

RETHINKING CORPORATE BONDS: THE TRADE-OFF BETWEEN INDIVIDUAL AND COLLECTIVE RIGHTS

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This Article presents a framework for analyzing the tradeoff between structuring bondholder rights as individual or as collective rights. Individual rights cannot be modified without the consent of each affected bondholder and they can be enforced by any bondholder whose right is violated. By contrast, if rights are collective, they can be modified by a majority of bondholders and they cannot be enforced without the consent of a majority of bondholders. The framework developed in this Article identifies the respective theoretical problems of vesting bondholder rights individually or collectively and examines the institutional setting of the United States corporate bond market to assess the practical significance of these problems. The Article ultimately endorses the presently prevailing structure of rights governing amendments, but identifies a number of defects with respect to the enforcement of rights. It concludes with specific recommendations for revisions in the structure and judicial interpretation of bondholder rights.

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Together with stocks, bonds are the most commonly issued corporate securities.¹ Bondholders and stockholders obtain rights from common legal sources: a contract (the "indenture") for bonds; corporate law and the certificate of incorporation for stocks. Among holders of bonds and stocks of the same issue, these rights are generally identical and thus, in a relevant sense, shared by all. Therefore, a degree of interdependence exists among bondholders as well as among stockholders. Any system for the modification and enforcement of

¹ See Bd. of Governors of the Fed. Reserve Sys., Flow of Funds Accounts of the U.S.: Flows and Outstandings, Third Quarter 1999, at 89, 90 tbls. L.212 & L.213 (reporting that, at end of third quarter of 1999, \$16 trillion worth of corporate equities and \$4.5 trillion worth of corporate bonds were outstanding).

these shared rights necessarily involves a tradeoff between individual rights, held separately by each holder, and collective rights, held only by a specified group of holders or by some representative.

For stocks, this system of individual and collective rights is largely set by law. Corporate statutes provide for a board of directors that is elected by shareholders and that represents shareholders' economic interests in the company.² The board is empowered to manage the company,³ though it must obtain shareholder approval for charter amendments and certain extraordinary transactions.⁴ When shareholder approval is required, consent by the requisite majority of shareholders, with some narrow exceptions,⁵ binds all shareholders of the company. Thus, shareholder rights are predominantly collective, exercised either by the collective representative (the board) or by a majority of shareholders.⁶ Still, some shareholder rights—enforcement rights being the most significant—are held individually. Hence, if the board of directors violates its duties to shareholders,⁷ an individual shareholder may bring a suit against the directors to enforce her rights.⁸

By contrast, the system of rights for bonds is largely specified in a contract, the bond indenture.⁹ While that system has superficial simi-

² See, e.g., Del. Code Ann. tit. 8, §§ 141, 211(b) (1974) (providing for election of directors and board management of corporation); see generally Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* (1932) (discussing separation of ownership and control of public corporations); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 *Stan. L. Rev.* 819 (1981) (discussing structure of shareholder rights).

³ See, e.g., Del. Code Ann. tit. 8, § 141(a) (1974) (establishing centralized management).

⁴ See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 *J.L. & Econ.* 395, 400 (1983) (discussing scope of shareholder voting rights in "fundamental" transactions).

⁵ See *Lewis v. Vogelstein*, 699 A.2d 327, 335 (Del. Ch. 1997) (noting that only unanimous shareholder approval insulates transactions constituting waste from shareholder suit); Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 1983 *Am. B. Found. Res. J.* 875, 875 (discussing appraisal remedy exercisable by any holder individually).

⁶ Apart from enforcement rights, individual shareholders typically only have the right to inspect the company's stockholder list and its books and records. Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 *Ariz. L. Rev.* 331, 332-38 (1996).

⁷ Even then, a majority of disinterested shareholders theoretically could block the suit by ratifying an alleged breach of fiduciary duties. See, e.g., Del. Code Ann. tit. 8, § 144(a)(2) (1974) (providing for ratification of transactions where one or more directors' interests conflict with those of corporation).

⁸ See generally Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 *Bus. Law.* 503 (1989) (discussing role of board and shareholder plaintiff in derivative litigation).

⁹ See Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 *Bus. Law.* 413, 413 (1986) ("Corporate law is for stockholders; contract law is for bondholders.").

larities to the system for stocks, the system for bonds differs in fundamental respects. Just like stockholders, bondholders have a collective representative, the "indenture trustee," who is meant to represent their economic interests.¹⁰ However, the structure of the indenture trusteeship diverges in important ways from the structure of the board of directors, not least in that bondholders do not elect the trustee.¹¹ Just as for stockholders, consent by holders of a majority of outstanding bonds is required to amend the indenture.¹² Nonetheless, unlike a stockholder, a bondholder faces substantial barriers to bringing a suit against the company if her rights are violated. Many claims can be brought only by the trustee or by a large group of holders, and then only after they comply with certain other requirements.¹³

This overview raises a fundamental question about the structure of bondholder rights: Whatever the substantive content of these rights, to what extent should any particular right be vested individually or collectively? After a brief summary of bondholder rights in Part I, Part II presents a framework for analyzing this question. This framework will take account of the theoretical advantages and disadvantages of vesting rights individually and collectively as well as of institutional features that bear on the practical significance of these advantages and disadvantages for the U.S. corporate bond market.

Part III argues that the structure of individual and collective bondholder rights established by the typical bond indenture is flawed. The resulting system is inconsistent, unworkable, illogical, and imprudent. The system is inconsistent in that individual bondholders have veto power over the *amendment* of certain rights yet lack the power to *enforce* these rights if they are violated. The system is unworkable in that neither bondholders nor the trustee may be able to assert certain bondholder rights. The system is illogical in that violations of certain rights which affect only individual bondholders, rather than all bondholders as a group, are nevertheless not enforceable individually. Finally, the system is imprudent in that significant enforcement powers are given to the trustee—who has limited incentives to enforce bond-

¹⁰ See Trust Indenture Act, 15 U.S.C. § 77jjj (2002) (requiring appointment of trustee for bonds subject to Act).

¹¹ See Yakov Amihud, Kenneth Garbade & Marcel Kahan, A New Governance Structure for Corporate Bonds, 51 Stan. L. Rev. 447, 473 (1999) (discussing indenture trustee); see also *infra* Part II.D.3.

¹² See Marcel Kahan & Bruce Tuckman, Do Bondholders Lose from Junk Bond Covenant Changes?, 66 J. Bus. 499, 501-02 (1993) (discussing ability of majority of bondholders to approve covenant changes). See generally Victor Brudney, Corporate Bondholders and Debtor Opportunism: In Bad Times and Good, 105 Harv. L. Rev. 1821 (1992) (discussing problems with majority amendments).

¹³ See *infra* Section I.B.2.

holder rights—and substantial limits are placed on enforcement by bondholders themselves. Part III also discusses several reasons that may account for the failure of market forces to correct these defects.

Part IV makes specific recommendations on how to revise the present system of individual and collective rights. Some of these recommendations entail changes in the interpretations courts have accorded to the relevant indenture provisions. Others entail changes in these provisions themselves. The Appendix contains a sample set of provisions that could be inserted in an actual indenture to correct the identified defects.

I

THE STRUCTURE OF BONDHOLDER RIGHTS

With few exceptions, the bond indenture must comply with the provisions in the Trust Indenture Act.¹⁴ The Trust Indenture Act requires that a trustee be appointed as representative of the bondholders and specifies certain ground rules relating to eligibility and disqualification of the trustee.¹⁵ Most aspects of bondholder rights, however—including the substantive content of bondholder rights and most provisions relating to the modification and enforcement of these rights—are not regulated by the Trust Indenture Act and are thus left open to contracting.¹⁶ Though this means that each bond indenture could contain widely varying provisions, many bond provisions are standardized and included in a virtually identical form in each indenture.¹⁷ This Part first presents an overview of the substantive rights of bondholders under the bond indenture and applicable law. It then analyzes in greater detail the provisions bearing on whether these rights are individual or collective.

A. *An Overview of Substantive Bondholder Rights*

The contractual rights of bondholders fall into three categories: financial terms, protective covenants, and miscellaneous provisions.

¹⁴ See Trust Indenture Act, 15 U.S.C. § 77ddd (2002) (specifying exempted securities); see also Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 *Yale L.J.* 232, 250-58 (1987) (examining history of Act).

¹⁵ See Trust Indenture Act, 15 U.S.C. § 77jjj (2002).

¹⁶ See Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 *Nw. U. L. Rev.* 565, 568-69 (1995) (examining extent to which bondholder rights are set by contract).

¹⁷ See *Sharon Steel Corp. v. Chase Manhattan Bank*, 691 F.2d 1039, 1048 (2d Cir. 1982) (noting that certain indenture provisions are often standardized). See generally Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting* (or "The Economics of Boilerplate"), 83 *Va. L. Rev.* 713 (1997) (providing theoretical and empirical analysis of standardized provisions in corporate contracts).

Beyond their contractual rights, bondholders—as creditors and security holders—have rights that arise under statutory and common law.

The most important right of bondholders is the right to receive payments of interest at stated intervals and payment of principal when the bonds mature. In addition, corporate bonds often contain other financial terms, the most important of which are optional redemption rights, sinking funds, put rights, conversion rights, and subordination clauses. Optional redemption (or call) provisions grant the company a right to repay its bonds prior to their maturity.¹⁸ By contrast, sinking fund (or mandatory redemption) provisions obligate the company to repay a specified portion of a bond issue prior to the final maturity of all bonds in that issue.¹⁹ Put rights, in turn, obligate the company, in specified circumstances, to repay the bonds of those bondholders who have elected to exercise their rights.²⁰ Conversion rights permit bondholders to exchange their bonds for other securities, usually common stock, of the issuing company.²¹ Subordination clauses contain an agreement by bondholders to subordinate their right to receive payments from the company to the rights of other specified creditors.²²

Protective covenants are a second important set of bondholder rights. Designed to protect the bondholders' entitlement to receive payments from the company, protective covenants are limitations on the company's conduct of its business. The most common types of protective covenants in publicly issued bonds are debt restrictions, dividend restrictions, asset sale restrictions, investment restrictions, restrictions on mergers, restrictions on liens and sale/leasebacks, and restrictions on transactions with affiliates.²³

¹⁸ See William A. Klein et al., *The Call Provision of Corporate Bonds: A Standard Form in Need of Change*, 18 J. Corp. L. 653, 659-68 (1993) (discussing call provisions).

¹⁹ See Andrew Kalotay & Bruce Tuckman, *Sinking Fund Prepurchases and the Designation Option*, Fin. Mgmt., Winter 1992, at 110 (noting that provisions of typical sinking fund require issuer to retire fixed principal amounts before maturity).

²⁰ See generally Leland Crabbe, *Event Risk: An Analysis of Losses to Bondholders and "Super Poison Put" Bond Covenants*, 46 J. Fin. 689 (1991) (estimating value of superpoison puts); Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. Rev. 931 (1993) (discussing variations in put rights triggered by control changes).

²¹ See generally William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 Wis. L. Rev. 667 (examining conversion rights).

²² See Am. Bar Found., *Commentaries on Indentures* 558-83 (1971) [hereinafter *Commentaries on Indentures*] (explaining concept of subordination); Edward I. Altman & Allan C. Eberhart, *Do Seniority Provisions Protect Bondholders' Investments?*, J. Portfolio Mgmt., Summer 1994, at 67-68 (discussing effect of subordination); see also Upic & Co. v. Kinder-Care Learning Ctrs., Inc., 793 F. Supp. 448, 456-60 (S.D.N.Y. 1992) (discussing validity and operation of subordination clauses in indenture).

²³ See generally Marcel Kahan & Bruce Tuckman, *Private Versus Public Lending: Evidence from Covenants*, in *The Yearbook of Fixed Income Investing* 1995, at 253 (John D.

Beyond financial terms and protective covenants, and beyond the provisions related to amendment and enforcement discussed below, bond indentures provide for a host of other bondholder rights. These provisions relate to matters such as the right to receive a replacement bond certificate should one's certificate get lost or stolen;²⁴ the right to receive notice of a special payment date for the payment of defaulted interest;²⁵ the right to receive notice of a redemption of bonds or of the fact that a put right has become exercisable;²⁶ the right to have the conversion price adjusted in certain events;²⁷ or the right of holders of subordinated bonds to be subrogated to the rights of holders of senior debt once all senior debt is paid in full.²⁸

In addition to these contractual rights, bondholders have rights that result from their status as creditors and securityholders. These include rights under fraudulent conveyance law,²⁹ under provisions of corporation law designed to protect creditors,³⁰ under federal securi-

Finnerty & Martin S. Fridson eds., 1996) (comparing covenants in private and public debt); Kenneth Lehn & Annette Poulsen, *Contractual Resolution of Bondholder-Stockholder Conflicts in Leveraged Buyouts*, 34 J.L. & Econ. 645 (1991) (providing overview of bond covenants); Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. Fin. Econ. 117 (1979) (same).

²⁴ See, e.g., *Commentaries on Indentures*, supra note 22, § 3-6.

²⁵ See, e.g., *id.* § 3-7.

²⁶ See, e.g., *id.* § 11-5.

²⁷ See, e.g., *id.* §§ 13-6, 13-9, 13-10. See generally Marcel Kahan, *Anti-Dilution Provisions in Convertible Securities*, 2 Stan. J.L. Bus. & Fin. 147 (1995) (discussing conversion price adjustments).

²⁸ See, e.g., *Commentaries on Indentures*, supra note 22, at § 14-3; David G. Carlson, *A Theory of Contractual Debt Subordination and Lien Priority*, 38 Vand. L. Rev. 975, 982 (1985) (discussing subrogation).

²⁹ See, e.g., *McMahan & Co. v. Warehouse Entm't Inc.*, 859 F. Supp. 743 (S.D.N.Y. 1994), *aff'd in part and rev'd in part*, 65 F.3d 1044, 1051 (2d Cir. 1995) (discussing bondholder fraudulent conveyance claims); *Victor v. Riklis*, No. 91 Civ. 2897, 1992 U.S. Dist. LEXIS 7025 at *8 (S.D.N.Y. May 15, 1992) (same); *Feldbaum v. McCrory Corp.*, No. 11,866, 1992 Del. Ch. LEXIS 113, at *9 (June 1, 1992) (same); Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 Vand. L. Rev. 829 (1985) (arguing for limits on reach of fraudulent conveyance law in debtor-creditor setting).

