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Reforming the Unbargained Contract: Avoiding Bondholder Claims for Surprise Par Calls

*By Robert S. Blanc and Randy D. Gordon**

INTRODUCTION

As interest rates fall, corporate borrowers seek to retire high interest debt and replace it with lower interest debt. Similarly, as a once-ailing company's financial condition and credit rating improve, it may seek to alleviate its interest burden via a debt retirement and replacement. Investors have anticipated these events in one of two ways: either by receiving compensation for taking the risk of early debt retirement, or by minimizing its possibility or impact.[1] In practice, risk-tolerant bond investors choose the increased compensation option by buying a callable instrument (typically a bond or debenture) carrying a higher interest rate than a non-callable instrument, whereas risk-averse buyers purchase a purportedly non-callable instrument or an instrument callable only at a premium.[2]

This regime worked quite well for decades and led to fairly settled expectations in both issuer and bondholder camps. The advent of high-yield (i.e., "junk") bonds, however, followed by a period of revitalized corporate fortunes and low interest rates, has destabilized these expectations and

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1. To retire debt without breaching its governing indenture, the issuer has to have anticipated the possibility of falling interest rates and negotiated certain provisions of the indenture to allow early retirement of the debt. At least one author has questioned whether issuers efficiently (i.e., at an appropriate price) trade the ability to retire the debt early for higher interest rates. *See* Alan Kraus, *An Analysis of Call Provisions and the Corporate Refunding Decision*, 1 MIDLAND CORP. FIN. J. 46 (1983). Another commentary questions Kraus's approach, but agrees that interest rate is a function of, among other things, call risk. *See* William A. Klein et al., *The Call Provision of Corporate Bonds: A Standard Form in Need of Change*, 18 J. CORP. L. 653, 669, 671 n.81 (1993).

2. *See generally* STEPHEN A. ROSS ET AL., FUNDAMENTALS OF CORPORATE FINANCE 169 (3d ed. 1995).

provided issuers with a powerful incentive to discover novel ways of retiring non-callable or protected-call debt at par.[3] This Article explores the authority for and legality of such par calls[4] and proposes a redefinition of the contractual relationship between the issuer and the investor in callable bonds.

As a threshold matter, it is often argued that bondholder protection is largely unnecessary because the great majority of bonds are bought by institutional investors, often in private transactions.[5] As we shall demonstrate, the ability of institutions to anticipate par calls and require protective indenture provisions is far from clear; all of the major litigation over par calls has been brought by institutions, not average investors. Second, unless issuers are willing to forego a public market, there remains a public interest in providing a sensible legal framework to protect the interests of otherwise unorganized, disparate bondholders, for whom the Trust Indenture Act of 1939 (TIA)[6] was created.[7]

3. *See, e.g.*, Morgan Stanley & Co. v. Archer Daniels Midland Co., 570 F. Supp. 1529, 1532-33 (S.D.N.Y. 1983).

4. This Article does not address other disruptions in bondholder expectations, such as mergers (especially cash mergers in the presence of convertible bonds), spin-offs, or recapitalizations. This Article, however, suggests a paradigm for redefining the issuer-bondholder contract in a way that would apply to most, if not all, of the problems raised by those actions. For discussion of those different but related situations, see generally Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821 (1992); Martin Riger, *The Trust Indenture as Bargained Contract: The Persistence of Myth*, 16 J. CORP. L. 211 (1991); Dale B. Tauke, *Should Bonds Have More Fun? A Reexamination of the Debate over Corporate Bondholder Rights*, 1989 COLUM. BUS. L. REV. 1.

5. *See* Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 583-86 (1995). *But see* 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, 1254 & n.136 (1991) (noting that even institutional investors can be taken advantage of). It may also be argued that bond rating agencies, such as Moody's Risk Management Services, Inc. (Moody's), provide information about each of the major bond covenants, such as collateral substitution provisions, so that prospective investors can anticipate the risk of a par call. In practice, those ratings are explanatory of call provisions rather than being true risk analyses and, for the reasons discussed below, cannot avoid the confusion and dissension caused by a par call.

6. 15 U.S.C. §§ 77aaa–77bbbb (1994 & Supp. III 1997).

7. One must differentiate "institutions." A life insurance company is an institution that buys for its own account; it probably owes a less direct duty to its policyholders and stockholders than, say, does a pension fund to its beneficiaries. A mutual fund may fall in between. The extent of liability that might attach to each of these "institutions" for failure to police call provisions in their portfolios has yet to be tested, especially in the wake of the "most adequate plaintiff" class action test contained in the Private Securities Litigation Reform Act of 1995 (Reform Act), 15 U.S.C. § 77z-1 (Supp. III 1997). It is at least arguable that such institutions could find themselves under pressure to bring or join litigation brought by disaffected bondholders or face claims of breach of fiduciary duty.

Bonds and debentures[8] allow business enterprises to obtain capital from investors in exchange for a promise to repay principal and to pay interest over a long period of time. Stocks, on the other hand, represent a promise to share in future profits, if any, and normally bear the risks of loss of invested capital and absence of return on investment. Under virtually universal principles, debt instruments always enjoy a higher priority upon liquidation of the enterprise.[9]

The relationship between issuers and their bondholders is more complicated than that of ordinary lenders and borrowers. A bank enters into a contract with a borrower, often just a promissory note, and in larger commercial loans also a loan agreement. Although the terms of the promise to repay can be quite complex, the borrower-lender relationship is direct; there is no intermediary.[10]

THE NATURE OF THE BONDHOLDER-ISSUER RELATIONSHIP

The bondholder-issuer relationship, however, is more complicated. Years ago, the debt represented by a bond was typically secured by specific assets of the issuer (e.g., the "trust estate" in the case of first mortgage bonds).[11] In order for the security interest to be protected under English common law, the property was conveyed to a trustee pursuant to a trust indenture.[12] Once debentures began to be issued without collateral for the repayment obligation, indentures became devices to designate corporate

8. The difference between "bond" and "debenture" has been authoritatively addressed as follows:

> There is no inherent or clearly established distinction between "bonds" and "debentures." . . . The terms "bond" and "debenture" came into use in the United States without any definite or consistent legal connotation and to some extent are still intermingled. Financial men refer to the "bond market" as including all forms of long-term debt securities. . . . (Under preferred usage), *"debenture" means a long-term debt security which is not secured,* and "bond" (except with respect to governmental or other public corporation securities) means a long-term debt security which is secured by a lien on some or all of the assets of the borrower. Most recent issues conform to this usage.

AM. B. FOUND., COMMENTARIES ON INDENTURES 7 n.3 (1971) (emphasis added) [hereinafter COMMENTARIES]; *see* Broad v. Rockwell Int'l Corp., 642 F.2d 929, 942 n.12 (5th Cir. 1981) (en banc).

9. Section 726(a)(6) of the Bankruptcy Code incorporates this principle in liquidation cases, and § 1129(b)(2) does so in reorganization cases under the "absolute priority rule." *See* 11 U.S.C. §§ 726(a)(6), 1129(b)(2) (1994); *see also* 7 WILLIAM M. COLLIER, COLLIER ON BANKRUPTCY ¶ 1129.04[a], at 1129-82[a][i] (Lawrence P. King ed., 15th ed. rev. 1999).

10. The same direct relationship exists in the case of commercial paper, whereby the corporate borrower deals directly with the investor.

11. *See Broad*, 642 F.2d at 941 & n.12 (noting the differences between corporate bonds and debentures).

12. For a synopsis of the development of the modern corporate indenture, see generally Churchill Rodgers, *The Corporate Trust Indenture Project*, 20 BUS. LAW. 551 (1965).

trustees to perform ministerial tasks connected with the collection and payment of interest on the debentures.[13]

Precisely because the trustees undertook only ministerial tasks and were not obligated to protect the interests of bondholders in the event of issuer default, Congress undertook regulation of trust indentures as the fourth of the Depression-era statutes regulating U.S. public capital markets.[14] Seeking to provide some protection to public bondholders in pre-default circumstances, Congress mandated certain provisions in the indenture and gave the U.S. Securities and Exchange Commission (SEC) power to prevent "qualification" of an indenture that omitted any mandatory provisions.[15] Otherwise, Congress preserved the trustee-bondholder indenture agreement and limited the trustee's liability to ministerial duties unless there was a default, upon which the trustee would have to act under a "prudent man" standard.[16] Under this system, "although the debts created by the debentures run directly from the issuer to the holders, the contractual rights conferred by the indenture run from the issuer to the trustee for the benefit of the holders of the debentures."[17]

As will be discussed in more detail, this structure is anomalous. Formerly, the trustee held the collateral; if the issuer defaulted, the collateral could be turned over to the bondholders. Today's trustee, however, usually has no collateral to turn over, but must fulfill the congressionally mandated duty to act prudently; in most cases, that will involve filing a lawsuit in the rare instance when there has been a monetary default and no consequent bankruptcy case. But what if there has been a non-monetary default? This can occur when the issuer invokes an alleged right under the indenture to call the bonds at par. There is no monetary default because the issuer pays principal and accrued interest to the date of call. The bondholders, however, lose the right to continue to receive the stated rate of interest, invariably above market at that time, until the stated maturity of the bond.

Negotiation of non-monetary default provisions is largely the province of the issuer and the underwriter (usually leading a syndicate) of the bonds. The issuer wants the loosest possible provisions so that it can speculate against interest rates: if rates go up, the issuer wants to keep the bonds

13. *See Broad*, 642 F.2d at 941.

14. In chronological order, the Securities Act of 1933 (1933 Act), 15 U.S.C. §§ 77a-77aa (1994 & Supp. III 1997); the Securities Exchange Act of 1934 (1934 Act), *id.* §§ 78a-78*ll*; the Public Utility Holding Company Act of 1935, *id.* §§ 79-79z-6; and the TIA, *id.* §§ 77aaa-77bbbb, passed as an amendment to the 1933 Act. Later statutes in the same vein were the Investment Company Act of 1940, *id.* §§ 80a-1 to -64, and the Investment Advisers Act of 1940, *id* §§ 80b-1 to -21. It may be said that the introduction of bankruptcy reorganization under the Chandler Act, Pub. L. No. 106-38, 52 Stat. 840 (1938), amending the Bankruptcy Act of 1898, Pub. L. No. 696, 30 Stat. 544 (repealed 1978), was a further regulation of capital markets in that it prevented liquidation of business enterprises in some circumstances.

15. *See* 15 U.S.C. § 77eee (1994).

16. *See id.* § 77*ooo*.

17. *Broad*, 642 F.2d at 941.

outstanding so that it repays a below-market cost of money; if rates go down, the issuer wants to call the bonds and refinance its debt, called "refunding" in the trade, at a lower cost of money. If its financial strength permits, the issuer may seek to issue stock and use the proceeds to retire the bonds.

