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A Practitioner's Guide to Exchange Offers and Consent Solicitations

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A PRACTITIONER'S GUIDE TO EXCHANGE OFFERS AND CONSENT SOLICITATIONS

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I. INTRODUCTION

Non-bankruptcy restructurings, which encompass a variety of corporate finance transactions, may prove to be the boom area of securities law in the 1990s, as the issuance of debt securities was in the 1980s.[1] The general purpose of restructuring transactions is to preserve the going concern value of a financially troubled corporation[2] by modifying its capital structure to reduce interest or dividend expense, or to eliminate or modify covenants in the corporation's existing securities that restrict or prohibit a restructuring, or that the corporation can no longer satisfy.[3]

A corporation can effect a restructuring in a number of ways. One often-used technique involves the consensual exchange (Exchange Offer) of new securities of the corporation (New Securities)[4] for certain of its then outstanding securities (Target Securities).[5]

In addition, a corporation contemplating an out-of-court restructuring may choose to solicit security holders' consents to modify Target Se-

1. *See, e.g., Cleaning Up After the '80s*, INST'L INVESTOR, May 1990, at 92; *Corporate Finance; Time to Pick Up the Pieces*, FIN. TIMES, June 18, 1990, at 1; Curran, *Hard Lessons from the Debt Decade*, FORTUNE, June 18, 1990, at 76; Light, *Yesterday's Bad Deals Are Today's New Business*, BUS. WK., Dec. 11, 1989, at 96; Osborne & Voorhees, *Looking for Trouble*, AM. LAW., Apr. 1990, at 6; Peterson, *The Bankruptcy Boom*, L.A. Times, June 30, 1990, at D1, col. 2; Perry, *Leveraged Buyout Firms Take Aim at Restructuring*, Reuters, June 27, 1990 (LEXIS, Nexis library, Business file); Wise, *Workouts, Bankruptcy Work Replacing Junk Bonds Practice*, N.Y.L.J., Nov. 2, 1989, at 1.

2. This Article focuses on out-of-court restructurings of corporations, although the concepts and laws often apply equally to other legal entities.

3. For example, a corporation may offer shares of its common stock to holders of its debt securities to eliminate interest expense or to preferred stockholders to eliminate dividend requirements. *See, e.g.*, BALLY MANUFACTURING CORP., OFFERING CIRCULAR (May 30, 1990); FINANCIAL CORPORATION OF SANTA BARBARA, PROSPECTUS (Nov. 7, 1989) (amended by three supplements, the last of which was dated Jan. 3, 1990) (common stock for one series of preferred stock and two series of debt). Obviously, the reduction of interest expense and dividend obligations would be attractive to non-financially troubled corporations, as well. Non-financially troubled corporations have, in fact, used some of the techniques described in this Article to accomplish these goals. *See, e.g.*, OCCIDENTAL PETROLEUM CORPORATION, OFFERING CIRCULAR (Sept. 23, 1987) (offering common stock for senior notes); OCCIDENTAL PETROLEUM CORPORATION, OFFERING CIRCULAR (July 2, 1987) (offering common stock for preferred stock that was exchangeable into debt securities).

4. The term, "New Securities," for the purposes of this Article, shall include any security that is issued or created pursuant to any form of restructuring, including any exchange for or modification of existing securities.

5. The term, "Target Securities," for the purposes of this Article, shall include any outstanding security that a corporation attempts to acquire (for cash or New Securities) or modify pursuant to any form of restructuring.

curities (Consent Solicitation),[6] reclassify equity securities pursuant to an amendment to the corporation's charter (Reclassification)[7] or repurchase Target Securities for cash.[8] A financially troubled corporation may also utilize a "pre-packaged" plan of bankruptcy (Prepackaged Bankruptcy) to avoid protracted chapter 11 proceedings.[9] This Article, however, focuses on issues related to out-of-court restructurings generally as well as certain issues unique to Exchange Offers that involve an exchange or a series of exchanges of New Securities for Target Securities pursuant to section 3(a)(9)[10] of the Securities Act of 1933, as amended (the Securities Act),[11] and on some of the issues raised by Consent Solicitations,[12] which frequently accompany restructurings that include an exchange of securities.

The issuance of New Securities in exchange for Target Securities

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6. *See infra* notes 44, 303-81 and accompanying text.

7. *See, e.g.*, CAL. CORP. CODE §§ 401, 903 (West 1991); DEL. CODE ANN. tit. 8, § 242 (1983 & Supp. 1990). Such an amendment can, for example, transform a share of preferred stock into a share of common stock. The Reclassification thereby would eliminate that preferred stock and, subject to relevant state corporate statutes and case law, eliminate its associated preference, dividend and other rights. In addition, a Reclassification would enable a corporation seeking to restructure its existing common stock or preferred stock into new stock to eliminate the issue of "holdouts," because once the corporation receives the requisite stockholder vote to effect the amendments, *all* holders of the modified (*i.e.*, reclassified) Target Securities, even those holders who voted against the Reclassification, are bound by the vote. For a discussion of the issue of holdouts generally, see *infra* notes 45-50 and accompanying text. When considering a Reclassification, practitioners must analyze whether the applicable corporate statute permits Reclassifications, and if it does, whether the stockholders who vote against the Reclassification would be entitled to dissenters' rights of appraisal. *See* 3 MODEL BUSINESS CORP. ACT ANN. § 13.01 (1990) (listing 29 states that provide dissenters' rights of appraisal when certain amendments to a charter are approved). *See, e.g.*, N.Y. BUS. CORP. LAW, § 802(b)(6) (McKinney 1986); 3 MODEL BUSINESS CORP. ANN. ACT § 13.02(a)(4) (1990). Delaware and California are among those states that do not provide for dissenters' rights of appraisal in such circumstances.

8. This usually occurs through a corporation's cash self-tender offer for Target Securities, *see, e.g.*, ZAPATA CORP., OFFER TO PURCHASE (Nov. 5, 1990), or through its open-market repurchase of its debt or equity securities. Rule 10b-18, 17 C.F.R. § 240.10b-18 (1990), governs an issuer's open market purchases of its common stock by providing a safe harbor from liability for manipulation under sections 9(a)(2) and 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78i(a)(2), 78j(b) (1988). *See* Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor, Exchange Act Release No. 19,244, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,276, at 85,477 (Nov. 17, 1982); *Post-Crash Repurchases: Legal Regulatory Concerns*, Manhattan Law., Dec. 8, 1987, at 34; Olson & Rosengren, *SEC Gives Issuer Repurchasers a Safe Harbor at Last*, Legal Times, Feb. 21, 1983, at 32.

9. Prepackaged Bankruptcies are authorized by section 1126(b) of chapter 11 of the Federal Bankruptcy Code, 11 U.S.C. § 1126(b) (1988). See *infra* notes 48-49 and accompanying text for a brief discussion of Prepackaged Bankruptcies. *See, e.g.*, THE SOUTHLAND CORPORATION, PROXY STATEMENT-PROSPECTUS (Oct. 5, 1990).

10. 15 U.S.C. § 77c(a)(9) (1988).

11. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1988).

12. *See infra* notes 303-81 and accompanying text.

requires registration of the offering of the New Securities with the Securities and Exchange Commission (the SEC),[13] unless an exemption is available.[14] Section 3(a)(9) of the Securities Act (Section 3(a)(9)) provides such an exemption and is often relied upon in the context of out-of-court restructurings.[15] This exemption, often called the "exchange exemption," applies when New Securities are exchanged, except in a case under title 11 of the United States Code,[16] "by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."[17]

A restructuring conducted as an exchange of securities pursuant to Section 3(a)(9) (Section 3(a)(9) Exchange)[18] offers a distinct advantage over alternative forms of restructurings—by avoiding the delay associated with the registration of securities with the SEC, a Section 3(a)(9) Exchange can be commenced relatively quickly and relatively inexpensively.[19] A Section 3(a)(9) Exchange, however, also has one significant disadvantage to the corporation—the corporation cannot retain paid agents to solicit the participation of the holders of Target Securities in

13. For a discussion of the judicial interpretation of exchanges of securities as "sales" under the Securities Act, see *infra* note 118 and accompanying text.

14. Securities Act of 1933, § 5, 15 U.S.C. § 77e. This Article does not specifically address the Securities Act registration process in any detail. For a general discussion of the registration process, see R. JENNINGS & H. MARSH, SECURITIES REGULATION CASES AND MATERIALS 110-219 (6th ed. 1987); I & II L. LOSS & J. SELIGMAN, SECURITIES REGULATION 513-743 (3d ed. 1989 & Supp. 1990).

15. Corporations also conduct exchanges that are exempt from the registration requirements of the Securities Act pursuant to exemptions for securities issued in (a) a settlement that includes the issuance of New Securities and that is approved by a qualifying governmental agency, provided by section 3(a)(10), 15 U.S.C. § 77c(a)(10) (Section 3(a)(10) Settlement Exchange), and (b) a private placement of New Securities, provided by section 4(2), 15 U.S.C. § 77d(2) (Section 4(2) Private Exchange).

16. Title 11 of the United States Code contains the Federal Bankruptcy Code. 11 U.S.C. §§ 101-1330 (1988).

17. 15 U.S.C. § 77c(a)(9).

18. While this defined term, as well as this Article, focuses on outright exchanges of a New Security for a Target Security, Section 3(a)(9) also can be relied on to exempt other forms of out-of-court restructurings, such as Reclassifications, which are effected through a stockholder vote rather than a voluntary exchange of securities. *See* Rule 145 & preliminary note 2, 17 C.F.R. § 230.145 & note 2 (1990) (providing that an "offer" or "sale" of a security occurs for purposes of the Securities Act when stockholders are asked to vote or consent to a plan or agreement that, in essence, requires an investment decision on their part, and expressly providing that Section 3(a)(9) is available to exempt certain Rule 145 transactions from the registration requirements of the Securities Act if the conditions of Section 3(a)(9) are satisfied); Securities Act Release No. 5463, 1 Fed. Sec. L. Rep. (CCH) ¶ 3058, at 3067-3 to -4 (Feb. 28, 1974) (Illustration C).

19. For a discussion of the importance of the time required to complete a restructuring in selecting a restructuring technique, see *infra* notes 37-38 and accompanying text.

the proposed exchange.[20] If a corporation believes that professional solicitation efforts are essential to the success of its restructuring, the corporation must either conduct the exchange within the parameters of another Securities Act exemption,[21] or it must register the sale of New Securities offered in the exchange by filing a registration statement with the SEC (Registered Exchange).[22]

From a legal standpoint, Exchange Offers may involve a plethora of regulations and issues, including the following:

- the elements of Section 3(a)(9), if applicable;[23]
- if there is a concurrent Consent Solicitation, the proxy rules set forth in Regulation 14A[24] and Regulation 14C[25] promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act);[26]
- the tender offer and "going private" rules[27] promulgated under the Williams Act, as amended;[28]

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20. *See infra* notes 204-57 and accompanying text. Another disadvantage of the Section 3(a)(9) Exchange is that, as in all consensual exchanges, participation of holders of Target Securities is voluntary, and as such cannot bind non-participating holders of Target Securities. These non-participating holders are often called "holdouts." For a discussion of the issue of holdouts, see *infra* notes 45-50 and accompanying text. The issue of holdouts in consensual restructurings may cause a corporation to use another form of restructuring that binds non-consenting holders of Target Securities, such as Reclassifications, see *supra* note 7, and Prepackaged Bankruptcies. *See*, Hylton, *Business and the Law: Prepackaging a Bankruptcy*, N.Y. Times, Nov. 26, 1990, at D2, col. 1; *Southland Uses New Weapon in Reorganization Battle*, Reuters, Oct. 24, 1990 (LEXIS, Nexis library, Current file); Helliker, *Prepackaged Bankruptcy Acts as a Weapon*, Wall St. J., Oct. 2, 1990, at A10, col. 1. See *infra* notes 48-49 and accompanying text, briefly discussing Prepackaged Bankruptcies.