³⁰ See *Elliott Assoc. v. Bio-Response, Inc.*, No. 10,624, 1989 Del. Ch. LEXIS 63 at *15 (May 23, 1989) (discussing bondholder claim for appointment of receiver under Delaware corporate statute). See generally Bayless Manning & James J. Hanks, Jr., *Legal Capital* (3d ed. 1990) (discussing legal capital requirements in corporate statutes).

ties laws and state blue-sky laws,³¹ under federal bankruptcy law,³² and under the common law of fraud.³³

B. *Individual and Collective Rights*

There are two dimensions along which one can structure a right as an individual or collective right: the dimension of amendment and the dimension of enforcement. The typical corporate bond indenture sets up an elaborate system under which some substantive rights are individual along both dimensions, others are collective along both dimensions, and yet others are individual for amendment purposes, but collective for enforcement purposes. Although for the most part not prescribed by the Trust Indenture Act, the contractual provisions setting up this scheme tend to be highly standardized. Thus, the system discussed below governs most, if not all, corporate bonds. The following subsections describe in greater detail the scope of individual and collective rights and the extent of the trustee's power, first with respect to an amendment to the bond indenture and the waiver of a default, and then with respect to the enforcement of bondholder rights.

1. *Amendments*

Indentures usually differentiate among three types of amendments, each with its separate approval requirements. First, certain largely nonsubstantive amendments require only the consent of the indenture trustee. These amendments include, for example, amendments to cure an error or inconsistency in the indenture or technical amendments necessitated by a merger.³⁴ Apart from giving consent to these nonsubstantive amendments, the indenture trustee plays no significant role in the amendment process.

A second set of specified provisions can only be amended with the consent of *each* affected holder.³⁵ Such unanimous consent generally is required to reduce or postpone the payment of principal or in-

³¹ See generally *Kusner v. First Pa. Corp.*, 531 F.2d 1234 (3d Cir. 1976) (discussing bondholder federal securities claim); *McMahan*, 859 F. Supp. at 749-50 (same); Louis Loss & Joel Seligman, *Securities Regulation* (3d ed. Supp., Aspen Law & Business 1998) (discussing federal securities and state blue-sky laws).

³² See 11 U.S.C. § 501 (2002).

³³ See, e.g., *Feldbaum*, 1992 Del. Ch. LEXIS 113, at **9-10 (discussing bondholder fraud claim); *Mabon, Nugent & Co. v. Tex. Am. Energy Corp.*, No. 8578, 1988 Del. Ch. LEXIS 11, at **14-15 (Jan. 27, 1988) (same); *Cont'l Ill. Nat'l Bank and Trust Co. of Chi. v. Hunt Int'l Res. Corp.*, Civ. Action No. 7888, 1987 Del. Ch. LEXIS 537, at **13-14 (Feb. 27, 1987) (same).

³⁴ See, e.g., Model Simplified Indenture, 38 Bus. Law. 741, 763 (§ 9.01) (1983).

³⁵ See, e.g., *id.* at 763 (§ 9.02).

terest on the bonds, reduce the redemption premium, or make the bonds payable other than in cash.³⁶ In addition, indentures frequently (though not uniformly) require unanimous consent to change the provisions relating to sinking funds,³⁷ conversion rights,³⁸ guarantees,³⁹ subordination,⁴⁰ and bondholder put rights.⁴¹ When unanimous consent for an amendment of a provision is required, modifications in the provision are usually effectuated through an exchange offer. In the offer, bondholders who consent to the modifications exchange their bonds for new securities with different terms. Bondholders who do not consent retain their bonds. Thus, a unanimous consent requirement does not preclude modifications; it merely assures that these modifications only bind holders who consented to them.

Finally, any other amendment not specifically listed among those that require only the consent of the trustee or those that require the consent of each affected holder requires the consent of holders of a majority (sometimes two-thirds) of the outstanding bonds.⁴² If the requisite majority consents, the amendment binds all bondholders. This category includes most covenant amendments as well as amendments to sinking funds, conversion rights, guarantees, subordination, and bondholder put rights in those indentures where such amendments do not require unanimous consent.⁴³

The provisions with respect to waivers of defaults usually mirror those with respect to amendments, with one exception: the trustee

³⁶ See, e.g., *id.*; see also *Federated Strategic Income Fund v. Mechala Group Jam. Ltd.*, 99 Civ. 10517, 1999 U.S. Dist. LEXIS 16996, at **9-10, 23 (S.D.N.Y. Nov. 1, 1999) (finding that proposed amendments stripping indenture of many restrictive covenants, releasing guarantors, and preceding reorganization resulting in transfer of all assets to subsidiaries and forgiveness of debt impairs right to payment and cannot be effected by majority consent).

³⁷ See, e.g., *Commentaries on Indentures*, *supra* note 22, at 309.

³⁸ See, e.g., *id.*; *Indenture Between Novacare, Inc. and Pittsburgh Nat'l Bank as Tr.*, 5 1/2% Convertible Subordinated Debentures Due 2000, § 902(a) (Jan. 15, 1993), on file with the *New York University Law Review* [hereinafter *Novacare Indenture*].

³⁹ See, e.g., *Indenture Between RJR Holdings Capital Corp., RJR Holdings Corp., RJR Holdings Group, Inc., and RJR Nabisco, Inc. and U.S. Trust Co. of Cal. as Tr.*, 13 1/2% Subordinated Debentures Due 2001, § 10.02(h) (May 22, 1989) [hereinafter *RJR Indenture*] (on file with the *New York University Law Review*).

⁴⁰ See, e.g., *Model Simplified Indenture*, *supra* note 34, at 763 (§ 9.02); *Novacare Indenture*, *supra* note 38, at § 902(a).

⁴¹ See, e.g., *Novacare Indenture*, *supra* note 38, at § 902(a).

⁴² See, e.g., *Model Simplified Indenture*, *supra* note 34, at 763 (§ 9.02). To the extent an indenture imposes a supermajority threshold for amendments, the same threshold usually applies for waivers of default. The threshold, however, does not apply to other provisions, such as the right of holders of a majority of bonds to give directions to the trustee. *Id.* at 757 (§ 6.05). For simplicity, the remainder of this Article omits reference to such supermajority provisions.

⁴³ See *supra* notes 37-41 and accompanying text.

has no power whatsoever to waive defaults.⁴⁴ Otherwise, defaults with respect to provisions that can be amended only with the consent of each affected holder can be waived only with the consent of each affected holder, and defaults with respect to provisions that can be amended by holders of a majority of bonds can be waived by holders of a majority of bonds.⁴⁵

2. *Enforcement*

The structure of bondholder rights with regard to enforcement is significantly more complex than the structure with regard to amendments and waivers. To understand the enforcement scheme, it is important to distinguish between a “default” and an “Event of Default.” A “default” basically includes *any* breach of a provision in the indenture. A breach of the indenture other than a payment default generally becomes an “Event of Default” only if either the trustee or holders of 25% of the bonds give a “Notice of Default” to the company and the company fails to cure the default within a specified time period.⁴⁶

Once an Event of Default occurs, an indenture typically provides for two categories of remedies. First, the bonds can be accelerated: the principal and any accrued interest become immediately payable.⁴⁷ Second, any other remedy to collect the payment of principal and interest or to enforce the performance of any provision in the indenture may be pursued.⁴⁸

To enforce bondholder rights, most indentures provide for an intricate scheme of checks and balances among the trustee, individual bondholders, majority bondholders, and holders of a substantial minority of bonds. First, subject to the powers of holders of a majority of bonds, the trustee has the power to accelerate the bonds or to pursue any other remedy.⁴⁹

Second, any individual bondholder has the right to bring suit for the payment of the principal of and interest on the bonds after the respective due dates of such payments.⁵⁰ This right is unqualified and

⁴⁴ The trustee has some de facto power regarding waiver of defaults through its ability to withhold notice of the default to bondholders if it believes in good faith that doing so is in their best interest. See Trust Indenture Act, 15 U.S.C. § 7700o(b) (2002).

⁴⁵ See, e.g., Commentaries on Indentures, *supra* note 22, at 239.

⁴⁶ See, e.g., Model Simplified Indenture, *supra* note 34, at 756 (§ 6.01) (requiring 25% of bondholders to generate Notice of Default).

⁴⁷ See, e.g., *id.* at 756 (§ 6.02).

⁴⁸ See, e.g., *id.* at 757 (§ 6.03).

⁴⁹ See, e.g., *id.* at 756-57 (§§ 6.02-6.03).

⁵⁰ See, e.g., *id.* at 757 (§ 6.07). This is one of the few provisions that the Trust Indenture Act prescribes. See Trust Indenture Act, 15 U.S.C. § 77ppp(b) (2002).

may thus be exercised independently by any holder regardless of whether the trustee or the other bondholders approve of such suit. Apart from this right to sue, typical bond indentures confer no express enforcement rights on individual bondholders.

Third, holders of 25% of the bonds have the right to accelerate.⁵¹ They also have the right to pursue any other remedy, but only after they comply with the so-called no-action clause. That clause requires that:

- (1) a holder notifies the trustee of a continuing Event of Default;
- (2) holders of at least 25% of the bonds request the trustee to pursue a remedy and offer indemnity, satisfactory to the trustee, against any loss, liability and expense; and
- (3) the trustee fails to take any action for 60 days.⁵²

The scope of the no-action clause is rather broad. It includes suits for breach of an implied covenant of good faith and fair dealing,⁵³ as well as for breach of express rights (including redemption⁵⁴ and sinking fund⁵⁵ provisions, bondholder put rights upon a change in control,⁵⁶ collection of principal after the maturity of bonds has been accelerated,⁵⁷ and miscalculation of the conversion ratio).⁵⁸ As interpreted by courts, the no-action clause also applies to most noncontractual claims (such as fraudulent conveyance claims,⁵⁹ certain fraudulent

⁵¹ See, e.g., Model Simplified Indenture, *supra* note 34, at 756 (§ 6.02).

⁵² See, e.g., *id.* at 757 (§ 6.06).

⁵³ See, e.g., *McMahan & Co. v. Warehouse Entm't Inc.*, 859 F. Supp. 743, 750-51 (S.D.N.Y. 1994), *aff'd in part and rev'd in part*, 65 F.3d 1044 (2d Cir. 1995) (holding claim for breach of good-faith covenant barred by no-action clause); *Feldbaum v. McCrory Corp.*, No. 11,866, 1992 Del. Ch. LEXIS 113, at **28-29 (June 1, 1992) (same).

⁵⁴ See, e.g., *Norte & Co. v. Manor Healthcare Corp.*, No. 6827, 1985 Del. Ch. LEXIS 526, at **15-18 (Nov. 21, 1985) (finding no-action clause bars claim that merger amounted to constructive dividend and constructive redemption of convertible bonds in violation of indenture); *Bank of N.Y. v. Battery Park City Auth.*, 675 N.Y.S.2d 860, 860 (App. Div. 1998) (holding that no-action clause bars suits by former bondholders for wrongful redemption).

⁵⁵ See, e.g., *Sutter v. Hudson Coal Co.*, 21 N.Y.S.2d 40 (App. Div. 1940) (holding that no-action clause bars suit alleging breach of sinking fund provision in indenture).

⁵⁶ See, e.g., *McMahan*, 859 F. Supp. at 748 (holding no-action clause bars suit to compel payment under put provision).

⁵⁷ See *Jackson Nat'l Life Ins. v. Ladish Co.*, No. 92 Civ. 9358, 1993 U.S. Dist. LEXIS 1785, at **12-20 (S.D.N.Y. Feb. 18, 1993) (suggesting that no-action clause applies to suit for payment after acceleration).

⁵⁸ See, e.g., *Feder v. Union Carbide Corp.*, 530 N.Y.S.2d 165, 166 (App. Div. 1988) (finding no-action clause bars suit alleging failure to adjust conversion rights of bond).

⁵⁹ See, e.g., *McMahan*, 859 F. Supp. at 747 (holding that no-action clause applies to fraudulent conveyance claims); *Victor v. Riklis*, 91 Civ. 2897, 1992 U.S. Dist. LEXIS 7025 at **19-20 (S.D.N.Y. May 15, 1992) (denying motion for leave to amend complaint since no-action clause would bar assertion of fraudulent conveyance claim); *Feldbaum v. McCrory Corp.*, No. 11,866, 1992 Del. Ch. LEXIS 113, at **26-28 (June 1, 1992) (holding that no-action clause applies to fraudulent conveyance claims).

misrepresentation claims,⁶⁰ RICO violations,⁶¹ and actions to appoint a receiver⁶² or to impose a constructive trust⁶³; to suits brought by former bondholders;⁶⁴ and to suits against defendants other than the company.⁶⁵ Suits against the trustee itself⁶⁶ and claims under the federal securities laws⁶⁷ have been held not to be subject to the clause.⁶⁸

⁶⁰ See, e.g., *Feldbaum*, 1992 Del. Ch. LEXIS 113, at **29-33 (holding that no-action clause applies to claim that fraudulent misrepresentations induced holders not to seek to enjoin transaction).

⁶¹ See, e.g., *Victor*, 1992 U.S. Dist. LEXIS 7025, at **19-20 (denying motion for leave to amend complaint since no-action clause would bar assertion of RICO claim).

⁶² See, e.g., *Elliott Assoc., L.P. v. Bio-Response, Inc.*, No. 10,624, 1989 Del. Ch. LEXIS 63, at **15-19 (May 23, 1989) (holding claim for appointment of receiver under Delaware corporate statute barred by no-action clause).

⁶³ See, e.g., *Alleco, Inc. v. IBJ Schroeder Bank & Trust Co.*, 745 F. Supp. 1467, 1476 (D. Minn. 1989) (dismissing intervenor claim seeking imposition of constructive trust as barred by no-action clause).

⁶⁴ See, e.g., *Cont'l Cas. Co. v. State of N.Y. Mortgage Agency*, No. 94 Civ. 8408, 1998 U.S. Dist. LEXIS 12784, at **13-14 (S.D.N.Y. Aug. 18, 1998) (holding no-action clause bars suits by former bondholders for wrongful redemption); *Bank of N.Y. v. Battery Park City Auth.*, 675 N.Y.S.2d 860, 860 (App. Div. 1998) (same).

⁶⁵ See, e.g., *Allan v. Moline Plow Co.*, 14 F.2d 912, 916 (8th Cir. 1926) (holding no-action clause barred action against recipient of fraudulent transfer from debtor firm); *McMahan & Co. v. Warehouse Entm't, Inc.*, 859 F. Supp. 743, 746, 749 (S.D.N.Y. 1994), *aff'd in part and rev'd in part*, 65 F.3d 1044 (2d Cir. 1995) (dismissing claims against officers of issuer, underwriter of bonds, and company that acquired issuer as barred by no-action clause); *Feldbaum*, 1992 Del. Ch. LEXIS 113, at *25 (dismissing claims against companies affiliated with issuer that allegedly benefitted from fraud and fraudulent transfers as barred by no-action clause). But see *Williams v. Nat'l Hous. Exch., Inc.*, No. 95-C4243, 1995 U.S. Dist. LEXIS 17290, at * 82 (N.D. Ill. Nov. 16, 1995) (holding that servicer of mortgage established by indenture who allegedly engaged in various fraudulent acts has no standing to invoke no-action clause); *Mabon, Nugent & Co. v. Tex. Am. Energy Corp.*, No. 8578, 1988 Del. Ch. LEXIS 11, at **7-8 (Jan. 27, 1988) (holding that no-action clause and no-recourse clause do not bar noncontractual claims against parent of issuer).