The underwriter wants to keep the issuer happy because the underwriter also wants to lead the syndicate for the company's later debt (and possibly equity) financings. Balanced against that interest is the underwriter's need to form a syndicate that will buy the bonds for resale to the public. The underwriter will "talk" the proposed bond issue with major bond purchasers, such as pension funds and insurance companies. The underwriter will know even before it approaches members of the syndicate that certain major purchasers are content with the financial and non-financial terms of the indenture. The head bond traders of major purchasers, who buy tens of millions of dollars of bonds, know the market: they know the issuer, the underwriter and money rates, and they have performed their own economic forecasts. They rarely study the indenture, but rely on the underwriters' "talk" and on the preliminary prospectus, or "red herring." They are in the business of pricing risk.

In a "firm" underwriting, the underwriters bear the risk that the bonds cannot be sold at the issue price, or maybe at all. If the institutional bond traders think the terms are unattractive, they will not "indicate an interest" in buying the bonds at the issue price; they will require a discount that would create an up-front loss for the underwriter unless the pricing were adjusted before the closing of the underwriting agreement.[18] But once the bond terms have been negotiated, the due diligence performed, the prospectus issued, and the bonds sold, the underwriter loses interest in the issuer's ability to call the bonds.[19] The underwriter does not assume any further duty to the eventual purchasers of the bonds.[20] The underwriter is not the agent of the bond purchasers, who are as yet unknown.[21]

18. In practice, lead underwriters always monitor sentiment in the underwriting syndicate and among bond traders extremely closely in the days before the "pricing amendment" to the public disclosure documents and the nearly simultaneous signing of the underwriting agreement with the issuer and the separate agreement among the underwriters themselves.

19. The lead underwriter's counsel has performed due diligence under § 11(b)(3)(A)-(B) of the 1933 Act and has tried to make sure that the indenture provides and the prospectus discloses only those circumstances in which the issuer may call the bonds. *See* 15 U.S.C. § 77k(b)(3)(A)-(B). By definition, an unexpected par call demonstrates that somebody missed something in the deal. The underwriter may also be the dealer, or seller, of a large block of bonds to its regular customers, who will be very unhappy that their interests were not protected. The underwriter and the dealer, however, will rarely have significant exposure to liability from third parties, although the underwriter may remain a holder and, as such, be the author of its own misfortune.

20. As a matter of fact, the underwriter will have no knowledge of the issuer's either secret or later-developed intent to call the bonds. Nor will the underwriter be exposed to dealer liability under § 12(a)(2) of the 1933 Act. *See* 15 U.S.C. § 77*l*(a)(2) (1994 & Supp. III 1997); *see also* Klein v. Computer Devices, Inc., 602 F. Supp. 837, 840-41 (S.D.N.Y. 1985).

21. *See generally* RESTATEMENT (SECOND) OF AGENCY § 85(1) cmts. a, e (1958).

The trustee does not negotiate the bond's call terms and thus offers no protection to buyers against a par call. The trustee's counsel makes sure that the mandatory language required by the TIA is present and that the prospectus reflects the indenture. To the extent that anyone tries to impose a duty or risk on the trustee, it and its counsel vigorously fend them off. Their goal is to limit the trustee's pre-default duties to the ministerial. Like the underwriter, the trustee is not the agent of the bond purchasers.

Ironically, it is the indenture system that has protected issuers seeking to "aggressively" redeem their non- or restricted-call debt at par. Indentures may contain provisions that allow for par calls, as distinguished from scheduled premium calls. These provisions (non-call exceptions) evolved to protect holders from erosion of their collateral through the sale or diminution of secured assets while the debts were outstanding. Four of the most common[22] non-call exceptions are:

(i) *Maintenance and replacement (M & R) fund requirements.* M & R provisions are designed to provide for the maintenance and replacement of an enterprise's (usually a utility's) physical plant, which is likely to suffer the effects of aging over the course of a long bond's maturity. Specific fund requirements vary, but in general they require a company to expend a portion of some benchmark (e.g., operating revenue) on yearly maintenance. Actual expenditures tend to meet this requirement. To the extent that there is a shortfall, however, indentures often allow the issuer to supply it with the proceeds of bonds redeemed at a special redemption price (often par). Such a provision allows an issuer to "arrange" a shortfall, often by accounting maneuvers, in order to redeem high interest bonds.

(ii) *Sinking funds.*[23] One particular type of sinking fund—viz., the "funneled" sinking fund—places high yield bonds at particular risk. This is so because the entire sinking fund obligation may be "funneled" to a single issue. Thus, a one percent sinking fund obligation measured against total bonded indebtedness may have a tenfold impact vis-à-vis a targeted issue.[24]

(iii) *Release and substitution (R & S) of property provisions.* Under typical R & S provisions, a company may redeem debt, often at par, if it sells all

22. *See generally* HELEN H. CLEMENT, ELECTRIC UTILITY REDEMPTION MANUAL (J.P. Morgan 1994).

23. *Id.* at iv-v. Although variously defined, a sinking fund has been said to be "[t]he aggregate of sums of money (as those arising from particular taxes or sources of revenue) set apart and invested, usually at fixed intervals, for the extinguishment of the debt of a government or corporation, by the accumulation of interest." BLACK'S LAW DICTIONARY 802-03 (4th ed. 1951).

24. CLEMENT, *supra* note 22, at iv (citing the example of Alabama Power, which—in January 1994—made a funneled sinking fund call at par that amounted to over 7% of an issue that appeared to have only a 1% sinking fund).

or part of its assets. Proceeds of a qualifying asset sale are deposited with the trustee, who, pursuant to provisions dealing with cash deposits, may be instructed to redeem bonds. Such a provision was designed to protect the value of the trust estate; however, it also encourages a company to time and structure asset sales in a manner likely to capitalize on the opportunity to redeem high-coupon debt.[25]

(iv) *Eminent domain provisions.* Par calls are also permitted when all or part of the trust estate is taken pursuant to a government entity's power of eminent domain. As with R & S provisions, eminent domain clauses were developed to prevent collateral erosion. The par call feature, however, encourages an issuer to seek government involvement—or the appearance of government involvement—in asset sales in order to invoke the right to eminent domain redemption.[26]

THE NATURE OF THE NON-CALLABLE BOND CONTRACT

Bonds are sold with two key terms: coupon rate and maturity date. Many institutional investors (e.g., pension funds and insurance companies) purchase non-callable bonds in order to match the cash flow from these bonds[27] to expected cash outlays. The non-callable feature of the bonds allows that matching without the risk of redemption if interest rates fall or corporate fortunes improve. This risk is, of course, partially quantifiable,[28] but all risk measurement ultimately remains a function of relative probabilities. A non-callable bond removes interest rate volatility as an issue of analytical concern because, in theory, such a bond will remain outstanding even if interest rates fall and its redemption would be financially expedient for the issuer.

The market has demonstrated in recent years that many bondholders are willing to pay to insure that their bonds will remain outstanding to

25. *Id.* at v (citing the recent example of Georgia Power's sale of its interest in a generating facility that led to the redemption at par of hundreds of millions of its bonds).

26. *Id.* (noting a condemnation, the proceeds of which Boston Edison used to call $10,000,000 of high-yield bonds); *see also infra* notes 57-60, 73-78, and accompanying text.

27. Insurance company and pension fund investors purchase bonds, not only for safety of principal and rate of return, but also for duration, a calculation of the "effective maturity" of the bond so as to match the interest-rate risk of holding the bond against the similar risk of liabilities the company owes. *See* STEPHEN A. ROSS ET AL., CORPORATE FINANCE 672-76 (4th ed. 1996). Duration allows the fund manager to match the expected proceeds against the requirements of a maturing pension or actuarially probable life insurance mortality. A premature redemption of the bond upsets that calculation unless a comparable bond, including a like yield to maturity, is available in the marketplace. Normally that would be difficult to find.

28. The longer the duration, the greater the percentage price changes of a bond. Thus reducing duration, or matching durations of assets and liabilities, can be said to partially quantify (by hedging) the risks of redemption owing to interest rate changes. *See id.* at 673.

maturity.[29] This insurance comes in the form of an indenture provision, generally repeated on the bonds themselves, stating that the bonds "shall not be subject to redemption at the option of the company prior to maturity." The prospectus[30] pursuant to which the bonds will be sold usually highlights that statement in the summary (at the beginning of the prospectus) and contains a longer, more detailed description of the indenture provisions in a later section in which the security is described. Exceptions to the general statement, such as an M & R clause, commonly will be described there. It is the adequacy of this description upon which an issuance-based claim (such as securities fraud) will turn. If a bond is marketed as non-callable, any exceptions to that characterization must be clearly disclosed in the prospectus.

LIABILITY CAN ARISE AT THE TIME OF ISSUANCE OR AT THE TIME OF REDEMPTION OF THE BONDS

We now examine the remedies that may be available to bondholders faced with an unauthorized par call. These remedies include both state and federal securities law and state common law causes of action, and various damage theories that can materially increase the bondholders' recovery.

A redemption is proper only if: (i) the terms of the bonds permit early redemption, and (ii) the possibility of early redemption was adequately disclosed at the time the bonds were offered and issued.[31] This paradigm suggests that liability can arise under the "agreement" with the bondholders governing the bonds and, if redemption was discretionary with the issuer, the circumstances under which the issuer would exercise that discretion. A breach of that agreement could occur at any time during the "life" of the bond, but a failure to disclose must ordinarily occur at the time of issuance. With those parameters in mind, we turn to the judicial attempts to apply the paradigm.

29. As two industry commentators have noted:

> Over the past several years, many private placement buyers of utility debt have been agreeing to rates on 30-year debt that are more favorable than those available in the public market. On the surface, it would appear to be a windfall to utilities; however, the low rate does not come without a cost. The low-cost debt is being sold with either no call feature in it at all, or with a "make-whole" provision, which essentially eliminates any economic incentive for a company to refinance should interest rates fall.

Merry L. Mosbacher & William H. Broderick III, *The Elimination of the Refinancing Option*, PUB. UTIL. FORT., Apr. 1, 1991, at 42.

30. The usual definition is that contained in § 2(a)(10) of the 1933 Act: "The term 'prospectus' means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security . . . ." 15 U.S.C. § 77b(a)(10) (1994 & Supp. III 1997).

31. *See infra* notes 65-67.

ISSUANCE-BASED LIABILITY

The first case in recent years to attract attention to the aggressive use of non-call exceptions was *Lucas v. Florida Power & Light Co.*[32] In that case, the indenture permitted the issuer to redeem bonds at a special redemption price by using cash deposited in an M & R fund. At the time the prospectus became effective, the issuer knew, but did not disclose to prospective bondholders, that there had been a substantial deficiency in the annual expenditures required from that fund. In effect, Florida Power & Light Co. (Florida Power) had not been spending enough to replace depreciated or obsolete property, thus theoretically diminishing the fixed capital assets that backed (but did not technically secure) the bonds. In late June 1977, approximately twenty-seven months after the bonds had been issued, Florida Power's board of directors voted to redeem approximately half of the outstanding bonds at the special redemption price using cash specifically deposited in the maintenance and replacement fund for that purpose.

