenforcement equilibrium. This new equilibrium may entail less stringent and more carefully drafted covenants.[5] As a preferable solution, however, we propose revisions to the remedy scheme that directly address the imperfections that generate selective enforcement.

In Part I of this Essay, we will give some illustrations of the recent actions by activist bondholders. In Part II, we discuss why mostly hedge funds engage in activism and why their activism has recently increased. In Parts III and IV, we analyze the historic underenforcement problem and the current selective enforcement problem. In Part V, we assess the short-term effects of selective enforcement on bondholders and companies. In Part VI, we examine how the market may adjust to the new selective enforcement paradigm and propose changes to the contractual provisions governing the remedy scheme that would greatly improve performance incentives.

I. RECENT EXAMPLES OF BONDHOLDER ACTIVISM

In this Part, we provide some examples to illustrate the nature and scope of recent bondholder activism.

A. *Interpretive Disputes*

One important set of bondholder activism relates to disputes over the interpretation of indenture provisions. Consider the following examples:

[5] We do not regard the trend toward covenant light loans prior to the recent credit crunch as evidence for such a new equilibrium. "Covenant light" refers to bank loan agreements that do not contain the traditional covenants, not to corporate bonds, and we are not aware of any suggestion that they were motivated by an overenforcement of traditional covenants by holders of bank debt. *See generally* Wikipedia, Cov-lite, http://en.wikipedia.org/wiki/Cov-lite (last visited Jan. 30, 2009). Moreover, because bank loans usually have a variable interest rate (and are not convertible into stock), the theoretical dynamics that can result in overenforcement and that we describe in this Essay would not apply to bank loans.

1. Citadel Broadcasting.—On February 21, 2006, a group of six hedge funds—Camden, Kamunting, RG Capital, SSI, Whitebox, and Zazove—sent a default notice to Citadel Broadcasting Corp.[6] The funds held Citadel's 1.875% Convertible Subordinated Notes, which traded at a substantial discount to their principal amount (par)[7] and the bulk of which they had acquired around the time that they gave the default notice.[8] The notice related to the February 6 announcement that Citadel and the Walt Disney Company had entered into a merger agreement. According to that agreement, ABC Chicago FM Radio, Inc., a Disney subsidiary, was to merge with Alphabet Acquisition Corp., a Citadel subsidiary, with ABC shareholders receiving one share of Citadel for each share of ABC (for a total of fifty-two percent of Citadel's stock). Prior to the merger, Disney was to distribute its stock of ABC to its shareholders, so that Disney shareholders (rather than Disney itself) would receive the Citadel stock in the merger. Citadel's controlling shareholder, Forstmann Little & Co., had signed a Support Agreement obligating it to oppose any alternative transaction.[9]

The funds claimed that the Disney transaction constituted a "Fundamental Change" under the indenture for the notes—defined to include certain mergers of the "Company" as well as any person becoming the beneficial owner of fifty percent or more of Citadel's stock—and thus triggered a right to require Citadel to repurchase the notes at par.[10] On July 17, Citadel filed a declaratory judgment action, arguing that no "Fundamental Change" had occurred because Citadel itself did not "merge" and Disney would not become an owner of more than fifty percent of Citadel's stock.[11] The holders and the trustee countered that Disney, as a result of the Support Agreement, became a "beneficial owner" of the 67.6% of Citadel stock held by Forstmann under the broad definitions of Rule 13d-3 under the Securities Exchange Act,[12] which were incorporated into the indenture.[13] As of

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[6] Citadel Broad. Corp., Current Report (Form 8-K) (Feb. 21, 2006); Summons at 8, Citadel Broad. Corp. v. Camden Asset Mgmt. LP, No. 06-602503 (N.Y. Sup. Ct. July 17, 2006).

[7] Summons at 5, Citadel Broad. Corp. v. Camden Asset Mgmt. LP, No. 06-602503 (N.Y. Sup. Ct. July 17, 2006).

[8] According to the 13F filings by these funds, they held an aggregate of $46 million in notes as of December 31, 2005 and an aggregate of $98 million as of March 31, 2006. Because $330 million of notes were outstanding, holders needed $82.5 million to issue a default notice. Curiously, two of the named funds—Camden and SSI—did not disclose any holdings of notes as of either date. However, Linden Capital, another activist hedge fund, acquired $39.5 million in notes between December 31, 2005 and March 31, 2006.

[9] Summons at 6–8, Citadel Broad. Corp. v. Camden Asset Mgmt. LP, No. 06-602503 (N.Y. Sup. Ct. July 17, 2006).

[10] Trustee's Answer to Amended Complaint and Counterclaims, Citadel Broad. Corp. v. Wilmington Trust Co., No. 06-602503 (N.Y. Sup. Ct. Mar. 16, 2007).

[11] Summons at 4–8, Citadel Broad. Corp. v. Camden Asset Mgmt. LP, No. 06-602503 (N.Y. Sup. Ct. July 17, 2006).

[12] Determination of Beneficial Owner, 17 C.F.R. § 240.13d-3 (2008).

November 2007, discovery in the case was completed and motions for summary judgment were pending.

2. *Spectrum Brands.*—In January 2007, Sandell, Sandelman, and Xerion—three hedge funds—sent a notice of default to Spectrum Brands alleging that the company's borrowing under its Revolving Credit Facility violated the indenture for Spectrum's 8-1/2% Senior Subordinated Notes.[14] Spectrum took the unusual step of filing with the SEC its own lengthy analysis of the indenture provision, explaining why no such violation had occurred.[15] Apparently, however, Spectrum was not sure it would prevail. Two months later, on March 12, it announced that it had entered into an Exchange and Forbearance Agreement with Sandell and Sandelman.[16] According to that agreement, the company agreed to offer to exchange the 8-1/2% Senior Subordinated Notes for new Toggle PIK Exchange Notes due 2013,[17] with an initial interest rate of 11%—which was to increase semi-annually to 15.25% unless redeemed—in exchange for a waiver of any defaults under the 8-1/2% notes.[18]

The activism of the hedge funds seems to have been profitable. The old notes traded at around ninety-four percent of the principal amount, both at the time of the notice of the default and before the exchange offer was announced. On March 12, however, the price shot up by over six percent to 100.25% of par.[19]

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13 Disney had indeed filed a Schedule 13D disclosing that it "may be deemed" to have beneficial ownership of that stock, though that schedule also said that it should not be deemed to constitute an admission that Disney was a beneficial owner. The Walt Disney Co., General Statement of Beneficial Ownership (Schedule 13D) (Feb. 6, 2006).

14 Spectrum Brands, Inc., Current Report (Form 8-K), at exhibit 99.2 (Jan. 16, 2007).

15 *Id.*

16 By the time the agreement was executed, Sandelman had increased its holdings of the 8-1/2% notes from $66 million to $150.71 million (out of $350 million outstanding) and together with Sandell held a majority of the outstanding notes—sufficient to approve the waivers contemplated by the Exchange and Forbearance Agreement. It is unclear what happened to Xerion. Xerion, however, held only $5 million of notes when the notice of default was given, compared to $26 million for Sandell and $66 million for Sandelman. Spectrum Brands, Inc., Current Report (Form 8-K), at exhibit 10.1 (Mar. 12, 2007).

17 For $1,000 in old notes, holders were to receive $950 in new notes and a $50 cash consent payment. *Id.*

18 The exchange offer was commenced four days later, and by March 29, the expiration of the solicitation period, 98.52% of the old notes had been tendered. An additional 0.66% of the old notes were tendered by April 13, the expiration of the exchange offer. Holders of these notes did not receive the $50 consent payment. *Id.*; Press Release, Spectrum Brands, Spectrum Brands Announces Expiration of Exchange Offer and Acceptance of Its 8 ½ % Senior Subordinated Notes Due 2013 Tendered Pursuant to the Exchange Offer (Apr. 16, 2007).

19 For other examples under this rubric, see, for example, Energy Corp. of Am. v. MacKay Shields LLC, No. 02-2431, 2003 U.S. App. LEXIS 25230 (4th Cir. Dec. 15, 2003) (involving a dispute over whether net proceeds of an asset sale, defined as "[t]he aggregate cash proceeds received by [ECA] in respect of any Asset Sale . . . net of . . . taxes paid or payable as a result thereof (after taking into account any available tax credits or deductions and any tax sharing arrangements)," are to be reduced by taxes

B. Read the Fine Print

Bondholders (or the company) sometimes try to exploit a flaw or imprecision in the drafting of a covenant and insist on a highly literal reading of the provision. Consider the following:

1. Regal Entertainment.—Convertible bonds issued by Regal Entertainment were subject to an indenture clause under which the conversion price would be reduced according to a specified formula if Regal paid dividends above a threshold amount. Regal paid such dividends and calculated the reduction based on its stock price prior to the ex-dividend date, as provided in conventional indenture clauses. The Regal indenture, however, specified the use of the market price prior to the *dividend date*, rather then the *ex-dividend date.* Amaranth LLC, a hedge fund, noticed the problem, purchased around $70 million in notes in early 2005,[20] and then argued that holders were entitled to receive 69.4 shares of Regal stock (rather than 64 shares) when they converted $1,000 in notes.[21] Regal countered that the wording of the covenant represented a scrivener's error.[22]

2. KCS Energy.—7-1/8% Senior Notes by KCS Energy, Inc. contained a change of control repurchase right that was triggered when a majority of the directors of the "Company" were neither "nominated for election or elected" with the "approval" of a majority of KCS's premerger directors. On July 12, 2006, KCS merged into Petrohawk Energy Corp., with Petrohawk surviving the merger. Prior to the merger, the board of KCS adopted a resolution "confirm[ing] and approv[ing]" the nomination and election of all the postmerger directors.[23] But only four of nine members of the postmerger board of Petrohawk (the "Company" for purposes of the indenture)

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resulting from the sale or only by taxes that were actually payable, the difference being due to tax credits and deductions unrelated to the asset sale); U.S. Bank Nat'l Assn. v. U.S. Timberlands Klamath Falls, L.L.C., 864 A.2d 930 (Del. Ch. 2004) (involving a dispute over the definition of "Subsidiary" and the scope of exception for "Permitted Investments"); *SEC Filing Delays and Potential Bond Defaults: What Is the Issuer's Real Promise?*, MOODY'S CORP. FIN., Jan. 2008, at 1–2 [hereinafter *Moody's Report*] (reviewing several cases on whether a covenant that required the filing of copies of SEC reports with the trustee within a specified number of days after the reports were filed with the SEC is violated when the company did not file any reports with the SEC by their due dates).

[20] Amaranth Advisors LLC, Quarterly Holdings Report (Form 13F) (Dec. 31, 2004) (showing holdings of $5.8 million of notes); Amaranth Advisors LLC, Quarterly Holdings Report (Form 13F) (May 12, 2005) (showing holdings of $73.3 million of notes).

[21] As the stock price of Regal was about $20, this difference amounted to about $110 per $1,000 principal amount, or $10 million for Amaranth.

[22] Regal Entm't Group v. Amaranth LLC, 894 A.2d 1104, 1107 (Del. Ch. 2006). The substantive issue in this case was never conclusively resolved. Regal brought a declaratory judgment action that its interpretation was correct. But Amaranth, which lost $6.5 billion in commodities speculation, essentially went bust in 2006 and agreed to the dismissal of the *Regal* case without prejudice against any holder other than itself. Regal Entm't Group, Annual Report (Form 10-K) (Dec. 28, 2006).