⁶⁶ E.g., *Cruden v. Bank of N.Y.*, 957 F.2d 961, 968 (2d Cir. 1992); *Argonaut P'ship v. Bankers Trust Co.*, No. 96 Civ. 1970, 1997 U.S. Dist. LEXIS 1092 at * 21 (S.D.N.Y. Feb. 4, 1992); *Gould v. J. Henry Schroder Bank & Trust Co.*, 433 N.Y.S.2d 32, 34 (App. Div. 1980). Some older cases also have permitted holders to sue, despite their failure to comply with the no-action clause, where the trustee had a conflict of interest or was for a reason other than a conflict of interest unable to fulfill its duties. E.g., *Borg v. N.Y. Majestic Corp.*, 139 N.Y.S.2d 72, 74, 78 (Sup. Ct. Special Term 1954); *Rabinowitz v. Kaiser-Frazer Corp.*, 111 N.Y.S.2d 539, 545 (Sup. Ct. Special Term 1952); see also *Campbell v. Hudson & Manhattan R.R. Co.*, 102 N.Y.S.2d 878 (App. Div. 1951), *aff'd*, 302 N.Y. 902 (1951) (suggesting that, by remaining passive, trustee renounced its duty to determine what is in best interest of bondholders and holding that no-action clause did not bar bondholder claim against issuer); *Ettlinger v. Persian Rug and Carpet Co.*, 142 N.Y. 189, 191-92 (1894) (no-action clause held not to bar claim where trustee was out of country and insane).

⁶⁷ See *McMahan*, 859 F. Supp. at 750 (holding that no-waiver provisions in the federal securities laws override no-action clause). In addition, courts have permitted suits where a single person held all outstanding bonds. See *Williams v. Nat'l Hous. Exch. Inc.*, 95 Civ. 1594, 1996 U.S. LEXIS 397, at *2 (S.D.N.Y. Jan. 16, 1996). At least some courts have permitted bondholders to assert claims that they have been fraudulently induced to purchase a bond. See *Feldbaum*, 1992 Del. Ch. LEXIS 113, at **29-30 (holding that no-

Finally, holders of a majority of outstanding bonds typically have the right to rescind any acceleration,⁶⁹ to block holders of 25% of the bonds from pursuing any remedy even after they have complied with the no-action clause,⁷⁰ and to give directions to the trustee as to the manner of enforcement.⁷¹ The trustee, however, may refuse to follow any direction that is unduly prejudicial to the rights of other bondholders and may insist on indemnification for all losses and expenses before taking any action.⁷²

3. *Concluding Remarks*

In the typical bond indenture, substantive rights fall into one of three categories. First, the right to receive payment of principal and interest when due, as well as the few noncontractual rights that do not fall under the purview of the no-action clause, are individual for amendment and enforcement purposes: The right cannot be modified without the holder's consent, and any holder can enforce it. Second, other important financial terms—including redemption rights, guarantees, conversion rights, and subordination—are often individual for amendment purposes but collective for enforcement purposes: The right cannot be modified without the holders' consent, but it can be enforced only by the trustee or by holders of 25% of the outstanding

action clause does not bar claim that holder was fraudulently induced to purchase securities, but dismissing suit for failure to state claim).

⁶⁸ Several courts have interpreted no-action clauses that were narrower in scope than the standard clause as permitting holders to bring certain claims. See, e.g., *Kusner v. First Pa. Corp.*, 531 F.2d 1234, 1239 (3d Cir. 1976) (holding that no-action clause that only applied to suits regarding indenture did not bar holder from asserting federal securities fraud claims); *Cruden v. Bank of N.Y.*, No. 85 Civ. 4170, 1990 U.S. Dist. LEXIS 11564, at **35-37 (S.D.N.Y. Sept. 4, 1990), *aff'd in part and rev'd in part*, 957 F.2d 961 (2nd 1992) (holding that no-action clause that only applied to claims made "under and with respect to Indenture" did not bar holder from asserting fraudulent conveyance and RICO claims as these claims are not made under indenture); *Mann v. Oppenheimer & Co.*, No. 7275, 1985 Del. Ch. LEXIS 436, at **7-8 (Apr. 4, 1985) (holding that no-action clause that only applied to suits under indenture did not bar holder from asserting fraud and securities law claims); *Noble v. European Mortgage & Inv. Corp.*, 165 A. 157, 159 (Del. Ch. 1933) (holding that no-action clause limited to actions under or in respect to indenture does not bar suit for appointment of receiver brought under corporate statute). But see *Tietjen v. United Post Offices Corp.*, 167 A. 846, 847 (Del. Ch. 1933) (holding that no-action clause that expressly limited right to seek appointment of receiver bars suit for such appointment under corporate statute); *Greene v. N.Y. United Hotels, Inc.*, 260 N.Y.S. 405, 406-07 (App. Div. 1932) (holding that no-action clause worded to bar "any action, at law or in equity, under or growing out of any provision of this Indenture, or for the enforcement thereof" did bar suit for appointment of receiver).

⁶⁹ See, e.g., Model Simplified Indenture, *supra* note 34, at 756 (§ 6.02).

⁷⁰ See, e.g., *id.* at 757 (§ 6.06(5)).

⁷¹ See Trust Indenture Act, 15 U.S.C. § 77ppp(a) (2002); Model Simplified Indenture, *supra* note 34, at 757 (§ 6.05).

⁷² See, e.g., Model Simplified Indenture, *supra* note 34, at 759 (§ 7.01(e)).

bonds if other requirements are satisfied. Most noncontractual rights, which fall under the purview of the no-action clause, are also in this category. Third, any other contractual rights are collective for amendment and enforcement purposes: They can be modified with the consent of holders of a majority of bonds (or sometimes with the consent of the trustee) and can be enforced only by the trustee or, under some conditions, by holders of 25% of the outstanding bonds.

II

THE TRADEOFF BETWEEN INDIVIDUAL AND COLLECTIVE RIGHTS

This Part presents a framework for analyzing whether a substantive right should be vested in bondholders individually or collectively. Section A discusses the problems of vesting rights individually. Section B then explores the problems of collective rights. Section C analyzes the extent to which the problems associated with collective rights are reduced by the presence of a bondholder representative. Section D examines the institutional setting of the U.S. corporate bond market in order to evaluate the significance of these problems.

A. The Problems with Individual Bondholder Rights

Giving rights to individual bondholders that are not subject to collective control can result in four problems: a “conflict of interest” problem, a “holdout” problem, a “collective action” problem, and a “frivolous suit” problem. The holdout and the collective action problem can arise in the context of amendments. The frivolous suit problem can arise in the context of enforcement. The conflict of interest problem can arise in either context.

1. The “Conflict of Interest” Problem

Individual bondholder rights create a “conflict of interest” problem when some bondholders have an interest in an amendment or in an enforcement action that conflicts with the interests of bondholders at large.⁷³ Such conflicts can arise when a bondholder also owns the company’s common stock or a different issue of bonds and the amendment or enforcement action affects the value of these other securities. Conflicts of interest can also arise when some bondholders have business dealings with the company apart from their ownership of the bonds or when they suffer special tax or regulatory consequences

⁷³ See, e.g., *Feldbaum v. McCrory Corp.*, No. 11,866, 1992 Del. Ch. LEXIS 113, at *20 (June 1, 1992) (noting possibility that small group of bondholders may want to bring suit that most bondholders consider not in their collective interest).

from an action. Finally, some individual bondholders merely may have a different opinion as to what action maximizes the value of the bonds than do bondholders at large.⁷⁴ To the extent that bondholder rights are individual, a bondholder can take an enforcement action opposed by, or block amendments favored by, bondholders at large. Thus, when bondholder interests conflict, making a right individual can enable a minority of bondholders to prevail over the majority.⁷⁵

2. *The "Collective Action" Problem with Respect to Amendments*

If bondholder rights are vested individually, only those bondholders who consent to an amendment would be bound by it. This can result in a significant "collective action" problem.⁷⁶ The more dispersed bondholdings are, the higher the costs of obtaining consent of all bondholders. As a result, the likelihood that a bondholder will fail to render her consent because she never received the consent materials, never read them, or never bothered to return the signed consent form (rather than because she disapproves of the proposed amendment)⁷⁷ increases.⁷⁸ Indeed, given the difficulty of getting unanimous consent, the company may not even try to amend individual rights. Thus, making a right individual increases the costs and reduces the likelihood of amendments that benefit both the company and bondholders.

With respect to amendments, the conflict of interest and the collective action problems arise only to the extent that the rights of bondholders who want to consent to an amendment cannot be severed

⁷⁴ See, e.g., *Federated Strategic Income Fund v. Mechala Group Jam. Ltd.*, No. 99 Civ. 10817, 1999 U.S. Dist. LEXIS 16996, at *8 (S.D.N.Y. Nov. 2, 1999) (reporting that plaintiff opposed restructuring plan approved by holders of 77% of bonds); *Katz v. Oak Indus., Inc.*, 508 A.2d 873 (Del. Ch. 1986) (involving suit by bondholder who opposed restructuring favored by other bondholders).

⁷⁵ Ordinarily, subjecting rights to collective control reduces the conflict of interest problem since holders of a majority of bonds are more likely to reflect the interest of bondholders at large than are holders of a minority. Subjecting rights to collective control, however, increases the conflict of interest problem if a majority of bondholders has an interest that conflicts with the interest of bondholders qua bondholders. See *infra* Section II.B.4 (discussing loss of control problem).

⁷⁶ See Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 Cal. L. Rev. 1071, 1080-81 (1990) (discussing collective action problem in context of shareholder voting); Roe, *supra* note 14, at 236-39 (discussing how collective action problem may impede workouts).

⁷⁷ Failure to consent because a bondholder disapproves of an amendment results in a conflict of interest problem rather than a collective action problem. See *supra* Section II.A.1.

⁷⁸ Due to similar collective action costs, the traditional rule in corporate law that mergers require the consent of all stockholders has been changed and replaced with a majority consent requirement coupled with appraisal rights for dissenting stockholders. Fischel, *supra* note 5, at 877.

easily from the rights of those bondholders who do not consent. To the extent that the rights of bondholders are severable, the company can proceed by changing the right of those holders who consent but not of those who do not consent. Such a change can be effected, for example, by exchanging the bonds of consenting holders for bonds of a different issue containing different rights.

Whether rights are severable depends on whether the company benefits disproportionately if *all* bondholders relinquish a right. Compare, for example, a conversion right to a covenant limiting the amount of dividends a company can pay. A conversion right often will be severable, as the company benefits proportionally as bondholders relinquish the economic value of their conversion options. Rights under a dividend covenant, however, cannot be severed easily. As long as any bondholder enjoys the benefit of the dividend covenant, and the company therefore observes the covenant, the company does not benefit proportionally from other bondholders having relinquished their rights.⁷⁹ More generally, the principal economic terms (i.e., provisions on the payment of principal and interest, conversion rights, call and put provisions, sinking funds, guarantees, and subordination rights) often are severable, while rights under protective covenants usually are not severable.

3. *The "Holdout" Problem*

The holdout problem arises when some bondholders benefit from the agreement by other bondholders to modify their rights. While the holdout problem can arise for any amendment that requires the consent of each affected holder,⁸⁰ its most important instance involves a company in financial distress that seeks financial concessions from its bondholders (such as an exchange of bonds for equity).⁸¹ If the rights

⁷⁹ To be sure, if the company fails to observe the covenant, only the bondholders who retained their rights can seek a remedy. However, if bondholders at large believe that the company will not observe the covenant, and if the remedies in case of breach are more beneficial to the bondholders than what the company offers to induce the amendment, bondholders may engage in strategic holdouts and not consent to the amendment. See *infra* Section II.A.3. In other words, if the company plans to observe the covenant as long as some bondholders retain their rights thereunder, there is no point to go forward with an amendment unless all bondholders consent. If the company plans to breach the covenant even if some bondholders retain their rights thereunder, it often will be beneficial to bondholders not to consent to the amendment and to pursue their remedies after the breach.

⁸⁰ See Fischel, *supra* note 5, at 877.

⁸¹ See Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. Fin. 1189, 1192-99 (1991) (modeling holdout problem in workouts). See generally Lewis S. Peterson, Note, *Who's Being Greedy? A Theoretical and Empirical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers*, 103 Yale L.J. 505 (1993) (same); Roe, *supra* note 14 (discussing holdout problem).

that bondholders are asked to relinquish (i.e., the right to receive payments on the bonds) are vested individually, only those bondholders that agree to participate in the restructuring are bound by its terms (i.e., get their bonds exchanged for equity); others retain their bonds. Even if consummating the restructuring benefits bondholders as a whole, there is a strong incentive for an individual bondholder not to participate in it. Whatever the benefits of the restructuring to bondholders as a whole, an individual bondholder is likely to be best off if sufficient other bondholders participate in the restructuring, but she does not (i.e., if other bondholders exchange their bonds for equity, thereby putting the company on a strong financial footing, but she keeps her bonds). A bondholder may therefore be tempted to "hold out"—refuse to participate in the restructuring—anticipating that her nonparticipation will not doom the whole restructuring. But if many bondholders reason this way, the restructuring will fail. Holding out is not possible when consent by a majority of bondholders to a restructuring binds the nonconsenting minority.⁸²

4. *The "Frivolous Suit" Problem*

A final problem with vesting rights individually is that it increases the potential for nonmeritorious suits against the company.⁸³ Such suits may be brought by plaintiffs' lawyers as class actions with the quiescence of a bondholder with a minimal economic stake in the outcome.⁸⁴ If defending against such a suit imposes major costs on the company, the company may settle the suit⁸⁵ for payment of plaintiffs' attorneys' fees, but no meaningful award to bondholders, even if the company were highly likely to prevail.⁸⁶ Such suits, in the end, benefit

⁸² In the case of collective rights, either the restructuring goes through and all bondholders participate, or the restructuring fails. Given this choice, individual bondholders have an incentive to favor a restructuring that is in their collective interest. A less severe "strategic bargaining" problem remains, however, in that bondholders may oppose a favorable restructuring in order to obtain an even more favorable restructuring.

⁸³ See, e.g., *Williams v. Nat'l. Hous. Exch., Inc.*, No. 95 Civ. 1594, 1996 U.S. Dist. LEXIS 397 at *2 (S.D.N.Y. Jan. 16, 1996) (noting strike-suit problem as justification for no-action clause); *Drage v. Santa Fe Pac. Corp.*, No. 67966, 1995 Ohio App. LEXIS 2833 at *10 (July 3, 1995) (same); Commentaries on Indentures, *supra* note 22, at 232 (same); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2084-88 (1995) (noting problem of frivolous suits in shareholder class action litigation).