A class action followed. The district court found that the prospectus had adequately disclosed the circumstances under which a special redemption could occur and held that there was no liability for having exercised those provisions.[33] The court was unpersuaded by the vague and imprecise disclosure concerning the replacement fund deficiency and did not believe that the issuer owed a duty to estimate the amount of the deficiency.[34]

On the issue of scienter, which was critical to the plaintiffs' Rule 10b-5 claims,[35] the court found that there was no evidence that at the time of issuance of the bonds, the issuer had intended to redeem them at a point in the future. "The *possibility* of a special redemption was clear on the face of the prospectus; the *vulnerability* or likelihood of such a redemption was a matter of speculation at the time."[36]

It is important that the case was presented on appeal from a judgment of dismissal that followed a bench trial. The U.S. Court of Appeals for the Eleventh Circuit, seeing no reason to disturb a thoughtful ruling by the district court, appeared to have been persuaded in part by expert testimony that the bond community was outraged and surprised by the audacity of the redemption, but not that it had been misled by statements of the issuer at the time of the bond purchase.[37] In other words, the investors had taken a risk that such a redemption might occur, and in fact it did occur.

Because the case necessarily turned on disclosure issues, there was little focus on the inadequacy of the indenture as an instrument to protect

32. 765 F.2d 1039 (11th Cir. 1985).

33. *See id.* at 1043.

34. *See id.* at 1044.

35. 17 C.F.R. § 240.10b-5 (1999); *see also* 15 U.S.C. §§ 78a-78*ll* (1994 & Supp. III 1997) (codifying § 10(b) of the 1934 Act); *infra* note 43.

36. *Lucas*, 765 F.2d at 1045.

37. *See id.* at 1046.

bondholder interests. Modern private debt placements require debtors to maintain certain debt to capital ratios and contain a number of financial covenants, rather than rely solely on maintenance of a fixed asset base.[38] Ironically, then, the very provision intended to protect bondholders became the instrument of defeasance of their bonds.

In the following year, *Harris v. Union Electric Co.*[39] demonstrated the interplay of non-call exceptions and their disclosure in a prospectus. Union Electric Co. (Union Electric) publicly announced that it intended to call $50,000,000 of its first mortgage bonds, which had been marketed under a representation that the bonds "would possess solid call protection."[40] This protection took the form of a covenant not to redeem bonds with funds borrowed below a certain rate of interest.[41] In a nutshell, although the Union Electric indenture prohibited redemption of bonds with money borrowed below a certain rate of interest, it allowed redemption at a premium if money were paid into the Maintenance Fund and then transferred to the Improvement Fund. It was silent on whether money in the Maintenance Fund itself could be used to redeem bonds and, if so, whether a premium needed to be paid. The company argued that money placed in the Maintenance Fund and the Improvement Fund could be used to redeem bonds, no matter the source of the money, and that the proposed redemption was thus permissible under the indenture. Courts in the state of Missouri agreed.[42]

The disappointed bondholders then sued in federal court, arguing that even if there was no breach of the indenture, the company was still liable, both for fraudulently redeeming the bonds and for fraudulently issuing them.[43] In reviewing a jury verdict in favor of the bondholders, the U.S.

38. In fact, fixed asset bases are often depreciated on a tax schedule bearing little reality to market obsolescence. Utilities for years avoided the modernization of their covenants because of their seemingly endless ability to obtain rate increases that allowed for amortization of an increasing capital base. Recent deregulatory moves have jeopardized that approach and made increased capital bases overtly dangerous as repositories of "stranded costs."

39. 787 F.2d 355 (8th Cir. 1986) [hereinafter *Harris II*].

40. *Id.* at 365.

41. This type of covenant is generally known as a "refunding" provision. It is designed to prevent the issuer from simply issuing bonds at a lower interest rate and using the proceeds to pay off, or "defease," the earlier issue.

42. *See, e.g.,* Harris v. Union Elec. Co., 622 S.W.2d 239, 249-50 (Mo. Ct. App. 1981) [hereinafter *Harris I*].

43. *See Harris II,* 787 F.2d at 361. The SEC Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material

Court of Appeals for the Eighth Circuit affirmed, holding that the call protection described in the prospectus was a "sham."[44]

The outcome of the case was perhaps foreordained because the plaintiffs had initially sued the issuer in state court for breach of contract. The lower court granted the plaintiffs' motion for summary judgment, construing the two applicable indentures and the bond contract to prohibit the redemption.[45] The Missouri Court of Appeals reversed, holding that a close reading of the indentures revealed that Union Electric was allowed to call the bonds.[46] Having thus achieved victory in state court, Union Electric was promptly hoist on its own petard in federal court, to which the plaintiffs next repaired. There, the jury found that the potential use of the indenture provisions that the Missouri state court had approved had not been disclosed in the prospectus.[47] Although the prospectus discussed redemption through use of cash that was first deposited in the Improvement Fund and then transferred to the Maintenance Fund, it failed to discuss redemption by using cash placed directly in the Maintenance Fund, which in fact is what was done.

Having found that the prospectus was misleading, the court had to deal with the absence of any specific finding by the jury on the question of scienter. The bonds had been issued three years prior to the redemption, but the court believed the jury verdict could be sustained on the basis that the jury might have found that there was an ongoing course of business and scheme or artifice, which operated as a fraud on the bondholders, under Rule 10b-5(2).[48] Accordingly, even though there was no direct proof of the issuer's intent at the time the bonds were issued, the court sustained the judgment based on the verdict.[49]

Perhaps of critical importance was the surprising testimony by several Union Electric officials, each of whom testified to the belief that the prospectus prohibited Union Electric from refunding the bonds at a lower

> fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1999). It is unclear whether any of the parties or the court considered that the plaintiff might have improperly split his cause of action by first suing in state court for breach of contract and not there raising the fraud claim, which would appear to have related to the same operative facts. *See, e.g.,* Coffey v. Dean Witter Reynolds Inc., 961 F.2d 922, 926-27 (10th Cir. 1992). *See generally* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1181-89 (3d ed. 1995).

44. *Harris II,* 787 F.2d at 364.
45. *See Harris I,* 622 S.W.2d at 241.
46. *See id.* at 251-52.
47. *See Harris II,* 787 F.2d at 364.
48. *See id.* at 362.
49. *See id.* at 361-62.

interest rate.[50] The general counsel and another person testified that the company intended to give protection against call for ten years. It is not discussed in the decision why the officials of the defendant chose to make admissions that appear to contradict the interpretation of the contract made by the state courts as well as to give credence to the plaintiffs' claims that the prospectus was misleading and incomplete.

Unfortunately, the court's rationale for finding that the fraud was in connection with the purchase or sale of securities was less than compelling: "Although [Union Electric] officials had no intent to defraud when they represented that the bonds possessed ten-year-call protection, they certainly intended to defraud the bondholders of this protection when they announced the plan to call the bonds before the ten-year period had run."[51] The court did not discuss whether each member of the class had to show reliance on the misrepresentations or could rely on the "fraud on the market" theory.[52]

By way of contrast, in *Florida Power & Light*, the U.S. Court of Appeals for the Eleventh Circuit examined the prospectus and found that the company adequately disclosed an M & R non-call exception.[53] In that case, the plaintiffs did not so much argue that the concept of M & R was not disclosed as that the vulnerability of their particular issue to redemption was not disclosed.[54] The court ultimately found this distinction unavailing.[55] If there is a lesson to be learned from a comparison of *Union Electric* to *Florida Power & Light*, it is that a failure to reveal the possibility of an early call is actionable under Rule 10b-5 and that a failure to reveal the magnitude or likelihood of such a call is not.[56]

50. It is unclear why interpretive testimony survived the parol evidence rule absent a finding that the indenture was ambiguous.

51. *Harris II*, 787 F.2d at 369.

52. For background information on the "fraud on the market" theory, see *Basic, Inc. v. Levinson*, 485 U.S. 224, 241-42 (1985); *Shores v. Sklar*, 647 F.2d 462, 470-71 (5th Cir. 1981) (en banc). *See also* Lipton v. Documation, Inc., 734 F.2d 740, 742-48 (11th Cir. 1984); *cf.* James I. Jaconette, *The Fraud-on-the-Market Theory in State Law Securities-Fraud Suits:* Mirkin v. Wasserman *and an Examination of Market Reliance Principles in the Common Law of Deceit*, 46 HASTINGS L.J. 1967 (1995).

53. *See* Lucas v. Florida Power & Light Co., 765 F.2d 1039, 1046 (11th Cir. 1985).

54. Because the indenture required redemption if the maintenance and repair fund fell below a certain level, it turned out to be critical that there had been a substantial deficit in that fund that was likely to increase in the future, a fact not disclosed in the prospectus. *See id.* at 1044.

55. *See id.* Although not necessary to its holding, the court prominently noted that Florida Power & Light was apparently under pressure from the Florida Public Service Commission to redeem high-coupon debt. *See id.* at 1042; *see also* Broad v. Rockwell Int'l Corp., 642 F.2d 929, 960 n.29 (5th Cir. 1981) (en banc) (declining to rule on the question of whether the prospectus had to describe conversion privileges in the event of a merger in greater detail than by simple cross reference to the indenture).

56. Since those decisions, the U.S. Supreme Court decided *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991). That decision bars Rule 10b-5 actions brought

In another intent case,[57] Texas-New Mexico Power Company (TNP) redeemed nearly $30 million of non-callable debt pursuant to an eminent domain non-call exception, even though no condemnation of property had taken place.[58] TNP argued that it had sold property "in lieu of condemnation" because a municipality had threatened condemnation. Its bondholders countered that the non-call exception did not provide for "threats" of condemnation and that the prospectus did not reveal that TNP interpreted the eminent domain clause to comprehend asset dispositions made other than in formal condemnation proceedings.[59] Because *Lampf, Pleva* barred a Rule 10b-5 claim,[60] the counter-claimant class asserted issuance-based claims primarily under the Texas Securities Act,[61] which includes an analogue to section 12 of the 1933 Act.[62] As this Article will discuss,[63] that statute and Rule 10b-5 were interpreted to address stock frauds in which invested capital was lost, not bond redemptions causing interest-rate harm.

Apparently only one court has articulated a standard against which to measure novel interpretations of standard non-call exceptions. In *Morgan Stanley & Co. v. Archer Daniels Midland Co.*,[64] the plaintiff argued that the defendant "failed to reveal its . . . view of the redemption language" in a prospectus and thereby committed fraud.[65] The case is interesting because the plaintiff attacked the early redemption on two theories. First, the plaintiff averred the early redemption violated the provisions of the indenture. Second, if the indenture were capable of being read to support the redemption, then that particular reading had not been disclosed to prospective investors in the prospectus. The court ruled against the first theory as a matter of law based on the indenture language and declined to grant summary judgment to the plaintiff on the second theory, stating that for the plaintiff to prevail, "it would have to show that the interpretation of the provision urged by the defendant was contrary to that prevailing in

more than three years after the violation of the statute. *See id.* at 364. If the violation is failure to disclose in the prospectus the risks of redemption, an issuer need only wait to redeem for three years after issuance to avoid liability under the 1934 Act. *See id; see also infra* note 68.