[23] Law Debenture Trust Co. of N.Y. v. Petrohawk Energy Corp., No. Civ.A. 2422-VCS, 2007 WL 2248150, at *10 (Del. Ch. Aug. 1, 2007).

were actual premerger directors of KCS. A group of note holders, reportedly organized by W.R. Huff Asset Management[24] (a firm specializing in high yield bonds), replaced the indenture trustee[25] and instructed the new trustee[26] to file a suit arguing that the merger constituted a change of control.[27] The court ruled in favor of Petrohawk, reasoning that the note holders were "attempting to exploit imprecise contract drafting" and to "use a technicality" to obtain a benefit.[28]

3. World Airways, Inc.—In October 2003, World Airways announced that it had reached an agreement with select bondholders to exchange $26 million of their bonds and that it would redeem the remaining $15 million, held by other bondholders, for cash. Whitebox, a hedge fund, owned bonds slated for redemption and claimed that World Airways had violated express indenture provisions as well as an implied covenant of good faith and fair dealing. When Whitebox sued, World Airways argued that Whitebox could not institute a suit until it complied with the "no-action clause," which required holders of twenty-five percent of the outstanding bonds to notify the trustee and then wait sixty days before bringing suit. The court rejected this argument, finding that World Airways had made compliance with the no-action clause impossible because the forthcoming redemption was fewer than sixty days from its announcement.[29]

C. What's "Substantially" All?

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

Consider, for example, the Jean Coutu Group (JCG), which, on August 24, 2006, announced the sale of its U.S. drug stores to Rite Aid Corp. JCG

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[24] Telephone Interview with Joseph McLaughlin, Partner, Simpson, Thacher & Bartlett LLP (Aug. 17, 2007). Mr. McLaughlin represented Petrohawk in the litigation described herein.

[25] *Petrohawk Energy Corp*., 2007 WL 2248150, at *5.

[26] Transcript of Oral Argument at 48, 50–51, Law Debenture Trust Co. of N.Y. v. Petrohawk Energy Corp., No. Civ.A. 2422-VCS, 2007 WL 2248150 (Del. Ch. Aug. 1, 2007) (counsel for the trustee stating that the trustee is acting upon the instructions of holders of seventy percent of the notes to bring the lawsuit).

[27] *Petrohawk Energy Corp*., 2007 WL 2248150, at *1.

[28] *Id.* at *1, *11. The Delaware Supreme Court affirmed. Law Debenture Trust Co. of N.Y. v. Petrohawk Energy Corp., No. 454, 2007, 2008 WL 223268 (Del. Jan. 23, 2008).

[29] Whitebox Convertible Arbitrage Partners, L.P. v. World Airways, Inc., No. Civ.A. 1:04-CV-1350-, 2006 WL 358270 (N.D. Ga. Feb. 15, 2006). For another example under this rubric, see CA, Inc., Current Report (Form 8-K) (Jan. 3, 2008) (documenting settlement of a dispute brought by hedge fund Linden Capital and by Swiss Re Financial Products Corp. relating to CA's obligation to pay additional interest due to its failure to register the notes, where registration was no longer needed as the notes could be sold without registration).

argued that the transaction involved "substantially all" of its assets, with Rite Aid assuming the $850 million of JCG's 8-1/2% Senior Subordinated Notes and JCG being released.[30] A group of note holders, consisting mostly of hedge funds and asset management companies, took the view that the sale did not involve "substantially all" of JCG's assets, that JCG would remain liable under the indenture, and that another covenant—applicable to the sale of significant, but less than "substantially all," assets—would kick in and inhibit the transaction. On December 8, 2006, JCG filed a declaratory judgment action in the Southern District of New York.[31] Concurrent with the litigation, JCG made an offer to buy the notes coupled with a solicitation of bondholder consents to remove any troublesome covenants. On March 30, 2007, on the eve of trial, JCG and a majority of the note holders struck a deal. JCG agreed to offer to buy the notes at a price determined by discounting the remaining scheduled payments at a treasury yield plus 150 basis points, and the note holders agreed to sell and deliver their consents to the indenture amendments.[32]

In the case of JCG, the company argued that the transaction involved "substantially all" assets; holders argued that it did not. In other cases, the tables are turned. For example, when Wendy's International, Inc. announced in June 2006 that it planned to spin off Tim Horton's to its shareholders,[33] a group of bondholders—both traditional holders and a hedge fund—sued, arguing that the spin-off constituted a transfer of "substantially all" of Wendy's assets.[34] Similarly, when Tyco announced its plan to split itself into three parts, a group of insurance companies sued, claiming the split involved a transfer of "substantially all" assets in violation of the Tyco bond indentures.[35]

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[30] Jean Coutu Group, Report of Foreign Private Issuer (Form 6-K), at exhibit 99.1 (Sep. 18, 2006).

[31] Complaint for Declaratory Judgment, Jean Coutu Group (PJC) Inc. v. Wells Fargo Bank, N.A., No. 06-CV-14301 (S.D.N.Y. Dec. 8, 2006).

[32] Press Release, Jean Coutu Group, The Jean Coutu Group Announces Settlement Agreement with Holders of Its 8-1/2% Unsecured Senior Subordinated Notes Due 2014 and Related Amendments to the Pricing of Its Tender Offer (Mar. 30, 2007). JCG's previous offer involved a discount rate of treasury plus 200 basis points.

[33] Katherine Hunt, *Wendy's Confirms Plan to Spin Off Rest of Tim Horton Shares*, MARKET WATCH, June 27, 2006, http://www.marketwatch.com/news/story/wendys-confirms-plan-spin-off/story.aspx?guid=%7BCB0D4AB6-6D73-433E-BA3C-69F0FEB7FC73%7D&dateid=38895.7024686458-878428444.

[34] The holders included Aflac Inc., Massachusetts Mutual Life Insurance, Swiss Re, and Millennium Partners. *See* Josh Fineman, *Wendy's Says Noteholders Sue on Tim Hortons Spinoff*, BLOOMBERG.COM, Sept. 28, 2006, http://www.bloomberg.com/apps/news?pid=20601082&refer=canada&sid=aSExbt4WJt1k. After a court denied a holder request for a preliminary injunction and Wendy's completed the spin-off, some of the holders issued a default notice on October 10, 2006, and Wendy's filed a declaratory judgment action the following day. Wendy's Int'l Inc., Quarterly Report (Form 10-Q), at 34 (Nov. 13, 2006).

[35] Marine Cole, *Who Needs Junk? Loose Tyco Bond Rules Force Suit: Angry Holders of Investment-Grade Bonds Fight Losses in Court*, FIN. WK., July 16, 2007, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070716/REG/70713022.

D. The Failure to File Boom

Several companies have recently run into problems as a result of their failure to file financial reports with the SEC. Corporate bond indentures inevitably contain a covenant requiring issuers to file with the trustee copies of periodic reports required to be filed with the SEC. When the issuer cannot make the SEC filings, and thus does not provide copies to the trustee within the requisite time period, a default can arise.[36]

In the Appendix, we have collected forty-two companies that have received default notices for a failure to file in the last five years or had to seek waivers from their bondholders. The aggregate principal amount of the affected bonds is over $25 billion. In most of the cases, the identity and role of the bondholders in pursuing the defaults were not disclosed. But in the six cases where we could ascertain the identity of the bondholders who issued a default notice or accelerated, they were always hedge funds. This suggests that hedge funds may account for a significant percentage of the other thirteen cases where unidentified bondholders gave default notices or accelerated.[37] Moreover, as shown in Table 1, hedge funds played a major role in negotiating the resolution of the defaults, such as what and how much bondholders received to consent to amendments and waivers that eliminated the defaults.

[36] This issue also raises another interesting problem. Under § 14(c) of the Securities Exchange Act and the rules promulgated under it, a company is not allowed to hold an annual meeting (or special meeting) without having sent out its annual report. Thus, companies that have not filed their 10-Ks are barred by federal law from holding shareholder meetings. Delaware law, however, requires companies to hold shareholder meetings every year (in approximately twelve-month intervals) for the election of directors. *See* Esopus Creek Value LP v. Hauf, 913 A.2d 593 (Del. Ch. 2006); Newcastle Partners v. Vesta Ins. Group, 887 A.2d 975 (Del. Ch. 2005), *aff'd*, 906 A.2d 807 (Del. 2005) (table). Federal law has the perverse effect that shareholders cannot replace directors of those companies that have not filed their SEC reports. Delaware has basically taken the view that the SEC regulations are nonsensical.

[37] Even where only the trustee issued default notices or accelerated, the trustee may have acted on instructions of or in consultation with hedge fund holders.

Table 1: Failure to File Cases

	Default Notice or Acceleration	*Negotiations/ Resolution*
Hedge Funds	6	1
Traditional Institutions	0	0
Both Hedge Funds and Traditional Institutions	0	3
Unidentified Holders	13	3
Trustee Only or Waiver Without Default Notice	23	
Likely Involvement by Unidentified Holders		11
Potential Involvement by Unidentified Holders		7
No Negotiations/Resolution[38]		17

Unlike the earlier examples, most of the failure to file cases involve covenant violations that were obvious and undisputed.[39] What makes these cases notable is not that hedge funds detected defaults that others had overlooked, but that, once the default occurred, hedge funds vigorously pursued the rights arising out of these defaults. In the past, when companies were late in filing their SEC reports, bondholders would look the other way, even though the company was technically in default and holders could take steps to seek repayment.[40] Nowadays, activist holders use these defaults to extract significant concessions.

Another example of hedge funds extracting significant concessions involves Metaldyne Corp., which on August 31, 2006 announced that it had entered into a merger agreement with Asahi Tec Corp. Two of Metaldyne's bond issues—the 11% Senior Subordinated Notes and the 10% Senior Notes—contained change of control covenants, which required the company to offer to purchase the notes at 101% of their principal amount upon

38 Default cured, court ruled no default arose, bonds paid or defeased, or resolution still pending.

39 In nine cases, litigation arose over whether there had been a default or acceleration that was proper. *See, e.g.*, *Moody's Report*, *supra* note 19; *see also* Bruce C. Bennett, *Reflections on Indenture Remedies and Investor Protection*, INSIGHTS: CORP. & SEC. L. ADVISOR, Feb. 2008, at 11, 16–18 (discussing judicial opinions). In other cases, the company disputed that a default had occurred but no litigation arose.

40 Peter Lattman & Karen Richardson, *Hedge Funds Play Hardball with Firms Filing Late Financials*, WALL ST. J., Aug. 29, 2006, at A1; *see also* Richard Aftanas & Yossi Vebman, *The Unexpected Ascent of Covenant Defaults*, FINANCIER WORLDWIDE, Oct. 2005 (describing default notices sent due to failure to file SEC reports as a "previously unknown phenomenon"); Bennett, *supra* note 39, at 15 ("Recently, however, institutional investors have aggressively been pursuing their rights under the reporting covenant in the event of a restatement.").

a merger. The merger was conditioned on obtaining bondholder consents for the elimination of the covenant.[41]

Prior to the merger announcement, the bonds traded near eighty cents on the dollar, and Metaldyne had planned to make a tender offer for the bonds at around the preannouncement market price.[42] After the agreement was announced, hedge funds and other activists banded together. The activists either already had or, more likely, quickly acquired sufficient notes to assure that the change of control provision could not be eliminated without their consent. The group then entered into a "lockup agreement" under which it agreed to consent to the elimination of the covenant only if a supermajority—amounting to 90% of the group's Senior Subordinated Notes and 80% of the group's Senior Notes—agreed.[43]

Metaldyne was now forced to negotiate. It ended up making a huge consent payment of $127.50 for each $1,000 of principal for Senior Subordinated Notes and $80 for the Senior Notes.[44] In addition, it agreed to purchase at least $25 million of the Senior Notes at par, provide security, and tighten other covenants.[45] Partly due to the added protections, the notes traded at around 108% of par at the end of 2006—well above both the preannouncement market price and the exercise price of the change of control put right.