⁸⁴ See generally Roberta Romano, *The Shareholder Suit: Litigation Without Foundation*, 7 J.L. Econ. & Org. 55, 55 (1991) (discussing how lawyers initiate shareholder suits).

⁸⁵ See generally David Rosenberg & Steven Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 Int'l Rev. L. & Econ. 3 (1985) (presenting model of settlement of frivolous suits).

⁸⁶ See *id.* at 4 (noting that defendants may be willing to settle even frivolous suits to avoid paying legal defense costs); see also, e.g., John C. Coffee, Jr., *The Unfaithful Cham-*

plaintiffs' lawyers, who pocket generous attorneys' fees, but leave the company worse off.⁸⁷ If only bondholders with significant holdings in a bond issue were permitted to bring suit, the potential for frivolous suits would be reduced because fewer persons would be entitled to bring a suit and because support for a suit by bondholders with a large stake may signal that the suit has merit.⁸⁸

B. *The Problems with Collective Bondholder Rights*

Making a bondholder right collective generates its own set of problems. Not all bondholders will possess the requisite amount or percentage of bonds to block an amendment or take an enforcement action. This inability, in turn, can result in four problems: a "collective action" problem regarding enforcement, an "incentive" problem, a "coercion" problem, and a "loss of control" problem. The coercion problem can arise in the amendment context. The collective action and the incentive problem can arise in the enforcement context. The loss of control problem can arise in either context.

1. *The "Collective Action" Problem with Respect to Enforcement*

The collective action problem with respect to the enforcement of collective bondholder rights has two aspects. First, the need to form a group holding the requisite percentage of bonds to take the enforcement action increases *information costs* because several bondholders must collect and analyze information before action can be taken. Second, it imposes *coordination costs* resulting from the need for bondholders to communicate and agree with each other to take an action.⁸⁹ Moreover, because taking an enforcement action is more costly, bond-

pion: The Plaintiff as Monitor in Shareholder Litigation, 48 Law & Contemp. Probs. 5, 9 (1985) (noting prevalence of settlements in shareholder class action litigation despite high win rate for corporate defendants).

⁸⁷ In the shareholder context, fear of frivolous lawsuits for securities fraud has led Congress to pass the Private Securities Litigation Reform Act of 1995, 15 U.S.C. §§ 77z-1 (2002). See *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 977-79 (9th Cir. 1999) (discussing legislative concern with abusive litigation underpinning Reform Act). Commentators have expressed similar concern about frivolous corporate law suits for breach of fiduciary duties. See, e.g., Romano, *supra* note 84, at 57.

⁸⁸ See Commentaries on Indentures, *supra* note 22, at 232 ("If the suit is worthwhile, 25% of the debenture holders would be willing to join in sponsoring it.").

⁸⁹ It is unclear whether collective rights aggravate or ameliorate the free rider problem, which arises when an enforcement action taken by one bondholder benefits bondholders at large. In that case, a bondholder may fail to take an action for which the benefits exceed the costs because she hopes that some other bondholder will take the action. The free rider problem may be more severe if rights are collective since it must be overcome with respect to several bondholders. On the other hand, if rights are collective, the chances that other bondholders will take the action may be lower, thus reducing the free rider problem.

holders will sometimes fail to take enforcement actions even if doing so were in their interest.

2. *The "Incentive" Problem*

The incentive problem arises when a company has infringed on a bondholder right that, as a practical matter, affects only a subset of all bondholders. For example, a company may fail to make payments to, or send a required notice to, some but not all bondholders. In such cases, bondholders whose rights are not infringed—who received (or were not entitled to receive) the requisite payment or notice—lack proper incentives to enforce the rights of their fellow bondholders. Making a bondholder right subject to collective enforcement generates an incentive problem by making it more difficult for the affected subset of bondholders to vindicate its rights.

3. *The "Coercion" Problem*

The coercion problem can arise when a company offers to pay bondholders for consenting to an amendment.⁹⁰ This way, bondholders can be pressured—"coerced"—to approve an amendment that is not in their interest. Even though all bondholders would want such amendments to fail, any individual bondholder is worse off if the amendment is approved without her consent: She would be bound by the detrimental amendment and would not receive the consent payment. Thus, a bondholder may consent to an adverse amendment proposal, reasoning that consenting is beneficial to her if sufficient other bondholders consent and detrimental only if her consent turns out to be pivotal in passing the amendment. If sufficient bondholders consent, the amendment will pass.⁹¹ Such coercion is not possible

⁹⁰ See *Katz v. Oak Indus., Inc.*, 508 A.2d 873 (Del. Ch. 1986) (holding that coercive structure of consent solicitation did not violate indenture); Brudney, *supra* note 12, at 1853-55 (proposing regulation of bondholder coercion); John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. Chi. L. Rev. 1207, 1227-33, 1243-46 (1991) (same). See generally Peterson, *supra* note 81 (same); Kahan & Tuckman, *supra* note 12 (empirically investigating bondholder coercion). Equivalently, a company may offer to exchange the bonds of holders that execute consents, with the exchange offer conditioned on receiving the requisite consents. This structure, called exit consents, has the same potentially coercive effect as the consent payment described in the text. *Id.* at 502.

⁹¹ The coercion problem is the mirror image of the holdout problem. In the latter, the preferred outcome for any bondholder is for the proposal to pass without that holder's participation, followed by passage with that holder's participation, followed by failure. In the former, the preferred outcome for any bondholder is for the proposal to fail, followed by passage with that holder's participation, followed by passage without that holder's participation.

when holders who do not consent to an amendment are not bound by its terms.

4. *The "Loss-of-Control" Problem*

A final problem with making bondholder rights collective is the loss of control problem. Bondholders may value the ability to control their own destiny with regard to their rights as bondholders.⁹² The loss-of-control problem can thus be viewed as the flipside of the conflict-of-interest problem. Bondholders may value control over certain rights that they received when they purchased the bonds even if, at some point, their fellow bondholders would be willing to amend these rights.⁹³ The loss-of-control problem then arises in instances where the interest of a *minority* of holders to *retain* their contractual rights ought to trump the interest of a *majority* of holders to *modify* the rights of bondholders as a group; the conflict of interest problem arises in instances where the interest of a *majority* of holders to *modify* the rights of bondholders as a group ought to trump the interest of a *minority* of holders to *retain* these rights.

C. *Bondholder Representatives and Collective Rights*

Vesting rights collectively in bondholders does not necessarily require bondholders to form a group to take an action with regard to that right. It is also possible to empower a representative to act on behalf of the bondholders. As mentioned, such a representative conceptually exists in the indenture trustee.⁹⁴ This Section discusses how the presence of a bondholder representative ameliorates some, and generates other, problems with vesting rights collectively.⁹⁵

The main potential benefit of a bondholder representative is that it can reduce the collective action, incentive, and coercion problems. To the extent that the bondholder representative is authorized to, and

⁹² See generally Gerald Dworkin, *The Theory and Practice of Autonomy* 85-112 (1988) (discussing autonomy in terms of governance by proxy and informed consent).

⁹³ For example, bondholders may be concerned that other bondholders have interests, due to ownership of other securities or other dealings with the company, that conflict with their interest as bondholders or they may simply fear that their fellow bondholders have bad judgement. Note that, other than restricting the voting rights of bonds held by the company or an affiliate of the company, bond indentures generally do not limit voting rights due to conflicting interests. See, e.g., *Model Simplified Indenture*, *supra* note 34, at 752-53 (§ 2.09) (excluding only bonds held by issuing company and its affiliates from voting on certain matters).

⁹⁴ See *supra* text accompanying note 10.

⁹⁵ In principle, it is possible to give the bondholder representative either the exclusive power to take action or a power to take action that is concurrent with the power of the requisite number or percentage of bonds. The analysis in this Section is confined to the concurrent power, which is the power granted to the indenture trustee.

does, act for bondholders as a group, the need to assemble a group of bondholders to approve an amendment or to take an enforcement action is obviated. Since the collective action and the coercion problems relate to the transaction costs of forming such groups (respectively, to take an enforcement action or to coordinate the defeat of a detrimental amendment) and the incentive problem relates to the incentives of bondholders to join such groups, the presence of a bondholder representative can ameliorate these problems.⁹⁶

On the other hand, the bondholder representative itself may suffer from conflicts of interest and lack of incentives. The bondholder representative may have interests that are adverse to those of the bondholders, for example, because it owns stock of or is a creditor of the company.⁹⁷ More significantly, the bondholder representative may lack affirmative incentives to take action on behalf of bondholders.⁹⁸ Thus, while the bondholder representative can reduce the collective action, coercion, and incentive problems, the extent of such reduction depends on whether the bondholder representative has the incentives to take proper actions.⁹⁹ Moreover, empowering a bondholder representative to act for bondholders may aggravate the loss-of-control problem.

D. The Institutional Setting

The significance of the problems discussed in the previous Sections and the effect of a bondholder representative depend to a large extent on the institutional setting of the bond market and the institutional arrangements affecting the indenture trustee. This Section assesses six aspects of that institutional setting: the identity of bondholders, the dispersion of bond ownership, the arrangements regarding the indenture trustee, the type of bondholder enforcement actions, the ability to modify bondholder rights under bankruptcy law, and the reputational incentives of the company issuing the bonds.

1. The Identity of Bondholders

The market for corporate bonds is heavily dominated by institutional investors. Flow of Funds accounts prepared by the Federal Re-

⁹⁶ See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976) (discussing agency function of managers and resulting costs).

⁹⁷ See generally Trust Indenture Act, 15 U.S.C. § 77jjj(b) (2002) (describing when conflict of interest results in disqualification of trustee).

⁹⁸ See discussion *infra* Section II.D.3.

⁹⁹ See generally Jensen & Meckling, *supra* note 96, at 305, 308-09 (discussing agency problem of managers).

serve Board indicate that individual investors (households) hold only approximately 15% of the outstanding corporate bonds.¹⁰⁰ Institutional investors, mostly insurance companies and pension funds, account for approximately 64% of the outstanding bonds.¹⁰¹ These holdings patterns differ sharply from the holdings of common stock. Even though holdings of common stock by institutions have increased significantly, individual investors continue to hold 41% of the outstanding corporate equities.¹⁰²

The fact that bond ownership is highly institutional reduces the frivolous-suit problem. Institutional investors—insurance companies, pension funds, banks, mutual funds, and brokers—generally are not thought of as instigating nonmeritorious lawsuits.¹⁰³ And individual ownership of bonds is so sparse that a plaintiffs' lawyer often would have trouble locating a holder willing to serve as named plaintiff.

The high percentage of institutional bond ownership probably also reduces the coercion problem and the collective-action problem. Coordination of institutional investors is likely to be easier than coordination of individual holders, because institutional investors tend to be sophisticated and because they interact with each other in a variety of settings due to their large portfolio of bondholdings. As coordination becomes less costly, the coercion and collective action problems decline in significance.

On the other hand, the fact that most bonds are owned by institutions may well increase the conflict of interest and loss of control problems. Institutional holders are more likely than individuals to hold substantial amounts of the stock or other debt securities of the company, have other business dealings with the company, or be subject to regulations that affect their bond portfolios. As explained, such ownership, dealings, and regulations are significant sources of conflicts of interest among bondholders.

2. *Dispersion of Bondholder Ownership*

Although precise data on holdings of particular bond issues are difficult to obtain, the available evidence indicates that bond ownership is significantly more concentrated than ownership of common stock. In many issues, the five largest holders will own 25% of the

¹⁰⁰ See Bd. of Governors of the Fed. Reserve Sys., *supra* note 1, at 89 tbl. L.212.

¹⁰¹ *Id.*

¹⁰² See *id.* at 90 tbl. L.213.

¹⁰³ See Weiss & Beckerman, *supra* note 83, at 2121-23 (arguing that institutional investors have incentives to discourage strike suits because they hold stakes in companies that are sued and because they will monitor amount of fees plaintiffs' lawyers earn from such suits).

outstanding bonds and twenty to fifty holders will own a majority.¹⁰⁴ The relative concentration of bond holdings indicates that the collective action problem regarding enforcement may not pose insurmountable barriers in the bondholder context. Even if it is not always easy, it is certainly often feasible to assemble a group holding 25% of the outstanding bonds necessary to give a notice of default, accelerate upon an Event of Default, or request the trustee to pursue a remedy. Such a feat would be virtually unimaginable if it took, say, holders of 25% of a company's shares to institute a derivative suit. Moreover, empirical evidence shows that bond ownership is sufficiently concentrated that bondholders cannot be coerced systematically to approve detrimental amendments.¹⁰⁵

Note, however, that the requirement of offering indemnification to the trustee—applicable when holders of a majority of bonds seek to give enforcement directions to the trustee and, under the no-action clause, when holders of 25% of outstanding bonds seek to bring a lawsuit—encumbers bondholder action. Any bondholder legitimately would be reluctant to offer blank-check indemnification—covering all expenses and any liability that may result—to a trustee whose actions she does not control. Assembling a group holding 25% (or a majority) of the company's bonds willing to offer such indemnification may well be difficult.

3. *The Indenture Trustee*

Usually, trust departments of large banks act as indenture trustees. The initial indenture trustee is selected by the company before the bonds are issued.¹⁰⁶ Bond indentures do not provide for an ordinary process, such as periodic elections, to replace the trustee. Rather, the initial trustee usually serves as trustee until the bonds ma-

¹⁰⁴ The most comprehensive source of data on bond ownership is Best's Market Guide Corporate Bonds, which lists bondholdings (sorted by issue) of life insurance companies. See generally A.M. Best Co., Best's Market Guide Corporate Bonds (1995) (last year guide was published). In a sample of twelve bond issues, on average, twenty different life insurance companies held a total of 49% of the outstanding bonds of an issue. (For the purposes of these calculations, affiliated insurance companies were treated as a single company. If affiliated companies are treated as different companies, the average number of insurance company holders increases to thirty.) The five largest holders held on average 31%, and the largest holder held on average 12%, of the outstanding bonds of an issue (median figures are, respectively, 31% and 10%). For seven of the twelve issues, holdings by the largest five holders exceeded 25%; and for two of the twelve issues, such holdings exceeded 50% of the outstanding bonds of an issue.

¹⁰⁵ See Kahan & Tuckman, *supra* note 12, at 513 (noting feasibility of bondholder coordination to defeat adverse proposals).