21. *See supra* note 15.

22. As noted above, this Article does not attempt to review the registration process under the Securities Act, which is not that different for Exchange Offers than for any other type of offering, and is described well by many other commentators. *See, e.g.*, authors cited *supra* note 14. Instead, this Article focuses more on Exchange Offers conducted pursuant to Section 3(a)(9), a topic that has not been analyzed extensively from a practitioner's perspective. *See infra* notes 118-302. For a brief discussion of some of the timing and other factors that govern a Registered Exchange and the proper form for registering an Exchange Offer pursuant to the Securities Act, see *infra* notes 37-38 & 287, respectively.

23. *See infra* notes 127-257 and accompanying text.

24. Regulation 14A, 17 C.F.R. §§ 240.14a-1 to 240.14b-2 (1990). For a discussion of the proxy rules, see *infra* notes 448-57 and accompanying text.

25. Regulation 14C, 17 C.F.R. §§ 240.14c-1 to -7 (1990). The requirements of Regulation 14C approximate those of Regulation 14A; consequently, Regulation 14C generally will not be referred to separately in the balance of this Article.

26. 15 U.S.C. §§ 78a-78kk (1988).

27. The tender offer and going private rules that primarily apply to Section 3(a)(9) Exchanges include Rule 13e-3, 17 C.F.R. § 240.13e-3 (1990), Rule 13e-4, 17 C.F.R. § 240.13e-4 (1990), and Regulation 14E, 17 C.F.R. § 240.14e-1 to -3 (1990). For a discussion of the tender offer and "going private" rules, see *infra* notes 382-447 and accompanying text.

28. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454 (codified as amended at 15

• if the New Security is a qualifying debt security, the requirements of the Trust Indenture Act of 1939, as amended (the TIA)[29] and the rules promulgated thereunder;[30]
• the continuing concern about the proper timing of public disclosure about the restructuring and related issues from the conception to consummation of the restructuring;[31]
• the laws governing fiduciary duties and contractual obligations owed to various classes of security holders;[32]
• state blue sky and securities laws;[33]
• the rules of securities exchanges;[34]
• the rules of the National Association of Securities Dealers, Inc. (the NASD);[35] and

U.S.C. §§ 78*l*(i), 78m(d)-(e), 78n(d)-(f) (1988)). The Williams Act, which was named after its sponsor, Senator A. Williams, enacted the portions of the Exchange Act that govern tender offers, §§ 13(d)-(e), 14(d)-(f), 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f).

29. 15 U.S.C. §§ 77aaa-7bbbb (1988) *as amended by* Trust Indenture Reform Act of 1990, Pub. L. No. 101-550 (Nov. 15, 1990).

30. 17 C.F.R. §§ 260.0-1 to .14a-1, 269.0-1 to 269.7 (1990); *see infra* notes 458-64 and accompanying text.

31. *See infra* notes 73-77 and accompanying text.

32. For a discussion of these issues as they have been applied in Delaware courts generally and in the context of "exit consents" particularly, see *infra* notes 313-59 and accompanying text.

33. Practitioners must determine whether the New Securities to be issued in a Section 3(a)(9) Exchange and the corporation conducting the exchange (because of its potential status as a "dealer") must be registered in each of the states in which holders of Target Securities reside. Approximately forty-four states presently provide a transaction exemption substantially similar to Section 3(a)(9). *See, e.g.*, DEL. CODE ANN. tit. 6, § 7309(b)(11) (1974). California does not provide for this exemption (along with Iowa, North Dakota, Utah and Vermont). One viable alternative is the "listed securities" exemption. *See, e.g.*, CAL. CORP. CODE § 25102 (West 1977).

Approximately forty-three states presently exclude issuers from the statutory definition of broker-dealer. *See, e.g.*, CAL. CORP. CODE § 25004 (West 1977); DEL. CODE ANN. tit. 6, § 7302(a)(3) (1974). *But see* ARIZ. REV. STAT. ANN. § 44-1801 (9)(b) (1987) (including issuers in definition of dealers); FLA. STAT. ANN. § 517.021(6)(a)(2) (West 1988); NEB. REV. STAT. § 8-1101(3) (1987) (includes non-resident issuers within definition); N.Y. GEN. BUS. LAW § 359-e(1)(a) (McKinney 1984); N.D. ADMIN. CODE § 10-04-02(2) (1985); OHIO REV. CODE ANN. § 1707.01(E) (Anderson 1985); VT. STAT. ANN. tit. 9, § 4202a (Supp. 1990). Practitioners are advised to start "blue-sky surveys" early in the process of planning any restructuring, especially in connection with the usually quick-paced Section 3(a)(9) Exchange, to investigate the available exemptions and ascertain the required filings. See *infra* note 414 and accompanying text for a brief discussion of limited exceptions to the tender offer rules for state blue sky problems.

34. *See infra* note 452 and accompanying text.

35. The NASD exerts jurisdiction over non-underwritten restructurings, including Section 3(a)(9) Exchanges. The NASD reviews both the level of compensation of a NASD member retained to advise a corporation conducting a non-underwritten restructuring, *see NASD Interpretations of the Board of Governors Relating to Section 1 of Article III of the Rules of Fair Practice*, NASD Manual (CCH) ¶ 2151.02, at 2023-37 (May 1989) [hereinafter *Interpretations*,

• tax and debtor/creditor considerations.[36]

Ultimately, the process of selecting and executing a particular Exchange Offer requires extensive cross-disciplinary legal analyses and guidance.

This Article provides issuers, financial advisors and their counsel with a practical guide to the legal and logistical considerations generated by Exchange Offers, particularly Section 3(a)(9) Exchanges and Consent Solicitations. First, this Article summarizes some important considerations in conducting Exchange Offers. It then describes the important aspects of the Section 3(a)(9) exemption, with particular focus on each of the elements of Section 3(a)(9) from a practitioner's perspective, including a checklist for complying with the element that can be most troublesome: the "no paid solicitation" requirement. The next section of this Article describes several logistical and legal aspects of Consent Solicitations, especially those that arise when Consent Solicitations are conducted in conjunction with Section 3(a)(9) Exchanges. This Article then presents an overview of additional statutes, rules and regulations that often apply to Section 3(a)(9) Exchanges and Consent Solicitations, such as the tender offer, "going private" and proxy rules of the Exchange Act, and the TIA. Finally, this Article concludes by presenting a summary of the advantages and disadvantages of Section 3(a)(9) Exchanges and Consent Solicitations.

II. Certain Preliminary Considerations

Several significant factors impact how and whether a corporation should attempt an out-of-court restructuring by means of an Exchange Offer. Though many of the issues raised in this section are discussed more thoroughly elsewhere, it is important to set them out initially to provide a framework for this Article.

A. *Time*

The passage of time is almost always an enemy of the financially troubled corporation. As time passes, suppliers may tighten credit and customers may question orders, both of which further damage a corporation's cash flow. Employees may question the security of their positions,

NASD Manual], and whether such a NASD member is participating in the public distribution of its own or its affiliates securities, *see* Schedule E to the By-Laws, NASD Manual (CCH) ¶ 1881, at 1611-18 (July 1990). As a result, absent an exemption, a NASD member must file many of the same documents with the NASD as it would file in an underwritten offering to determine whether its fees are fair and reasonable, and whether its participation in the transaction creates a "conflict of interest."

36. *See infra* notes 78-117 and accompanying text.

possibly depriving the corporation of valuable human resources. Rating agencies may downgrade existing securities. All of these factors can directly or indirectly decrease a corporation's access to capital and thereby exacerbate its difficulties. Consequently, the more quickly a corporation can successfully restructure, the better its future prospects tend to be. Section 3(a)(9) Exchanges generally can be commenced more quickly than most other types of out-of-court restructurings, in some cases within a few weeks.[37] Consequently, time pressures by themselves might dictate the use of a Section 3(a)(9) Exchange.[38]

B. Development of Incentives for Existing Security Holders to Participate in an Exchange Offer and the Issue of "Holdouts"

Corporations have long sought to create both positive and negative incentives for existing investors to participate in Exchange Offers. The positive incentives have included inserting terms in the New Securities that are intended to make them trade at a premium over the current market price of the Target Securities, such as a higher interest or divi-

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37. The offering documents for most other forms of restructurings, for example, any Registered Exchange, or any Reclassification or Consent Solicitation subject to the proxy rules, must be reviewed by the SEC prior to formal commencement. Furthermore, a qualified governmental agency must approve any Section 3(a)(10) Settlement Exchange prior to the issuance of any New Securities thereunder. Only a Section 4(2) Private Exchange potentially can be commenced in the same time-frame as a Section 3(a)(9) Exchange. A Section 3(a)(9) Exchange may be subject to SEC review if it is a tender offer or if it constitutes a "going private transaction" and, in either case, the Target Security is an "equity security" under Securities Exchange Act of 1934, § 3(a)(11), 15 U.S.C. § 78c(a)(11) (1988), *see infra* notes 382-447 and accompanying text, or if the New Securities are debt securities that must be qualified under the TIA, see infra notes 459-64 and accompanying text. SEC filings in such instances, however, are made, and SEC review begins, concurrently with the commencement of the Section 3(a)(9) Exchange. The only situation in which the commencement of a Section 3(a)(9) Exchange might be delayed because of Federal securities laws is when a Section 3(a)(9) Exchange is conducted in connection with a Consent Solicitation or proxy solicitation that is subject to the proxy rules. *See infra* notes 448-57 and accompanying text. But see *supra* notes 33 & 35, discussing the few state blue sky laws that do not provide for an exemption similar to Section 3(a)(9) and the issue of NASD clearance, respectively. For a summary of the filing and disclosure requirements that the structure of a Section 3(a)(9) Exchange could trigger, see *infra* notes 288-302.

38. For example, if a corporation determines it must register an exchange, it can expect that the time (and associated cost) required for the registration process likely would be considerably greater than that required for a Section 3(a)(9) Exchange. The primary timing considerations in planning a Registered Exchange include (i) the amount of time the SEC requires to review and provide initial comments on a registration statement (generally four to six weeks) and (ii) the amount of time required for the corporation to complete the comment-response phase of the registration process (generally one to two weeks).

dend rate than the Target Securities,[39] a shorter maturity,[40] a ranking senior to the Target Securities (with the New Securities possibly being secured),[41] protective covenants not included in the Target Securities, or other attributes that might benefit the New Securities relative to the Target Securities.

A common negative incentive is the possibility of bankruptcy if the Exchange Offer is not completed.[42] Additionally, nonexchanging holders often run the risk that if the exchange succeeds, their Target Securities will be contractually subordinated to the New Securities.[43] To create another negative incentive, some corporations have sought to amend or eliminate certain covenants in Target Securities that remain outstanding after the Exchange Offer through a Consent Solicitation of the holders of the Target Securities (including those participating in the Exchange Offer) that is conducted concurrently with the Exchange Offer.[44]

From the corporation's perspective, a continuing issue that can inhibit the success of an Exchange Offer is the issue of "holdouts," *i.e.*, holders of Target Securities who do not participate in the exchange. Some holders of Target Securities choose to hold out in hopes of negotiating a better deal. Others may simply believe retaining their Target Securities is better than owning the New Securities.[45] In other cases,

39. *See, e.g.*, NEW WORLD ENTERTAINMENT, LTD., SECOND SUPPLEMENT TO OFFERING CIRCULAR (Aug. 2, 1988) (offering new 12-7/8% senior subordinated notes due 1995 for existing 11% subordinated notes due 1995 and 12-1/4% subordinated debentures due 1998).