II. WHY HEDGE FUNDS? WHY NOW?

In the previous Part, we argued that there has been a recent surge of bondholder activism by hedge funds—activism that has often been quite profitable. This raises two questions: Why do we witness more activism now than in the past? Why is it that hedge funds play such a dominant role in bondholder activism?

A. Why Now?

Two reasons may explain why bondholder activism has recently increased. First, there may be more opportunities for profitable activism than in the past. This clearly accounts, at least in part, for the failure to file cases. The Sarbanes-Oxley requirement that CEOs certify their companies' SEC reports has probably injected additional caution and corresponding de-

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41 Metaldyne Corp., Current Report (Form 8-K) (Aug. 31, 2006).

42 Vipal Monga, *Investors Clash over Metaldyne*, DAILY DEAL, Sep. 25, 2006, *available at* 2006 WLNR 16509974.

43 *Majority of Holders of Metaldyne 10% Senior Notes Due 2013 Announce Execution of Lockup Agreement*, BUS. WIRE, Nov. 4, 2006, *available at* 11/4/06 BWIRE 00:11:00 (Westlaw); *Majority of Holders of Metaldyne 11% Senior Subordinated Notes Due 2012 Announce Execution of Lockup Agreement*, BUS. WIRE, Oct. 13, 2006, *available at* 10/13/06 BWIRE 12:00:00 (Westlaw).

44 *See* Metaldyne Corp., Consent Solicitation Statement 1 (Dec. 4, 2006).

45 *Id.* at 2–3.

lay into the preparation of these reports.[46] Moreover, at least twenty of the forty-two issuers that received default notices or waivers related to a failure to file were also on a *Wall Street Journal* list of companies that had come under scrutiny for their stock options.[47] To clear up these problems, issuers often had to delay filing their reports with the SEC.[48]

Second, and more importantly, the assets under management by hedge funds, the prime activists, have grown significantly—from $40 billion in 1990 to $1.7 trillion in 2007.[49] If hedge funds are more likely to become activist—indeed, hedge funds have long engaged in bondholder activism[50]—and hedge funds now manage more assets, the recent increase in activism may be due to the rise of hedge funds.

B. Why Hedge Funds?

To place hedge fund activism in perspective, it is important to note that hedge funds are not the *only* activist bondholders. Traditional institutional investors in corporate bonds—insurance companies and mutual funds—also engage in activism. One of the best-known historic instances of activism involved Metropolitan Life Insurance Co.—among the bluest of blue-chips—which argued that RJR Nabisco's leveraged buyout in 1988 violated

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[46] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302, 116 Stat. 745.

[47] *Perfect Payday: Options Scorecard*, WALL ST. J. ONLINE, Sept. 4, 2007, http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html.

[48] Moreover, options back-dating seems to be concentrated in the high tech industry. David Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 576–77 (2007). Many high-tech companies also issue convertible bonds. Convertible bonds have a low coupon (i.e., they pay a low interest rate), and when the stock prices of these companies are low, the bonds trade below par. This means that pursuing a failure to file can be highly profitable. *See infra* Part IV.

[49] *See* NOVARE INVS. LTD., *supra* note 1; Gentilini & Sanderson, *supra* note 1.

[50] One example of hedge fund activism that generated a fair amount of publicity relates to debt guaranteed by the Republic of Peru. Peru defaulted on the debt and most debt holders agreed to exchange their claims for "Brady Bonds" (which had a lower principal or carried a lower interest rate). While the restructuring negotiations were ongoing, Elliott Associates purchased $20.7 million of these claims, did not exchange them for Brady Bonds, and obtained judgment against Peru in the Southern District of New York. Elliott then faced the problem of obtaining payment as Peru had no assets in the U.S. on which Elliott could levy execution. Peru, however, made payments on the Brady Bonds via Euroclear (a clearing house based in Belgium). Elliott brought suit in Belgium when Peru was about to make a payment through Euroclear and, in 2000, the court blocked the payment to the Brady Bond holders unless Elliott was paid on a *pari passu* payment. Peru, faced with the choice of either defaulting on the Brady Bonds or paying off Elliott, decided to pay Elliott in full. *See* William W. Bratton, Pari Passu *and a Distressed Sovereign's Rational Choices*, 53 EMORY L.J. 823, 823–25 (2004). For another example of hedge fund activism, see *Elliott Associates, L.P. v. Bio-Response, Inc.*, Civ. A. No. 10624, 1989 WL 55070 (Del. Ch. May 23, 1989) (involving a suit by a hedge fund bondholder arguing that the company defaulted under the terms of the indenture because it was unable to provide an assurance that the company would be able to satisfy the put option in the indenture).

its bond indentures.[51] More recently, a group of insurance companies sued Tyco alleging that its split-up was a transfer of substantially all its assets.[52]

The activism of hedge funds, however, differs from the activism by traditional institutions. In this respect, it is interesting to compare the activism of hedge funds as bondholders—the topic of this Essay—to the activism of hedge funds as shareholders—the topic of a prior article by us. In our prior article, we argued that *shareholder* activism by hedge funds differs from shareholder activism by traditional institutional investors in several respects. First, per dollar invested, hedge funds engage in more activism than traditional institutional investors. But although most of the activism comes from hedge funds, most hedge funds do not engage in activism. Rather, a few hedge funds seem to specialize in pursuing activist strategies and several others pursue activism occasionally, while a large majority of hedge funds are rarely or never activist. Second, hedge funds pursue different and more aggressive tactics than traditional institutions, such as running proxy contests as opposed to sending letters to the company. Third, activism by hedge funds is strategic, whereas activism by traditional institutions is incidental.[53]

In the bondholder context, we observe a similar pattern. First, hedge funds engage in more activism than traditional institutional investors. The available evidence clearly indicates that hedge funds are at the forefront of bondholder activism, while traditional institutions remain the owners of the bulk of outstanding corporate bonds.[54] Moreover, several hedge funds seem to specialize in pursuing bondholder activist strategies (and they are not the same ones who are also shareholder activists), and several others pursue activism occasionally, while a large majority of hedge funds are rarely or never activist.[55]

Traditional institutions also become active, and when they do so they pursue similar strategies as do hedge funds: they issue default notices, file

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[51] Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989).

[52] *See supra* note 35 and accompanying text. Other cases in which traditional institutions as well as hedge funds were involved include Wendy's and probably KCS. *See supra* notes 23–28, 33–34 and accompanying text; s*ee also Bell Canada Debenture Holders Unveil Litigation Strategy*, PR NEWSWIRE, Sept. 19, 2007, http://prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/09-19-2007/0004666174 (noting that a "'blue chip' roster of life insurance companies and money managers" was leading the litigation effort in a Bell Canada bondholder dispute); Al Yoon, *Equity Office Sweetens Bond Tender After AIG Block*, REUTERS, Jan. 10, 2007, http://www.reuters.com/article/companyNewsAndPR/idUSN1062063320070110 (noting that the opposition by bondholder American International Group, an insurance company, and other holders to the terms of the consent solicitation forced Equity Office to improve its offer terms).

[53] *See* Kahan & Rock, *supra* note 3, at 1042–47.

[54] According to data compiled by the Federal Reserve Board, banks and insurance companies held over 30% of corporate and foreign bonds, mutual funds held around 15%, pension funds about 5%, and foreign residents close to 30%. FLOW OF FUNDS, *supra* note 2, at 89 tbl.L.212.

[55] The repeated appearance of certain funds in the examples in this Essay and the Appendix, *infra*, is likely due to the fact that these funds have developed a specialty in bondholder activism.

lawsuits, or negotiate for higher consent payments.[56] This is probably due to the limited arsenal available to bondholders. As we explain below, issuing a default notice is a prerequisite to most remedies, and if no agreement can be reached with the company, bondholders have few alternatives besides a lawsuit.

But more important than the similarity in tactics are the differences in the type of activism. As in the shareholder context, hedge fund activism is strategic: Hedge funds invest *in order to* become active, and the activism is designed to generate gains rather than reduce loses. Thus, we have documented several instances in which hedge funds acquired or increased their position in bonds shortly before or around the time when they became active.[57] Furthermore, because their activism is not motivated by the reduction of losses, hedge fund activism does not usually follow the announcement of a transaction that diminishes bond values. Finally, because hedge funds acquire a substantial percentage stake before they become active, the threshold for activism—in terms of its effect on the value of the entire bond issue—is reduced.

By contrast, activism by traditional institutions is incidental to their investment activities. Traditional institutions tend to become active when an investment they hold for different reasons suffers a significant decline in value, and their activism is designed to recoup some of these losses.[58] That was how it was in 1989, when Met Life sued RJR Nabisco over its LBO, which led to a precipitous drop in the value of their RJR bonds.[59] It remains largely true today, when large institutional holders of blue-chip companies like Tyco[60] and Bell Canada[61] bring suit after the announcement of major transactions with significant impact on bond values. As a result, activism by traditional institutions is rare (large drops in bond prices are not all that common), relate to major transactions involving major companies (only those resulting in major dollar losses), and are pursued by the largest finan-

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[56] *See* Marcel Kahan & Bruce Tuckman, *Do Bondholders Lose from Junk Bond Covenant Changes?*, 66 J. BUS. 499, 512 (1993) (noting the formation of bondholder groups to negotiate for higher consent payments).

[57] *See supra* Part I (discussion of Spectrum, Citadel, and Regal). Moreover, in each of the four instances in the Appendix, *infra*, where we were able both to identify the bondholder who gave a default notice or accelerated and to obtain holdings data from 13F filings, the filings indicated that the fund involved raised its stakes before or around the time when it became active.

[58] Traditional institutions also become active when the company, on its own, seeks consent for an indenture amendment and in those cases tries to obtain gains. *See* Kahan & Tuckman, *supra* note 56. As in the instances where institutions become active when an investment suffers a decline in value, this "activism" is fundamentally reactive.

[59] Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989).

[60] Cole, *supra* note 35 (noting that bondholders sued "in hopes of stemming losses from a spin-off that effectively strips their holdings of much of their underlying assets").