¹⁰⁶ See Trust Indenture Act, 15 U.S.C. § 77eee(a)(1) (2002) (requiring disclosure of identity of trustee in bond registration statement).

ture. A different trustee is appointed only if the initial trustee resigns or holders of a majority of outstanding bonds remove the indenture trustee.¹⁰⁷ If the trustee resigns or is removed, then, depending on the provisions of the indenture, either the company or the bondholders select a replacement trustee.¹⁰⁸

The term "trustee" evokes strictly enforced fiduciary duties. But an indenture trustee for a corporate bond has quite a different status and serves different functions than, say, a trustee in a traditional trust.¹⁰⁹ Until an Event of Default occurs, the trustee has virtually no obligations towards the bondholders (though it performs administrative tasks for the company, such as mailing notices or selecting bonds for redemption). Most importantly, the trustee has no obligation to give a "notice of default" to the *company*, which could cause the default to ripen into an Event of Default, has no affirmative duty to determine whether a default has occurred,¹¹⁰ and is protected if it relies on certificates supplied by the company stating that no default has occurred.¹¹¹ The only substantive pre-Event of Default obligation of the trustee is to inform bondholders of any default known to the trustee, and even this obligation can be dispensed with if the trustee determines that withholding such notice from the bondholders is in their interest.¹¹² Once an Event of Default has occurred, the trustee's duties increase. Specifically, the trustee must comply with a "prudent person" standard¹¹³ (though the trustee is protected against any "error of judgment made in good faith" unless the trustee was negligent in ascertaining the pertinent facts).¹¹⁴

The trustee typically receives a modest annual fee for its services.¹¹⁵ The trustee also is entitled to be reimbursed for its "reasonable" out-of-pocket expenses, such as payment for outside legal

¹⁰⁷ See, e.g., Model Simplified Indenture, *supra* note 34, at 761 (§ 7.08) (establishing removal rights); Indenture Between the Interlake Corp. and Harris Trust and Sav. Bank, Trs., 12 1/8% Senior Subordinated Debentures Due 2002, § 608(c) (June 18, 1992) (on file with the *New York University Law Review*) (same).

¹⁰⁸ See, e.g., Model Simplified Indenture, *supra* note 34, at 761 (§ 7.08) (specifying that company selects temporary replacement trustee and bondholders may later appoint new permanent trustee or retain company's appointee); RJR Indenture, *supra* note 39, at 46 (§ 7.08) (same).

¹⁰⁹ See, e.g., *Elliott Assocs. v. J. Henry Schroder Bank & Trust Co.*, 655 F. Supp. 1281, 1288-89 (S.D.N.Y. 1987), *aff'd*, 838 F.2d 66 (2d Cir. 1988) (holding that indenture trustee owes no general fiduciary duty to bondholders).

¹¹⁰ See, e.g., Model Simplified Indenture, *supra* note 34, at 796 (§§ 7.01-7.02 n.3).

¹¹¹ Trust Indenture Act, 15 U.S.C. § 7700o(a)(2) (2002).

¹¹² See, e.g., Model Simplified Indenture, *supra* note 34, at 760 (§ 7.05).

¹¹³ Trust Indenture Act, 15 U.S.C. § 7700o(c) (2002).

¹¹⁴ Trust Indenture Act, 15 U.S.C. § 7700o(d)(2) (2002).

¹¹⁵ See Amihud et al., *supra* note 11, at 479 n.111 (stating typical annual fee for an unsecured bond trustee is \$5000-\$10,000).

counsel, by the company as well as from any funds collected for the bondholders.¹¹⁶ The trustee, however, receives no extra compensation for its own efforts if its duties increase as a result of an Event of Default.¹¹⁷

The structure of the trusteeship thus creates few incentives for the trustee to act as an effective representative of the bondholders.¹¹⁸ The trustee has no direct monetary stake in preserving the value of the bonds, and neither the trustee's compensation structure nor its pre-Event of Default duties creates any incentives to do so. Prior to an Event of Default, the trustee's basic incentive is to do nothing, as taking any action entails effort for which the trustee is not compensated. To be sure, after an Event of Default, the liability regime creates incentives to satisfy the "prudent person" standard. It is, however, doubtful whether the fear of liability alone is sufficient to induce the trustee to take optimal actions to represent bondholder interests. Moreover, the heightened post-Event of Default duties create incentives for the trustee to refrain from any action that could trigger an Event of Default, such as investigating suspicions of a default or giving a notice of default to the company.¹¹⁹

4. *Bondholder Enforcement Actions*

Another aspect of the institutional setting relates to whether it is likely that, but for contractual restrictions, many lawsuits brought by bondholders would be frivolous. A plaintiff, of course, incurs costs in bringing a lawsuit and is unlikely to do so unless she believes that she can recover these costs either by prevailing in court or by settling.¹²⁰ If the lawsuit is frivolous, the likelihood of prevailing in court is, by definition, low. Thus, frivolous suits are brought for their settlement value.¹²¹ The defendant, however, presumably is aware that the lawsuit is frivolous and that she is overwhelmingly likely to prevail in

¹¹⁶ See, e.g., Model Simplified Indenture, *supra* note 34, at 760 (§ 7.07).

¹¹⁷ Amihud et al., *supra* note 11, at 473.

¹¹⁸ See *id.* at 469-85 (providing more elaborate discussion of trustee's incentives and their inadequacy).

¹¹⁹ Trustees also have no significant reputational incentives to provide effective bondholder representation. In principle, such reputational incentives could arise if bondholders were willing to pay a premium for bonds issued with a "high-quality" trustee. But since most bonds never default, success in the trustee business turns on the efficient performance of administrative and routine tasks, rather than on the effectiveness in representing bondholders. See *id.* at 484-85.

¹²⁰ Plaintiffs may sometimes bring a lawsuit for noneconomic reasons. This is, however, unlikely to be the case for bondholder lawsuits.

¹²¹ Frivolous suits may also be brought because the plaintiff is mistaken about the likelihood of prevailing at trial, e.g., because she failed to research the law. There is no obvious reason why bondholders are particularly likely to bring such lawsuits.

court. Ordinarily, the prospect of prevailing in court would make the defendant unwilling to settle the lawsuit for a substantial amount. Why, then, would the plaintiff (or her lawyer) believe that the defendant will settle the frivolous suit for enough money to make it worthwhile to initiate the suit?

Commentators have identified two general scenarios in which a plaintiff reasonably may expect to settle a frivolous suit for more than her cost of bringing the suit. First, the defendant may agree to such a settlement if her costs in continuing the lawsuit—especially those incurred in the earlier stages of the lawsuit—substantially exceed plaintiff's costs.¹²² This often will be the case when the defendant incurs substantial costs in complying with discovery requests without imposing equivalent costs on the plaintiff.

Second, agency costs may induce the defendant to agree to such a settlement. In particular, corporate officers who are codefendants in a lawsuit may induce the corporate defendant to settle the lawsuit in order to avoid even a remote possibility of personal liability.¹²³ Moreover, the presence of liability insurance may distort settlements.¹²⁴ The defendant may want to, and pressure her insurer to, agree to a settlement within the insurance limits to avoid both the hassle of a lawsuit and the (albeit small) possibility of losing the lawsuit and becoming liable for an amount beyond the insurance limits.

In the context of bondholder suits, however, neither of these scenarios is likely.¹²⁵ For one, corporate officers rarely would face any personal liability to bondholders. Officers and directors are not signatories to the bond contract in their personal capacity and are thus not personally liable for breaches. Indeed, bond indentures specifically exclude personal liability of officers and directors.¹²⁶ Other noncontractual bondholder suits—such as actions for the appointment of a receiver, the imposition of a constructive trust, or the institution of a

¹²² See Lucian A. Bebchuk, *A New Theory Concerning the Credibility and Success of Threats to Sue*, 25 *J. Legal Stud.* 1, 10-15 (1996) (providing model for when threats to pursue negative expected value suits are credible); Coffee, *supra* note 86, at 17-18 (describing asymmetrical litigation costs in shareholder lawsuits).

¹²³ See Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 *Stan. L. Rev.* 497, 529-31 (1991) (arguing that fear of personal liability by corporate officers and directors induces companies to settle securities fraud lawsuits regardless of merit).

¹²⁴ See Romano, *supra* note 84, at 57-58.

¹²⁵ Note that both these scenarios are present in shareholder securities fraud lawsuits, a type of suit often asserted to have low merit, where officers and directors may be responsible for misrepresentations, damages can be staggering, insurance and indemnification for settlements are usually available, and defendants' costs of complying with discovery requests can be high.

¹²⁶ See, e.g., *Model Simplified Indenture*, *supra* note 34, at 772 (§ 12.08).

bankruptcy filing—inherently are directed against the company or, in the case of fraudulent transfer claims, do not entail liability of corporate officers and directors unless they were the transferee in the allegedly fraudulent transfer.¹²⁷ To be sure, some bondholder actions—for fraud,¹²⁸ securities fraud,¹²⁹ or dividend payments in violation of legal capital rules¹³⁰—can entail personal liability of officers and directors. Interestingly, however, there have been no complaints about frivolous securities fraud suits by bondholders even though bondholders have an individual right to bring such suits. And since legal capital requirements in corporate statutes are widely regarded as ineffective, bondholder suits for violations of these requirements are practically nonexistent.

Moreover, bondholder suits often will not impose disproportionate litigation costs on the company. A large number of contract claims will turn on the proper interpretation of the indenture, where the underlying facts are undisputed or easily discoverable.¹³¹ These claims are likely to impose roughly equivalent costs on plaintiffs and on defendants. And, although noncontractual claims—for securities fraud or fraudulent transfer—often may be more costly to defend than to pursue, it does not appear that they have resulted in a substantial number of frivolous suits, even though bondholders are unrestricted in bringing the former and other creditors are unrestricted in bringing the latter. Thus, the apprehension that an unrestricted right to sue will result in a substantial number of frivolous bondholder lawsuits is not warranted.

5. *Bankruptcy Law*

If a company files a petition for reorganization under Chapter 11 of the Bankruptcy Code,¹³² federal bankruptcy law (rather than the contractual provisions of the bond indenture) governs the ability to

¹²⁷ See, e.g., Uniform Fraudulent Transfer Act § 7 (1984), <http://www.nccusl.org> (providing that creditor remedies include avoidance of transfer).

¹²⁸ See, e.g., *Cont'l Ill. Nat'l Bank and Trust Co. of Chi. v. Hunt Int'l Res. Corp.*, Civ. Action No. 7888, 1987 Del. Ch. LEXIS 537, at *3 (Feb. 27, 1987) (discussing bondholder fraud claim against officers and directors).

¹²⁹ See, e.g., *McMahan & Co. v. Warehouse Entm't, Inc.*, 900 F.2d 576 (2d Cir. 1990) (involving bondholder suit against officers for false statement made by company).

¹³⁰ See, e.g., Del. Code Ann. tit. 8, § 174 (1974) (establishing liability of directors for unlawful dividends).

¹³¹ See, e.g., *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 906 F.2d 884, 891-92 (2d Cir. 1990) (discussing interpretation of negative pledge clause); *Sharon Steel Corp. v. Chase Manhattan Bank*, 691 F.2d 1039, 1048-49 (2d Cir. 1982) (discussing interpretation of sale of "substantially all assets" clause); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 943-46 (5th Cir. 1981) (discussing interpretation of antidilution provisions).

¹³² 11 U.S.C. § 1101 (2001).

modify bondholder rights. Under federal bankruptcy law, even bondholder rights that are individual can be changed in a reorganization if the reorganization plan is approved by two-thirds in holdings and a majority in number of bondholders and other requirements are met.¹³³ Dissenting holders, however, enjoy procedural protections, including the right to a hearing in which they may persuade the court not to confirm a reorganization plan even though the plan received the requisite creditor approval.¹³⁴

The ability to amend individual rights in Chapter 11 by majority consent can and is used to eliminate the holdout problem which otherwise encumbers distressed restructurings. Indeed, lawyers have developed so-called “prepackaged” bankruptcies, in which consents to a reorganization plan are solicited *before* the company files for Chapter 11.¹³⁵ Such prepackaged bankruptcies greatly reduce the time and the concomitant costs a company needs to spend in Chapter 11. The ability of financially distressed companies to circumvent the contractual amendment provisions through a Chapter 11 filing significantly reduces the practical significance of the holdout problem in distressed corporate restructurings.¹³⁶

6. Reputation

Companies arguably have reputational incentives not to abuse bondholders. Companies may have to return to the public bond market to refinance their bonds or to raise additional capital, and companies that have developed a bad reputation may have to pay a higher interest rate when they do so than do companies that have a reputation for treating bondholders fairly. Such reputational incentives can ameliorate imperfections in the enforcement regime to the extent that companies, for reputational reasons, do not violate bondholder rights to start with.

At least with respect to determining whether a bondholder right should be collective or individual, however, reputational incentives are unlikely to be a significant factor. For one, it is likely that the reputational incentives for companies not to abuse bondholders are weak. Many companies that have issued bonds do not need to raise

¹³³ See §§ 1126(c), 1129 (providing conditions for acceptance and confirmation of reorganization plan).

¹³⁴ See § 1128 (providing for confirmation hearing and right to object).

¹³⁵ See generally John McConnell & Henri Servaes, *The Economics of Pre-Packaged Bankruptcy*, in *Corporate Bankruptcy: Economic and Legal Perspectives* 322 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996) (describing prepackaged bankruptcies).

¹³⁶ The holdout problem remains significant in distressed sovereign restructurings, since foreign countries are ineligible for Chapter 11. Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 *UCLA L. Rev.* 59, 67 (2000).

additional capital in the near future and, if they do, can raise capital by issuing equity or by private borrowing rather than by tapping the public bond market. Even if these companies issue public bonds, they can include provisions in the bond indenture that assure bondholders against future abuse.

Moreover, to the extent that companies have incentives not to abuse bondholders, the presence of such incentives is more likely to affect whether a substantive right is granted to bondholders in the first place, rather than whether any right granted is structured as an individual or collective right. The fact that a right has been granted indicates that, despite reputational incentives, violations of that right by the company are a serious concern to bondholders. But once the probability of a violation is sufficiently high to warrant the granting of a right, reputational incentives by the company do not relate much to the factors that determine whether a right should be enforced individually or collectively.¹³⁷

E. Concluding Remarks

The foregoing analysis of individual and collective bondholder rights in the setting of the U.S. corporate bond market yields several conclusions. First, two of the theoretical problems are likely to be of limited significance: the frivolous suit problem and the coercion problem.

Second, the case against individual rights is particularly strong in the context of amendments that do *not* relate to the principal economic terms. For such amendments, requiring the consent of each affected holder could entail severe drawbacks due to conflicts of interest, with a minority of bondholders blocking amendments favored by a majority; due to collective action costs, forcing the company to get approval by each individual holder; and due to the strategic holdout of consents. In contrast, permitting an amendment by majority consent only creates a potential loss of control problem. Consistent with this analysis, most amendments that do *not* relate to principal economic terms can be effected by majority consent.