40. *See, e.g.*, INTERNATIONAL CONTROLS CORP., OFFERING CIRCULAR (June 15, 1990) (offering senior subordinated debentures due in 2001 for existing subordinated debentures due in 2005); ENRON CORP., OFFERING CIRCULAR (Dec. 2, 1987) (offering senior notes due in 1998 for existing subordinated debentures due in 2008).

41. *See, e.g.*, INTERNATIONAL CONTROLS CORP., supra, *note* 40; ENRON CORP., *supra* note 40; NEW WORLD ENTERTAINMENT, LTD., *supra* note 39. Corporations have also utilized Section 3(a)(9) to offer new debt securities for existing common stock in an effort to decrease long-term debt and increase book value per share amounts, thereby offering holders of such common stock the opportunity to receive an interest-bearing security and a more senior ranking security. *See, e.g.*, THE PENN CENTRAL CORPORATION, OFFERING CIRCULAR (Nov. 13, 1987); ZENITH NATIONAL INSURANCE CORP., OFFERING CIRCULAR (Nov. 4, 1987).

42. *See, e.g.*, *Interco Readies "Prepak" Chap. 11; Interco Inc.*, FOOTWEAR NEWS, May 21, 1990, at 23. For a discussion of the disadvantages and advantages of Chapter 11 reorganization proceedings, see *infra* notes 78-96 and accompanying text.

43. *See generally* Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 246-50 (1987) (discussing techniques that provide incentives for holders of target securities to participate in debt restructurings).

44. *See, e.g.*, OAK INDUSTRIES, INC., OFFERING CIRCULAR AND CONSENT SOLICITATION (Feb. 14, 1986); SAVIN CORPORATION, PROSPECTUS AND CONSENT SOLICITATION (Feb. 12, 1988). This device is often called an "exit consent" solicitation. *See* Roe, *supra* note 43, at 248. For a description and discussion of exit consents, see *infra* notes 303-12 and accompanying text.

45. As one commentator speculated, holders of Target Securities who "refuse to participate in the workout will benefit, because the [corporation] more easily can pay residual credi-

entities—often called "debt raiders" or "vulture capitalists"—buy strategic layers of a corporation's securities at distressed prices with the hope of taking control of the corporation or at least the negotiation process.[46]

Corporations employ a variety of techniques, including the incentives and disincentives discussed above, to discourage holdouts. Another important technique frequently used to reduce the number of holdouts is to include a high minimum acceptance condition in the Exchange Offer, such as requiring the tender of at least a specified percentage (often eighty percent or higher) of the aggregate outstanding principal amount or number of shares of the Target Securities.[47]

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tors [*e.g.*, the holdouts] in full after (and if) the recapitalization succeeds. The holdouts would benefit disproportionately, at the expense of those who . . . renegotiate their credits." Roe, *supra* note 43, at 233 & n.3 (calling the holdout's benefit of an increased chance at full pay-off, the "buoying-up effect").

> In a basic exchange offer, bondholders that do not exchange will be enriched at the expense of those that do: The exchange will leave the company able to pay the diminished fixed debt to the holdout bondholders in full. Indeed, the exchanging bondholders might be made worse off, since they help assure payment to the holdouts.

Id. at 236. In addition, some holders of Target Securities may not want to assume the risk of a potentially reduced claim in bankruptcy if, notwithstanding the restructuring, the corporation goes bankrupt. *See infra* notes 97-110 and accompanying text.

46. *See All Eyes on Distressed Companies; Takeovers of Distressed Companies on the Rise*, CORP. FIN. WEEK., Sept. 17, 1990, at 1; Baker, *The Debt Raiders*, GLOBAL FIN., Dec. 1990, at 27 ("For some [debt raiders] the aim is to acquire a company, while others hope to parlay their positions into sizeable equity stakes. Still others are more like arbitragers than debt raiders, and they're buying defaulted debt on the hope that a company will produce a settlement with bondholders that will lead to big cash profits."); Farrell, *The 'Vulture Capitalists' Are Circling*, BUS. WEEK, Sept. 5, 1988, at 84; Gillen, *Debt Raiders Put New Spin on Takeovers After Wreckage of Junk-Financed Buyouts*, BOND BUYER, Aug. 24, 1990, at 3; Richter, *Debt Raiders' See Bull Market in Bankruptcies*, L.A. Times, Oct. 21, 1990, at D1, col. 5; Dutt, *'Vulture Investors' Prey On Miseries of Indebted Firms*, Newsday, Sept. 16, 1990, at 53 (city ed.); "Debt raiders" (the term generally used for entities that attempt to acquire control of a financially distressed corporation by purchasing that corporation's debt) and "vulture capitalists" (the term generally used for entities that invest in the debt securities of financially distressed corporations to sell at, or negotiate with the corporation to obtain, a significantly higher price, but not with a view to acquire control of the corporation) are often backed by investment funds or partnerships that have been launched during the last few years to invest in distressed and/or bankrupt corporations. Baker, *supra*, at 27 & 32 (more than $3 billion committed by pension funds and other major institutions "to new restructuring funds that, among other things, purchase debt of workout companies," including $780 million raised by Goldman Sachs & Co. for its Water Street Recovery fund, and $1 billion raised by Zell/Chilmark Fund "to acquire financially troubled companies"); *1990 in Review; Restructurings & Bankruptcies*, CORP. FIN. WEEK, Dec. 24, 1990, at 2 (more than $2.7 billion raised in 1990 by funds to invest in securities of troubled corporations). See articles cited *infra* note 58, which discusses acquisitions of corporations through the acquisition of its debt.

47. *See, e.g.*, INTERNATIONAL CONTROLS CORP., OFFERING CIRCULAR (June 15, 1990) (80% minimum tender condition); OAK INDUSTRIES INC., OFFERING CIRCULAR (Feb. 7, 1985) (70% minimum tender condition); SAVIN CORP., PROSPECTUS AND CONSENT SOLICITATION (May 12, 1988) (90% minimum tender condition); WESTERN UNION TELEGRAPH CO., PROSPECTUS AND SOLICITATION (Sept. 21, 1987) (80% minimum tender condition). See

If the particular circumstances permit, some other forms of restructuring can eliminate holdouts. For example, Prepackaged Bankruptcies are increasing in popularity[48] largely because all holders of Target Securities are bound if the Prepackaged Bankruptcy is approved by more than two-thirds in amount and more than one-half in number of the allowed claims casting a vote.[49] In addition, reclassifications will bind all stockholders of the Target Securities upon the receipt of the requisite stockholder vote.[50]

C. Composition of, and Negotiation with, Security Holders and Their Committees

An important factor in the success, and therefore the advisability, of an Exchange Offer is the composition of the holders of prospective Target Securities. Depending on the number of such holders, as well as the complexity of the restructuring proposal, a corporation may determine that a form of restructuring that permits the retention of paid solicitors (*e.g.*, Registered Exchanges) may be preferable to a Section 3(a)(9) Exchange;[51] or, it may decide that it should merely hire an information agent to help distribute offering materials or run tombstone advertisements or both in order to inform holders of Target Securities about the

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infra note 395, describing SEC interpretation governing the waiver of minimum tender conditions.

48. *See, e.g.*, REPUBLIC HEALTH CORP., PROSPECTUS AND CONSENT SOLICITATION (Nov. 13, 1989); THE SOUTHLAND CORP., PROXY STATEMENT-PROSPECTUS (Oct. 5, 1990).

49. 11 U.S.C. § 1126(b) (1988). *See* Kaplan, *Prepackaged Ch. 11 Plans: Popular But Limited Restructuring Tool*, BANKR. STRATEGIST, Dec. 1990, at 6 (second of 2-part series); Kaplan, *Prepackaged Plans: Popular, Limited Tool*, BANKR. STRATEGIST, Nov. 1990, at 1 (first of 2-part series); Hylton, *supra* note 20; Hellitzer, *supra* note 20.

50. *See, e.g.*, BANKS OF MID-AMERICA, PROSPECTUS-PROXY STATEMENT (Sept. 9, 1988) (Reclassification with Registered Exchange); READING & BATES CORP., PROXY STATEMENT-PROSPECTUS (July 28, 1989) (Reclassification with Registered Exchange); WESTERN UNION CORP., PROXY STATEMENT-PROSPECTUS (July 31, 1990) (Reclassification with Registered Exchange and Consent Solicitation).

51. For example, if there are few holders with large holdings, the company may want to consider conducting a Section 4(2) Private Exchange. *See supra* note 15. If there are many holders of relatively small amounts of Target Securities, then a cash tender offer or Registered Exchange accompanied by a well-organized paid solicitation campaign may be preferable. *See, e.g.*, tombstone advertisements of Southland Corp., Wall St. J., Oct. 11, 1990, at C13, col. 1 (Registered Exchange in conjunction with a Prepackaged Bankruptcy); *see also* Brennan, *Western Union Urgently Searches For Debt Holders*, Wall St. J., Nov. 6, 1990, at C18, col. 6 (describing difficulties a corporation can face in attempting to contact widely disbursed holders of securities); tombstone advertisement of Western Union Corp., Wall St. J., July 31, 1990, at C15, col. 4 (concurrent Registered Exchanges, Consent Solicitation, Reclassification and proxy solicitation).

transaction.[52] The key to this decision is whether a corporation believes that its regular employees can effectively solicit the proposed exchange.[53]

A corporation should also consider the mix of recent purchasers of the Target Securities[54] and long-time holders of Target Securities, who already may have incurred large losses. This mix may indicate the different motives of the holders of the Target Securities and, thereby, how best to structure the terms of the New Securities to be offered in the Exchange Offer.[55]

Another important factor is the now common practice of certain holders of Target Securities' organizing committees (committees) that negotiate on behalf of holders of Target Securities.[56] Committees, often represented by legal counsel and financial advisors,[57] can form a unified front, enhancing the likelihood of the consummation of the Exchange Offer. On the other hand, the differing motives of committee members and disagreements amongst committees of different security holders can delay or even prevent the completion of the restructuring.[58]

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52. *See, e.g.*, tombstone advertisement of Westwood One, Inc., Wall St. J., Nov. 20, 1990, at C16, col. 1 (Section 3(a)(9) Exchange).

53. For a discussion of the parameters of the permissable solicitation activities of employees of a corporation conducting a Section 3(a)(9) Exchange, see *infra* notes 206-10 and accompanying text.

54. *See supra* note 46.

55. For example, the manager of a portfolio containing Target Securities may accept or reject a restructuring proposal based on how it would affect his or her compensation. *See* Weingarten, *Consensual Non-Bankruptcy Restructuring of Public Debt Securities*, 23 SEC. & COMMODITIES REG. 159, 163 (1990). A portfolio manager whose compensation is based upon the value of the portfolio may be reluctant to accept restricted equity securities in an exchange if the value of restricted equity securities held in the portfolio must be marked to zero; a portfolio manager whose compensation is based upon cash yield would be reluctant to accept pay-in-kind or zero coupon securities. *Id.* Portfolio managers of federally insured savings and loan associations, which may not hold "junk bond" investments after July 1, 1994, *see* 12 U.S.C. § 1831e(d) (1990)), may be unwilling to accept low-rated debt securities that do not mature before that date. Weingarten, *supra*, at 163.