[61] *See Bell Canada Debenture Holders Unveil Litigation Strategy*, *supra* note 52 (noting that bondholders believed that the proposed Bell Canada LBO would result in "significant losses").

cial institutions (which tend to be the biggest investors and suffer the largest losses) rather than specialized boutiques.[62]

These differences between hedge fund activism and activism by institutional investors suggest that strategic activism requires specialization. There must be some investment professional who knows how to analyze bond indentures; who can detect actual, potential, or expected defaults that the market is not yet aware of; who has a good sense of the probability of winning; who has experience in negotiating with issuers; and who has the proper monetary incentives to become activist. Activist hedge funds have such professionals working for them. Traditional institutions generally do not. The reason is not that traditional institutions cannot, but rather that they are not set up to do so.[63] Traditional institutions invest in bonds to earn yield. For example, for life insurance companies, the largest group of institutional bond investors, the payoff structure of bonds matches the expected payout structure on life insurance policies they have underwritten. The professionals working for them concentrate on making sure that their bond portfolio has the right term structure and risk profile, rather than on squeezing profits out of a potential default. Similarly, mutual funds are designed to provide diversification for individuals who want to hold fixed income securities that offer a higher yield than treasury bonds. Neither of these types of institutions sees activism as integral to their business success, and neither pays their professionals incentive fees similar to the ones paid by hedge funds.[64] Their institutional structure does not lend itself to the pursuit of strategic activism, and they do not engage in it.

Hedge funds have thus become a dominant force in bondholder activism. To understand how this activism has transformed the enforcement of bondholder rights, it is necessary to discuss in more detail the barriers to activism that traditional institutions have encountered in the past and the incentives for activism that hedge funds face. In the next two Parts, we address these topics.

III. THE UNDERENFORCEMENT PROBLEM

In this Part, we explain why bondholder rights historically have been underenforced. Our discussion here, as in the rest of this Essay, focuses on violations, or potential violations, of bondholder rights *other than* a failure

[62] For example, MetLife Inc., the public holding company of Metropolitan Life Insurance Co., had total assets of $563 billion on September 30, 2007, almost a third of the total assets of all hedge funds combined. MetLife Inc., Quarterly Report (Form 10-Q) (Nov. 5, 2007).

[63] There are some differences in the regulations applicable to hedge funds and other institutional investors. *See* Kahan & Rock, *supra* note 3, at 1047–70. However, with the possible exception of regulations that make it difficult for mutual funds to pay performance-based compensation, we do not believe that these regulatory differences account for the differences in bondholder activism.

[64] *See id.* at 1050–54 (discussing comparative incentives of hedge funds to engage in shareholder monitoring).

to make required interest or principal payments. As we will argue, there are three causes of historic underenforcement: Bondholders may not be aware of a violation; bondholders face significant barriers if they want to enforce their rights without the cooperation of the trustee; and the trustee itself has limited incentives to enforce bondholder rights vigorously.[65]

A. The Detection Scheme

Before the issue of any enforcement of a bondholder right even arises, one must be aware of a violation. In some instances—for example, if the company fails to make a scheduled interest payment—the violation will be evident. But with respect to other provisions, this may not be so. Consider the standard debt covenant, which limits the ability of a company to incur indebtedness depending on the ratio of its current income relative to its interest expense and other fixed charges, and contains numerous special rules and exceptions.[66] The information required to determine whether additional debt can be incurred tends to be complex and usually cannot be easily gleaned from the company's publicly filed financial statements. How, then, do bondholders learn about these violations? There are basically two ways. First, the company is generally obligated to furnish the trustee with an annual certificate which states whether the company has complied with all its covenants.[67] But because these certificates contain no background information that would enable the trustee to confirm their conclusions, companies are inclined to issue a clean certificate whenever there is some plausible interpretation leading to the conclusion that no violation has occurred.[68] And

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[65] To clarify, when we argue in this Part that bondholder rights have been underenforced, and in the next Part that they are now selectively enforced, we are comparing the actual level of enforcement to a baseline enforcement level that would prevail under two conditions. The first condition is the absence of enforcement impediments that result from collective actions or agency problems, and the second is the absence of incentives to enforce, or not to enforce, bondholder rights that are related to extraneous market developments, rather than to the right being enforced. That is, we consider as a baseline the enforcement level that would prevail if all bonds were held by a single person and the remedy for violations of a right corresponded to the damages related to that violation.

[66] *See* MODEL NEGOTIATED COVENANTS AND RELATED DEFINITIONS, 61 BUS. LAW. 1439, § 4.04, at 1500–09 (2006).

[67] *See* MODEL SIMPLIFIED INDENTURE, 38 BUS. LAW. 741, § 4.03, at 755 (1983) [hereinafter MODEL INDENTURE].

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

because these certificates must generally be delivered only once a year, bondholders may learn of a violation only several months after it occurred. Second, bondholders can perform their own investigation.[69] However, the incentives for and the ability of bondholders to investigate are reduced by collective action problems, by the lack of access to nonpublic information,[70] by the fact that public information may not be sufficient to determine whether a covenant has been violated, and by the complexity of the analysis even if all the necessary information can be obtained. As a result, a violation or potential violation may either never be detected or may be detected too late.

B. The Enforcement Scheme and the Trustee

Once bondholders learn of any violation, a complex enforcement scheme kicks in. Violations of bondholder rights (other than failures to pay principal or interest when due) generally constitute a so-called "default." Before any enforcement action can be taken, however, the default must be converted into an "event of default."[71] To do this, the trustee or holders of twenty-five percent of the bonds typically have to give a "notice of default" to the company and afford the company a specified period of time to cure the default (cure period).[72]

Once an event of default has occurred, an indenture typically provides for two categories of remedies. First, the bonds can be accelerated so that the principal and any accrued interest become immediately payable.[73] Generally, either the trustee or holders of twenty-five percent of the outstanding bonds can accelerate. Second, any other remedy may be pursued.[74] The second category includes suits to collect principal that has become due as a result of an acceleration. The trustee is entitled to bring such suits, and, if directed by the holders of a *majority* of the outstanding bonds, is generally obligated to do so.[75] Bondholders, however, can only bring such suits after they comply with the "no-action clause." This clause requires, among other things, that holders of at least twenty-five percent of the bonds request that the trustee pursue a remedy; offer indemnity, satisfactory to the trustee,

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YEARBOOK OF FIXED INCOME INVESTING 1995, at 253 (John D. Finnerty & Martin S. Fridson eds., 1996).

[69] The trustee, in the absence of bad faith, is entitled to rely conclusively on such compliance certificates and has neither the duty nor any incentives to determine independently whether any violation has occurred. *See* MODEL INDENTURE, *supra* note 67, § 7.01, at 758–59.

[70] *See* Yakov Amihud, Kenneth Garbade & Marcel Kahan, *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 465 (1999) (noting a lack of access to nonpublic information for public bondholders).

[71] *See* MODEL INDENTURE, *supra* note 67, §§ 6.02–.03, at 756–57.

[72] *See, e.g.*, AM. BAR FOUND., COMMENTARIES ON INDENTURES 207 (1971).

[73] *See* MODEL INDENTURE, *supra* note 67, § 6.02, at 756–57.

[74] *See id.* § 6.03, at 757.

[75] *See id.* § 6.05, at 757.

against any loss, liability, and expense; and then wait for sixty days to give the trustee a chance to bring the suit itself.[76] Thus, to enforce covenant violations without the active cooperation of the trustee, holders must either organize a group holding a majority of the outstanding bonds (which can issue the requisite notices and direct the trustee to take action), or organize a group holding twenty-five percent of the bonds (which can issue the requisite notices) and be willing to write a blank-check offer of indemnification to the trustee and wait sixty days.

The difficulty of overcoming these barriers obviously depends on the concentration of bond holdings. Historically, even though bond holdings have been concentrated relative to share ownership, it was rare for a single holder to own twenty-five percent of the bonds. According to ownership data assembled by *Best's Market Guide Corporate Bonds* for 1995, the five largest holders held more than twenty-five percent of the outstanding bonds in seven of twelve issues sampled and more than fifty percent of the bonds in only two of twelve issues sampled.[77] This suggests that it would usually be necessary to assemble a group of bondholders, albeit not necessarily a large group, to pass the twenty-five percent threshold.

As discussed above, enforcement becomes much easier if the trustee is willing to act as an effective enforcement agent.[78] Alas, the trustee has little incentive to act in this manner. First, the initial indenture trustee is selected by the company before the bonds are issued.[79] A different trustee is appointed only if the initial trustee resigns or holders of a majority of the outstanding bonds demand the trustee's removal.[80] Second, until an event of default occurs, the trustee has virtually no legal obligations toward the bondholders.[81] Specifically, the trustee has no general fiduciary duty to act in the interest of bondholders and no obligation to give a notice of default to the company, which could cause the default to ripen into an event of default.[82] Third, the trustee has no direct monetary incentives to act as an ef-

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[76] *See id.* § 6.06, at 757.

[77] A.M. BEST CO., BEST'S MARKET GUIDE CORPORATE BONDS (1995). 1995 was the last year this guide was published.

[78] In addition to the advantages mentioned above, the trustee (but not bondholders) is entitled to indemnification of its "reasonable" out-of-pocket expenses (e.g. to pay outside legal counsel) by the company as well as from any funds collected for the bondholders. *See* MODEL INDENTURE, *supra* note 67, § 7.07, at 760.

[79] Trust Indenture Act § 310(b)(i), 15 U.S.C. § 77jjj(b)(i) (2006).

[80] *See* MODEL INDENTURE, *supra* note 67, § 7.08, at 761 (establishing removal rights).

[81] *See* Elliott Assocs. v. J. Henry Schroder Bank & Trust Co., 655 F. Supp. 1281 (S.D.N.Y. 1987), *aff'd*, 838 F.2d 66 (2d Cir. 1988) (holding that an indenture trustee owes no general fiduciary duty to bondholders and that the only implied duty is to avoid conflicts of interest). Once an event of default has occurred, the trustee must comply with a "prudent man" standard. Trust Indenture Act § 315(c), 15 U.S.C. § 77jjj(c) (2006). This increase in duties creates a disincentive for the trustee to generate an event of default, such as by giving a notice of default.

[82] *See* MODEL INDENTURE, *supra* note 67, at 796 (note 3 to §§ 7.01/7.02). The trustee's only substantive pre-event of default obligation is to inform bondholders of any default known to the trustee,

fective agent. Typically, the trustee receives a fixed annual fee[83] and is entitled to be reimbursed for its out-of-pocket expenses,[84] but receives no extra compensation for its own efforts or for increased duties resulting from an event of default. Thus, before an event of default has occurred, and often when the company disputes that an event of default has occurred, the trustee's fundamental economic incentive is to do nothing. Though trustees may sometimes do more,[85] the economic incentive structure indicates that trustees cannot be relied on to represent the bondholders effectively.[86]

C. Evident, Opaque, and Ambiguous Defaults

For both the detection and the enforcement scheme, it is helpful to distinguish between opaque defaults, ambiguous defaults, and evident defaults. By opaque defaults, we mean defaults where the information necessary to determine whether a default has occurred is not easily available. By ambiguous defaults, we mean defaults where, once the requisite information has been obtained, it is uncertain whether a default has occurred. Evident defaults are defaults that are neither opaque nor ambiguous.

An example of a relatively evident default is the failure of the company to supply the trustee with the reports that the company is required to file with the SEC.[87] A default can be both opaque and ambiguous when a transaction involves the transfer of substantially all assets.[88] Such defaults are often opaque, as one may need to obtain detailed information both about the assets transferred and the assets not transferred (in terms of market value and earnings potential).[89] They are also ambiguous, though, because the term "substantially all" is not precisely defined.

Although far from perfect, the detection and enforcement schemes work tolerably well for evident defaults. By definition, evident defaults are easy to detect and unambiguous. Once alerted to such a default, the trustee may be willing to send a default notice and pursue a remedy. Even if the

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unless the trustee determines that withholding such notice from the bondholders is in their interest. *Id.* § 7.05, at 760.