57. Texas-New Mexico Power Co. v. Jackson Nat'l Life Ins. Co., No. 4.95-CV-738-Y, 1997 U.S. Dist. LEXIS 5748 (N.D. Tex. Mar. 31, 1997). The case was commenced as a declaratory judgment action. The defendant counterclaimed on behalf of a class of bondholders for damages under federal and state law causes of action.

58. *See* Fred Vogelstein, *Electric Utility Bond Holders Face More Risk*, WALL ST. J., Nov. 24, 1995, at C1.

59. *See Texas-New Mexico Power*, 1997 U.S. Dist. LEXIS 5748, at *3, *5. The case was settled without a ruling by a court on any of the substantive motions, although certain findings of fact and conclusions of law were entered by agreement. *See infra* notes 75, 78.

60. *See supra* note 56.

61. TEX. REV. CIV. STAT. ANN. art. 581-33 (West Supp. 1999).

62. 15 U.S.C. § 77*l* (1994 & Supp. III 1997).

63. *See infra* notes 142, 151-65, and accompanying text.

64. 570 F. Supp. 1529 (S.D.N.Y. 1983).

65. *Id.* at 1537.

the investment community when the Debentures were issued."[66] The court also noted that The American Bar Foundation's *Commentaries on Model Debenture Indenture Provisions* (*Commentaries*) offered interpretive guidelines to the key language of the indenture and tended to support the defendant.[67] The court did not address whether expert testimony from traders of debt securities would be admissible to establish an interpretation at variance with that in the *Commentaries.*

Although issuance-based fraud plainly falls within section 10(b) of the 1934 Act (and Rule 10b-5 thereunder), the length to maturity of many bonds may render section 10(b) an ineffective weapon. This result follows the U.S. Supreme Court's holding in *Lampf, Pleva,* which mandates that a claim must be made with one year of discovery of fraud and in any event within three years of the violation of the statute.[68] Whatever sense *Lampf, Pleva* makes in the context of stocks, it makes no sense in an issuance-based redemption case. In a garden-variety stock fraud case, the issuer misstates earnings, salts a gold mine, or otherwise commits an act that, in theory, should be discoverable in three years. But in a bond case like *Texas-New Mexico Power* or *Union Electric,* the misrepresentation cannot be discovered (even in theory) until the announcement of a redemption, which could be many years after issuance.[69] Absent a legislative solution, section 10(b) issuance-based claims falling without the *Lampf, Pleva,* limitations period must be brought under more favorable state securities laws[70] or common law theories of fraud and negligent misrepresentation.

66. *Id. Archer Daniels Midland* thus suggests that a bondholder can state and prove a securities fraud claim if it can demonstrate that a condemnation clause did not include, as a matter of indenture construction, a "sale in lieu of condemnation" at the time the prospectus and the bonds were issued. *See id.* at 1536. Adequate pleading would require specific allegations of scienter (at least under Rule 10b-5), which might be supplied by proof of motive. *See* Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1068 (5th Cir. 1994). A plaintiff bondholder would presumably need to develop expert testimony on this issue, a task made lighter because the widely followed Mortgage Bond Indenture Form suggests that "sale in lieu" language is not comprehended by standard eminent domain language, but is a separately negotiable provision. *See* AM. B. FOUND., MORTGAGE BOND INDENTURE FORM §§ 6.02, 6.03 n.14 (1981).

67. *See Archer Daniels Midland,* 570 F. Supp. at 1535; *see generally* COMMENTARIES, *supra* note 8.

68. *See* Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 364 (1991). The Court held that an implied private action under § 10(b) of the 1934 Act and Rule 10b-5 thereunder "must be commenced within one year after the discovery of the facts constituting the violation and within three years after such violation." *See id. See generally* Lewis D. Lowenfels & Alan R. Bromberg, *SEC Rule 10b-5 and Its New Statute of Limitations: The Circuits Defy the Supreme Court,* 51 BUS. LAW. 309 (1996).

69. *See, e.g., Harris II,* 787 F.2d 355, 360 (8th Cir. 1986) (using the discovery rule to find that bondholders' claims were not barred by a state statute of limitations even though the bonds called for redemption over three years after issuance).

70. Class actions, however, may have to be brought in federal court under § 16 of the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3228 (to be codified in scattered sections of 15 U.S.C.).

Although a comprehensive discussion of state securities laws is beyond the scope of this Article, it is worth noting that some states provide analogues to section 12 of the 1933 Act and section 10(b) of the 1934 Act, whereas others provide only one of those choices. In *Texas-New Mexico Power*, the issuance-based section 10(b) claim was blocked by expiration of the statute of limitations under *Lampf, Pleva,* and the state statute provided only limited relief under an analogue to the 1933 Act.[71] The statutory measure of damages was aimed at rescission and restitution, was clearly drafted with stock losses in mind, and did not fit a bond interest-loss case. Most federal cases awarding damages in bond cases are based on 1934 Act section 10(b), largely because of the uncertain measure of damages under a rescissional standard.[72] In states with only rescissional remedies provided by statute, it will be difficult for plaintiffs in bond cases, particularly where interest or market loss rather than loss of principal is at issue, to explain to the court why the statute must be construed to do justice.

REDEMPTION-BASED LIABILITY

Redemption-based liability may be premised on a number of theories: breach of contract, breach of the implied covenant of good faith, securities fraud, violation of the TIA, and common law fraud or misrepresentation.

BREACH OF CONTRACT

Early redemption may be a breach of contract under either the non-call provision itself[73] or a non-call exception. For instance, in *Texas-New Mexico Power*, TNP made no claim that a governmental entity actually

71. *See* Texas-New Mexico Power Co. v. Jackson Nat'l Life Ins. Co., No. 4.95-CV-738-Y, 1997 U.S. Dist. LEXIS 5748, at *2, *5 (N.D. Tex. Mar. 31, 1997); *see also Lampf, Pleva,* 501 U.S. at 364.

72. One commentary states:

> [L]ike the plaintiff at common law in the case of a contract allegedly induced by fraud—and unlike the section 12(2) plaintiff, who is restricted to rescission or a rescissionary measure of damages—the seller who proves a violation of Rule 10b-5 has the choice of undoing the bargain (when events since the transaction have not made rescission impossible) or holding the defendant to the bargain by requiring him or her to pay damages.

LOSS & SELIGMAN, *supra* note 43, at 1061 (citations omitted).

73. A separate breach can arise from the non-call provision. For instance, on the face of the Series T bonds, TNP contractually promised that it would not redeem them at its "option." At the time of the asset sale discussed above, TNP had outstanding at least $80 million of other bonds, all of which were fully callable (i.e., for any reason or no reason). Thus, the bondholders argued that even if the non-call exception had permitted redemption of the Series T Bonds, TNP obligated itself in the Supplemental Indenture not to redeem them when bonds of other series could be redeemed.

condemned[74] or ordered the sale of TNP property.[75] Rather, TNP argued that it sold assets "in lieu of condemnation." A sale in lieu of condemnation was not an enumerated ground under the non-call exception, although it could have been had the parties so chosen when the Indenture was negotiated.[76] Indeed, "sale in lieu of condemnation"[77] language is a standard "negotiable" clause to be considered in drafting the "eminent domain" provisions of an indenture. Thus, the court concluded that the "[s]ale although under threat of condemnation, was not a transaction or event which authorized redemption of any part of the Series T Bonds within the meaning or contemplation of [the indenture]."[78] The harder case, however, is the contract claim in *Florida Power & Light*.[79] In that case, the expectations of the bondholders were dashed by the issuer's redemption of the bonds despite seemingly protective non-call provisions; the bondholders' contract claims, however, were defeated.[80] What if effective relief cannot be granted under issuance-based theories because of *Lampf*, *Pleva* and inadequate state securities law?

The problem may be the myths of the indenture contract.[81] The first myth is that it is negotiated to protect bondholders. Because it is negotiated

74. Condemnation, i.e., the exercise of the power of eminent domain, is controlled by a rigorous statutory formula in Texas. That is, statutory condemnation proceedings must be preceded by a bona fide attempt to reach agreement with a property owner concerning the amount of compensation to be awarded for a taking. *See* TEX. PROP. CODE ANN. § 21.012 (West 1984). More importantly, the findings of fact reveal that no condemnation actually took place. *See Texas-New Mexico Power*, 1997 U.S. Dist. LEXIS 5748, at *4.

75. *See id.* at *4-*5 ("None of the Panhandle Cities had commenced, prior to September 15, 1995 [the notice of redemption date], any eminent domain or condemnation proceedings against any of the Panhandle Properties.").

76. The non-call exception at issue was triggered only if: (i) any part of the Trust Estate was taken by power of eminent domain; (ii) a municipal or governmental body exercised a right to purchase any part of the Trust Estate; (iii) a municipal or governmental body exercised a right to designate a purchaser of any part of the Trust Estate; or (iv) a municipal or governmental body exercised a right to order the sale of any part of the Trust Estate. *See id.* at *3.

77. A sale in lieu of condemnation may be distinguished from condemnation by the voluntary nature of the transaction. Typically, the governmental entity approaches the property owner and offers to buy the property, stating that failure to negotiate a purchase contract will cause the governmental entity to commence condemnation proceedings. In Texas the two concepts have been recognized in the statute, which mandates an effort to negotiate a purchase as a prerequisite to the governmental entity's resort to the courts in a condemnation proceeding. *See* TEX. PROP. CODE ANN. § 21.012. *See generally* Clarissa Kay Bauer, *Eminent Domain Basics for General Practitioners*, 59 TEX. B.J. 742 (1996).

78. *Texas-New Mexico Power*, 1997 U.S. Dist. LEXIS 5748, at *6. The court went on to state: "In following its interpretation or [sic] the Supplemental Indenture and the Original Indenture, TNP unintentionally breached the terms of the Series T Bond, the Supplemental Indenture and the Original Indenture by calling $29.2 million of the Series T Bonds for redemption on October 15, 1995." *Id.*

79. *See* Lucas v. Florida Power & Light Co., 765 F.2d 1039 (11th Cir. 1985).

80. *See id.* at 1044.