56. Weingarten, *supra* note 55, at 160.

57. "[I]t has become commonplace for the holders of [Target Securities] to retain their own investment bankers and attorneys, whose fees and expenses are often paid by the troubled company." *Id.*

58. For example, a "vulture capitalist" or "debt raider," see *supra* note 46 and accompanying text for a description, may have a different agenda from other investors, not uncommonly "to acquire securities of a troubled company for the purpose of acquiring control of the company's common stock" upon consummation of a restructuring. Weingarten, *supra* note 56, at 160 & n.7. *See* Baker, *supra* note 46, at 38; Dutt, *supra* note 46, at 53 (describing Japonica Partners' acquisition of Allegheney International, Inc. (operator of the Sunbeam and Oster appliance businesses) after Japonica purchased majority or blocking positions in virtually all of Allegheney's eight creditor classes). *See also* Fortgang & Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990) [hereinafter Fortgang & Mayer I] (describing several transactions in which investors purchased public and private debt securities, bank loan claims, trade claims and other claims of corporations that

The formation of a committee also may make a Section 3(a)(9) Exchange more feasible in some circumstances due to two recent no-action positions[59] taken by the staff of the SEC (the Staff).[60] Generally, a corporation's paid advisors, such as legal counsel and financial advisors, may not have any substantive discussions with security holders without invalidating the use of Section 3(a)(9).[61] Before the release of these two no-action letters, it was unclear whether the Staff would permit discussions between the corporation's outside advisors and advisors to holders of Target Securities. Such discussions, however, are often essential, if only to explain the often complex financial analyses involved in many restructurings. These two no-action positions clarified the Staff's position on this matter, indicating that the Staff, at least, would condone discussions on the merits of a Section 3(a)(9) Exchange between the advisors to the corporation and the advisors to committees of security holders.[62]

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had filed a petition for reorganization under chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 1101-1174 (1988), to acquire control of corporations, and providing a comprehensive historical analysis of the regulation of, and the reasons for, the post-petition trading of a corporation's debt securities and other claims); Fortgang & Mayer, Developments in Trading Claims and Taking Control of Corporations in Chapter 11 (1990) (unpublished manuscript) [hereinafter Fortgang and Mayer II] (updating and discussing developments that "occurred too late for detailed examination" in Fortgang & Mayer I, *supra*, and including a thorough discussion of Japonica's acquisition of Allegheney International.

59. *See* International Controls Corp., SEC No-Action Letter (avail. Aug. 6, 1990) (LEXIS, Fedsec library, Noact file); Seaman Furniture Co., SEC No-Action Letter, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,360, at 79,335 (Oct. 10, 1989).

60. No-action letters issued by the Staff are cited throughout this Article as support for various propositions. We note at the outset, however, that the Staff is not the final arbiter of issues relating to securities law matters. The no-action letter process "is merely an informal process by which private persons and their counsel may seek . . . an indication of the staff's enforcement attitude toward a particular transaction prior to its consummation." Securities Act Release No. 5691, 41 Fed. Reg. 13,682 (1976); Exchange Act Release No. 13,017 (Nov. 29, 1976) (LEXIS, Fedsec library, Secrel file). The SEC is not officially bound by a Staff no-action position, nor are the Staff no-action positions dispositive of Federal securities law issues raised in the letters. Securities Act Release No. 5691, *supra*; Exchange Act Release No. 13,107, *supra*. Despite this official position, however, the recipient of a no-action response can be fairly certain that the SEC will abide by the Staff position if the facts are as presented in the no-action request. *See* Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019, 1042 (1987); *Obtaining No-Action Letters and Interpretive Advice*, CORP. COUNSEL, Jan.-Feb. 1989, at 1, 2. While no-action letters do not insulate recipients from private litigation, courts are likely to give some weight to the views of the Staff and "the collateral estoppel effect of a no-action letter has had an impact on private litigation." Lemke, *supra*, at 1043; *accord Obtaining No-Action Letters and Interpretive Advice*, *supra*, at 2.

61. For a discussion of the "no paid solicitation" requirement of Section 3(a)(9), see *infra* notes 204-57 and accompanying text.

62. In *Seaman Furniture Co.*, a seemingly important factor was that the Section 3(a)(9) Exchange had not commenced when the proposed discussions were to take place. *See* Seaman Furniture Co., *supra* note 59, at 79,339. The Staff extended its position, however, to post-commencement discussions between the corporation's advisors and the committee's advisors in

In any event, all participants in any restructuring, including a Section 3(a)(9) Exchange, should realize at the outset that most restructurings involve a process of negotiation. Most holders and committees expect that the corporation's first offer will not be its best offer. The ability of a corporation and its advisors to commence and conduct negotiations, however, is often limited by regulations applicable to the proposed restructuring.[63] Ultimately, in many troubled-company situations, holders must be convinced that the offer on the table is the last offer, and potentially the last hope for the corporation short of bankruptcy.

D. Fiduciary Duties Owed to Different Security Holders

Courts in Delaware clearly and repeatedly have concluded that, except in "special circumstances," neither a corporation, its directors nor its controlling stockholders owe a fiduciary duty to holders of convertible or non-convertible debt securities[64] or, in certain instances, preferred stock.[65] The basic rationale for this conclusion is that rights of debtholders and the preferential rights of preferred stockholders are derived from contract law, while those of common equity holders are based upon the trust relationship between the board of directors of a corporation and its common stockholders.[66] Contracting parties generally are

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International Controls Corp., *supra* note 59. See *infra* notes 245-54 and accompanying text discussing these two no-action positions.

63. For example, negotiations in a Section 3(a)(9) Exchange can be conducted at any time, but must be between holders of Target Securities and the corporation directly, or between the company's advisors and the committee's advisors if they stay within the parameters set forth in the *Seaman Furniture Co.* and *International Controls Corp.* no-action letters. *See infra* notes 245-54 and accompanying text. Alternatively, when the restructuring is a Registered Exchange, practitioners must be concerned with the limitations of the prospectus delivery requirements imposed by section 5 of the Securities Act. *See* 15 U.S.C. § 77e (1988). In addition, when the restructuring includes a Consent Solicitation subject to the proxy rules, solicitation materials must be filed with the SEC prior to or upon the date such material is first sent, given or used, as the case may be. *See* Rule 14a-6, 17 C.F.R. § 240.14a-6 (1990).

64. *See, e.g.*, Simons v. Cogan, 542 A.2d 785, 786 (Del. Ch. 1987), *aff'd*, 549 A.2d 300 (Del. 1988). *See* cases cited *supra* notes 313-23.

65. *See, e.g.*, Rosan v. Chicago Milwaukee Corp., No. 10,526, slip op. at 14-17 (Del. Ch. Feb. 6, 1990) (citing Jedwab v. MGM Grand Hotels, 509 A.2d 584, 593 (Del. Ch. 1986) (no fiduciary duty is owed to preferred stockholders with respect to the "preferential rights" (and "special limitations") of preferred stock that are specified in the company's charter)). *See infra* notes 315-16 and accompanying text. For a discussion of fiduciary duties generally owed to non-common stockholders, see *infra* notes 313-23 and accompanying text. For a discussion of the fiduciary duties owed by a corporation, its directors and its controlling stockholders to holders of the corporation's debt securities and preferred stock in "special circumstances," see *infra* notes 331-35 and accompanying text.

66. *See* Norte & Co. v. Manor Healthcare Corp., Nos. 6827, 6831, slip op. at 10-11 (Del. Ch. Nov. 21, 1985). While it appears that the Delaware law on fiduciary duties owed to bondholders is generally followed outside of that state, *see* Bratton, *Corporate Debt Relationships:*

limited in seeking redress of alleged wrongs to the remedies provided or implied within the four corners of the document.[67] As a result, a corpo-

Legal Theory In A Time of Restructuring, 1989 DUKE L. J. 92, 118-19 [hereinafter Bratton II]; Bratton, *The Economics and Jurisprudence of Convertible Bonds*, 1984 WISC. L. REV. 667, 691-98 [hereinafter Bratton I], a modicum of case law (mostly federal district court decisions) and commentary has developed for the proposition that such a fiduciary duty exists even absent a special circumstance. *See* cases cited *infra* notes 322-23; McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 265-312 (1988) [hereinafter McDaniel II]; McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 442-50 (1986) [hereinafter McDaniel I]. *See also* Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1168-69 n.11 (Nov. 1990) (listing "[t]he universe of scholarly literature directly focused on bondholders' rights in a non-bankruptcy context," and generally proposing "a comprehensive set of principles that support the extension of [fiduciary] rights to bondholders").

67. *See* Katz v. Oak Indus., 508 A.2d 873, 879 (Del. Ch. 1986). See *infra* notes 324-30 & 339-42 and accompanying text for a discussion of *Oak Industries*. One Delaware court has held, in fact, that a board of directors breached its fiduciary duty to common stockholders when it favored one bidder for the company over another bidder in part because the favored bidder agreed to support the trading price of outstanding debt securities. Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 178-79, 182 (Del. 1986). *Cf.* Committee on Corporate Laws, *Other Constituency Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990) (report of Committee on Corporate Laws of the Section of Business Law of the American Bar Association) (recommends against the adoption of a so-called "stakeholders" or "other constituencies" provision in the Revised Model Business Corporation Act because such provisions "create opportunities for misunderstanding and thus pose potential for mischief" and "radically alter" "long-standing and tested concepts of relationships that should exist between corporations and their directors and shareholders," and advises that other constituency statutes adopted in states such as in New York, Connecticut, Indiana and Pennylvania should be interpreted narrowly and "in a manner consistent with existing common law," "unless the enacting legislature clearly evidenced a different intent"); Salwen, *SEC Chairman Considers Holders' 'Bill of Rights,'* Wall St. J., Feb. 28, 1991, at C16, col. 4 (reporting that SEC Chairman Richard Breeden testified to the Senate Securities Subcommittee that he was angered by state anti-takeover statutes, such as "other constituency" provisions, that allegedly enabled management entrenchment, and that Chairman Breeden said that "he is considering a 'shareholder bill of rights'" that would limit the impact of those state anti-takeover statutes). Stakeholder provisions generally permit directors to consider constituencies other than stockholders (such as creditors, employees and communities) in the discharge of their fiduciary duties. *See, e.g.*, N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1991); CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1990); GA. CODE ANN. § 22-202(5) (Harrison 1990); 15 PA. CONS. STAT. § 1715(a) (Pamphlet 1990). Although these statutes were generally adopted to provide directors of corporations that were subject of hostile takeovers with a broader basis to respond to such takeover attempts, Committee on Corporate Laws, *supra*, at 2253, it is possible that these statutes could be turned on their heads to infer a fiduciary duty running to the new classes of constituents they recognize. *Id.* at 2263-71. *Compare* N.Y. BUS. CORP. LAW § 717(b), GA. CODE ANN. § 22-202(5) *and* PA. CONS. STAT. § 1715(a) (which merely *permit* directors to consider other constituencies) *with* CONN. GEN. STAT. ANN. § 33-313 (which *mandates* that directors consider other constituencies). At least three states expressly deny that its stakeholders statute confers any new rights to the enumerated constituencies. N.Y. BUS. CORP. LAW § 717(b) ("nothing in this paragraph shall create any duties owed by any director to any person or entity to consider or afford any particular weight to any of the foregoing or abrogate any duty of the directors, either statutory or recognized by common law or court decisions"); GA. CODE ANN. § 22-202(5) (providing that it "shall not be deemed to provide to any constituency any right to be considered"); 15 PA. CONS. STAT. § 1717 (section 1715(a) does not

ration should proceed with a restructuring plan on the basis of what is in the best interests of the common stockholders, unless one of the special circumstances arises.