83 *See* Amihud et al., *supra* note 70, at 479 n.111.

84 *See, e.g.*, MODEL INDENTURE, *supra* note 67, § 7.07, at 760.

85 Trustees sometimes take actions to enforce bondholder rights when the company disputes that an event of default has occurred. *See, e.g.*, Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039 (2d Cir. 1982) (involving a case where the trustees issued default notices and instituted litigation); *see also supra* tbl.1. In some of these cases, the trustee may have acted at the direction of bondholders.

86 *See generally* Amihud et al., *supra* note 70.

87 The wording of some of the filing covenants has generated disputes over whether the covenant is violated if the company never makes any filings with the SEC. For alternate wordings of the filing covenant, a failure to file generates an evident default. *See Moody's Report*, *supra* note 19.

88 *See supra* Part I.C.

89 *See Sharon Steel*, 691 F.2d at 1049–52 (discussing percentage of operating revenue, operating profits, and book value accounted for by sold assets to determine whether transaction involved substantially all assets).

trustee remains passive, coordination among bondholders to form a group holding twenty-five percent of the bonds is easier when a default is evident.

For opaque and ambiguous defaults, by contrast, the detection and enforcement schemes involve much greater imperfections. Without significant bondholder investigation, these defaults may never become known. For ambiguous defaults, the company will invariably want to take the position that no default has occurred and sign a clean compliance certificate. For opaque defaults, the company may not discover the default on its own[90] or may be able to cure the default before the compliance certificate is due. The opacity and ambiguity of these defaults, of course, also makes it harder for a bondholder to detect the default on its own. Finally, even when a bondholder has detected such a default, it will be harder to persuade the trustee to take action or to form the requisite bondholder group. In other words, opaque and ambiguous defaults are often difficult to understand, and if the trustee or other bondholders do not fully understand the relevant default, it will be harder to persuade them to take action.

IV. THE SELECTIVE ENFORCEMENT PROBLEM

A. Why Have Things Changed?

In the preceding Part, we discussed the reasons why bondholder rights have generally been underenforced. The rise of hedge funds, however, has led to a fundamental change. Bondholder rights are no longer systematically underenforced. This Part discusses how and why this change occurred.

The fundamental barriers to enforcement—investigation difficulties, collective action problems, underincentivized trustees, and barriers to bondholder self-help—have not changed. What has changed is that hedge funds have taken a proactive approach and have overcome these barriers. Compared to traditional investors, hedge funds are more likely to specialize in activism and to acquire bonds in order to pursue a claim *after* they have determined that they have a potential claim. Due to their efforts and expertise, hedge funds are more likely to detect opaque and ambiguous defaults. Because they acquire bonds in order to become active, they tend to have higher stakes. The existence of higher stakes makes it easier for hedge funds to overcome the collective action problem and provides incentives to detect defaults. Finally, the professionals at activist hedge funds will tend

[90] The company's incentive is to make the initial compliance review as cursory as possible. If that initial review reveals no problem, the company's incentive is to stop and have the compliance certificate issued. If the initial review reveals a problem, the company's incentive is to investigate further to see whether, upon more careful analysis, the problem remains. If the problem disappears, the incentive is again to stop. If it remains, the company may engage in further review. Only if, at each stage of the review process, the company concludes that a covenant has been violated will even an honest company be forced to report a default in its compliance certificate.

to know each other, making it easier for them to cooperate and further reduce collective action costs.

As a result of hedge fund activism, the factors that have historically resulted in underenforcement, which we discussed in Part III, have faded in importance. Instead, there is now a mix of underenforcement and overenforcement—a phenomenon which we refer to as "selective enforcement" of bondholder rights. As the next section argues, selective enforcement results from imperfections in the contractual remedy scheme.

B. The Remedy Scheme: The Central Role of Acceleration

The key feature of the remedy scheme for bonds is the right to accelerate the payment of the outstanding principal and all accrued interest. In effect, acceleration ends the lending relationship, with bondholders getting their money back (assuming the company pays) and bidding good-bye. Acceleration is the principal remedy provided for defaults: it is the only remedy specifically stated to be available and the only remedy regularly sought if an event of default has occurred.[91] Though technically the trustee or the bondholders could seek other remedies, such as damages from breach, this is rarely done and damages are typically difficult to prove. The threat of acceleration thus forms the baseline for negotiations between the company and bondholders about the terms on which bondholders will consent to waivers and amendments that eliminate the default.[92]

Whether acceleration is attractive to bondholders—and conversely, whether the threat of acceleration can be used to extract consent payments or other concessions from the company—depends on the hypothetical value of the bonds *assuming that bondholders had no right to accelerate* (the nonaccelerated bond value). In acceleration, if the company has sufficient assets to pay, bondholders gain the difference between the nonaccelerated bond value and the principal amount of the bonds (par). Economically, the acceleration remedy resembles a liquidated damages clause where the amount of liquidated damages is equal to the difference between par and the nonaccelerated bond value. Acceleration is thus attractive only if par exceeds the nonaccelerated bond value; acceleration becomes increasingly attractive as the nonaccelerated bond value decreases. The more attractive acceleration is for bondholders, and the more costly it is for the company, the more leverage the bondholders have to extract concessions from the company in exchange for a waiver of the default.[93]

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[91] *See* MODEL INDENTURE, *supra* note 67, § 6.02, at 756–57. The only notable exception is that breaches of anti-dilution provisions are generally enforced specifically, not via acceleration. *See infra* text accompanying notes 98–99.

[92] *See supra* Part I.

[93] We were able to obtain information on bond prices for some of the cases listed in the Appendix, *infra*, that resulted in a negotiated resolution. We then classified the resolution as involving trivial, small, modest, or significant benefits to bondholders. In all ten instances where the benefit was trivial or

Three factors, in turn, determine the relationship between the nonaccelerated bond value and par: changes in treasury rates, changes in the risk premium, and for convertible bonds, stock price movements.

1. Changes in the Risk-Free (Treasury) Interest Rate.—Most corporate bonds are issued at fixed interest rates. Their value is thus subject to changes in market interest rates after the bonds are issued. The interest rate payable on treasury securities issued by the United States forms a benchmark for interest rates on other bonds. Other things being equal, when the rate payable on treasury securities with a maturity similar to the bond in question declines after issuance of the bond, the nonaccelerated bond value will increase. If the rate payable on treasury securities with a maturity similar to the bond in question increases, the nonaccelerated bond value will decrease.[94]

2. Changes in the Default Risk Premium.—Unlike treasury bonds, most corporate bonds entail more than a minimal risk of default. To compensate holders for this risk, corporate bonds carry a yield that is higher than the yield of a treasury security with a similar maturity (i.e., they are issued at a higher interest rate). We will refer to this difference as the default risk premium. The risk of default and the associated risk premium vary over time. When the risk premium increases, the nonaccelerated bond value declines, reflecting the higher likelihood of nonpayment. When the risk premium declines, the nonaccelerated bond value increases.

3. Stock Price Movements and Convertible Bonds.—For convertible bonds, there is a third reason why the nonaccelerated bond value may change. Convertible bonds carry, in addition to the right to payment of principal and interest, the right to convert the bonds into stock at a specified conversion price. Because of this right, convertible bonds have a lower yield (i.e., they are issued at a lower interest rate) than otherwise equivalent nonconvertible bonds. At issuance, the conversion price of a convertible bond is generally at a premium over the market price for the stock. Conversion becomes attractive only if the market price of the stock increases. For convertible bonds to maintain their market value, the market price for the stock must, over time, increase sufficiently so that the expected gains upon conversion equal the loss from the lower interest rate. If the market price of the company's stock increases by a greater amount, the nonaccelerated

small, the predefault market price of the bonds was above 98% of par. Of the eight instances where the resolution involved modest or significant benefits, the market price was above 98% of par in two, between 90% and 98% in three, and below 90% in three.

[94] *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 325 (10th ed. 2007) (discussion of discounting).

bond value will tend to increase. If the price increases by a lesser amount or declines, the nonaccelerated bond value will decline.[95]

C. Acceleration and Selective Enforcement

Acceleration, as a remedy, should ideally provide effective compensation to bondholders for any damages associated with the violation of their rights. As we have seen, however, acceleration economically resembles liquidated damages in an amount equal to the difference between par and the nonaccelerated bond value. To the extent that this difference is affected by factors that are not related to the violation at issue—that is, to the extent that the nonaccelerated bond value has changed due to factors not related to the violation at issue—the acceleration remedy will be deficient.

The relationship between the nonaccelerated bond value and a violation is strongest when the nonaccelerated bond value declines due to an increase in default risk. The principal function of protective covenants is to protect bondholders against certain actions by the company and other events that increase the default risk.[96] Thus, when the company has violated a covenant and the default risk after the violation is higher than it was when the bonds were issued, there is a prima facie case that the covenant violation is related to the increase in default risk. To the extent that the nonaccelerated bond value has declined due to an increase in default risk, acceleration constitutes a proper remedy.[97]

Unlike changes in default risk, changes in treasury interest rates are unrelated to a violation. As such, there is no good reason why changes in the nonaccelerated bond value that are caused by changes in the treasury interest rates should affect the amount of de facto damages that bondholders receive upon acceleration.

Movements in the stock price of convertible bonds raise further complexities. To analyze the relation between such movements and a violation, one must distinguish between indenture provisions related to default risk

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[95] A convertible bond can be viewed as a combination between a nonconvertible bond and a warrant to purchase common stock. The Black-Scholes option pricing formula, in turn, can be used as a basis to value the warrant element of a convertible bond. Under that formula, the value of the warrant decreases as (1) the time to expiration decreases and (2) the value of the stock into which the warrant can be converted decreases. *See* Marcel Kahan, *Anti-Dilution Provisions in Convertible Securities*, 2 STAN. J.L. BUS. & FIN. 147, 162 (1995).

[96] RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 678–79 (8th ed. 2006).

[97] To be sure, even with respect to changes in default risk, acceleration is not a perfect remedy. The default risk of a bond could have changed for reasons completely unrelated to the covenant violation. Although acceleration does not always work perfectly in these instances, it is hard to devise a superior remedy. When the default risk of the company has increased, it is practically impossible to determine the extent to which the decline is related to a covenant violation. This difficulty is enhanced because covenants sometimes function as trip-wires. That is, they are designed to be more likely to be violated by companies where the default risk has increased substantially, even though the specific act that causes the violation did not substantially and directly increase the default risk.

(protective covenants) and provisions specifically designed to protect the value of the conversion feature (anti-dilution provisions). Anti-dilution provisions often address actions that reduce the share price, such as stock splits or dividends. Unlike most protective covenants, anti-dilution provisions do not prohibit these actions, but instead provide for an adjustment of the conversion price if the company takes these actions (e.g., they provide that the conversion price be halved if the company's stock is split two-for-one).[98]

For protective covenants in convertible bonds or for anti-dilution provisions, there is no reason why the amount of de facto damages bondholders receive upon acceleration ought to vary with the effect of stock price movements on the value of the conversion right. For anti-dilution provisions, however, the deficiency of the acceleration remedy is not practically significant because acceleration—though theoretically available—is not used to rectify these breaches. To see why this is so, consider first the case where bondholders, upon conversion, stand to receive stock with a value in excess of par. Acceleration would undercompensate bondholders. Thus, bondholders instead can and do seek specific performance of the anti-dilution provision. Now consider the case where bondholders stand to receive stock with a value below par even if the conversion price is calculated the way they deem proper. In these cases, acceleration would overcompensate bondholders. Bondholders may seek to trigger a default by tendering, say, $1,000 of bonds for conversion, accepting the lower number of shares that the company deems proper, and then issuing notices of default and acceleration. But the company could simply pay holders the higher number of shares (i.e., the number that the bondholders deem proper) and then either do nothing further or sue holders for a repayment of the extra shares. By doing that, the company would not only avoid generating a default, but it would also call the bondholders' bluff because, in their (futile) attempt to generate the default, the bondholders would have converted their bonds into shares with a value below their principal amount.[99] For these reasons, disputes involving anti-dilution provisions are not likely to result in acceleration.