81. *See generally* Riger, *supra* note 4. A good example of the poor fit between investor

between the issuer and the underwriter without a clear intent to benefit the future bondholders, it cannot usefully be analyzed as a third-party beneficiary contract.[82] In fact, the bondholders have no effective representation at the time the contract is negotiated, and thus do not obtain the aggressive prohibitions against issuer redemptions that risk-averse bondholders might require.[83]

The second myth is that the indenture controls the investment decision. As discussed earlier, the TIA-mandated indenture is largely a boilerplate document that is conformed to the terms of the deal.[84] In practice, it may be reviewed briefly by bond traders at the major investment houses, but more likely will be summarized by one or more rating services, such as Moody's, Bloomberg L.P., or Standard & Poor's. The bond traders will generally rely on those summaries to determine whether the bonds carry an acceptable level of redemption risk. Although this process may be thought adequate for the very large institutional investors, who can be presumed to protect their interests as they would in a private placement,[85] it renders nugatory the entire regulatory scheme of the 1933 Act if it were thought adequate for individual investors. The indenture cannot be upheld as an integrated contract because the bondholders do not even see it, but instead rely on oral descriptions of the investment and, in law if not in fact, the prospectus.

The indenture often begins with a clear non-call provision, which is then weakened by the issuer's draftsmanship to include various non-call exceptions. Neither the indenture trustee nor the underwriter seriously

reliance and contract principles is *Prescott, Ball & Turben v. LTV Corp.*, 531 F. Supp. 213 (S.D.N.Y. 1981), wherein the court interpreted a notice provision to provide a definition of "capital reorganization," without which the holders of convertible subordinated debentures had no rights to receive stock of the principal subsidiary, which was being spun off by the otherwise unprofitable parent. *See id.* at 219. The court did not discuss the obvious damage to the credit rating of the debentures.

82. For an *ipse dixit* analysis to the contrary, see *Broad v. Rockwell International Corp.*, 642 F.2d 929, 941 (5th Cir. 1981) (en banc).

83. In private bond placements, the investors usually require extensive financial covenants, including debt-equity ratio, current ratio, and earnings tests, to measure the financial health of the borrower. They do not rely on asset-based standards such as an M & R clause. *See* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1509 (S.D.N.Y. 1989).

84. "The prospective buyer can take it or leave it; should the buyer take it, the deficiencies of the indenture go with it. The terms of the indenture may be highly specified, but the purchaser did not negotiate them, nor could he have. Regardless of the technical adequacy of prospectus disclosure, prospectus dissemination is limited and of short duration; the secondary market benefits accrue only on a trickle down basis. What might have trickled down beyond the basic business terms would be negligible." Riger, *supra* note 4, at 219 (footnotes omitted).

85. *But see Metropolitan Life*, 716 F. Supp. at 13-14 (noting that the large institutional investor failed to protect its interests in the public offering, although it had done so in a similar private placement). Needless to say, individual investors could not protect themselves in either situation.

impedes that effort. The underwriter's focus is on interest rate and maturity, with only a broad interest in the language of the call provisions.[86]

The third myth is that the parties could anticipate each of the variables that might cause a non-call exception to apply. The more detailed the draftsmanship, the more opportunities for the issuer to later find an effective means to frustrate bondholder expectations, assuming that it did not plan the loophole from the beginning. It is poor policy to limit bondholder remedies to those contained in a "contract" they rarely see, much less sign, but that purports to have been carefully drafted to meet every possible contingency that could affect their interests. That myth promotes an ill-considered game of legal "gotcha" that can be constrained only by the bondholders' energetic search for extra-contractual remedies, such as the securities laws, or by business considerations such as the issuer's desire to sell bonds in the future.[87]

BREACH OF GOOD FAITH

In addition to an ordinary breach of contract claim, a plaintiff may be able to demonstrate that an issuer breached an indenture by exercising a non-call exception in bad faith (a claim sounding in *contract*). Such a good faith claim is quite narrow: it does not depend on a generalized or independent duty of good faith and fair dealing, nor does it give rise to tort liability. Rather, it is premised on the common law notion that the exercise of a particular contractual provision must be made in good faith, which—at a minimum—requires honesty in fact and commercial reasonableness.[88]

86. *See supra* notes 18-21 and accompanying text .

87. *See* RICHARD S. WILSON AND FRANK J. FABOZZI, THE NEW CORPORATE BOND MARKET 188 (Probus 1990) (stating that Archer Daniels' next bond issues "were not well received"); Coffee & Klein, *supra* note 5, at 1254 n.136 (citing WILSON & FABOZZI, *supra*).

88. This common law duty has been codified in the Uniform Commerical Code (U.C.C.) *See, e.g.*, TEX. BUS. & COM. CODE ANN. § 1.203 (West 1984). Thus, the standard under either the common law, as stated in § 205 of the *Restatement (Second) of Contracts*, or the U.C.C. is essentially the same. *See* U.C.C. § 1-203 (1995); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979). Note that the law of many states, e.g., New York, implies a duty of good faith and fair dealing in the performance of contracts. *See, e.g.,* Rowe v. Great Atl. & Pac. Tea Co., 385 N.E.2d 566, 569 (N.Y. 1978). Nevertheless, the implied covenant of good faith and fair dealing is breached only when one party to a contract seeks to prevent its performance by, or withhold its benefits from, the other. *See* Collard v. Incorporated Village, 427 N.Y.S.2d 301, 302 (App. Div. 1980). The mere exercise of one's contractual rights, without more, cannot constitute such a breach. *See* Mutual Life Ins. Co. v. Tailored Woman, Inc., 128 N.E.2d 401, 403 (N.Y. 1953); Adolph Coors Co. v. Rodriguez, 780 S.W.2d 477, 482 (Tex. App. 1989) ("[I]n order to be actionable as a breach of contract . . . bad faith conduct must relate to some aspect of performance under the terms of the contract."); *cf.* Travelers Int'l A.G. v. Trans World Airlines, Inc. 41 F.3d 1570, 1576 (2d Cir. 1994) (invoking implied duty "to measure compliance with an explicit contract obligation."); First Nat'l Bank & Trust Co. v. Kissee, 859 P.2d 502, 509 (Okla. 1993) ("[W]ithout 'gross recklessness or wanton negligence on behalf of a party' to a commercial contract, a breach of the implied covenant of good faith and fair dealing merely results in a breach of contract."). Recently,

It is possible, for instance, that an issuer made representations to an indenture trustee as to the propriety of a redemption, or it "arranged" facts in ways that were neither honest in fact nor reasonable.

The problem with "good faith" arguments is that they are usually substitutes for analysis of contract language and will not be upheld, particularly by appellate courts, unless it appears that the defendant abused a contractual right in order to do harm to the plaintiff. This concept has more currency under the French *Code Civile* as "abuse of right" (*abus de droit*)[89] and, in some states, under the doctrine of prima facie tort.[90] For example, in *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*,[91] Metropolitan Life Insurance Company (the Met) argued that the equitable principles of good faith and fair dealing supplied an otherwise absent indenture restriction (not a non-call exception) against issuance of debt. The problem arose when RJR Nabisco Inc.'s (RJR Nabisco's) management decided to propose a leveraged buyout, with the usual concomitant debt burden. The bond market savaged the RJR Nabisco bonds, and the Met, one of the largest holders, was dismayed to learn that the indenture did not contain a negative covenant against incurring that debt. The district court dismissed, holding that the indenture was clear and that the court would not imply a fiduciary or equitable duty to augment the written "agreement."[92] The subtext was that the Met, which had required such restrictions in earlier private placements of RJR Nabisco debt, should have known better.[93] The inadequacy of the indenture as the exclusive source of contract terms is unlikely to be remedied by recourse to a general notion of fairness.

Unless the claim gives rise to punitive damages under state law, however, "good faith" would seem to add nothing to the contract claim except perhaps to make admissible some prejudicial evidence relating to conspiracy to breach. While that approach might enhance the prospect of a substantial award from an inflamed jury, query whether it would not also increase the likelihood of reversal on appeal for just that reason.

the Oklahoma Supreme Court allowed a separate cause of action in *tort* for "breach" of good faith. *See* Beshara v. Southern Nat'l Bank, 928 P.2d 280, 291 (Okla. 1996).

89. *See* C. CIV. art. 1382 (Fr.).

90. For a thorough discussion of the doctrine of prima facie tort, see *Schmitz v. Smentowski*, 785 P.2d 726, 733-39 (N.M. 1990).

91. 716 F. Supp. 1504 (S.D.N.Y. 1989).

92. *See id.* at 1522. This Article will not revisit the oft-argued notion that implication of a "fiduciary" duty from the issuer to the bondholder will protect bondholders. Suffice it to say that courts are more enamored by the concept than commentators, many of whom incisively point out its defects. *See, e.g.*, Coffee & Klein, *supra* note 5, at 1254-55; Kahan, *supra* note 5, at 612-13.

93. The district court buttressed its rationale with the notion that bondholders are entitled only to repayment of principal and payment of interest as agreed. *Metropolitan Life*, 716 F. Supp. at 1518. This formulation ignores the bondholders' legitimate expectation of receiving a rate of interest commensurate with the risk undertaken, which had just increased dramatically.

VIOLATION OF THE TRUST INDENTURE ACT

Bondholders may claim that the TIA provides a private right of action to redress an improper redemption. Section 316(b) provides, *inter alia*, "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security . . . shall not be impaired or affected without the consent of such holder."[94]

In 1990, Congress amended the TIA in an apparent attempt to create a statutory private right of action. Unfortunately, Congress only did half the job; it made clear that the TIA imposed duties on the parties to the indenture, but it did not state that private parties could enforce those duties. Apparently unmindful of the rest of the statute, Congress did not amend section 12 of the 1933 Act to identify the type of action that could be brought under section 316, and thus failed to identify the applicable statute of limitations.[95]

The TIA amendments are collectively referred to as the Trust Indenture Reform Act of 1990 (TIRA),[96] and one of them seems to establish federal jurisdiction concurrent with existing state law jurisdiction to enforce the indenture.[97] "The addition [of the phrase 'or duty' to TIA section 322 (b), 15 U.S.C. § 77vvv(b)] clarifies the status of prescribed indenture provisions as federal questions. Jurisdiction is concurrent in federal and state courts to preserve a plaintiff's right to select a forum."[98]

The Senate report accompanying Senate Bill 1712 (the 1989 bill[99] preceding the final version) found that the bill's jurisdictional provision included an implied private right of action. The report noted that "a mod-

94. 15 U.S.C. § 77ppp(b) (1994).

95. Limitations on § 12 suits are specified in § 13. *See id.* § 77m. Section 323 of the TIA contains a private right of action for misstatements and omissions and specifies a statute of limitations. *See id.* § 77www. It relates to omissions from a document filed with the SEC, which would include the registration statement containing the prospectus. It thus provides an analogue to § 11 of the 1933 Act, but does not clearly relate to § 316 of the TIA. *See id.* §§ 77k, 77ppp.

96. *See* Pub. L. No. 101-550, 104 Stat. 2713, *reprinted in* 1990 U.S.C.C.A.N. 2713.