¹³⁷ The presence of reputational incentives has no evident relationship to conflicts of interest among bondholders as to whether an enforcement action should be taken, to the collective action problem faced by bondholders in taking collective enforcement actions, to the incentive problem of joining in the enforcement of a right when some bondholders are not directly affected by the violation, or to the loss of control problem. Reputational incentives arguably aggravate the frivolous suit problem inasmuch as they reduce the number of actual rights violations and thus raise the *a priori* probability that a claim alleging a violation is not meritorious. More importantly, however, reputational incentives do not generate incentives to initiate frivolous suits, which, for the reasons discussed in Sections II.D.1 and II.D.4, are low.

Third, it is plausible to vest rights that relate to the amendment of principal economic terms either collectively or individually. For such amendments, the conflict of interest problem and the collective action problem do not constitute strong reasons to make rights collective, as the rights of bondholders who consent to an amendment often can be severed from the rights of bondholders who do not consent. The holdout problem in the context of distressed restructurings can be overcome by filing a bankruptcy petition. On the other hand, the loss of control problem can justify restrictions on the ability of a majority of holders to bind a minority to changes in the principal economic terms. Again, the analysis is consistent with the present treatment of such amendments, where, depending on the bond issue, certain principal economic terms are vested individually and others are vested collectively.¹³⁸

Fourth, given the setup of the trusteeship, the trustee should not play a significant role in approving amendments. Again, the present structure, in which the trustee's role is mostly ministerial, is sensible. Overall, therefore, the typical structure of individual and collective rights in the amendment context accords with this analysis.

Fifth, whatever the proper balance of individual and collective bondholder rights with respect to amendment, the balance with respect to enforcement should be tilted more towards individual rights. The holdout problem, which favors collective rights in the amendment context, is not present in the enforcement context. The collective action problem, which again favors collective rights in the amendment context, now points towards enabling individual holders or small groups of holders to take enforcement action. And the incentive problem, which is irrelevant in the amendment context, also suggests that rights should be more individual in the enforcement context.

Indeed, some features of the enforcement system accord with this analysis: Even when enforcement rights are collective, enforcement can be initiated either by the trustee or by a large minority group of bondholders, unless a majority of bondholders affirmatively decides to block enforcement. In other respects, however, the enforcement structure does not accord with the analysis; bondholder rights in the enforcement context are collective to a greater extent than in the amendment context; the enforcement regime does not take account of the fact that some bondholders may lack incentives to pursue violations of other holders' rights; and the enforcement regime imposes

¹³⁸ The Trust Indenture Act requires that the right to receive payment of interest and principal at maturity be vested individually. Trust Indenture Act, 15 U.S.C. § 77ppp(b). However, as discussed in Section I.B.1, *supra*, bond indentures regularly go beyond the strictures of the Trust Indenture Act.

unreasonable barriers to the collective enforcement by bondholders. The next Part will analyze these deficiencies in greater detail.

III

FLAWS IN THE PRESENT STRUCTURE OF INDIVIDUAL AND COLLECTIVE RIGHTS

The structure of individual and collective enforcement rights established by typical bond indenture provisions and courts' interpretations of these provisions is flawed in four ways. First, certain substantive rights are vested in the individual bondholder with respect to amendment—they cannot be modified by majority vote. But they vest collectively with respect to enforcement—that is, enforcement of these rights is subject to the no-action clause and to control by the majority of bondholders. This differential treatment is inconsistent with the analysis in Part II, which suggested that individual bondholder powers with respect to enforcement should be the same as, or stronger than, the powers with respect to amendment.

Second, the broad interpretation courts have given to the no-action clause makes the enforcement system for some claims unworkable. Courts have held that holders must comply with the no-action clause to vindicate most noncontractual rights. But a violation of these rights cannot result in an "Event of Default" and compliance with the no-action clause is therefore impossible.¹³⁹ Moreover, courts have denied the trustee standing to assert noncontractual rights of bondholders.¹⁴⁰ As a result, it would appear that neither bondholders nor the trustee can bring such noncontractual claims.

Third, indenture provisions delineating what types of claims are subject to collective enforcement are illogical. Indentures subject claims to collective enforcement even if they are held only by a few bondholders, and other bondholders accordingly lack proper incentives to join in the pursuit of these claims.

Fourth, the present structure of individual and collective enforcement rights is imprudent. The system places excessive reliance on enforcement by the trustee—a party that is not well suited to play the role accorded to it—and excessive limits on enforcement by bondholders.

A. The Present System Is Inconsistent

Presently, certain substantive rights are individual for purposes of amendment but collective for purposes of enforcement. This renders

¹³⁹ See *infra* Section III.B.

¹⁴⁰ See *infra* Section III.B.

the structure of rights internally inconsistent because a bondholder can be denied the ability to enforce a right that cannot be amended without her consent. Moreover, it renders the structure inconsistent with the preceding analysis, which showed that the scope of individual rights in the enforcement context should be the same as, or wider than, their scope in the amendment context.¹⁴¹

With respect to enforcement, the no-action clause requires bondholders to comply with its requirements before they can “pursue a remedy with respect to [the] Indenture or the [Bonds].”¹⁴² The only exception for which bond indentures provide is the individual right of holders to bring a “suit for the enforcement of [payment of principal and interest] on or after [the] respective [due] dates” expressed in the bond.¹⁴³ The no-action clause severely limits the ability of individual bondholders to enforce their rights. If the trustee is not on its own inclined to take enforcement measures, a bondholder would have to assemble a group holding at least 25% of the principal amount of bonds, request the trustee to pursue a remedy, and offer to the trustee indemnity against any loss, liability, or expense. Even if this is done—or, for that matter, even if the trustee is willing to bring the claim—holders of a majority of the principal amount of bonds may direct the trustee not to pursue the claim. If so, the claim cannot be brought.¹⁴⁴

With respect to amendment, however, indenture provisions often vest a broader set of rights in individual bondholders, including, in addition to the right to receive payments of interest and principal, conversion rights, guarantees, subordination, redemption and sinking funds, and put rights.¹⁴⁵ Moreover, there is substantially more variation in the indenture clauses dealing with amendment than in the no-action clauses, suggesting that the former reflect a more considered judgment as to which rights should be individual and collective, while the latter are treated as “boilerplate.”¹⁴⁶

The inability by holders of a majority of bonds to amend a substantive provision clashes directly with the power of the holders of a majority of bonds by affirmative action. It also clashes with the power of the trustee and holders of 75% of the bonds, by passivity, to pre-

¹⁴¹ See *infra* Section II.E.

¹⁴² See, e.g., Model Simplified Indenture, *supra* note 34, at 757 (§ 6.06).

¹⁴³ *Id.* at 757 (§ 6.07); see also Trust Indenture Act, 15 U.S.C. § 77ppp(b) (2002).

¹⁴⁴ See, e.g., Model Simplified Indenture, *supra* note 34, at 757 (§ 6.05). The trustee is not bound, however, to follow the majority's instruction if doing so is “unduly prejudicial to the rights of other security holders.” *Id.*

¹⁴⁵ See *supra* Section I.A.

¹⁴⁶ See *Sharon Steel Corp. v. Chase Manhattan Bank*, 691 F.2d 1039, 1048 (2d Cir. 1982) (finding that boilerplate indenture provisions do not reflect individualized intent of contracting parties).

vent enforcement of that provision if it is violated. In effect, although some substantive rights are not technically amendable, they are de facto waivable because these groups can prevent their enforcement. As a result, the structure of individual and collective rights is internally inconsistent.

In addition, the arguments for constraining the power of individual bondholders are stronger in the context of amendments than in the context of enforcement. Specifically, the collective action problem supports individual rights in the enforcement context but points to collective rights in the amendment context. Similarly, the holdout problem reduces the desirable scope of individual rights in the amendment context, while the incentive problem increases that scope in the enforcement context. The present system of rights, which is more individual in the amendment context than in the enforcement context, is thus inconsistent with the analytical framework for structuring individual and collective rights.¹⁴⁷

B. The Present System Is Unworkable

The no-action clause, as construed by the courts, applies to a wide variety of claims. Some of these claims are contractual; others are rooted in statutory or common law, such as fraudulent conveyance law, state corporation law, and the law of fraud.¹⁴⁸ Some are asserted against the company that issued the bonds; others are asserted against third parties, such as the underwriter or a parent of the issuer.¹⁴⁹

The underlying premise of subjecting claims to the no-action clause—and thus of relegating their enforcement to bondholders collectively and to the trustee as their representative—is that collective enforcement of the claims is at least theoretically possible. This in turn entails two conditions. First, bondholders must be able to satisfy the requirements of the no-action clause. Second, the trustee must be able to assert the claims on behalf of the bondholders. With regard to

¹⁴⁷ The contexts of amendment and enforcement also differ in the significance of the role accorded to the trustee. The trustee plays no significant role in the context of amendment. However, it has substantial discretion in whether to enforce the indenture. This treatment of the trustee, however, is not inconsistent. Both for purposes of amendment and enforcement, the primary power to act lies with holders of a majority of bonds, who can approve most amendments and may ordinarily instruct the trustee on what enforcement actions to take. The role of the trustee only varies if holders of a majority of bonds do not act affirmatively. If holders do not act affirmatively, the trustee has residual power to enforce the indenture but no residual power to amend the indenture. This difference is due to the fact that bondholders are more inclined to give the trustee residual power to vindicate bondholder rights (by enforcing the indenture) than they are to give the trustee residual power to lessen bondholder rights (by approving substantive amendments).

¹⁴⁸ See *supra* notes 59-63.

¹⁴⁹ See *supra* note 65.

noncontractual claims and claims against third parties, however, neither of these conditions is satisfied, rendering the collective enforcement mechanism envisioned by the no-action clause unworkable.

Recall the initial requirement imposed by the no-action clause: Holders must notify the trustee of a continuing Event of Default. Event of Default is a term defined in the indenture and is limited (with some exceptions not relevant in this context)¹⁵⁰ to a failure by the company to comply with its contractual obligations.¹⁵¹ In other words, only a breach of contract can result in an Event of Default; a violation of a noncontractual entitlement of bondholders—by the company or by a third party—does not result in an Event of Default. Since bond indentures do not incorporate into themselves the provisions of fraudulent conveyance law, state corporation law, blue-sky law, or the law of fraud, violations of these laws do not result in an Event of Default. Similarly, violations of bondholder rights by persons other than the company generally will not result in a breach of the bond indenture, since these persons are not party to the indenture. With respect to these violations, it is therefore impossible for bondholders to give the trustee the notice required by the no-action clause. Nevertheless, courts have on multiple occasions dismissed bondholder claims, asserting such violations for failure to comply with the no-action clause.¹⁵²

Moreover, the authority of the trustee to pursue noncontractual claims and claims against third parties on behalf of bondholders is questionable. The trustee is entitled to exercise the powers bestowed upon it by the indenture. These powers typically include the right to accelerate the bonds if an Event of Default has occurred¹⁵³ and the right to pursue any other remedy “to collect the payment of principal or interest . . . or to enforce the performance of any provision” of the bonds or the indenture if an Event of Default has occurred.¹⁵⁴ The trustee’s express authorization to act is thus contingent on the occurrence of an Event of Default and is limited to the collection of money owed to the bondholders and enforcement of the performance of the indenture and the bonds.

¹⁵⁰ These exceptions relate to bankruptcy or similar filings and sometimes to cross-defaults. See, e.g., Model Simplified Indenture, *supra* note 34, at 756 (§ 6.01).

¹⁵¹ See, e.g., *id.* To the extent that actions by persons other than the company, such as guarantors, can result in an Event of Default, and such persons are parties to the indenture, the no-action clause is properly interpreted to treat suits against such parties as equivalent to suits against the company.

¹⁵² See *supra* notes 59-65.

¹⁵³ See, e.g., Model Simplified Indenture, *supra* note 34, at 756 (§ 6.02).

¹⁵⁴ See, e.g., *id.* at 757 (§ 6.03). In addition, the trustee has the power to file papers and documents in a bankruptcy or similar proceeding. See, e.g., *id.* at 758 (§ 6.09).

When courts explicitly have considered whether the trustee has standing to bring a suit, they have looked to the express powers conferred to the trustee by the indenture. Accordingly, courts have denied the trustee standing to bring securities fraud claims,¹⁵⁵ claims for the recovery of losses arising from the purchase of the bonds,¹⁵⁶ and negligence claims against an auditor,¹⁵⁷ on the grounds that no Event of Default occurred or that the claims were not for collection of money owed or the enforcement of contractual provisions.

In sum, if a claim is covered by the no-action clause, there are two avenues through which it can be asserted: by bondholders, after compliance with the clause, or by the trustee. With regard to noncontractual claims or claims against third parties, the first of these avenues is foreclosed since no Event of Default of which holders can notify the trustee has occurred. The second avenue is foreclosed since the trustee lacks standing to assert noncontractual claims or claims against third parties. Inasmuch as courts have interpreted the no-action clause to encompass noncontractual claims and claims against third parties, the enforcement mechanism envisioned by the clause is unworkable.¹⁵⁸

C. The Present System Is Illogical

It is sensible to impose a threshold requirement before bondholders can bring, or direct the trustee to bring, an enforcement action. The relevant threshold requirements include the 25% threshold for giving notice of a default to the company, the 25% threshold for requesting that the trustee bring a suit, and the majority threshold for giving directions to the trustee. If information and coordination costs are modest, properly set threshold requirements can help assure that actions detrimental to bondholders at large are not brought, without

¹⁵⁵ See *United Bank of Ariz. v. Sun Mesa Corp.*, 119 F.R.D. 430, 431 (D. Ariz. 1988).

¹⁵⁶ See *Nat'l City Bank v. Coopers & Lybrand*, 409 N.W.2d 862, 864 (Minn. Ct. App. 1987).

¹⁵⁷ See *Cent. Bank of Denver v. Deloitte & Touche*, 928 P.2d 754, 755 (Colo. Ct. App. 1996).

¹⁵⁸ Arguably, the bond indenture is intentionally designed to prevent the assertion of statutory claims which impose inefficient terms on the company-bondholder relationship. See, e.g., *Baird & Jackson*, *supra* note 29, at 854-55 (arguing that fraudulent conveyance law, as interpreted by courts, is inefficient). If that were the case, however, one would expect to find explicit indenture clauses waiving statutory rights or limiting the right of bondholders or the trustee to assert such rights, rather than general clauses which leave it to judicial interpretation to determine whether they cover statutory claims. Moreover, one would expect that the prospectus for the bonds alerts bondholders that the no-action clause is meant to (and will) result in the de facto waiver of statutory rights, but prospectuses do not contain such warnings. For these reasons, it is unlikely that the bond indenture is intentionally designed to prevent the assertion of statutory claims.

imposing overwhelming barriers on the ability of bondholders to bring beneficial actions.