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[98] *See generally* Kahan, *supra* note 95, at 149–58 (discussion of anti-dilution provisions). More rarely, provisions designed to protect the value of the conversion right offer bondholders a special right to put the bonds, such as when the stock into which the bonds are convertible is converted into cash in a merger. *See id.* at 160–61.

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

Both changes in market interest rates and, for protective covenants in convertible bonds, stock price movements will thus distort enforcement incentives. When treasury rates increase or the stock price declines, acceleration overcompensates bondholders. Bondholders therefore have incentives to expend excessive resources in detecting defaults and to pursue claims of dubious merit. Companies have excessive incentives to avoid triggering a potential default and defending even against meritorious claims. When treasury rates decrease, the situation is reversed. Bondholders have *insufficient* incentives to investigate and pursue defaults, so companies will tend to be overly lax in their covenant observance.[100]

V. THE EX POST EFFECTS OF INCREASED ENFORCEMENT ON BONDHOLDERS AND THE COMPANY

The activism by hedge funds raises the question of who, besides the activists themselves, benefits from the increased enforcement of bondholder rights. This Part first addresses whether increased enforcement benefits other bondholders who do not participate in enforcement actions, and concludes that it does. Second, this Part argues that it is uncertain whether increased enforcement also benefits bondholders and companies in the aggregate.

As in the shareholder context, there is at least a theoretical possibility that activism by hedge funds comes at the expense of their fellow bondholders.[101] An activist could, for example, detect a default and then seek a payment from the company—the bondholder equivalent of greenmail—in exchange for a promise not to expose the default. An activist could also acquire a majority of bonds and then approve an amendment, which would be binding on all bondholders, in exchange for a consent payment made only to the majority holder.[102]

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[100] A special situation arises when the stock price of a company that has issued a convertible bond increases, making the conversion feature more valuable than anticipated. In theory, this could lead to the same dynamic as a decline in treasury rates. In practice, however, this increase usually does not generate a significant underenforcement problem. It is unlikely that the stock price has increased sufficiently to make the conversion feature more valuable while, at the same time, the default risk of the company has deteriorated such that bondholders suffered damages associated with a covenant violation.

[101] *See* Kahan & Rock, *supra* note 3, at 1070–91 (examining whether hedge fund activism benefits fellow shareholders).

[102] Some indentures contain covenants requiring that all bondholders have the same opportunity to deliver the consent and receive the consent payment. *E.g.*, Freeport-McMoran Copper & Gold Inc., Indenture for 10-1/8% Senior Notes § 9.07 (Jan. 29, 2003).

In our research, we have found no instances of such practices.[103] To the contrary, whenever activist hedge funds obtained benefits, other bondholders were offered the chance to obtain the same pro rata benefits as the activists. For example, when hedge funds negotiated the terms of the exchange offer in Spectrum Brands, which entailed an amendment that removed any potential default, all bondholders had equal rights to participate in the offer. In these cases, other bondholders were in effect able to free-ride on the efforts of the activists. We also found instances where activist funds obtained separate payments as reimbursement of expenses, but these instances were rare and the amounts involved modest sums.[104] This suggests that other bondholders benefited from the hedge fund activism, possibly (because they incurred no costs) even more than the hedge funds themselves. Moreover, compared to underenforcement, selective enforcement increases the incentives of companies to avoid covenant violations or actions that may result in future violations. This deterrence effect associated with a higher enforcement level is likely to benefit bondholders at large.

There are, however, some caveats to our conclusion that hedge fund activism benefits other bondholders. Hedge funds could, through their ownership of other securities or derivatives, benefit from activism even if the activism harms other bondholders.[105] For example, a hedge fund that is short on the company's stock or long on a credit default swap could benefit from accelerating a bond and pushing the company into bankruptcy, even if a bankruptcy filing reduces bond values. It is also quite possible that activist funds have held derivatives that generated gains from activism beyond any gains they derived as a result of their bond holdings. But we did not find any cases where activists suffered *losses* in their bond holdings but nevertheless derived overall gains because of their other investments. Thus, on the whole, there is a strong case that hedge fund activism benefits fellow bondholders from an ex post perspective.

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[103] It may be that we simply failed to discover cases of bondholder greenmail. After all, neither a greenmailed company nor a greenmailing activist would have an incentive to reveal such payments. By the same token, however, a company would have incentives to reveal a *request for* greenmail that it refused. Moreover, greenmail leaves tracks—in the company's financial statements, in the bondholder's trading pattern, in the knowledge of other participants—that should eventually lead to the discovery of some such payments. We thus believe that bondholder greenmail payments, if they are made at all, represent at most isolated occurrences. *Cf.* Kahan & Rock, *supra* note 3, at 1082–83 (finding no evidence that hedge funds as shareholders seek greenmail and discussing reasons for this).

[104] For example, the settlement agreement between Riverstone Networks, Inc., the trustee, and bondholders related to an alleged default included a reimbursement of $675,000 in attorneys' fees and administrative costs incurred by the note holders as a result of the litigation, in addition to an offer to redeem up to $65.875 million of the bonds. *See* Riverstone Networks, Inc., Current Report (Form 8-K) (Mar. 24, 2005).

[105] *See* Kahan & Rock, *supra* note 3, at 1073–77 (discussing similar concerns for shareholder activism by hedge funds).

A more difficult question is whether activism increases the aggregate benefits for bondholders and the company. On the one hand, covenants are included in bond indentures because they generate such aggregate benefits by reducing agency costs of debt, and, once included, they ought to be enforced.[106] On the other hand, hedge fund activism creates transaction costs (such as lawyers' fees) and disruption costs for the company, and the merits of the claims asserted vary in strength. More disconcertingly, covenants that are written during a period of underenforcement are arguably designed to be optimal in a climate of underenforcement and may not be optimal for a systematically higher enforcement level. But then again, underenforcement is generated by exogenous factors and is not a contractual choice, so it is highly unlikely that it is optimal for covenants to be underenforced. On the whole, therefore, it is unclear whether bondholders and the company, in the aggregate, are better off under a paradigm where bond indentures are designed to be underenforced and are in fact underenforced, or one where bond indentures are designed to be underenforced but are selectively enforced.

VI. THE EX ANTE EFFECTS OF SELECTIVE ENFORCEMENT

From an ex ante perspective, selective enforcement has neutral effects on bondholders generally. When issued, bonds are priced given an anticipated enforcement pattern, and once bonds are anticipated to be selectively enforced, selective enforcement should have no systematic effect on bondholder wealth.[107] Selective enforcement may, however, affect the way indentures are drafted. In particular, provisions that may have been desirable or at least harmless when bonds were underenforced may be undesirable when bonds are selectively enforced. In this Part, we explore several possible adjustments to bond indentures.

A. Weaker Covenants

One possible adjustment to the tougher enforcement environment is to weaken the strength of the covenants that are included in bond indentures. Tougher enforcement coupled with weaker covenant protection is one way to return the overall protection back to equilibrium.

With respect to the covenant requiring companies to file reports with the trustee—one that has recently caused trouble for several companies—

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[106] BREALEY & MYERS, *supra* note 96, at 486.

[107] Because selective enforcement is, other things being equal, more beneficial to bondholders than underenforcement, we would expect the required yield on bonds to decline. On the other hand, the greater de facto restrictions on companies through selective enforcement (compared to underenforcement) impose costs on companies. If, *mutatis mutandis*, selective enforcement is more beneficial than underenforcement to bondholders and the company in the aggregate, we would further expect the attractiveness of bonds relative to other forms of financing to increase. If it is worse, we would expect the attractiveness of bonds to decrease.

there is evidence that covenants have already become weaker. For example, several recent indentures provide that, upon a failure to file, the company has to pay additional interest to bondholders and that bondholders are not entitled to accelerate unless the failure lasts longer than a specific period of time.[108] Other indentures provide for special, extended cure periods applicable to a failure to file reports with the trustee.[109]

B. "Better" Provisions

As discussed above, one category of activism has involved technical flaws or imprecision in indenture terms. Such flaws may have mattered less when bondholder rights were underenforced. With selective enforcement, however, such flaws are more likely to generate costly disputes. From an ex ante perspective, selective enforcement increases the incentives to avoid flaws when indenture terms are drafted; in other words, selective enforcement encourages more precise drafting of indentures.

C. Improving Enforcement Incentives

Systematic underenforcement of bondholder rights was, to a large extent, caused by exogenous factors, such as the dispersion of bond holdings and the behavior of traditional bondholders. As such, it was difficult to revise the contractual terms of bond indentures to reduce the underenforcement problem.[110] By contrast, selective enforcement is caused by imperfections in the remedy scheme. Accordingly, a promising approach would be to revise the remedy scheme to generate more optimal enforcement of bondholder rights. In this section, we propose a set of modifications that would fix most of the selective enforcement problems described above.[111]

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[108] *See* CACI Int'l Inc., Current Report Indenture for 2-1/8% Convertible Senior Subordinated Notes (Form 8-K), at exhibit 4.1, § 7.02 (May 16, 2007) (providing that, at the company's election, the remedy for an event of default caused by such a failure to file shall not be acceleration, but for the first ninety days a right to receive additional interest at a rate of 0.25%). *See generally* Bennett, *supra* note 39.

[109] Rayonier TRS Holdings Inc., Registration Statement Rayonier Inc. Form of Senior Indenture (Form S-3), at exhibit 4.2, § 6.1(d) (May 22, 2007) (providing for a sixty-day cure period for regular covenant violations and a 180-day cure period for a failure to file reports).

[110] Certain contractual terms, such as lack of access to nonpublic information and the no-action clauses, aggravated the underenforcement problem. These terms, however, served other functions, like preserving the confidentiality of information and limiting nonmeritorious lawsuits, and were thus difficult to change. For further analysis of these issues, see Amihud et al., *supra* note 70; Marcel Kahan, *Rethinking Corporate Bonds: The Tradeoff Between Individual and Collective Rights*, 77 N.Y.U. L. REV. 1040 (2002).