Insolvency and bankruptcy are among the "special circumstances" that can create a fiduciary duty in a contractual relationship.[68] In these circumstances, the class of beneficiaries to whom directors of a corporation owe fiduciary duties is enlarged, if not shifted, to include the corporation's creditors.[69] This metamorphosis creates an enormous practical problem for the directors of a troubled company and its advisors. If a corporation is solvent,[70] the directors' relationship with bondholders and, in certain instances, preferred stockholders, is at arm's length and commercial in nature. In a transaction between a corporation and its bondholders, directors have a fiduciary duty to negotiate with bondholders to obtain the best possible result for the corporation and its common stockholders.[71] If, however, the corporation is insolvent, the directors risk liability to creditors for failing to protect the best interests of creditors.[72] Therefore, if there is any doubt about the "solvency" of a corporation, directors of the troubled corporation are well advised to establish a record that demonstrates that they did their best to attempt to resolve matters on a basis that is "fair" to all constituencies of security holders—common stockholders, preferred stockholders and debtholders.

"impose upon the board of directors . . . any legal or equitable duties, obligations or liabilities or create any right or cause of action against, or basis for standing to sue, the board of directors"). *But see* Committee on Corporate Laws, *supra*, at 2264 (citation omitted) (noting apparently contradictory New York legislative history).

In any event, the *contractual* remedy created by a breach of the implied covenant of good faith and fair dealing is theoretically available to holders of a company's debt. Only three cases have discussed this implied covenant in the context of Consent Solicitations. *See Oak Indus.*, 508 A.2d at 880; Kass v. Eastern Air Lines, Nos. 8700, 8701, 8711, slip op. at 11-12 (Del. Ch. Nov. 14, 1986); Pisik v. BCI Holdings Corp., No. 14593/87, slip op. at 2 (N.Y. Sup. Ct. June 21, 1987). See also *infra* notes 336-50 and accompanying text discussing this implied covenant.

68. *See infra* notes 331-35 and accompanying text.

69. *See* Milmoe, *Troubled Directors: Fiduciary Duties of Directors of Troubled Companies in the Merger and Acquisition Context*, in INVESTING IN THE TROUBLED COMPANY 1990, at 167, 196-209 (Practising Law Institute Course Handbook Series No. 556, 1990) (discussing standards for director conduct during mergers and acquisitions in the context of bankruptcy and insolvency); Block & Hoff, *Duties of Directors of Distressed Corporations*, N.Y.L.J., Nov. 8, 1990, at 5, col. 1.

70. *See infra* note 334 and accompanying text.

71. *See supra* note 67.

72. For a brief discussion of the fiduciary duties of directors of insolvent corporations, see *infra* notes 331-35 and accompanying text.

E. Liabilities and Disclosure Obligations Under Securities Laws

There is always a tension between the obligation of a public corporation to disclose information to the public in certain situations and the practical difficulty of trying to conduct business in a fishbowl.[73] The securities laws recognize that, in many circumstances, a corporation may lawfully choose to keep information confidential, particularly where premature disclosure would be harmful to the corporation and its stockholders.[74]

This tension is particularly acute for a financially troubled corporation. For example, although an announcement that the corporation is having preliminary discussions with its bank group regarding the restructuring of its senior debt may be desirable from a full disclosure point of view, it may also cause suppliers to withhold normal trade credit and customers to delay ordinary course payments, all exacerbating a downward spiral for the corporation. Even if such an announcement is deemed to be unnecessary, the troublesome issue of selective disclosure remains.[75] This problem typically arises when a corporation conducts discussions with one or more of its creditors in an attempt to determine the feasibility of a restructuring before turning to its other creditors and security holders generally.[76] Rumors and leaks about the corporation's

73. *See generally* W. WALTON & C. BRISSMAN, CORPORATE COMMUNICATIONS HANDBOOK: A GUIDE FOR MANAGING UNSTRUCTURED DISCLOSURE IN TODAY'S CORPORATE ENVIRONMENT (1990) (providing a framework for corporate disclosure outside of the express filing and reporting requirements of the Federal securities laws).

74. *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 224, 239-40 n.17 (1988); Backman v. Polaroid Corp., 910 F.2d 10, 12 (1st Cir. 1990); Roeder v. Alpha Indus., 814 F.2d 22, 26 (1st Cir. 1987); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n.12 (2d Cir. 1968).

75. Selective disclosure is the disclosure of material non-public information to certain persons or entities, such as selected analysts, without publicly disclosing the information. *See* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980) ("The duty imposed on a company and its officers is an alternative one: they must disclose material inside information either to no outsiders or to all outsiders equally."). In some situations, selective disclosure may subject a corporation to liability for "tipping" or "aiding and abetting" insider trading. *See* W. WALTON & C. BRISSMAN, *supra* note 73, § 4.01[4], at 4-8. Liability for "tipping," however, only arises if the insider discloses material non-public information in breach of a fiduciary duty. Dirks v. SEC, 463 U.S. 646, 659-60 (1983). Liability for "aiding and abetting" insider trading only arises when a party assists another in an act that the party rendering assistance knows is a violation of Federal securities laws. Metge v. Baehler, 762 F.2d 621, 624 (8th Cir. 1985). *See generally* R. JENNINGS & H. MARSH, *supra* note 14, at 1139-44 (discussing "aiding and abetting" liability under Rule 10b-5); Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972).

76. The problem can arise, for example, when a corporation enters discussions with informal or formal committees of holders of its public debt securities, some of whom may not feel inhibited about trading on the information they may receive while serving on such committees. *See* Cohen & Salawen, *SEC Starts Insider Trading Probe in Junk-Bond Market*, Wall St. J.,

financial position may creep into the market following such meetings, possibly forcing the corporation to issue a press release disclosing its troubled financial situation to the world.[77]

F. The Bankruptcy Alternative

Bankruptcy is often the only alternative (other than a Section 3(a)(10) Settlement Exchange) for a financially troubled corporation that is not able to restructure successfully out of court. As such, it may provide the strongest incentive for security holders to participate in an out-of-court restructuring, such as a Section 3(a)(9) Exchange, or at least to reach an agreement on a Prepackaged Bankruptcy.

While a reorganization under chapter 11 of the Bankruptcy Code[78] offers its own unique advantages, it also presents significant disadvantages to the ongoing operations of a financially troubled corporation and to its security holders. The financially troubled corporation must balance the advantages and disadvantages of a chapter 11 reorganization

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Apr. 10, 1991, at C1, col. 3; Paltrow, *SEC Probes Junk Bond Insider Trading*, L.A. Times, Apr. 11, 1991, at D4, col. 1; Schifrin, *Sellers Beware*, FORBES, Jan. 21, 1991, at 36, 37. Commentators have noted that "committee members may be subject to sanctions for trading claims under principles of bankruptcy law even if they are not violating securities laws." Fortgang & Mayer II, *supra* note 58, at 27 (citing Fortgang & Mayer I, *supra* note 58, at 24-37). To remove disincentives for such large holders from serving on creditors committees, Messrs. Fortgang and Mayer suggest that there is a need for both a SEC ruling and a Rule of Bankruptcy Procedure officially recognizing the use of "Chinese Walls" for chapter 11 committee members. Fortgang & Mayer II, *supra* note 58, at 29-30 (stating that the "authors intend to submit a draft of such a [bankruptcy] rule for consideration by the Task Force on Trading Claims of the Chapter 11 Subcommittee of the Bankruptcy Committee of the American Bar Association."). *See also* Corporate Reorg. Rel. No. 384, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,502 (Sept. 27, 1989) (considering proposing a rule recognizing "Chinese Walls" for institutional investors who serve on creditors committees); Memorandum of the SEC in Support of Motion of Fidelity Management & Research Co. (filed Jan. 28, 1991), *In re* Federated Dep't Stores, Inc., No. 1-90-00130 (Bankr. S.D. Ohio filed Jan. 25, 1990) (SEC urging the court to allow an entity to serve on a creditors' committee and, at the same time, trade in a debtor's securities if that entity satisfied two requirements: (1) "it is engaged in the trading of securities in its regular course of business," and (2) it implements an effective Chinese Wall), *decided by* Order Permitting Securities Trading in Certain Circumstances, *In re* Federated Dep't Stores, Inc., Consolidated Case No. 1-90-00130 (Bankr. S.D. Ohio Mar. 7, 1991) (LEXIS, Bkrtcy library, FDS file) (essentially adopting the SEC's conclusion in its memorandum, and setting forth the " 'Chinese Wall' procedures to be employed by Fidelity").

77. "A company has no duty to correct or verify rumors in the marketplace unless those rumors can be attributed to the company." State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 850 (2d Cir. 1981); *accord Elkind*, 635 F.2d 156; Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969). The New York Stock Exchange, Inc. and the American Stock Exchange require listed companies to respond to rumors or unusual market activity. AMERICAN STOCK EXCHANGE COMPANY GUIDE §§ 401(c)-(d), 402(a), (c)-(d) (1988); NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 202.03-.04 (2d ed. 1990).

78. 11 U.S.C. §§ 1101-1174 (1988).

against other restructuring alternatives in selecting the best course of action.

A chapter 11 reorganization presents the following disadvantages:

- The corporation's business is disrupted. Business relations may be harmed because the corporation cannot pay prepetition creditors, and many vendors will not do business with a debtor-in-possession.[79]
- The corporation operates in a "fish bowl"—it must meet stringent financial reporting requirements;[80] creditors' committees and the United States Trustee, an official in the United States Department of Justice, review its business operations; non-ordinary course transactions are subject to creditor review and bankruptcy court approval;[81] executive compensation may be subject to the United States Trustee's review and approval.[82]
- The announcement of a chapter 11 filing may trigger the filing of otherwise unmatured claims against the corporation.[83] These claims often represent enormous potential liability and may seriously impede the reorganization process.
- The added time to complete the in-court restructuring, often combined with the many levels of creditors, whose legal and financial advisors may be paid by the corporation, can result in extremely high aggregate costs to the corporation.
- The corporation's management may lose control of the corporation through the appointment of a trustee or an examiner,[84] the conversion of the case to a chapter 7 liquidation[85] or the adoption of a creditor's reorganization plan.[86]

Conversely, a chapter 11 reorganization provides a corporation with the following advantages:

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79. In chapter 11 cases a trustee is typically not appointed. Instead, the debtor as "debtor-in-possession" continues to operate its business and manage its affairs. With limited exceptions, the debtor-in-possession has all the rights and powers of a trustee in a case under chapter 11. 11 U.S.C. §§ 1101(1), 1107(a).

80. Local rules typically require the filing of monthly operating reports with the United States Trustee and the court. *See, e.g.*, FED. R. BANKR. P. 2015(2) (requiring periodic reports and summaries); U.S. BANKR. CT. C.D. CAL. GUIDELINE NO. 3 (requiring bi-weekly "interim reports" and monthly "operating statements").

81. *See, e.g.*, 11 U.S.C. § 363(b).

82. *See, e.g.*, U.S. BANKR. CT. C.D. CAL. BANKR. R. 141(1).

83. Such potential claims include tax claims, environmental claims, product liability claims, unfunded pension liabilities and retiree health and medical claims.

84. *See* 11 U.S.C. § 1104.

85. *See id.* § 1112(b).

86. *See id.* § 1121(c).

• Filing the bankruptcy petition automatically stays all creditor collection efforts.[87]

• The debtor-in-possession or trustee may avoid and recover certain transfers of the corporation's property.[88]

• The court may authorize the debtor-in-possession to obtain funds for working capital by granting first priority security interests in the corporation's property over the objection of other creditors, including secured creditors.[89]

• The court may authorize the debtor-in-possession to reject unfavorable unexpired leases and executory contracts, or assign leases and contracts despite anti-assignment provisions.[90]

• Certain claims may receive specified favorable treatment: interest stops accruing on most unsecured claims;[91] if a reorganization plan is confirmed, unpaid pre-petition taxes may be paid over an extended time period;[92] unliquidated claims may be estimated;[93] certain claims arising from rejected leases or employment contracts may be subject to statutory limitations.[94]

• The reorganization plan may be confirmed over the objection of dissenting creditors, if certain "cram-down" standards are met,[95] and once the plan is confirmed, all creditors are bound by its terms.[96]

G. *Recent Developments in Bankruptcy and Tax Law*

There are also various bankruptcy and tax issues that must be considered when formulating an out-of-court restructuring that includes an exchange of New Securities for Target Securities, such as a Section 3(a)(9) Exchange. This Article will not address these subjects in detail.[97]

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87. *Id.* § 362.