97. Section 322 (b) of the TIA provides:

> Jurisdiction of offenses and violations under, and jurisdiction and venue of suits and actions brought to enforce any liability or duty created by, this subchapter, or any rules or regulations or orders prescribed under the authority thereof, shall be as provided in section 22 (a) of the Securities Act of 1933.

15 U.S.C. § 77vvv(b). Section 22 of the 1933 Act provides federal jurisdiction of offenses and violations, and concurrent federal and state jurisdiction of "suits in equity and actions at law brought to enforce any liability or duty created by this subchapter." *Id.* § 77v(a).

98. 135 CONG. REC. 6063, 6064 (1989); 135 CONG. REC. 4817, 4822 (1989); 134 CONG. REC. 15,947, 15,952 (1988).

99. "H.R. 1396 originated in the House as the International Securities Enforcement Cooperation Act of 1989." 136 CONG. REC. 26,828, 26,833 (1990). "The House passed H.R. 1396 in its original form on September 25, 1989. The Senate then adopted H.R. 1396 on November 16, 1989, with a package of amendments. Those amendments included . . . the Trust Indenture Reform Act of 1990 . . . ." *Id.*

ification to section 322, the Act's jurisdictional provision, would codify the holdings of *Zeffiro v. First Pennsylvania Banking and Trust Co.*, 623 F.2d 290 (3d Cir. 1980), and *Morris v. Cantor*, 390 F. Supp 817 (S.D.N.Y. 1975), finding private rights of action for enforcement of mandatory indenture terms."[100]

Accordingly, the court in *LNC Investments, Inc. v. First Fidelity Bank, National Ass'n*[101] held that all "duties imposed by the statute . . . may be enforced by private parties."[102] The "anti-impairment" provision of section 316(b) of the TIA is of the type subject to private action because it was originally a mandatory indenture term and is now a duty at law. Thus, as with the breach of contract theory discussed above, an issuer breaches its duty to pay interest when it redeems bonds under a scenario not expressly authorized in an indenture. In *UPIC & Co. v. Kinder-Care Learning Centers, Inc.*,[103] the court held that a plaintiff's "right to bring an action to recover principal and interest under [bonds] is guaranteed by operation of Section 316(b)."[104]

Although Congress did not see fit to identify a statute of limitations, the U.S. Supreme Court addressed a similar issue under the Racketeer Influenced and Corrupt Organizations Act (RICO),[105] which entirely omitted a statute of limitations, and adopted a four-year statute based on a review of statutory causes deemed similar.[106] Justice Scalia concurred, but said there should be no statute of limitations on RICO actions because Congress needs to address the problem and will be forced to do so if RICO actions exist forever.[107] Despite the purity of Justice Scalia's logic, it would seem that the majority of the Justices correctly "filled the gap" in the legislation. Otherwise, it would seem hard to discern congressional intent.[108] Based on that reasoning, section 323[109] of the TIA should be held to govern actions under sections 322[110] to enforce rights under sections 305[111] and 318.[112]

Assuming that Congress did intend a private right of action under section 322, and that section 323 should provide the statute of limitations, one again confronts the rationale of *Lampf, Pleva.* In a nutshell, if section

100. *See* S. REP. NO. 101-155, at 31 (1989).
101. 935 F. Supp. 1333 (S.D.N.Y. 1996).
102. *Id.* at 1340.
103. 793 F. Supp. 448 (S.D.N.Y. 1992)
104. *Id.* at 457.
105. 18 U.S.C. §§ 1961-1968 (1994 & Supp. III 1997).
106. *See* Agency Holding Corp. v. Malley-Duff & Assocs., 483 U.S. 143, 156 (1987).
107. *See id.* at 170.
108. *See* Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules,* 99 YALE L.J. 87, 129 (1989).
109. 15 U.S.C. § 77www (1994).
110. *Id.* § 77vvv.
111. *Id.* § 77eee.
112. *Id.* § 77rrr.

323 bars an action brought more than three years from the date of issuance of the bonds, then a federal contract action under TIA section 322 is of little use, unless the issuer happens to call the bonds within three years of issuance. There is also no policy reason why limitations should be shorter for a federal contract action than the four or six years permitted under most state statutes, particularly when the effect is to preclude an action before the bondholder realizes that one exists. *Lampf, Pleva* dealt with tolling the statute because of non-discovery of the violation and decided as a matter of policy that three years was an absolute bar.[113] That rationale does not apply to a redemption case, where there is no problem with discovery of the violation; the issuer makes the violation clear by the act of redemption of the bonds. Instead, courts should hold that the statute does not begin to run until the date of purchase *by the issuer*, which is to say the date of redemption. That would satisfy the policy reason behind limitations: to prevent parties from sleeping on their rights and bringing actions after memories have faded, witnesses have disappeared, and the participants have otherwise proceeded with their lives. It is the redemption that heightens everyone's sensitivities. The issuer knows or should know that its actions will be challenged. Indeed, in *Texas-New Mexico Power Co. v. Jackson National Life Insurance Co.*,[114] upon notice of extreme unhappiness from its major bondholders, the issuer promptly escrowed an amount roughly equal to the interest differential between the then-market rate and the coupon rate for the remaining life of the bonds. It was then up to the bondholders to sue or not, and it would not be unreasonable to impose a short, even a one-year, limitations period in such circumstances. Courts could separately address issues of punitive damages, possibly indicated for deliberate conduct, under non-contract theories.

A MODEST PROPOSAL FOR A FEDERAL CONTRACT REMEDY

All of the discussion of the TIA seems interesting, but redundant of a state law contract claim. The only advantage to a TIA claim would seem to be preservation of federal jurisdiction in the absence of diversity. There may, however, be another part of the argument. Unless TIA section 322(b)[115] merely provides a federal forum for breach of the indenture, it should be more broadly read to provide a remedy for breach of a federal contract, namely the offer contained in the prospectus as well as the indenture.

Among the "duties" imposed by TIRA, section 305(a)(2)[116] requires the issuer to specify the terms of replacement and substitution of collateral.

113. Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 364 (1990).

114. No. 4.95-CV-738-Y, 1997 U.S. Dist. LEXIS 5748 (N.D. Tex. Mar. 31, 1997).

115. 15 U.S.C. § 77vvv(b).

116. *Id.* § 77eee(a)(2).

This provision seems to require a description of the terms on which a special redemption, particularly at par, would be permitted in the event that collateral were not to be replaced or substituted.[117] Moreover, amended section 318(a) provides that the duties imposed by sections 310 through 317 control contrary or omitted indenture provisions.[118] If so, then the TIA offers an independent legal basis for suit based on the prospectus as part of the bond contract. Such a reading would require the issuer to specify in the prospectus all of the instances in which it would be entitled to redeem the bonds at par, thereby complying with section 305, and supplying the omitted indenture provisions, as required by section 318. Unless specified, the right would not exist. This construct would more nearly meet the expectations of the parties. The bondholders could actually read the terms of their contract in the language of disclosure instead of the often obscure language of the indenture. The issuer, forced to disclose all of the circumstances of redemption, could not later find a loophole such as was upheld in *Broad v. Rockwell*[119] and *Prescott, Ball & Turben v. CTV Corp.*[120] In each of those cases, at least one court found that either a literal omission[121] or a tortured reading[122] permitted the par call. If the prospectus omission were a bar, however, none of those redemptions would have been allowed.[123]

117. Section 305 of the TIA provides, in pertinent part:

> (a) *Information required* . . . a registration statement relating to a security shall include . . .
> (2) an analysis of any provisions of such indenture with respect to (A) the definition of what shall constitute a default under such indenture . . . (C) the release or the release and substitution of any property subject to the lien of the indenture . . . .

Id.

118. Section 318 of the TIA provides, in pertinent part:

> (a) Imposed duties to control
> If any provision of the indenture to be qualified limits, qualifies, or conflicts with the duties imposed by operation of subsection (c) of this section, the imposed duties shall control.
>
> . . .
>
> (c) Provisions governing qualified indentures
> The provisions of sections [310] to and including [317] of this title that impose duties on any person . . . are a part of and govern every qualified indenture, whether or not physically contained therein . . . .

Id. § 77rrr(a), (c).

119. 642 F.2d 929, 955-57 (5th Cir. 1981).

120. 531 F. Supp. 213, 219-20 (S.D.N.Y. 1981).

121. *See Broad*, 642 F.2d at 947 (stating that "a court must be concerned with what the parties intended, but only to the extent that they evidenced what they intended by what they wrote").

122. *See Prescott*, 531 F. Supp. at 219 (interpreting a section of the TIA).

123. A similar outcome was reached in *Van Gemert v. Boeing Co.*, 520 F.2d 1373 (2d Cir. 1975). In that case, the indenture provided for mailed notice of a redemption only to holders who registered their convertible subordinated debentures; the bond itself and the prospectus

Would this be a good outcome for the capital markets? Again, the conflict is between the issuer's desire to avoid paying an above-market rate of interest versus the bondholders' desire to retain the promised return on investment. First, one should disregard the anomalous results. *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.*[124] is such a case. Put simply, although the Met had been careful to limit the issuer's ability to downgrade its credit rating in earlier private placements, somebody missed the omission in the public deal that went to litigation. The Met had no real expectation that debt quality would be maintained because it did not insist on maintaining debt quality at the time of purchase. That case was correctly decided, despite some unfortunate dicta about the nature of the bargained contract.[125]

More difficult are the close cases like *Harris v. Union Electric Co.*[126] There the indenture said that the issuer could not redeem the bonds by transferring funds from the Improvement Fund to the Maintenance Fund, which described that which was expected to be the most customary type of transaction. It did not say that direct transfers from the Maintenance Fund were a prohibited source of redemption funds. Most likely, nobody even thought about it. Perhaps the issuer saw the loophole and reserved it for future use. The bondholders' expectations were saved only because the ultimate outcome was via jury verdict. None will know what the jury had in mind, other than that the bondholders' legitimate expectations were frustrated. The U.S. Court of Appeals for the Eighth Circuit believed that justice had been done and refused to upset the verdict, even though there were obvious logical holes, if not inconsistencies.[127] Absent a verdict, however, the result would have been impossible to sustain on traditional contract analysis of the indenture alone. Unless the guiding legal theory is going to be "get to the jury," that is an unsatisfactory result. A more disciplined principle is required and would better serve the capital markets by meeting the expectations of both the issuer and the investor. Simply put, if the issuer wants to sell a non-callable bond, it should say so. The market can then price the bond accordingly, granting it a lower interest rate than a callable version. If there are to be non-call exceptions, they

failed to reveal the limited notice provision. The Second Circuit, assuming putative jurisdiction under a stock exchange rule supposedly effectuating a 1934 Act provision, found a private right of action and held that the notice was inadequate and would not be enforced. *Id.* at 1380, 1383. There was no evidence of fraudulent intent to conceal the indenture provision; it simply was not repeated in the prospectus. As the Court tacitly acknowledged, liability was better analyzed under contract law principles. *Id.* at 1385. It found that there was no meeting of the minds because the bondholders never knew about the limited notice provision. *Id.* at 1383-84.