[111] Another possibility is to make acceleration available only upon material defaults. There are several problems with this approach. First, it is likely to generate a lot of litigation over whether any default is material. Second, for covenants that serve as triggers—where a violation is the symptom rather than the cause of a problem—materiality of default is difficult to judge. Third, even for material defaults, the acceleration remedy would result in selective enforcement. For the first two of these reasons,

1. The Underenforcement Problem.—From a financial perspective, a decline in treasury rates makes acceleration less attractive because the decline increases the discounted present value of the scheduled interest and principal payments if the bonds are not accelerated. This problem can be addressed by giving bondholders, upon acceleration, an amount based on that (higher) discounted value, rather than on the (lower) principal amount of the bonds, by incorporating a so-called "make-whole" clause.[112] Make-whole clauses provide a discount rate for the remaining scheduled principal and interest payments that is equal to the yield of treasury bonds *at the time of acceleration* plus a fixed premium. If the discounted value of these payments exceeds par, bondholders receive that higher value upon acceleration.[113]

Make-whole clauses have long been included in most agreements related to privately placed debt securities.[114] More recently, some publicly issued bonds have started to use these clauses.[115] Consider, for example the $400 million in 5.75% notes due 2012 issued by Simon Property Group, LP. Assume the notes had been accelerated on May 2, 2007. At that point, the scheduled remaining payments are $11.5 million on each November 1 of 2007 through 2011 and on each May 1 of 2008 through 2011, and $411.5 million on May 1, 2012. These payments are discounted at a rate equal to the yield on treasury securities with a maturity equal to the remaining life of the principal (here, five years) plus 0.2%. Table 2 below contains hypothetical calculations of the discounted value for different discount rates.

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it would also be inadvisable to replace the acceleration remedy with a regular damage remedy (where holders would only be entitled to actual damages caused by a violation, rather than acceleration).

[112] Make-whole clauses would not address any underenforcement problem for convertible bonds generated by an increase in the stock price. However, as discussed in Part IV.C, *supra*, that problem is not likely to occur frequently.

Make-whole provisions often also apply to the amount the company must pay when it redeems its debt securities. To fix the underenforcement problem, however, the make-whole approach must apply only to acceleration, not to redemption. If a company has the right to redeem the bonds at a price below the make-whole amount, bondholders should be entitled to receive acceleration only on the lower redemption price, not the make-whole amount.

[113] *See* Kahan & Tuckman, *supra* note 68, at 253–74 (describing make-whole clauses).

[114] *Id.* (finding that 87% of private placements from 1986 to 1990 used make-whole clauses for acceleration).

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

Table 2: Discounted Values for Various Discount Rates

Discount Rate	*Discounted Value of Scheduled Payments*
4.00%	$432,176,636
4.50%	$423,073,291
5.00%	$414,217,973
5.50%	$405,602,687
5.75%	$401,382,638

As the table shows, this method yields a payment in excess of par for discount rates below the interest rate on the notes, which declines to par as the discount rate approaches that interest rate.[116]

With a make-whole clause, declines in treasury rates thus have parallel effects on the nonaccelerated bond value and on the amount bondholders receive upon acceleration—both increase by about the same amount. Such declines will therefore not reduce the attractiveness of the acceleration remedy and not reduce enforcement incentives.

Make-whole clauses typically provide for a discount rate that represents only a small premium over treasury rates.[117] At these levels, make-whole clauses generate a payment over par upon acceleration (in an amount that is declining over time) even when treasury rates remain constant. The limited excess payment that make-whole clauses generate in the event of an acceleration can serve as an incentive for bondholders to incur the expenses involved in detecting and pursuing a default. However, if no such incentive (or only a smaller one) is desirable, make-whole clauses can employ a discount rate that incorporates a higher premium over treasury bonds.

2. The Overenforcement Problem.—The overenforcement problem arises when treasury rates have increased or, in the case of convertible bonds, when the stock has failed to appreciate sufficiently, and the nonaccelerated bond value for these reasons is below par. Conceptually, the overenforcement problem can be addressed by providing bondholders with assurances that they will receive the scheduled principal and interest payments—in effect compensating them for any increase in the default risk—but changing neither the required timing of these payments nor any conversion rights.

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[116] The reason why the payment is not exactly equal to par at a 5.75% discount rate is that the semi-annual interest payments are based on the arithmetic average of the interest due for a year (i.e., half the annual 5.75% interest due) but are discounted at a rate based on the geometric average of the annual discount rate (i.e., at $0.5 \times (1 + 0.0575)$).

[117] *See* Kahan & Tuckman, *supra* note 68 (finding an average premium of thirty-three basis points for a sample of 34% investment grade and 66% junk bonds); *supra* note 115 (discussing, in the case of Simon Property Group, LP, a premium of, respectively, twenty and twenty-five basis points).

As currently drafted, most indentures already contain a provision called "defeasance"[118] that, in principle, enables the company to do just that. To effect a defeasance, a company must deposit with the trustee treasury securities that generate sufficient cash to make all scheduled interest and principal payments.[119] As a result of a defeasance, the company is no longer obligated to comply with protective covenants, and violations of these covenants no longer constitute grounds for an acceleration.[120] But, in the case of convertible bonds, the company remains obligated to honor its conversion obligations.[121]

If a company has the option to defease its bonds rather than having them accelerated, the overenforcement problem will be substantially reduced. Defeasance compensates bondholders for any predefeasance increase in default risk. Because the company's payment obligations are now backed by treasury securities held by the trustee for the benefit of the bondholders, bondholders are virtually assured to receive all scheduled payments. But defeasance does not provide them with any windfall related to an increase in treasury rates or a decline in the stock price because, unlike acceleration, it does not advance the timing of the principal payment and it leaves the conversion obligations intact. The company's right to defease, as an alternative to paying off the bonds at par upon acceleration, in turn reduces the incentives of bondholders to overenforce because bondholders are less likely to obtain a windfall upon acceleration.

A hypothetical example illustrates this point. Consider a 5% bond maturing five years from now. Further, assume that treasury rates have increased from 3% when the bonds were issued to 8% today and that the premium over treasury rates at which the company can borrow has increased from 2% to 2.5%. The nonaccelerated value of these bonds would be around 79%. Purchasing treasury securities to defease the bonds would cost the company around 88% of par, more than the nonaccelerated bond value but still far less than paying off the bonds after acceleration.[122]

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[118] Indentures sometimes distinguish between legal defeasance and covenant defeasance. For purposes of our argument, either type of defeasance would reduce the overenforcement problem.

[119] *See, e.g.*, MODEL INDENTURE, *supra* note 67, § 8.01, at 762.

[120] *See, e.g.*, MCMS, Inc., Indenture for 9-3/4% Senior Subordinated Notes § 8.02(c) (Feb. 26, 1998).

[121] *Id.* (providing that conversion obligations in article 10 of the indenture survive defeasance).

[122] The nonaccelerated bond value and the defeasance costs were calculated by discounting the scheduled principal and interest payments by 10.5% and 8%, respectively. Obviously, the company would have to finance the purchase of these treasury securities at its new borrowing rate of 10.5%, which is higher than the interest rate on its bonds. The refinancing rate, however, will not affect the choice between defeasance and payment upon acceleration.

As the example illustrates, bondholders would still receive a windfall due to the fact that defeasance *eliminates* any default risk, rather than reduces it to a bargained-for level. In our example, this windfall is represented by the difference between the postdefeasance value of the bonds (88% of par) and the value of the bonds had treasury rates increased as they did and the default premium stayed at 2% (81%

As currently drafted, however, defeasance provisions usually contain conditions that greatly limit their usefulness. Some indentures permit the company to effect a defeasance only if no default has occurred.[123] Thus, once a default has occurred—the very context in which we are most interested—defeasance is unavailable. Other indentures permit defeasance only of bonds that mature within one year.[124] For those bonds, defeasance would be effective postdefault, but only if the default occurs shortly before the bonds mature.[125] Neither of these conditions, however, serves an important function,[126] and most bond indentures do not contain one or the other.[127] Modifying the standard defeasance clauses to permit defeasance up until the time the bonds are accelerated, even if a default has occurred,[128] and without any limitation related to when the bonds mature, would greatly reduce the overenforcement problem.[129]

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of par). This windfall is analogous to the excess payments incorporated into make-whole clauses, *see supra* Part VI.C.1, and justifiable for the same reasons.

As an alternative to the expanded defeasance option we propose below, one could address the overenforcement problem through the make-whole approach discussed above, *supra* Part VI.C.1, with the addition that bondholders *always* receive the discounted value of the scheduled principal and interest payment, even if that value is less than par. That approach would have the benefit of enabling parties to adjust the size of any windfall by increasing the premium over the treasuries component of the discount rate. On the other hand, this approach would not solve the overenforcement problem due to declines in the stock price because payment of a make-whole amount, unlike defeasance, eliminates any conversion rights. Moreover, insurance companies are, for regulatory reasons, averse to liquidating any bonds at a capital loss and would thus be hostile to a clause that enabled the company to pay less than par upon acceleration. Indeed, we are not aware of any debt security—private or public—that provides for such a payment.

[123] *See* MCMS Inc., *supra* note 120, § 8.03(d).

[124] *See, e.g.*, MODEL INDENTURE, *supra* note 67, § 8.01, at 762.

[125] Although defeasance would also be available for bonds that can be redeemed within one year, this does not effectively fix the overenforcement problem as the company would be required to repay the bonds prior to their original maturity and, in addition, pay a redemption premium.

[126] Because defeasance effectively removes any default risk, there is no evident reason why defeasance should be limited to instances where no default has occurred. Nor are there any adverse tax effects for holders that would justify limiting defeasance to bonds that are payable within one year.

[127] *See* MCMS Inc., *supra* note 120, §§ 8.03–.04 (having no requirement that notes mature within one year); MODEL INDENTURE, *supra* note 67, § 8.01, at 762 (having no requirement of absence of default).

[128] This would force companies to choose whether to defease or dispute the validity of an acceleration, and would be beneficial to the extent that companies assert nonmeritorious defenses or want to delay payment.

[129] Some problem may remain to the extent that a company has difficulty raising the funds required to effect a defeasance before the cure period expires and the bonds are accelerated. Most companies, however, have relationships with banks and, if solvent, would probably be able to raise the funds needed for defeasance in a timely manner. Moreover, indentures could permit the company to extend the period to effect a defeasance, possibly in exchange for some additional payment. Finally, companies with liquidity problems would face even greater problems if they did not have the defeasance options and their bonds were accelerated.

CONCLUSION

In this Essay, we documented the increased activism of hedge funds in the corporate bond market. Traditional investors in corporate bonds—insurance companies and mutual funds—have long taken a hands-off approach to violations of their contractual rights. They have spent little time investigating whether such violations occurred and have taken action only if the company announced a transaction that resulted in substantial declines in the value of their bonds. In contrast to traditional investors, hedge funds turn to activism not to limit their losses, but to make gains. They investigate potential defaults, buy bonds when an attractive opportunity for activism arises, and then pursue their rights vigorously.

This more aggressive enforcement promises to generate better incentives for companies to comply with their contractual obligations. However, the remedy scheme for violations of bondholder rights and the centrality of the acceleration remedy has introduced its own set of imperfections. Whether acceleration is attractive to bondholders, and how attractive it is, depends significantly on two factors that have nothing to do with the harm associated with the violation: changes in treasury interest rates and, for convertible bonds, changes in the price of the shares into which the bonds can be converted. Specifically, when treasury rates increase or the share price declines, acceleration generates a windfall for bondholders. This windfall, in turn, results in the overenforcement of potential violations by bondholders and overcompliance by companies trying to avoid any potential violations, creating unnecessary costs and inefficiencies in the market. When treasury rates decline, acceleration results in insufficient compensation. This, in turn, leads to underenforcement by bondholders and insufficient compliance incentives for companies.