88. *Id.* § 547 (avoiding preferences); *id.* § 548 (avoiding fraudulent transfers); *id.* § 544 (giving debtor-in-possession or trustee rights of judicial lien creditor or good faith purchaser or both).

89. *Id.* § 364.

90. *Id.* § 365(f).

91. *Id.* § 502(b)(2).

92. *Id.* § 1129(a)(9)(c).

93. *Id.* § 502(c).

94. *Id.* § 502(b)(6), (7).

95. *Id.* § 1129(b).

96. *Id.* § 1141.

97. *See generally* G. HENDERSON & S. GOLDRING, FAILING AND FAILED BUSINESSES (CCH Tax Trans. Lib. 1990); Cieri, Heiman, Henze II, Jenks, Kirschner, Riley & Sullivan, *An*

Nevertheless, the effects of a 1990 bankruptcy court decision and the Revenue Reconciliation Act of 1990 merit a brief discussion because, in the case of the bankruptcy decision, certain debt-for-debt exchanges may be less attractive to holders of Target Securities and, in the case of the tax changes, the effective cost of such exchanges may be higher for certain corporations. Because these changes affect only certain debt-for-debt exchanges, it is crucial that practitioners understand these developments not only to analyze their meaning and applicability, but also to determine the extent of their impact.

1. The LTV decision (*In re* Chateaugay Corp.)

A recent United States Bankruptcy Court decision involved an exchange by The LTV Corporation of new debt securities for target debt securities with an equal face amount shortly before the filing of LTV's petition for chapter 11 reorganization.[98] In response to a motion to disallow a portion of claims represented by the new debt securities on grounds that the claims included "unmatured interest,"[99] the court relied on a combination of bankruptcy authority[100] and certain tax and accounting authority[101] (the latter two of which it conceded were not conclusive) to hold that the difference between the face amount of the New Securities and the "value" of the Target Securities represented unmatured interest.

Introduction to Legal and Practical Considerations in the Restructuring of Troubled Leveraged Buyouts, 45 BUS. LAW. 333 (1989) (discussing, among other things, fraudulent conveyance, tax and bankruptcy issues confronted by companies that have become financially troubled following leveraged buyouts); Haims & Schaumberger, *Restructuring the Overleveraged Company*, 48 TAX NOTES 91 (1990); Zonana, *Tax and Restructuring Troubled Corporations*, N.Y.L.J., 1990, at 5, col. 1 (part two of two-part series); *id.*, Aug. 23, 1990, at 5, col. 1 (part one of two-part series).

98. *In re* Chateaugay Corp., 109 Bankr. 51, 52 (Bankr. S.D.N.Y.), *appeal filed*, (S.D.N.Y. 1990). The exchanging holders of the Target Securities received common stock in addition to the new debt securities.

99. *Id.* at 57-58; *see* Bankruptcy Code, § 502(b)(2), 11 U.S.C. § 502(b)(2) (1988) (providing that a claim shall be disallowed to the extent that it includes "unmatured interest").

100. *Chateaugay Corp.*, 109 Bankr. at 57-58. According to applicable legislative history, "unmatured interest" includes any original issue discount (OID). S. REP. NO. 989, 95th Cong., 2d Sess. 62 (1978); H.R. REP. NO. 595, 95th Cong., 1st Sess. 352-53 (1977). For a quotation from the applicable legislative history, see *infra* note 108. In general, a debt security is issued with OID to the extent its stated redemption price at maturity exceeds its issue price. *See* I.R.C. § 1273(a) (1988).

101. The court cited section 1273(b) of the Internal Revenue Code of 1986, as amended, 26 U.S.C. § 1273(b) and ACCOUNTING PRINCIPLES BOARD OPINION NO. 21 (Am. Inst. of Certified Pub. Accountants 1971) to support the proposition that the calculation of the OID is based on the issue price of the security, and the issue price of a note or bond issued in exchange for non-cash property is the market value of the property. *Chateaugay Corp.*, 109 Bankr. at 55. But see *infra* notes 108-09 and accompanying text discussing the apparent inapplicability of these authorities and the superior relevancy of alternative authorities.

As a result, the court reduced the claims of the holders of the New Securities from the face amount of those debt securities to the fair market value of the Target Securities at the time of exchange, plus matured interest to the date of bankruptcy.[102]

The result reached in the LTV decision is inappropriate and extremely unfair.[103] The decision disproportionately penalizes public bondholders who exchange their existing debt securities for a new debt instrument with an identical face amount in an effort to accommodate the debtor's financial difficulties.[104] Meanwhile, other classes of creditors who also may have restructured their credit to accommodate the financial difficulties of the corporation apparently have not had their bankruptcy claims reduced to the fair market value of their extensions of credit prior to a bankruptcy filing by the troubled corporation.[105] Indeed, by so reducing the claims of public security holders who participate in the out-of-court restructuring, the LTV decision provides other creditors with a windfall by permitting them to receive a greater *pro rata*

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102. *Chateaugay Corp.*, 109 Bankr. at 58.

103. In an earlier decision involving the reorganization of Allegheny International, the court considered the claim of a creditor who had received new debentures from the debtor in a pre-bankruptcy exchange for outstanding *preferred stock*. *In re* Allegheny Int'l, 100 Bankr. 247 (Bankr. W.D. Pa. 1989). In that case, the court held that the claim of the holder of the newly issued debentures would equal the issue price of those debentures (plus interest), for example, the value of the existing preferred stock at the time of the exchange. *Id.* at 252-55. The result in *Allegheny Int'l* does not seem unfair because a stockholder who exchanges his outstanding stock for debt has elevated his status to that of creditor; consequently, it is not unreasonable that his claim should be determined by the value of the stock that he surrendered before he is permitted to share *pari passu* with other creditors.

104. Presumably the existence of the public trading market for the Target Securities enabled the court to determine a "fair market value" for the Target Securities that could be used to determine the issue price of the New Securities. Although there is no such readily available mechanism for determining the value of other types of obligations of the debtor (such as trade claims and bank credit), we suppose the existence (or perhaps the possibility) of any exchange of such obligations prior to bankruptcy filing by a debtor logically could be included in the court's reasoning to cover any such obligations.

105. The comparative advantage afforded non-public debt creditors is particularly inequitable in light of the similarities between issuances of debt securities and the syndication of non-public credit and the increasing tradability of non-public debt creditor claims. *See* Fortgang & Mayer I, *supra* note 58, at 4-9, 13-56 (describing why and how claims are treated and some of the issues involved in the trading of claims). The Advisory Committee on the Rules of Bankruptcy Procedure has recognized the increasing tradability of non-public debt creditor claims in its proposed amendment to Bankruptcy Rule 3001(e). The amended rule would allow transfers of non-public claims without requiring approval from the bankruptcy court. *See* Proposed Amendments to the Bankruptcy Rules—Preliminary Draft of the Comm. on Rules of Practice and Procedure of the Judicial Conference of the United States (Aug. 1989), *reprinted in* Bankr. L. Rep. (CCH) No. 265 Part II (Oct. 12, 1989); Fortgang & Mayer I, *supra* note 58, at 42-43 (discussing the proposed rule). As stated above, however, we suppose that the reasoning used in the LTV decision could be applied to claims of other creditors who exchange their claims in a restructuring. *See supra* note 104.

bankruptcy distribution than they otherwise would receive.[106]

The purpose of excluding "unmatured interest," including original issue discount, from claims in bankruptcy[107] is to prevent creditors from claiming *disguised, unearned interest.*[108] In other words, the rule protects the debtor and its other creditors from the assertion of claims for amounts in excess of the benefit actually conveyed to the debtor. If a debtor has, in reality, only borrowed $900, the claim should not be $1,000. The LTV decision, however, ignores the statute's purpose. Instead of determining the value of the claim with reference to the amount of the original creditors' investment in the debtor or the benefit received by the debtor, the court picked an apparently arbitrary figure—the market value of the surrendered security on the date of the exchange—a value that has nothing to do with the value the debtor received from the

106. In extreme cases in which the New Securities that are debt constitute most of the outstanding claims, the reduction of the claims of the holders of such New Securities may be so great that the corporation will be able to pay those reduced claims in "full" and still make a distribution to stockholders. Under at least the spirit of the "absolute priority" rule, codified in section 1129(b)(2)(B) of the Bankruptcy Code, 11 U.S.C. § 1129(b)(2)(B) (1988), however, shareholders should not receive any distribution until creditors are paid the full amount of their investment in the debtor. The absolute priority rule provides that if a class of unsecured creditors votes not to accept the debtor's reorganization plan, the plan cannot be confirmed unless (i) each creditor in the dissenting class receives property under the plan with present value equal to the amount of its claim, or (ii) no holder of a junior claim or interest will receive any distribution under the plan. *Id.*

107. *See supra* note 100 and accompanying text.

108. Section 502(b)(2) of the Bankruptcy Code provides that a claim for "unmatured interest" as of the date of the bankruptcy petition is not allowable. 11 U.S.C. § 502(b)(2). The legislative history of section 502(b)(2) makes it clear that the term "unmatured interest" includes OID and suggests that OID should be determined by taking the difference between an obligation's face amount and its original issue price, at least in the context of a note issued for cash. It states:

> Paragraph (2) [of section 502(b)] requires disallowance to the extent that the claim is for unmatured interest as of the date of the petition. Whether interest is matured or unmatured on the date of bankruptcy is to be determined without reference to any ipso facto or bankruptcy clause in the agreement creating the claim. Interest disallowed under this paragraph includes post-petition interest that is not yet due and payable, and any portion of prepaid interest that represents an original discounting of the claim, that would not have been earned on the date of bankruptcy. *For example, a claim on a $1,000 note issued the day before bankruptcy would only be allowed to the extent of the cash actually advanced. If the original discount was 10 percent so that the cash advanced was only $900, then notwithstanding the face amount of the note, only $900 would be allowed. If $900 was advanced under the note some time before bankruptcy, the interest component of the note would have to be prorated and disallowed to the extent it was for interest after the commencement of the case.*

S. REP. No. 989, 95th Cong., 2d Sess. 62-65, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5848-51 (emphasis added).

The problem, of course, is that neither the legislative history nor the Bankruptcy Code addresses how "issue price" and OID are to be determined in the context of a debt instrument issued by the debtor as part of a pre-bankruptcy exchange of securities.

issuance of the target debt security.[109]

Finally, while it may be argued that the LTV result is not so unfair when applied to investors who purchase debt in the secondary market often at a tremendous discount, and who may only expect to recover a portion of the face value of the debt, this argument is flawed. Instead of focusing on the benefit the debtor received from the initial investor as the basis for the claim, the LTV decision focuses on investment potentially made by a subsequent investor; consequently, the debtor and the other creditors receive a windfall based solely on the trading activity of the existing public securities, not on any tangible attribute of the debtor's estate. Moreover, if the LTV decision were taken to its logical extreme and applied to all claims that trade after they are incurred, the likelihood of completing any restructuring, in or out of court, would be reduced.[110]

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109. The LTV decision cited a provision of the Internal Revenue Code that was not applicable at the time, and ignored the then applicable provision (since repealed), under which the claims of the holder of a new debt security with a face value equal to the face value of the target debt security would not be affected. *Chateaugay Corp.*, 109 Bankr. at 55 (citing section 1273(b) of the Internal Revenue Code of 1986, as amended, 26 U.S.C. § 1273(b) (1988)). The court ignored, however, I.R.C. § 1275(a)(4) (1988), *repealed by* Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11325(a)(2), 1991 U.S. CODE CONG. & ADMIN. NEWS, (104 Stat.) 1017,1177, which was in effect at the time of the LTV decision and which provided a special rule for the calculation of the issue price of a debt instrument issued in exchange for another debt instrument of the same issuer. Under that section, the issue price of such a debt instrument could not be less than the "adjusted issue price" (i.e., the original issue price plus accrued OID) of the old debt instrument surrendered in the exchange, regardless of what the issue price otherwise would have been under section 1273(b). *Id.* Thus, section 1275(a)(4), in effect, permitted the "carryforward" of the issue price of the surrendered debt instrument. For a brief discussion of section 1275(a)(4) and its repeal, see *infra* note 112 and accompanying text.