124. *See* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989).

125. *Id.* at 1517.

126. 787 F.2d 355 (8th Cir. 1986).

127. *See id.* at 372.

can be stated. The market can guess at the likelihood that one of them will come to pass and make price adjustments.

A technical issue is the life of the prospectus, which currently must be delivered to purchasers who buy within ninety days of the effective date of the registration statement.[128] The prospectus need not be delivered to, and may not be relied upon by, a later buyer in the secondary market.[129] It is unclear whether a later buyer from the issuer could rely on the issuer's statements in an outdated prospectus.

SEC rule-making would be required to provide that statements in the prospectus relating to the issuer's ability to call the bonds, and perhaps other contents, remain effective for the life of the bonds. They amount to warranties, not merely disclosure points. Analytically, this characterization fits within the notion of an expanded federal contract governing the bonds, meets the expectations of the parties, and provides a logical underpinning for the private right of action Congress seems to have provided in TIRA.[130]

LIABILITY FOR SECURITIES FRAUD IN THE REDEMPTION OF BONDS

A bondholder also may be able to allege that a redemption, as distinguished from an issuance, was fraudulent within the meaning of section 10(b) of the 1934 Act and Rule 10-b(5) thereunder.[131] The theory in such a case is that the redemption at issue violated section 10(b) under the "forced seller doctrine," which is occasionally referred to as "transaction fraud."[132]

There is a source of proof of a device or artifice unique to bond debt. To redeem bonds (or to procure a release of trust estate property with which to fund a redemption), an issuer typically must provide one or more certifications to the indenture trustee. Moreover, in a case involving the release of property that is cross-collateralized, certifications under more

128. *See* 15 U.S.C. § 77d(3) (1994).

129. *See id.* § 77*l*; *see also* Budget Rent A Car Sys., Inc. v. Hirsch, 810 F. Supp. 1253, 1256 (S.D. Fla. 1992).

130. Although it might be argued that this scheme would place debt securities on a different plane than equity securities, this Article submits that the argument is true and the differentiation proper. An equity security is an investment in the fortunes of the company, not a contract for a stated amount to be repaid with interest. A contract's terms remain in force for the "life" of the contract, even if that extends over a period of years and the circumstances of the parties change. A stock purchase, on the other hand, is an investment without certainty that either a return will be paid or that the original investment can be recovered if the business fails. Different circumstances justify different regulatory approaches.

131. *See* 17 C.F.R. § 240.10b-5 (1999). Rule 10b-5 makes it illegal to use deceptive devices or to make misleading statements "in connection with the purchase or sale of any security."

132. *See Harris II*, 787 F.2d 355, 366 (8th Cir. 1986); Alley v. Miramon, 614 F.2d 1372, 1380 (5th Cir. 1980).

than one indenture and to more than one trustee, or to a bank, are common. Thus, if a particular redemption is a stretch under a non-call exception, the issuer may stretch or omit facts in order to satisfy one or more trustees' needs for appropriate certifications.[133] Depending on the facts revealed, the claim could be pleaded as securities fraud.

In *Texas-New Mexico Power Co. v. Jackson National Life Insurance Co.*, for example, the issuer had to certify to one indenture trustee that there were no actions pending or threatened that would encumber any of the trust estate.[134] Simultaneously, the issuer had to certify to the trustee of the bonds to be redeemed that a portion of the trust estate was being condemned by a governmental entity. This anomaly presented serious credibility problems for the issuer. Compounding the inherent contradiction was the routine nature of such certificates: officers, including the president, signed them without any personal knowledge of their truth. Although the financial community might wink at such offhand averments, a jury might be less inclined to do so.

Even in the absence of a jury, such evidence would tend to show a conscious indifference to the truth, or recklessness,[135] that could lead to a finding of scienter, if not common law fraudulent intent. It is the type of evidence from which a fraud could be inferred.[136] The problem, however, is that the bondholders are unlikely to find out about it before their case is dismissed. Under the Reform Act, it may be necessary to plead such generally unavailable evidence rather than a more general set of facts from which the motive to commit fraud can be inferred.[137] This anomaly shows

133. Of course, an issue of standing may arise in this type of case, given that the pertinent misrepresentations would be made to the trustee, not the bondholders. But if the certifications made to the trustee are inadequate, the trustee may have liability. *See, e.g.,* Shawmut Bank v. Kress Assocs., 33 F.3d 1477, 1481-82 (9th Cir. 1994) (involving bondholders who sued for disbursements made by trustee on inadequate requisition certificates). A suit against a trustee in this circumstance might prod the otherwise reluctant trustee to bring any misrepresentation claims.

134. No. 4.95-CV-738-Y, 1997 U.S. Dist. LEXIS 5748, at *4-*5 (N.D. Tex. Mar. 31, 1997).

135. Recklessness probably qualifies as scienter in most circuits:

> [R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990) (quoting Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977)).

136. *See, e.g.,* Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1067 (5th Cir. 1994).

137. *See* 15 U.S.C. § 77z-1 (Supp. III 1997). Although the amount of a public company's outstanding public debt will be reported in various financial publications, only a study of its SEC filings will locate copies of the indentures under which the various bonds were issued. If the indentures can be found, so can the language required in certificates to permit the

that federal securities fraud cases are blunt and inherently unsatisfactory weapons to address contract breaches and statutory violations absent obvious evidence of malefaction.

Under the proposed federal contract, however, fraudulent misstatements or omissions would be easier to discern and to punish. Either the prospectus described the type of redemption event or it did not. There could be room for legitimate disputes, of course, but the issuer would have the heavy burden of showing that the prospectus language effectively warned a reasonable investor of the possible redemption. Technical indenture language would not impede such a showing. In fact, the practical necessity of alleging fraudulent or knowing behavior would diminish if not be eliminated in all but egregious cases. Issuers could take some comfort in knowing that a wrong guess on the adequacy of a disclosure term could more easily be dealt with as a matter of federal contract law rather than fraud law with its attendant risks of punitive damages. A fraud case might, in keeping with recent statutory amendments elsewhere,[138] require pleading and proof of intentional wrongdoing, a difficult hurdle. That type of rule would avoid the anomalous negative pregnant in *Morgan Stanley & Co. v. Archer Daniels Midland Co.*[139] In that case, the plaintiff argued that the defendant "failed to reveal its . . . view of the redemption language" in a prospectus and thereby committed fraud.[140] The court noted that "[i]n order for Morgan Stanley to prevail on this claim, it would have to show that the interpretation of the provision urged by the defendant was contrary to that prevailing in the investment community when the Debentures were issued."[141] One must ask: why would a showing that the defendant held a minority view of the meaning of a provision constitute fraud? Where is the intentional conduct, the scienter, at least? Does that not merely sound in breach of contract? Again, a federal contract including the prospectus offers a more disciplined rationale for the rule.

INVESTORS AND ISSUERS NEED A COHERENT THEORY OF DAMAGES FOR IMPROPER REDEMPTIONS

The theory and calculation of damages in improper redemption cases often present novel questions of law and fact. When bonds have been

redemption of other debt. At that point, however, it will be difficult to obtain copies of the certificates, making it impossible to fairly allege their contents. Depending on the jurisdiction, pleading on information and belief may be sufficient, but some counsel, particularly for larger institutions, would be reluctant to bring suit on that basis.

138. *See id.*; Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (amending scattered sections of 15 U.S.C.).

139. 570 F. Supp. 1529 (S.D.N.Y. 1983).

140. *Id.* at 1537.

141. *Id.*

redeemed, the primary injury is lost interest over the remaining term of the bond, rather than loss or diminution in value of principal. Most securities fraud cases have involved stocks, not bonds. The holdings and *ratio decidendi* in those cases tend to focus on out-of-pocket loss, not a useful concept in the interest-loss context. For example, the traditional measure of recovery under Rule 10b-5 is out-of-pocket loss.[142]

In a case based on an unauthorized redemption, damages may appear deceptively simple to quantify. In one approach, bondholders may be said to have lost the difference between the interest that their redeemed bonds were earning and that of an equivalent reinvestment. Proof of this loss can be shown in one of two ways. First, if there is a market for the bonds at the time of redemption, damages would be the difference between the market price and the special redemption price. Second, and alternatively, an expert may show that a comparable reinvestment is earning a certain percent less than the redeemed bonds and can then project that differential over the remaining life of the redeemed bonds.[143]

If, however, the central claim is that call risk was neither agreed upon nor adequately disclosed at issuance, causing the bonds to be mispriced, then the expert's task will be to determine the higher coupon rate (or lower price) assigned to the bonds so that they would have been marketable at issuance. Appropriate proof may be developed through the use of comparables, price drops[144] and/or such financial models as Black-Scholes-Merton.[145] As the court held in *Union Electric*,

142. *See, e.g.*, Huddleston v. Herman & MacLean, 640 F.2d 534, 555-56 (5th Cir. 1981). In this situation, a plaintiff can recover damages equal to the difference between the price paid and the "real" value of the security, i.e., the fair market value absent the misrepresentations, at the time of the initial purchase by the defrauded buyer. That formula, however, does not exactly fit an interest rate loss.

143. The two methods should yield roughly the same results.

144. The Reform Act's amendment to § 21(e)(1) of the 1934 Act bars certain damage claims for market loss when the price of a security "bounces back" after the dissemination of a misstatement or omission:

> [I]n any private action arising under this title in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

15 U.S.C. § 78u-4(e)(1) (1994 & Supp. III 1997).

145. Several studies have examined the question of how the presence of a call provision affects the rate of interest set on a bond at issuance. *See, e.g.*, THE HANDBOOK OF FIXED INCOME SECURITIES (Frank J. Fabozzi et al. eds., 1991) (reviewing various approaches); RICHARD A. BREALY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE (3d ed. 1988) (opining that the Black-Scholes pricing model, which was developed to value options generally, could be used for call provisions); Kraus, *supra* note 1 (noting study from the 1970s determining that a call provision was worth 30 basis points and opining that current

[t]he proper measure of damages in this case is the difference between the purchase price and the actual value of the bonds on the date they were issued. This remedy is best suited to the harm in this case because it represents the reduction in the value of the bonds caused by the lack of call protection. Although the plaintiffs purchased the bonds for less than 101, the bonds were worth much less because the call protection that the plaintiffs thought they were purchasing did not exist. The plaintiffs paid more for the bonds than they were actually worth. This is not one of those cases recognized by the court in *Harris v. American Investment Co.* in which the value of the security should be determined on the date the fraud was discovered because its true value on the date it was purchased is too difficult to ascertain. To the contrary, we believe that the true value of the bonds on the date they were issued is reflected by the *drop* in the market price once the fraud was discovered. We agree with the plaintiffs that the reduction in market value fairly represents the reduction in the initial purchase price of the bonds that would have been necessary in order to sell them at 10½% without the call protection. The plaintiffs introduced ample evidence demonstrating that if [Union Electric] had issued the bonds without the ten-year-call protection, the plaintiffs would have either paid a substantially lower price for the bonds or demanded a higher coupon rate.[146]

Although the theoretical choices may be so described, few courts have actually employed a *Union Electric* type of analysis under the securities laws. A few cases under section 12(a)(2) of the 1933 Act[147] have attempted to approach a market-rate calculation by awarding prejudgment interest at an above-market level, a crude instrument at best.[148] One court noted that although punitive damages were not allowed, the appropriate rate of prejudgment interest was "that which will adequately compensate the plaintiffs for the loss of use of their money."[149] The court then awarded the plaintiffs twelve percent interest, pointing out that they could have obtained this much from an alternative investment in their money market fund.[150]

increment would be several times higher because of the increase in interest rate volatility since that time).