To rectify this selective enforcement problem, we have proposed revisions to the contractual provisions that govern the remedy scheme. To deal with overenforcement, we suggest an expansion of the defeasance option. Under our expanded defeasance option, bondholders would no longer benefit from an acceleration merely because treasury rates have increased or, for a convertible bond, the share price has declined. To deal with underenforcement, we suggest that bondholders receive, upon acceleration, a make-whole premium that would compensate them for the fact that they would have to reinvest the funds received upon acceleration at prevailing interest rates that are lower than the rates at the time the bonds were issued. These changes would result in enforcement levels that are more optimal than, and create incentives superior to, the underenforcement of yore or the recent trend of selective enforcement.

APPENDIX

Company	*Issue*	*Hedge Fund / Holder Involvement*	*Outcome*	*Terms/Other*
AES Corp.	Various issues ($2.8B)	Unclear	Cured	
Affiliated Computer Services, Inc.	4.7% Senior Notes due 2015 ($250M)	Unidentified holders give default notice and accelerate	Trial court finds no default	Litigation
Affiliated Computer Services, Inc.	5.2% Senior Notes due 2015 ($250M)	Unidentified holders give default notice and accelerate	Trial court finds no default	Litigation
Amkor Technology, Inc.	Various issues ($1.62B)	Unclear	Cured	
Asyst Technologies, Inc.	5.75% Convertible Subordinated Notes due 2008 ($85M)	Unclear	Cured	
Bally Total Fitness Holding Corp.	10-1/2% Senior Notes due 2011 and 9-7/8% Senior Subordinated Notes ($535M)	Unclear	Waivers	Consent payment
Bearingpoint, Inc.	2.75% Ser B Convertible Subordinated Debentures due 2024 ($200M)	Fore, Linden, and Whitebox (HF) give default notice and accelerate	Settled / amended	Increase in interest rate / litigation
Bearingpoint, Inc.	2.5% Ser A Convertible Subordinated Debentures due 2024 ($250M)	Likely holder involvement in negotiation	Settled / amended	Increase in interest rate
Bearingpoint, Inc.	5% Convertible Senior Subordinated Debentures due 2025 and 0.50% Convertible Senior Subordinated Debentures due 2010 ($240M)	Unclear	Settled / amended	Consent payment

Company	*Issue*	*Hedge Fund / Holder Involvement*	*Outcome*	*Terms/Other*
Beazer Homes USA, Inc.	8.625% Senior Notes due 2011 and 4-5/8% Convertible Senior Notes due 2024 ($1.525B)	Likely holder involvement in negotiation	Amended	Consent payment and additional covenants / litigation
Bell Microproducts, Inc.	3-3/4% Convertible Subordinated Notes due 2024 ($110M)	Unclear	Amended	Company made tender offer at par
Brocade Communication Sys-tems, Inc.	2% Convertible Subordinated Notes due 2007 ($280M)	Linden and Whitebox (HF) accelerate	Defeased	Litigation
Cablevision System Corp.	8% Series B Senior Notes due 2012 ($1B)	Unidentified holder(s) give default notice	Cured	
Carmike Cinemas, Inc.	7.5% Senior Subordinated Notes due 2014 ($150M)	Unidentified holder(s) accel-erate	Paid upon acceleration	
CNET Networks, Inc.	0.75% Senior Convertible Notes due 2024 ($125M)	Unclear	Paid upon acceleration	
Computer Sciences Corp.	3.5% Notes due 2008, 7.375% Notes due 2011 and 5% Notes due 2013 ($1.1B)	Unclear	Cured	
Computer Sciences Corp.	6.25% Notes due 2009 ($200M)	Unclear	Amended	Consent payment
Connetics Corp.	2% Convertible Senior Notes due 2015 ($200M)	Unidentified holder(s) give default notice	Cured	
Connetics Corp.	2.25% Convertible Senior Notes due 2008 ($90M)	Unidentified holder(s) give default notice	Amended	Consent payment and condi-tional increase in interest rate

Company	*Issue*	*Hedge Fund / Holder Involvement*	*Outcome*	*Terms/Other*
Cyberonics, Inc.	3% Senior Subordinated Convertible Notes due 2012 ($125M)	Unclear	Trial court finds no default	Litigation
Dresser, Inc.	9-3/8% Senior Subordinated Notes due 2011 ($300M)	Likely holder involvement in negotiation	Amended (twice)	Consent payment (first); consent payment and conditional increase in interest rate (second)
Emcore Corp.	5% Convertible Senior Subordinated Notes due 2011 (issued 2004 ($80M))	Unidentified holder(s) give default notice and accelerate; both hedge funds and traditional institutions negotiate amendment terms	Amended	Increased interest rate and reduced conversion price
Emcore Corp.	5% Convertible Senior Subordinated Notes due 2011 (issued 2005 ($17M))	Holder(s) (probably Alexandra (HF)) give default notice and Alexandra negotiates amendment terms	Amended	Increased interest rate and reduced conversion price
Ferro Corp.	8% Debentures due 2025 and 7.125% Debentures due 2028 ($105M)	Unclear	Paid upon acceleration	
Ferro Corp.	7.375% Debentures due 2015 and 7.625% Debentures due 2013 ($50M)	Unidentified holder(s) give default notice (for one of issues)	Paid upon acceleration	
Ferro Corp.	9.125% Senior Notes due 2009 ($200M)	Unclear	Cured	

Company	*Issue*	*Hedge Fund / Holder Involvement*	*Outcome*	*Terms/Other*
Finisar Corp.	2.5% Convertible Senior Subordinated Notes due 2010, 2.5% Convertible Subordinated Notes due 2010, and 5.25% Convertible Notes due 2008 ($250M)	Unclear	Litigation pending	Litigation
Getty Images, Inc.	0.5% Convertible Subordinated Debentures due 2013 ($265M)	Unidentified holder(s) give default notice	Pending	
HealthSouth Corp.	Various issues of senior notes and 10.75% Senior Subordinated Notes due 2008 ($2.6B)	HFs part of bondholder group in some or all issues	Amended	Consent payment (all issues); repurchase right (some) / litigation
KB Home	Various senior notes ($1.65B)	Unidentified holder(s) give default notice	Amended	Consent payment
KB Home	Various senior subordinated notes ($750M)	Unclear	Unclear	
Key Energy Services, Inc.	8.375% Senior Notes due 2008 ($275M)	Unclear	Amended (3 times) then redeemed at premium	Consent payments (for each of 3 amendments)
Key Energy Services, Inc.	6.375% Senior Notes due 2013 ($150M)	Unidentified holder(s) accelerate	Amended (3 times) then paid upon acceleration	Consent payments (for each of 3 amendments)
Landry's Restaurants, Inc.	7.5% Senior Notes ($400M)	Holder involvement in negotiations	Amended	Increased interest rate
Medarex, Inc.	2.25% Convertible Senior Notes due 2011 ($150M)	Citadel Equity Fund (HF) gives default notice	Amended	Change in redemption provisions

Company	*Issue*	*Hedge Fund / Holder Involvement*	*Outcome*	*Terms/Other*
Mercury Interactive Corp.	4.75% Convertible Subordinated Notes due 2007 ($300M)	Likely holder involvement in negotiations	Amended (twice)	Consent payment, then change in repurchase right
Mercury Interactive Corp.	Zero Coupon Senior Convertible Notes due 2008 ($500M)	Likely holder involvement in negotiations	Amended (twice)	Change in repurchase right
Metromedia International Group, Inc.	10-1/2% Senior Discount Notes due 2007 ($152M)	Likely holder involvement in negotiations	Amended, then waived conditional on redemption	Consent payment (for amendment); redeemed
Navigant International, Inc.	4.875% Convertible Subordinated Debentures due 2023 ($72M)	Both hedge funds and traditional institutions negotiate amendment terms	Amended	Modification in "change of control" provision
Navistar International Corp.	4.75% Subordinated Exchangeable Notes due 2009 ($220M)	Unidentified holder(s) give default notice; likely holder involvement in negotiations	Amended	Tender offer with exit consents
Navistar International Corp.	2.5% Senior Convertible Notes due 2007 and 9.375% Senior Notes due 2006 ($580M)	Likely holder involvement in negotiations	Amended	Tender offer with exit consents
Navistar International Corp.	6.25% Senior Notes due 2012 ($400M)	Unidentified holder(s) accelerate	Paid upon acceleration	
Navistar International Corp.	7.5% Senior Notes due 2011 ($250M)	Likely holder involvement in negotiations	Amended	Tender offer with exit consents
Newpark Resources, Inc.	8-5/8% Senior Subordinated Notes due 2007 ($125m)	Unidentified holder(s) give default notice	Redeemed	

Company	*Issue*	*Hedge Fund / Holder Involvement*	*Outcome*	*Terms/Other*
Novell, Inc.	0.5% Convertible Senior Debentures due 2024 ($600M)	Likely holder involvement in negotiations	Amended	Additional interest
Riverstone Networks, Inc.	3-3/4% Convertible Subordinated Notes due Dec. 1, 2006 ($132M)	Highbridge (HF) and Mackay Shields negotiate settlement	Settled / amended	Litigation / company redeems half of issue / reimbursement of expenses
Saks, Inc.	7-1/2% Notes due 2010, 7% Notes due 2013, and 7-3/8% Notes due 2019	Unclear	Amended	Tender offer with exit consents
Saks, Inc.	2% Convertible Senior Notes due 2024 ($230M)	Highbridge (HF) gives default notice	Amended	Nominal consent payment
Saks, Inc.	9-7/8% Notes due 2011 and 8-1/4% Notes due 2008 ($383M)	Unclear	Amended	Nominal consent payment
Sanmina-SCI Corp.	6-3/4% Senior Subordinated Notes due 2013 and 8-1/8% Senior Subordinated Notes due 2016 ($1B)	Unidentified holder(s) negotiate amendment terms	Amended	Consent payment
Tenet Healthcare, Inc.	6-7/8% Senior Notes due 2031 ($450M)	Unidentified holder(s) give default notice	Cured	
Terayon Communication Systems, Inc.	5% Convertible Subordinated Notes due 2007 ($65M)	Unidentified holder(s) give default notice	Paid upon acceleration	
United Rentals, Inc.	Senior and senior subordinated notes ($1.9B)	Unidentified holder(s) negotiate amendment terms	Amended	Consent payment

Company	*Issue*	*Hedge Fund / Holder Involvement*	*Outcome*	*Terms/Other*
United Rentals, Inc.	1-7/8% Convertible Senior Subordinated Notes due October 15, 2023 ($144M)	Unidentified holder(s) negotiate amendment terms	Amended	Change in conversion rate
UnitedHealth Group, Inc.	5.8% Subordinated Notes due March 15, 2036 ($850)	Whitebox, Linden, and Pandora (HF) give default notice	Trial court finds no default	Litigation
UTStarcom, Inc.	7/8% Convertible Subordinated Notes due 2008 ($275M)	Likely holder involvement in negotiations	Amended	Additional interest
Valeant Pharmaceuticals	3% Convertible Notes due 2010 and 8-1/8% Senior Subordinated Notes due 2016 ($480M)	Unclear	Cured	
Vitesse Semiconductor Corp.	1.5% Convertible Subordinated Debentures due 2024 ($97M)	Holder involvement in negotiations	Amended	Change in repurchase right and conversion price
Willbros Group, Inc.	2.75% Convertible Senior Notes due 2004 ($70M)	Whitebox (HF) gives default notice	Amended	Extension in call protection and revisions of "fundamental change" provision