It also appears that the LTV decision cited inapplicable accounting authority, while ignoring applicable accounting authority that, if used for analogous support, generally would allow a holder of New Securities to retain the same claim in bankruptcy as it would have had if it had retained its Target Securities. *Chateaugay Corp.*, 109 Bankr. at 55 (citing ACCOUNTING PRINCIPLES BOARD OPINION NO. 21 (Am. Inst. of Certified Pub. Accountants 1971)). APB Opinion No. 21 does not explicitly deal with notes issued in exchange offers by troubled companies. The applicable accounting authority, dealing explicitly with "troubled debt restructurings," is FINANCIAL ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 15, 1977 [hereinafter FAS 15]. Paragraph 16 of FAS 15 provides that in a restructuring involving only the modification of the terms of a payable, the debtor shall not change the carrying amount of the payable unless the total future cash payments under the new terms will be less than the carrying amount. Such will never be the case in a debt-for-debt exchange of securities when notes of equal face amount are exchanged, and only interest rates and/or maturity dates are changed. *Id.* para. 16.

110. *See supra* notes 104-05 and accompanying text.

2. New tax legislation regarding cancellation of indebtedness income and original issue discount

The Revenue Reconciliation Act of 1990[111] attempted to resolve years of confusion by making it clear that the issue price of a New Security will determine both the original issue discount (OID) and cancellation of indebtedness (COD) income in debt-for-debt exchanges of securities.[112] COD income will generally equal the excess of the adjusted issue price of the Target Security over the issue price of the New Security.

If the New Securities in debt-for-debt exchanges are traded on an "established securities market,"[113] the issue price of the New Securities will equal the market value of the New Securities. If the Target Securities are traded on an established securities market but the New Securities are not, the issue price of the New Securities will equal the market value of the Target Securities at the date of the exchange. If neither the Target Securities nor the New Securities is traded on an established securities market, then, if the stated interest on the New Securities equals or exceeds the applicable Federal rate (as would normally be the case), the issue price of the New Securities will equal their face amount.[114]

The fair market value of a New Security issued in most debt-for-debt exchanges, including those conducted pursuant to Section 3(a)(9), is frequently less than its own face amount and the adjusted issue price of the Target Securities being retired. Therefore, the changes to the Internal Revenue Code will increase the instances in which COD income will

111. Pub. L. No. 101-508, 1991 U.S. CODE CONG. & ADMIN. NEWS (104 Stat.) 1017 (to be codified in scattered sections of 26 U.S.C.).

112. *See id.* § 11325(a), 1991 U.S. CODE CONG. & ADMIN. NEWS at 1176 (adding new I.R.C. § 108(e)(11)(A) and repealing I.R.C. § 1275(a)(4)); H.R. CONF. REP. No. 964, 101ST CONG., 2D SESS. 98-101 (1990). Before the repeal of section 1275(a)(4), new OID could not be created in most debt-for-debt exchanges because the issue price of the New Security could not be less than the adjusted issue price of the Target Security. The extent to which section 1275(a)(4) governed the determination of the issue price of New Securities for purposes of computing COD income was unclear. *See* Haims & Schaumberger, *supra* note 96, at 94-98; Cohen, The Repeal of Section 1275(a)(4) (Dec. 3, 1990) (unpublished manuscript).

113. Under proposed Treasury regulations, an instrument is only considered to be traded on an established securities market if it is "traded on an established securities market on or within 10 trading days after the date it is issued." Prop. Treas. Reg. § 1.1273-2(c)(1), 51 Fed. Reg. 12,022 (1986). An "established securities market" includes a national securities exchange, an over-the-counter market, or an "interdealer quotation system" that "regularly disseminates quotations of obligations by identified brokers or dealers." Treas. Reg. § 15A.453-1(e)(4)(iv) (as amended in 1981).

114. *See* I.R.C. §§ 1273(b)(4), 1274 (1988); Prop. Treas. Reg. § 1.1273-2(c), 51 Fed. Reg. 12,022 (1986). The issue price of a Target Security will be less than its face amount if the stated interest is less than the applicable Federal rate, *see id.*, and hence the amount of COD income may be more.

arise, thereby increasing the cost of such debt-for-debt exchanges to many corporations.

As with the LTV decision, however, these tax changes do not eliminate exchanges of securities, such as Section 3(a)(9) Exchanges, as viable out-of-court restructuring techniques. Any COD income that a corporation recognizes from an exchange of securities can be reduced to the extent that the corporation is insolvent immediately before the exchange.[115] Furthermore, COD income can be further reduced by any net operating loss carryforwards, which are likely to be available to financially troubled companies.[116] In addition, these tax changes apply only to debt-for-debt exchanges. As a result, equity-for-debt exchanges may become increasingly popular. This trend may be accelerated by the LTV decision,[117] as well as the general liquidity advantages of eliminating interest expense that are likely to be particularly important for financially troubled corporations.

III. THE POLICY AND ELEMENTS OF SECTION 3(a)(9)

A. *The Policy of Registration and the Section 3(a)(9) Exemption*

When a corporation proposes to exchange—and thereby sell[118]—New Securities for Target Securities, it must comply with the registration requirements of section 5 of the Securities Act, unless an exemption from the registration requirements of section 5 is available for the transaction.[119] Section 5 makes the sale of securities unlawful unless a registra-

115. *See* Haims & Schaumberger, *supra* note 96.

116. *Id.*

117. See *supra* notes 97-110 and accompanying text.

118. Case law has established clearly that the exchange of a new security for an existing security constitutes a "sale" of the new security under the Securities Act. *See* United States v. Wernes, 157 F.2d 797, 799 (7th Cir. 1946); United States v. Riedel, 126 F.2d 81, 83 (7th Cir. 1942); R. JENNINGS & H. MARSH, *supra* note 14, at 399; 2 L. LOSS & J. SELIGMAN, *supra* note 14, at 1085; *see also* McGuigan & Aiken, *Amendment of Securities*, 9 REV. SEC. REG. 935, 935 n.1 (1976) (quoting H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933), explaining that such an exchange, and therefore such a sale, may be deemed to occur when an existing security is significantly modified).

119. 15 U.S.C. § 77e (1988). Section 5 provides that:

> (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise . . .
>
> . . . .
>
> (c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell . . . through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security . . . .

Id.

tion statement "is in effect," and makes any offer to sell securities unlawful unless (a) a registration statement "has been filed," and (b) all prospectuses relating to such securities comply with applicable regulations.[120]

There are a number of exemptions to the provisions of sections 5 and 10 of the Securities Act. Section 5 of the Securities Act is premised on the theory that issuers should provide potential investors with full and fair disclosure of all information that could be material to their investment decision and sufficient time to digest this information before making any decision about purchasing or selling the offered securities.[121] In considering the Securities Act's policy of full disclosure, however, Congress identified circumstances "where there is no practical need for its application or where the public benefits are too remote."[122] Consequently, Congress exempted certain transactions from the ambit of section 5. Among the exempted transactions are exchanges that meet the requirements of Section 3(a)(9).[123]

Congress determined that the Section 3(a)(9) exemption was appropriate to permit corporations to effect certain voluntary readjustments of their securities without the delay, expense and, in financial distress situations, embarrassment of registration.[124] Congress also determined that prohibiting paid solicitations in Section 3(a)(9) transactions would guard against the use of Section 3(a)(9) to evade the registration requirements of the Securities Act,[125] as well as ensuring that "excessive promoters' or

120. 15 U.S.C. § 77e. Section 5 of the Securities Act, and the applicable exemptions therefrom, dictate the circumstances in which a prospectus is needed. *See* Securities Act of 1933, § 3, 15 U.S.C. § 77c (1988) (generally exempted securities); *id.* § 4, 15 U.S.C. § 77d (exempted transactions); *id.* § 5, 15 U.S.C. § 77e (registration and prospectus requirements). Section 10 of the Securities Act and Regulation C, adopted thereunder, dictate the content of a prospectus. *See* Securities Act of 1933, § 10, 15 U.S.C. § 77j (1988); Regulation C, 17 C.F.R. § 230.400-.497 (1990).

121. H.R. REP. NO. 85, 73d Cong., 1st Sess. 3-4 (1933).

122. *Id.* at 5.

123. Securities Act of 1933, § 3(a)(9), 15 U.S.C. § 77c(a)(9). For a discussion of the requirements of Section 3(a)(9), see *infra* notes 127-257 and accompanying text. Corporations also utilize the exemptions from section 5 available under sections 4(2) and 3(a)(10) of the Securities Act to conduct exchanges without complying with the Securities Act's registration requirements. *See supra* note 15.

124. *See* H.R. REP. NO. 152, 73d Cong., 1st Sess. 25 (1933) (referring to former Securities Act of 1933, § 4(3), 15 U.S.C. 77d(2) (1933) (reenacted as section 3(a)(9), 15 U.S.C. § 77c(a)(9))); Throop & Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 LAW & CONTEMP. PROBS. 89, 98 (1937).

125. H.R. REP. NO. 152, *supra* note 124, at 25 ("Inasmuch as any exchange that involves the payment of a commission of any sort is not exempt, there is no danger of the provision being used for purposes of [evading registration requirements of the Securities Act]." (referring to former section 4(3) under the Securities Act (reenacted as section 3(a)(9), 15 U.S.C. § 77c(a)(9)))).

sponsors' interests" are not concealed from investors.[126]

B. The Elements of Section 3(a)(9)

As noted above, Section 3(a)(9) exempts the issuance of the following securities from the registration requirements of section 5 of the Securities Act:

> Except with respect to a security exchanged in a case under title 11 of the United States Code [the Federal Bankruptcy Code], any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange.[127]

In the absence of published congressional or SEC guidelines, commentators have long attempted to establish a set of required "elements" for compliance with Section 3(a)(9). Although commentators have differed as to the number[128] and content of these elements, the four "prerequisites" set forth by Professor Hicks[129] encompass most discussions of Section 3(a)(9).[130] Trying to force the issues encountered in practice or the Staff's no-action positions on Section 3(a)(9) into these *four* elements, however, invariably becomes cumbersome and redundant. Consequently, for purposes of analyzing Section 3(a)(9), only the following *three questions* need be asked to determine whether an exchange of securities can be conducted without registration under the Securities Act in reliance on Section 3(a)(9):

126. Letter from Chief of Securities Division of Federal Trade Commission, *quoted in* 1 Fed. Sec. L. Rep. (CCH) ¶ 2165.25, at 2588 [hereinafter Letter from Chief of Securities Division]; *accord* H.R. REP. NO. 152, *supra* note 124, at 25.

127. 15 U.S.C. § 77c(a)(9) (1988).

128. *Compare* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 276-77 (2d ed. 1988) (setting forth three elements) *with* Connell, *Section 3(a)(9): Recapitalizations*, in 1 SECURITIES LAW TECHNIQUES 5-1 (A.A. Sommer, Jr. ed. 1990) (setting forth five elements).