146. Harris v. Union Elec. Co., 787 F.2d 355, 367-68. Note the imbedded acceptance of the efficient market theory.

147. Owing to statutory amendments in 1995, former § 12(2) was renumbered as (a)(2), and a new subsection (a)(1) was added. *See* 15 U.S.C. § 77*l* (1994 & Supp. III 1997); *see also* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, § 105.

148. *See* Kaufman & Enzer Joint Venture v. Dedman, 680 F. Supp. 805, 814 (W.D. La. 1987).

149. *See* Scheve v. Clark, 596 F. Supp. 592, 596 (E.D. Mo. 1984).

150. *Id.*

The federal courts have had to craft a damages rule for implied actions under section 10(b) of the 1934 Act[151] and Rule 10b-5 thereunder.[152] Because Rule 10b-5 contains no damages provision, the courts turned to section 28 of the 1934 Act, which provided that the plaintiff could recover only "actual damages on account of the act complained of."[153] This unclear phrase led some courts to the belief that it meant an "out-of-pocket" rather than "benefit-of-the-bargain" measure.

This issue arose in *Zeller v. Bogue Electric Manufacturing Corp.*,[154] where the plaintiff complained in a derivative suit that the defendant caused the injured company, which it controlled, to lend it money at a favorable rate. Eventually, the defendant repaid the loan with the agreed upon, but below-market, interest and claimed that the plaintiff, having no out-of-pocket loss, had suffered no damages cognizable at law.

The facts were as follows: Zeller, a stockholder of Belco Pollution Control Corp. (Belco), sued derivatively Bogue Electric Manufacturing Corp. (Bogue), certain of its directors and others. He alleged that Bogue caused Belco to offer to the public 200,000 of its 810,000 common shares, that Belco suffered operating losses thereafter and was short of working capital, but that the individual director defendants caused Belco to lend to Bogue over $300,000 at eight percent interest, a below-market rate for the risks undertaken. When those loans were disclosed, a second Belco public offering was aborted. Suit was based on Rule 10b-5 and state securities laws.

The district court granted defendants' motion for summary judgment and dismissed the complaint on the basis that section 28(a) of the 1934 Act entitled plaintiff to recover only under the "federal" out-of-pocket damages rule.[155] The plaintiff appealed.

In a decision by Judge Henry Friendly, the U.S. Court of Appeals for the Second Circuit's panel noted plaintiff's arguments that Belco could have obtained more than eight percent interest in an arm's-length transaction.[156] The panel then observed that, although the "benefit of the bargain" rule had been repudiated in 1934 Act cases in several circuits, "[s]uch repudiation does not necessarily call for a rule that, if a fraudulent seller can be shown to have made a windfall profit, principles of the law of restitution do not require that he be made to disgorge it."[157]

In this light, Judge Friendly discussed the plaintiff's claim that the eight percent interest rate was fraudulently imposed:

> Plaintiff's first theory of damages . . . is, in essence, that the 8% note and the preceding open account debt were not worth what Belco paid for

151. 15 U.S.C. § 78j(b) (1994).
152. 17 C.F.R. § 240.10b-5 (1999).
153. 15 U.S.C. § 78bb(a).
154. 476 F.2d 795 (2d Cir. 1973).
155. *Id.* at 798.
156. *Id.* at 801.
157. *Id.* at 802 (citation omitted).

> them. We cannot agree with the district court that damage to a subsidiary from forcing it to loan money to a parent necessarily is fully compensated by the parent's paying off the note, even with a fairly liberal rate of interest, if the subsidiary was in a position to lend money at a higher rate. If Bogue had had outstanding 8% debentures which were selling say at 80, it would be hard to deny that Belco was damaged if Bogue forced it to purchase at 100 such bonds, whether held in Bogue's treasury or an additional issue, even though they were paid at maturity.[158]

The Second Circuit therefore held that the grant of summary judgment was improvident and that plaintiff should be allowed to try his claims.[159]

One can note initially that Judge Friendly discussed the proper measure of damages in rescissionary terms. He focused on restitution, which in equity is the award upon a finding that rescission has occurred or should be ordered.[160] He also focused on returning the plaintiff to the *status quo ante*, much as the 1933 Act cases have done. Judge Friendly recognized that such a result was not adequate compensation for the misappropriation of the bondholders' money, and that the bondholders should receive the difference between the contractual rate and the rate necessary to reflect the higher risk of premature call.[161] That approach is truly rescissionary and restores to the plaintiff the position he would have occupied but for the misrepresentation.

In *Madigan, Inc. v. Goodman*,[162] the U.S. Court of Appeals for the Seventh Circuit followed Judge Friendly in deciding that a form of rescissionary damages was appropriate in a 10b-5 case despite the general rule.[163] The Madigan Group, a joint venture of corporate and individual investors, sued selling shareholders of Fidelity General Insurance Co. for false representations under Rule 10b-5 and for Illinois common law fraud. The plaintiffs sold stock to an affiliate, prior to bringing suit, for the same amount they had paid. The district court dismissed the complaint on the ground that plaintiffs had suffered no loss from their purchase and could not recover lost profits or consequential damages.[164] The Seventh Circuit thought otherwise:

> The federal rule has traditionally been that only "out of pocket" losses are recoverable in a fraud action. A defendant "was bound to make good the loss sustained, such as the moneys the plaintiff had paid out and

158. *Id.*
159. *Id.* at 803-04.
160. *Id.* at 801 n.10; *see also* LOSS & SELIGMAN, *supra* note 43, at 971-72.
161. *Zeller*, 476 F.2d at 801 n.10. Note that Judge Friendly spoke of the buyer being made to buy at 100 bonds selling at 80. Because the price of the bond is inversely related to the interest rate, he saw that his example was another way of looking at being forced to accept 8% when 10% or more was the arguably correct rate.
162. 498 F.2d 233 (7th Cir. 1974).
163. *Id.* at 239-40.
164. *Id.* at 235.

> interest, and any other outlay legitimately attributable to defendant's fraudulent conduct; but this liability did not include the expected fruits of an unrealized speculation."
>
> We adhere to this rule. Plaintiffs have not alleged a breach of contract; they complain of a misrepresentation. If defendants had told the truth, plaintiffs would have no complaint. Neither would they have had a million dollars in expected profits on a 1-3/4 million dollar investment. The consequence of defendants' acting legally would have been that plaintiffs would not have purchased, or would have purchased at a lower price. Plaintiffs are entitled to compensation for lost alternative uses of their money, but defendants' fraud did not obligate them to create profits that never existed and, under the alleged circumstances, never could have existed.
>
> Even lost alternative investments are not literally "out of pocket" expenses, but that shorthand phrase should not obscure proper analysis. . . . Had plaintiffs not purchased the Fidelity stock, or purchased at a lower price, they would have put the unused money somewhere, even if only in a savings account. Unlike the non-existent profits envisioned as a result of defendants' misrepresentations, the chance to use their money elsewhere was actually lost to plaintiffs. But we agree with *Zeller, supra,* that if plaintiffs seek more than the market rate of interest, they must prove with a 'good deal of certainty' that they would have made a particular alternative investment that would have produced a higher return than market interest.[165]

Much of the confusion might be alleviated if the proposed federal contract model were adopted. Contract damages precisely fit the harm to a bondholder suffering an improper redemption. The customary measure is lost profits; in this instance, lost profits are the differential between the bargained-for rate of interest and the rate available from an alternative investment of like kind and quality. The argument, presumably, would be: (i) what was the bargained-for rate, and (ii) whether the differential is measured from the point of investment or point of redemption.

Bearing in mind that the rate is set as a function of safety and term (or duration, in institutional cases), the bondholder would argue that the contract rate would not be the appropriate baseline. That is because the rate was set based on a misunderstanding of the risks involved. The investor thought that he was buying a bond having a certain rate for a certain term. He may have made the purchase because he thought rates were likely to decline in the future or because he needed to match the maturity of the bond against an obligation to pay money at that time. If the term was to be shorter, he would have demanded a higher rate (to compensate for the lost future opportunity to enjoy

165. *Id.* at 239-40 (citations omitted).

the face rate[166]) or would have bought another bond of the desired maturity. In this sense, then, the "bargained-for" rate may be different from the stated rate, which may reflect the issuer's belief that it could call the bonds before maturity.

If the investor's perspective controls, then the applicable point of measurement is the date of issuance, not of redemption. If the "bargained-for" rate is to be measured based on the term matching the investor's expectations, it must begin at the point of investment. If it were measured at the point of redemption, then the investor would not be compensated for overpaying for the call-risk bond and accepting a lower rate of interest during the period leading up to the redemption. Stated differently, the issuer will have been given a free look at the market during the bond term leading up to the point of redemption, whereas the investor will have been saddled with an overpriced bond.

CONCLUSION

Existing paradigms of liability for wrongful par calls are inadequate. The notion that the indenture is a contract between the investor and the issuer is flawed by the investor's usual total ignorance of its terms and the ease with which public investors can be misled by lacunae in the drafting. At the other extreme, using fraud theories to attack contract breaches creates pleading and proof problems that reveal the inappropriateness of the approach. The amended TIA offers some help, but it, too, has areas of uncertainty that allow widely divergent outcomes much like those in prior litigation. A more predictable theory would better serve the capital markets.

Amending applicable SEC rules to incorporate the prospectus in the contract would allow for a clear extension of TIA section 305[167] duties to bind the issuer to its statements. After all, we are discussing the means by which the issuer will be allowed to vitiate investor expectations by redeeming the bonds. It is more than reasonable to require those means to be precisely stated and to admit of no further exceptions. While some issuers might resent the loss of "wriggle room," they will likely be rewarded for candor by the lower interest rates that confident investors will be willing to accept.

166. This type of speculation is contrary to the norm that, because risk increases with term, rates increase with term. In times of perceived high interest, however, such as 1980 to 1981, some short-term rates exceed long-term rates because of the belief that rates will decline in the future.

167. 15 U.S.C. § 777eee (1994).