This reasoning, however, limits the logical scope of threshold requirements to those instances where the company has violated the rights of all bondholders. Even though bond indentures, on their face, confer identical rights on all bondholders, many instances can arise where only the rights of a subset of holders have been violated. First, even when all bondholders enjoy the same rights, it is possible for the company to violate only the rights of some. For example, the company can fail to give a notice or make a payment (that should be given or made to all bondholders) only to a subset of holders. Second, some bondholder rights take the form of entitlements that only a subset of holders may want or need to exercise. These rights include, for example, conversion and put rights or the right to receive a replacement certificate should one's get lost or stolen. If only some bondholders want or need to exercise these rights at any point in time, the company would, by failing to comply with the indenture, directly affect only a subset of holders. Third, provisions such as those relating to sinking funds and partial redemptions confer rights (to receive notice and payment) on a randomly selected group of bondholders.¹⁵⁹ Breaching these rights thus affects only a subset of holders.

When a company has taken an action that infringes only on the rights of a subset of bondholders—possibly a subset that holds fewer bonds than needed to satisfy the applicable threshold requirement—uniform thresholds no longer make sense. As only a subset of holders is affected directly by the company's action, the threshold requirement becomes harder to meet. If the threshold—say, holders of 25% of the outstanding bonds—was reasonable assuming that the rights of all bondholders were affected, it can become oppressive if the affected subset holds only 40% or 20% of the outstanding bonds.

To be sure, bondholders that are not affected directly may, out of solidarity or to preempt future violations that affect them directly, help the affected subset to meet the threshold requirements. Clearly, however, their incentives to do so are lower than they would be if their own rights had been violated. Indeed, unaffected bondholders may have affirmative incentives not to help the affected subset, for example, because providing a remedy to the affected subset would reduce the company's ability to make payments to the unaffected holders. Even if unaffected bondholders have no conflicting incentives,

¹⁵⁹ See, e.g., Model Simplified Indenture, *supra* note 34, at 754 (§§ 3.02, 3.03) (providing for random selection of securities to be redeemed and for notice to holders of redeemed securities).

collective action costs would increase. For one, it is harder for holders that are directly affected by the violation to convince unaffected holders that they have a valid claim than it would be if all holders had such a claim, thus raising information costs. Second, unaffected bondholders will likely be reluctant to offer indemnity to the trustee, as required by the no-action clause, merely to help vindicate the rights of others. The present system, which imposes uniform threshold requirements whether or not all bondholders are affected by a violation, is thus illogical.

D. The Present System Is Imprudent

A final problem with the present system lies in the excessive reliance it places on the indenture trustee. Apart from possible liability to bondholders for failure to comply with the "reasonable person" standard—which applies only after an Event of Default has occurred—the trustee has little incentive to take any affirmative action. To the contrary, as discussed, the trustee has incentives to prevent or delay the occurrence of an Event of Default.¹⁶⁰

If the trustee does not act, bondholders ordinarily must form a group holding at least 25% of the outstanding bonds to give a default notice to the company and thereby (after passage of a cure period) generate an Event of Default. If the trustee still does not act, bondholders only can take an enforcement action (unless an exception to the no-action clause applies) if they re-form a group holding at least 25% of the outstanding bonds and offer indemnity to the trustee. Even then, the group would have to wait for sixty days, a delay that (coming on top of the cure period and other delays) may well prejudice their ability to get an effective remedy.

Since corporate bond ownership is significantly less dispersed than stock ownership, forming a group of bondholders that holds at least 25% of the outstanding bonds rarely will be overwhelming. But neither will it always be trivial. Thus, the no-action clause may well inhibit bondholders from bringing meritorious actions. Of course, when collective rights are to be enforced, setting the proper threshold level involves a delicate balance between conflict of interest, collective action, and other problems, and the analysis in this Article does not enable one to conclude that the 25% threshold is definitively too high. Nevertheless, until the institutional structure of the trusteeship is modified significantly,¹⁶¹ alternative measures should be explored by

¹⁶⁰ See *supra* text accompanying note 119.

¹⁶¹ See Amihud et al., *supra* note 11, at 469-85 (proposing to revise indentures to create "supertrustee").

which the excessive reliance on the trustee can be reduced without significantly increasing the conflict of interest problem. Part IV will propose such measures.

E. The Need for Contractual Reform

The preceding Sections have identified four ways in which the present contractual arrangement of individual and collective bondholder rights is flawed. This raises the question of why flawed contractual terms persist in corporate bond indentures. If companies and bondholders prefer different terms, they are free to adopt them. Does the fact that they have not done so show that the argument that the present terms are flawed is mistaken?

To weak contractarians, the answer to this question is a self-evident “no.” Although parties try to devise contractual terms that work, actual contracts contain mistakes and imperfections.¹⁶² It is therefore not surprising that improvements to actual contract terms are possible. Whether a particular proposal constitutes an improvement is to be judged “on the merits”—by arguments over what is wrong with an actual term and how the proposed term would fix it—but no particular deference should be given to the actual term just because it is the term parties have used in the past. No more needs to be said to these weak contractarians.

To strong contractarians, the answer to this question is a self-evident “yes.” Like the famed Chicago economist who refuses to pick up a twenty-dollar bill from the floor because, if one really lay on the floor, someone would have picked it up already,¹⁶³ strong contractarians believe that contractual freedom results in terms that are optimal to the contracting parties (or at least in terms that are so nearly optimal that any remaining inefficiencies are trivial).¹⁶⁴ To someone who believes that freely entered into contractual arrangements can never be improved, a paper arguing that these arrangements should be revised holds little interest.

The remainder of this Section is therefore addressed to middle-of-the-roads: persons who believe that actual terms generally tend to be efficient but admit that market imperfections sometimes result

¹⁶² See, e.g., John C. Coates IV, Explaining Variation in Takeover Defenses: Blame the Lawyers, 89 Cal. L. Rev. 1301, 1301-05 (2001) (attributing lack of antitakeover provision in some IPO charters to flawed legal advice).

¹⁶³ Claire A. Hill, Why Financial Appearances Might Matter: An Explanation for “Dirty Pooling” and Some Other Types of Financial Cosmetics, 22 Del. J. Corp. L. 141, 186 n.156 (1997).

¹⁶⁴ See, e.g., Dennis W. Carlton & Daniel R. Fischel, The Regulation of Insider Trading, 35 Stan. L. Rev. 857, 866 (1983) (arguing that failure of companies to prohibit insider trading shows that insider trading should be permitted).

in inefficient terms. I first present several reasons why the reforms I propose are consistent with a moderate contractarian approach. I then assess the significance of the proposed reforms.

1. The Distinction Between Contractual and Legal Reform

Most fundamentally, the reform proposals presented in this Article are consistent with a moderate contractarian approach because they relate to “contractual” rather than “legal” reforms. I do not suggest enactment of a law that imposes any amendment and enforcement provisions. Rather, the bulk of my proposal seeks to modify the contractual arrangements that parties decide to include in the bond indenture.

Unlike proposals for legal reform, proposals for contractual reform do not need to be justified by particular market failures. In a world of imperfect information, there is always the possibility to discern value-enhancing innovations. The mere fact that these innovations could have been discovered earlier does not prove that they are not value-enhancing—otherwise, most scholarship would be pointless.¹⁶⁵ The fact that bond contracts are written in a certain way is not proof that they cannot be improved substantially.

Indeed, except under perfect information, even strong contractarianism does not imply that no value-increasing innovations can be made; it merely implies that parties make optimal investment in *searching* for innovations. Such a search will be directed predominantly to areas where the *ex ante* likelihood of coming up with an innovation is high. When deciding in what areas to conduct a search, rational parties can be affected by informational cascades.¹⁶⁶ Once a contractual term is widely employed, parties rationally may believe that others have studied the term and concluded that it operates well. This may lead them to set aside their own view that the term is deficient and could be improved. That such an inference is rational, however, does not mean that it is always correct: Even widely employed contractual terms sometimes will be deficient, though less often than idiosyncratic terms. As a result, even in well functioning markets,

¹⁶⁵ For example, generations of economists preceding Coase could have arrived at the insight that the initial allocation of property rights does not affect social wealth if property owners can sell their property to higher-valuing users, but the fact that they did not does not render the Coase Theorem either incorrect or unimportant. See generally Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1 (1959).

¹⁶⁶ For models of such informational cascades, see Abhijit V. Banerjee, *A Simple Model of Herd Behavior*, 107 Q.J. Econ. 797 (1992); Sushil Bikchandani et al., *A Theory of Fads, Fashion, Custom, and Cultural Change as Informational Cascades*, 100 J. Pol. Econ. 992 (1992).

once a term becomes standardized, its deficiencies may well remain uncorrected for long periods of time.¹⁶⁷

2. *Market Imperfections*

Beyond imperfect information, specific market failures will cause the drafters to search for, and incorporate, value-enhancing innovations in corporate bonds to a lesser extent than is socially optimal. These market failures include innovation externalities, network externalities, agency problems, and cognitive biases. As a result of these market failures, corporate bonds represent a particularly fruitful area for contractual imperfections.

(a) *Innovation Externalities*

Innovations in contractual provisions in bonds entail a substantial innovation externality.¹⁶⁸ The development of novel provisions is costly: Lawyers and other professionals have to detect a deficiency in an existing term, devise a suitable way to correct it, and market the innovation to issuers and investors. The value of such an innovation, however, does not lie principally in the improvement in the first bond issue that includes the innovative term. Rather, it includes the potential value enhancement in many future bond issues that make use of the innovative term.

But while the originators of an innovation bear the bulk of these innovation costs, the gains from an innovation must be shared with other companies and investment banks that had no role in originating it. Bond terms cannot be protected effectively by patenting them, copyrighting them, or keeping them confidential. Thus, once they are included in the first indenture, others are free to appropriate them. As a result, drafters have socially suboptimal incentives to develop and incorporate innovations in bond indentures.

(b) *Network Externalities*

As Mike Klausner and I have argued, the contractual terms of corporate bonds are network products, the value of which depends to some extent on how many other bonds employ the same term.¹⁶⁹ Most importantly, commonly used terms will be familiar to lawyers, other professionals, and investors. As a result, it is easier to obtain

¹⁶⁷ See Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 Wash. U. L. Q. 347, 353-58 (1996) (arguing that informational cascades may contribute to deficiencies in standard terms).

¹⁶⁸ Kahan, *supra* note 16, at 596-600 (discussing externalities generated by contractual provisions).

¹⁶⁹ See Kahan & Klausner, *supra* note 17, at 725.

legal advice about the meaning and to assess the value of securities containing such terms than it is with respect to securities containing rarely used terms.¹⁷⁰

These network externalities can cause the wrong term to become standardized in bond contracts. Consider, for example, a standardized clause in a bond, such as the present no-action clause. Assume that an alternate clause would be superior to the present clause if adopted by a substantial portion of issuers. However, due to network effects, the alternate clause would be inferior if contained in only a few indentures. Companies may be reluctant to be among the first to issue bonds containing the alternate clause for two reasons. First, early adopters will be uncertain whether other companies will in fact issue bonds containing the alternate clause in the future. Secondly, early adopters of the alternate term will obtain lower network benefits than later adopters because these benefits will only materialize once the term is adopted by others. The presence of network externalities therefore creates the possibility that standardized contract terms are socially suboptimal.¹⁷¹

(c) Agency Problems and Cognitive Biases

Agency problems and behavioral biases also may contribute to the persistence of suboptimal standardized terms. Bond indentures are drafted by corporate lawyers who work for the company that issues the bonds or for the underwriter. Drawing on economic models, Mike Klausner and I have argued that these lawyers may well face an asymmetrical payoff structure with respect to changes in standardized terms: Their reputation suffers more if the change turns out, for some reason, to reduce value than it is increased if the change, as expected, increases value.¹⁷² As observed by John Maynard Keynes: "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."¹⁷³

In addition, experimental research in behavioral psychology has documented several phenomena that may lead to a reluctance to diverge from standardized terms.¹⁷⁴ Status quo bias (a preference for the present state) may entrench standard terms to the extent that parties who negotiate a contract regard such terms as the status quo.

¹⁷⁰ Id. at 725-27.

¹⁷¹ Id. at 733-35.

¹⁷² Kahan & Klausner, *supra* note 167, at 353-58.

¹⁷³ John Maynard Keynes, *The General Theory of Employment, Interest and Money* 158 (1936).

¹⁷⁴ See Kahan & Klausner, *supra* note 167, at 359-65, for a more detailed discussion of these biases and the extent to which they may contribute to a reluctance to depart from standard terms.

Since bond indentures are drafted by marking up a "precedent" (a bond indenture drafted for a prior deal), it is plausible that this precedent is viewed as the status quo, especially if it contains standard terms. For similar reasons, anchoring bias (a reluctance to depart from an initial reference point, even if it is arbitrary) may lead parties to make insufficient changes when marking up precedents. Finally, conformity bias (a preference to conform one's individual judgement to a group judgment) could lead to the enshrinement of standard terms to the extent such terms are perceived as reflecting the judgment of lawyers on how indentures ought to be drafted.

3. *How Significant Are the Flaws?*

Even taking into account that contractual terms are never perfect and that particular market failures may result in insufficient innovation in standard terms, it is likely that flaws that regularly result in substantial problems are, over time, corrected. While I have argued that the present contractual arrangement of individual and collective bondholder rights is flawed, these flaws—*within the context of a single bond issue*—are of limited significance. Nevertheless, *when viewed from the perspective of the bond market as a whole*, these flaws are rather substantial.

As a starting point in assessing the quantitative significance of the imperfections in the design of individual and collective rights, one can consider how much a company could save in interest if these flaws were corrected and the market fully incorporated these corrections in the market price of the bonds. Bond interest rates are measured in basis points, with each basis point constituting one one-hundredth of a percentage point. As a plausible range of the quantitative significance of the flaws, I propose one-half to one-tenth of a basis point. That is, if the company made somewhere between two and ten changes in the bond indenture, each of the same significance as the proposed revisions set out below, the interest rate on a typical bond would drop, say, from 8.54% to 8.53%. For a bond issue of \$100 million, this interest differential would amount to between \$1000 and \$5000 a year (a rather small amount in relation to the billing rates of the law firms that would have to draft the changes). For the bond market as a whole, however, such an interest differential would result in savings of between \$50 million and \$250 million per year. Capitalized at 8%, these annual savings would amount to \$625 million to \$3.125 billion. Thus, given the size of the corporate bond market, even imperfections that are relatively slight with respect to a single bond issue are sizable from a marketwide perspective.

IV

A PROPOSAL FOR REFORM

This Part discusses how the four defects in the present structure of individual and collective rights can be reduced substantially. My proposed solution has two components. First, courts should modify the way in which they have interpreted the no-action clause. Second, the contractual provisions governing bondholder enforcement in the indenture should be revised.

A. Judicial Interpretation of the Indenture

Probably the easiest way to fix some of the problems discussed would be for courts to reinterpret the no-action clause to apply only to contractual claims against the company. Such a step would eliminate the unworkability problem. Recall that the unworkability problem has two aspects: First, courts have interpreted the clause to apply to claims that cannot result in an "Event of Default," where compliance with the clause is impossible; second, courts have applied the clause to claims which the trustee lacks standing to assert. Limiting the scope of the clause to contractual claims against the company eliminates both of these problems, since breaches of the indenture by the company can give rise to an Event of Default and since the trustee has standing to enforce the provisions of the indenture.

What makes such a reinterpretation even more advisable is that the interpretation presently accorded to the clause is far from compelling. The clause, by its terms, applies to any remedy with respect to the bond or the indenture. Even apart from the unworkability problems engendered by the present interpretation, it is more plausible to read this clause as covering only claims of bondholders arising under the contractual provisions of the indenture or the bond; not their claims arising as a result of their status as creditors or security purchasers. Moreover, since the no-action clause is contained in a contract between the trustee and the company, there is no evident reason to assume that the no-action clause limits the ability of bondholders to sue a third party.

B. Modifications to the Indenture

Even if courts interpret the indenture in the way discussed above, the structure of individual and collective rights will remain inconsistent, illogical, and imprudent. To make inroads into these problems, it is necessary to revise the indenture itself.

The inconsistent treatment of substantive rights for purposes of amendment and enforcement is the easiest defect to eliminate. If the

indenture identifies certain rights as not being subject to amendment by majority consent, the same set of rights should be exempt from the scope of the no-action clause, which limits individual enforcement of rights. This change, which would eliminate the inconsistency problem, easily can be effected by expanding the clause that presently exempts claims for payment of principal and interest from the no-action clause to encompass any claims that are not subject to amendment by majority consent.

The illogic of the present rights structure is a more difficult problem to attack. This problem results from the fact that the no-action clause covers instances in which only the rights of a subset of bondholders have been infringed. A blanket exemption from the clause of any claims not held by all bondholders would be vague and both over-inclusive and underinclusive.¹⁷⁵ A preferable method would be to identify specifically those provisions in the indenture conferring rights on bondholders under which only the rights of a subset may be infringed and to permit individual holders to bring claims to enforce their own rights under these provisions. Moreover, such a listing could be confined to provisions the enforcement of which would not be adverse to the interests of bondholders at large.

The most intricate problem to attack, however, is the imprudence of placing excessive reliance on the trustee. As long as the structure of the trusteeship is not substantially revised,¹⁷⁶ the trustee will remain an unreliable champion of bondholder interests. On the other hand, the conflict of interest problem is severe enough to make it undesirable to vest all enforcement rights individually.

There are, however, three revisions to the enforcement provisions which would reduce significantly the problem of excessive reliance on the trustee without materially increasing the problems associated with vesting rights individually. For one, the requirement that bondholders offer indemnity to the trustee should be removed. This requirement hampers collective enforcement by bondholders who are legitimately wary to write a blank check to the trustee—over whom they have no control—for any expenses and liabilities the trustee may incur. On the other hand, it adds little to the positive aspects of the clause. The trustee is not adversely affected if holders do not have to offer indemnity since the trustee is not obligated to take any action even if bond-

¹⁷⁵ For example, an affiliate of the company may not have certain claims otherwise held by all bondholders, and technically any bondholder has—but for the no-action clause—standing to enforce a violation even if not directly affected by it.

¹⁷⁶ See Amihud et al., *supra* note 11 at 469-85.

holders satisfy the no-action clause.¹⁷⁷ And if the trustee chooses to take an action, the trustee is in any case entitled to be reimbursed for its reasonable out-of-pocket expenses by the company as well as from any funds collected for the bondholders.¹⁷⁸ Finally, the fact that holders of 25% of outstanding bonds got together to make a demand on the trustee should be a sufficient *prima facie* indication that bringing an action is in the interest of bondholders at large even if they are unwilling to offer indemnity.

Second, any group of bondholders satisfying a relatively low threshold, say 10% of the outstanding bonds, should be permitted to take an enforcement action as long as the trustee or other bondholders do not affirmatively object. Holders owning a similar threshold percentage should also be entitled to send a "notice of violation" to the company and the trustee. Unlike the "notice of default" given by holders of 25% of outstanding bonds or the trustee, such a notice would not trigger an Event of Default and would not result in a right to acceleration. It would, however, inform the company and the trustee of the bondholder claim and would be a prerequisite to any remedy sought by a bondholder other than acceleration.¹⁷⁹

These modifications would not only address the problem of excessive reliance on the indenture trustee but they would also lower the threshold for bondholder action, significantly reducing the incentive problem. Moreover, they would not be likely to have substantial adverse effects. The two possible functions of the no-action clause are to reduce bondholder conflicts of interest and to prevent frivolous suits. As explained, the likelihood of frivolous lawsuits by bondholders is remote to start with.¹⁸⁰ Any remaining potential for frivolous lawsuits would be addressed sufficiently by requiring a 10% threshold for instituting a lawsuit. With respect to conflicts of interest among bondholders, the trustee and holders of, say, 25% of the outstanding bonds (but *not* the company) should have the right to block any suit to which they object. Since the main problem with the trustee lies in its reluctance to exert effort, relying on the trustee to object to a suit—an action that requires little effort on its part—is less problematic than relying on the trustee to bring a suit on its own. And even if the trustee fails to

¹⁷⁷ That is, the trustee may well request indemnity before the *trustee* takes an action. I therefore do not propose eliminating the indemnity requirement from the direction clause entitling holders of a majority of the outstanding bonds to direct the trustee to take actions. But an offer of indemnity should not be a condition to *bondholders* taking an action.

¹⁷⁸ See *supra* text accompanying note 116.

¹⁷⁹ Similarly, if holders bring a lawsuit, they should inform immediately the trustee and send to the trustee all pleadings and motions made in the lawsuit.

¹⁸⁰ See *supra* Section II.D.4.

object when doing so would be advisable, holders of 25% of outstanding bonds could do so.

To be sure, the trustee and holders of 25% of the outstanding bonds on occasion may fail to object to suits that run counter to the interest of bondholders at large. But if the trustee and holders of 25% of the outstanding bonds cannot be relied on to perform the simple task of objecting to such suits, then they certainly cannot be relied on to perform the more complex task of bringing suits that are in the interest of bondholders, as envisioned by the present no-action clause. Thus, the proposed system is less error-prone than the system that is presently in place.

Third, whatever the threshold and indemnity requirements for instituting a bondholder lawsuit, the sixty-day waiting period in the no-action clause should be shortened or even eliminated. This sixty-day period comes on top of any cure period afforded to the company to eliminate a default, and on top of the time it takes for bondholders to discover a default and to form a bondholder group. The cumulative delay may well be prejudicial to the ability of bondholders to enforce their rights. Eliminating the waiting period in the no-action clause is the simplest way to enable bondholders to act expeditiously. A group of bondholders satisfying the threshold requirement should be entitled to sue the company as soon as the cure period has passed, as long as they promptly inform the trustee that they have commenced a suit. If the trustee or other bondholders object, they retain the right to block continuation of the lawsuit after it has been commenced. Such a system protects the rights of bondholders who oppose the lawsuit while reducing the delay in bondholders' ability to enforce their rights.

The Appendix contains a set of provisions implementing these suggestions that can be inserted in an actual bond indenture.

CONCLUSION

Bond indentures presently set up a mixed system of rights. Amendments to some provisions require only the approval of holders of a majority of bonds; others require the approval of each affected holder. With respect to enforcement, indentures provide for an intricate scheme of checks and balances among the trustee, individual bondholders, majority bondholders, and holders of a substantial minority of bonds.

Both individual and collective bondholder rights entail certain problems. Individual rights can result in holdout and collective action problems in the amendment context, frivolous suits in the enforcement context, and conflict of interest problems in either context. Col-

lective rights can result in incentive and collective action problems in the enforcement context, coercion problems in the amendment context, and loss of control problems in either context. Several aspects of the institutional setting of U.S. corporate bonds affect the severity of these problems. In particular, the facts that institutions dominate the bond market and that bond ownership is relatively concentrated reduce the frivolous suit problem, the collective action problem, and the coercion problem, but may aggravate the conflict of interest and loss of control problems. The nature of legal claims bondholders can assert further reduces the frivolous suit problem. The possibility of a Chapter 11 filing reduces the holdout problem in distressed restructurings. Finally, because it lacks adequate incentives, the trustee is unlikely to be a reliable and effective representative of bondholder interests. On the whole, the case for individual rights is stronger in the context of enforcement than in the context of amendments.

The present structure of bondholder rights in the amendment context is consistent with this analysis. In the enforcement context, however, the structure has four defects. It is inconsistent because certain substantive rights are vested in individual bondholders with respect to amendment but vest collectively with respect to enforcement. It is unworkable because certain claims can be brought neither by bondholders (since they cannot comply with the relevant indenture provisions) nor by the trustee (since the trustee lacks standing). It is illogical because indentures subject certain claims to collective enforcement even though these claims may be held only by some of the bondholders. And it is imprudent because it places excessive reliance on enforcement by the trustee and excessive limits on enforcement by bondholders. Several market imperfections affecting corporate bonds—imperfect information, innovation externalities, network externalities, agency problems, and cognitive biases—can explain why these defects have not been corrected.

To reduce the flaws in the present structure of bondholder rights, courts should accord a narrower scope to the no-action clause, which limits individual enforcement by bondholders. The broad interpretation courts have given to the clause is responsible for the unworkability of the enforcement regime with respect to certain claims. In addition, the indenture provisions on amendment and enforcement should be harmonized such that rights that are individual for purposes of amendment can also be enforced individually. The list of provisions that can be enforced individually also could be expanded to include instances when a company is likely to infringe the rights of only some bondholders and when enforcement generally would not be adverse to the interests of bondholders at large. Finally, three changes

should be made to the no-action clause to reduce excessive reliance on the indenture trustee. First, the requirement to offer indemnity to the trustee before holders can bring a suit should be removed. Second, holders satisfying a substantially lower threshold than the present 25% threshold should be permitted to pursue a suit *unless* the trustee or a substantial minority of bondholders objects. Third, the sixty-day waiting period before a suit can be brought should be eliminated, thus permitting bondholders to bring an action as soon as they satisfy the other provisions of the clause.

APPENDIX

Section ____: Suits by Holders¹⁸¹

(a) Notwithstanding any other provision of this Indenture, the right of any Holder (x) to receive payment of principal of and interest on the Securities, on or after the respective due dates expressed in the Securities, (y) to bring suit for the enforcement of any such payment on or after such respective dates, or (z) to pursue any remedy (other than acceleration) in respect of a provision that under Section ____ [Section dealing with Amendments with Consent of Holders] cannot be amended without the consent of each Securityholder affected, shall not be impaired or effected without the consent of such Holder.

(b) Subject to paragraph (a) of this Section and subject to the rights of Holders to accelerate in accordance with Section ____, a Holder may not pursue any remedy in respect of any provision of the Securities or this Indenture¹⁸² unless:

Alternative 1:¹⁸³

(i) the Holder gives written notice to the Trustee stating that an Event of Default is continuing;

(ii) the Holders of at least 25% in principal amount of the Securities at the time outstanding (or such lesser amount as shall be satisfactory to the Trustee) make a written request to the Trustee to pursue the remedy;

(iii) the Trustee does not comply with this request within 30 days after the receipt of the request or notifies such Holders that it does not intend to comply with this request; and

(iv) the Holders of a majority in principal amount of the Securities at the time outstanding do not give the Trustee a direction inconsistent with the request during such 30-day period.

Alternative 2:¹⁸⁴

(i) the Holders of at least 10% in principal amount of the Securities at the time outstanding give written notice to the Company and

¹⁸¹ This Section is designed to replace the standard sections on Limitation on Suits and Rights of Holders to Receive Payment.

¹⁸² This language assures that only contractual claims, violations of which can result in an Event of Default, are limited by this subsection.

¹⁸³ Alternative 1 retains the structure and contains most elements of the standard no-action clause, except that the clause is clarified to apply only to contractual claims, the requirement to offer indemnity is removed, and the Trustee is authorized to permit holders of a lesser percentage than 25% to institute suits and the 60-day period before a suit can be brought is shortened to 30 days.

¹⁸⁴ Alternative 2 makes more substantial changes to the standard no-action clause. In addition to limiting the clause to contractual claims and removing the indemnity offer requirement, it provides for a new type of notice of default which can be given by a lesser percentage of holders and which, after passage of a cure period, permits holders to bring an action against the Company immediately. (To give Holders or the Trustee a right to accelerate, however, a regular notice of default must be given by the Trustee or Holders of

the Trustee, or the Trustee gives written notice to the Company, that the Company has failed to observe or perform any covenant contained in this Indenture or the Securities;

(ii) such failure continues for at least 30 days after the Company's receipt of such notice;

(iii) such Holders agree in writing, in form and substance satisfactory to the Trustee, promptly to notify the Trustee of any claims asserted against the Company and of any material event in any legal proceeding instituted against the Company; and

(iv) no contrary direction, in accordance with the next succeeding sentence, shall have been given (or, if given, shall have been revoked or modified in the relevant respects).

In the event a Holder should assert claims against the Company in accordance with the next preceding sentence, (x) if such claims are asserted by Holders of less than 25% in principal amount of the Securities at the time outstanding, the Trustee or Holders of at least 25% in principal amount of the Securities at the time outstanding or (y) if such claims are asserted by Holders of 25% or more in principal amount of the Securities at the time outstanding, Holders of at least a majority in principal amount of the Securities at the time outstanding, may at any time within 120 days after the Trustee receives notice of such claims in accordance with clause (iii) of this paragraph (b) direct the manner, if any, in which any remedy in respect of any provision of the Securities or this Indenture shall be pursued (which direction, if given by the Trustee, can be modified or revoked at any time by the Trustee, or if given by Holders or the Trustee, can be modified or revoked at any time by Holders of a majority in principal amount of the Securities at the time outstanding).

Only the Trustee or Holders of at least 25% in principal amount of the Securities at the time outstanding shall have standing to assert noncompliance with this paragraph (b) in any legal proceeding.

(c) A Holder may not use this Indenture to prejudice the rights of another Holder or to obtain a preference or priority over such other Holder.

25% of the Securities.) The right of holders to bring an action against the Company is subject to two limitations. First, the Holders must agree to keep the Trustee informed about the basis of the action and any material events in any proceeding instituted against the Company. Second, the right to bring an action is subject to a direction to the contrary given, depending on the percentage of Holders who bring an action, by a larger percentage of Holders and/or the Trustee.