129. 7 J. HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 § 2.03[1] (1990). Professor Hicks short-titles his four prerequisites of Section 3(a)(9) as: (1) "Identity of Issuer," (2) "Exclusively by Exchange," (3) "Exclusively with Security Holders," and (4) "Absence of Remuneration or Commissions." *Id.* §§ 2.04-.07.

130. *See* L. LOSS, *supra* note 128, at 276-79 (the second of his three elements contains both of Professor Hicks' second and third elements). Connell basically duplicates Professor Hicks' four "prerequisites," and adds a fifth "condition" for use of Section 3(a)(9): "[T]he transaction must not be part of a scheme to evade registration." Connell, *supra* note 128, at 5-1. Connell also sets forth factors for determining whether a transaction is a bona fide exchange or part of a plan to evade registration. *Id.* § 5.02[5], at 5-10 (citing Securities Act Release No. 646, 1 Fed. Sec. L. Rep. (CCH) ¶ 2136, at 2583-15 (Feb. 3, 1936)). For a quotation of relevant portion of Release No. 646, see *infra* note 150.

- Is the exchange being made by an issuer for its own securities (the "same issuer" requirement)?
- Are security holders parting with any consideration in the transaction other than outstanding securities of such issuer (the "exclusively by exchange" requirement)?
- Will the issuer pay any commission or other remuneration, directly or indirectly, for the solicitation of the exchange (the "no paid solicitation" requirement)?

In addition to asking these three questions, practitioners must be concerned about whether a Section 3(a)(9) Exchange might be integrated into another offering of securities by the corporation, if any, that is being conducted within roughly the same time frame as the Section 3(a)(9) Exchange and, if so, whether any of the three elements set forth above would be violated in such offerings.[131] Other commentators apply this integration analysis to Section 3(a)(9) through an additional fourth element of the exemption: whether the offering is made exclusively to the issuer's existing security holders, commonly referred to as the "exclusively with existing security holders" requirement.[132] The probable genesis of this "fourth requirement" is Securities Act Release No. 2029 (Release 2029)[133] and Professor Loss' analysis (likely based on this Release) that the word "exclusively" in Section 3(a)(9) performs a "double duty," modifying both the phrase "existing security holders" and the word "exchange."[134] Release 2029, however, really should stand for

131. *See* R. JENNINGS & H. MARSH, *supra* note 14, at 440.

> [F]or an exemption to be available, each transaction must satisfy all of the conditions of a single exemption. Moreover, where there are a series of offerings, every proposed unregistered offering may be linked with a prior or subsequent offering; if such linkage occurs, two or more ostensibly discrete offerings may be deemed to comprise a single transaction. The doctrine of integration entails the process of combining multiple offerings into a single offering, and the effect of such combination may be to destroy one or more of the exemptions.

Id.

132. *See, e.g.*, 7 J. HICKS, *supra* note 129, § 2.06[2] (discussing the problem of integration under the general heading of "Exclusively with Security Holders.").

133. Securities Act Release No. 2029, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2140-2141, at 2583-17 to 2584 (Aug. 8, 1939). The general counsel of the SEC opined that the Section 3(a)(9) exemption "is available only to securities constituting part of an issue which, as a whole, is exchanged in conformity with *the requirements* of the section." *Id.* ¶ 2140, at 2584 (emphasis added) (the "issue" referred to is the issuance of securities at a particular point or points in time, not the entire class of such securities). This language seems to refer back to other "requirements," not create an additional and wholly new requirement.

134. L. LOSS, *supra* note 128, at 277-78; *see also* 7 J.HICKS, *supra* note 127, § 2.05[1][a], at 2-77 (stating that the word "exclusively" in Section 3(a)(9) modifies both the phrase "existing security holders" and the word "exchange"). Professor Loss does not cite Release 2029 in his "double duty" analysis of the word "exclusively" in Section 3(a)(9). There is no legislative history or case law expounding on the word "exclusively," although the SEC has promulgated

nothing more than the proposition that the use of Section 3(a)(9) can be invalidated by integration,[135] a fact that is also true for other exemptions under the Securities Act.[136] Moreover, the only SEC interpretations or Staff no-action letters that can be roughly characterized as involving an "exclusively with existing security holders" requirement involve basic integration analyses,[137] such as a concurrent public or private offering of new securities for cash.[138] While these offerings, which (by virtue of the integration of otherwise separate transactions) are deemed to include the

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two rules under the Securities Act that address the "exclusively by exchange" requirement. *See* Rules 149 & 150, 17 C.F.R. §§ 230.149, 230.150 (1990). For a discussion of Rules 149 and 150, see *infra* notes 192-93 & 198-203 and accompanying text. Release 2029 uses the word "exclusively" to apply integration analysis to Section 3(a)(9), *see* Securities Act Release No. 2029, *supra* note 133, at 2584, which theoretically can be combined with the "exclusively by exchange" requirement to impose a double duty on the word "exclusively." This second duty, however, is illusory; integration analysis has its own history apart from Section 3(a)(9), *see* R. JENNINGS & H. MARSH, *supra* note 14, at 440 (quoted *supra* note 131 and discussed *infra* note 136), and undoubtedly would apply to Section 3(a)(9) even if the word "exclusively" was not contained in it. *See generally infra* notes 136 & 261 (discussing integration in the context of other Securities Act exemptions, particularly those provided by Regulation D and section 3(a)(11), neither of which contain the word "exclusively").

135. *See* Securities Act Release No. 2029, *supra* note 133, ¶ 2141, at 2584 (SEC General Counsel opining that a concurrent Section 3(a)(9) Exchange of new debt securities for existing debt securities and a section 4(1) (now section 4(2)) private placement of debt securities to new investors for cash constituted "separate 'issues,' and may be offered and sold . . . without being registered under the Securities Act"). *See supra* note 134. For a more detailed discussion of integration as applied to Section 3(a)(9) Exchanges generally, see *infra* notes 258-71 and accompanying text.

136. *See* R. JENNINGS & H. MARSH, *supra* note 14, at 440 (noting that integration analysis applies to, among other Securities Act exemptions, the private offering exemptions available under Sections 4(2) and 4(6), 15 U.S.C. § 77d(2), (6) (1988), and Rules 505 and 506, 17 C.F.R. §§ 230.505, .506 (1990); the limited offering exemptions under Section 3(b), *e.g.*, Regulation A, 17 C.F.R. § 230.251-.264 (1990), and Rule 504, 17 C.F.R. § 230.504 (1990); the interstate exemption available under section 3(a)(11), 15 U.S.C. § 77c(a)(11) (1988), and Rule 147, 17 C.F.R. § 230.147 (1990); and exchange exemptions available under sections 3(a)(9) and 3(a)(10), 15 U.S.C. § 77c(a)(9), (10) (1988)).

137. The discussions of variants of the "exclusively with the existing security holders" requirement by each of the other commentators mentioned in this discussion also primarily concern integration analysis. *See* 7 J. HICKS, *supra* note 129, § 2.06, at 2-88 to 2-94; L. LOSS, *supra* note 128, at 278-81; 3 L. LOSS & J. SELIGMAN, *supra* note 14, at 1211-28; Connell, *supra* note 128, § 5.02[3], at 5-7 to 5-8. In fact, none of the no-action letters cited in those discussions of an "exclusively with existing security holders" requirement would have violated *only* that requirement had the other offerings been integrated with the Section 3(a)(9) Exchanges. In each case, one or more of the three Section 3(a)(9) elements listed in this Article also would have been violated.

138. *See, e.g.*, Four-Phase Sys., SEC No-Action Letter (avail. Dec. 10, 1973) (LEXIS, Fedsec library, Noact file) (substantially simultaneous private placement pursuant to section 4(2) and a Section 3(a)(9) Exchange not integrated); *see also* 7 J.HICKS, *supra* note 129, § 2.06[2], at 2-91 to 2-94 (discussing *Four-Phase Systems* in its primary analysis of the "exclusively with existing security holders" requirement). These are also the facts addressed by the SEC General Counsel in Release 2029. *See* Securities Act Release No. 2029, *supra* note 133.

sale of securities for cash, would violate an exclusively with existing security holders requirement, they also would violate, if integrated, the exclusively by exchange requirement.[139] Even a concurrent third-party exchange of securities, after integration with an issuer's exchange of its New Securities for its Target Securities, would violate the same issuer requirement in addition to an exclusively with existing security holders requirement.[140] Consequently, after reviewing the many Section 3(a)(9) no-action letters on this subject, it is apparent that all ostensibly "exclusively with existing security holder" situations really involve an integration analysis of one or more of the three elements set forth above.[141] As a result, an "exclusively with existing security holders" requirement serves no *analytic* purpose. Ultimately, practitioners must feel comfortable that, after an independent integration analysis, the *three* elements of Section 3(a)(9) identified in this Article have been satisfied.[142]

1. The "same issuer" requirement

Historically, the same issuer requirement of Section 3(a)(9)[143] was construed strictly to require that the issuer of the New Securities in an exchange transaction (the Offeror) be the same entity that issued the Target Securities.[144] The Staff, however, has taken no-action positions in an

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139. *See infra* notes 186-203 and accompanying text.

140. For a discussion of the same issuer requirement, see *infra* notes 143-85 and accompanying text. What is interesting in this context is that an "exclusively with existing security holders requirement" theoretically should have been applied equally to the many no-action letters concerning the same issuer requirement. Instead, the letters focused solely on the same issuer requirement. *See, e.g.*, Gulf & W. Indus., SEC No-Action Letter (avail. Sept. 6, 1976) (LEXIS, Fedsec library, Noact file) (Staff denying no-action request "particularly because the exchange contemplated is not an exchange of a security by the *same issuer* with its security holder" (emphasis added)); Worldwide Energy Co., SEC No-Action Letter (avail. Feb. 5, 1973) (LEXIS, Fedsec library, Noact file) (must be "same legal entity").

141. For a general discussion of integration analysis in the context of Section 3(a)(9), see *infra* notes 258-71 and accompanying text.

142. Ultimately, however, even the three elements for Section 3(a)(9) set forth in this Article should only be construed as a convenient way to analyze Section 3(a)(9). While most no-action letters readily fall into one or more of these three categories, there is, as noted above, no legislative history or public interpretation by the SEC, the Staff or any judicial body that similarly breaks Section 3(a)(9) into any set number of "elements."

143. Section 3(a)(9) exempts "any security exchanged by the issuer with *its* existing security holders." 15 U.S.C. § 77c(a)(9) (emphasis added).

144. *See* Crowell-Collier Publishing Co., Securities Act Release No. 3825, [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,539 (Aug. 12, 1957); O'Neill Bondholders Comm., SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 79,947, at 84,438 (July 10, 1974); 7 J. HICKS, *supra* note 129, § 2.04[1], at 2-37. The same issuer requirement is not satisfied, and therefore Section 3(a)(9) is unavailable, in connection with the issuance of New Securities in a transaction in which the issuer's legal form is changed. *See, e.g.*, NEOKA Group 1987-I, SEC No-Action Letter (avail. Jan. 19, 1990) (LEXIS, Fedsec library, Noact file) (Staff "unable" to issue no-action position because "there is no 'identity

increasing variety of circumstances—typically involving Offerors that are parent or successor corporations proposing Section 3(a)(9) Exchanges of their New Securities for the Target Securities of subsidiaries or predecessors, respectively. In the transactions that are the subject of these no-action letters, before the issuance of the New Securities the Offerors either became jointly and severally (*i.e.*, primarily) liable for Target Securities issued by another entity (the Other Issuer),[145] or became secondarily liable for the Target Securities of the Other Issuer by guaranteeing such Target Securities.[146]

In at least one instance, it is apparent that an Offeror assumed the primary obligation for the securities of the Other Issuer for the sole purpose of satisfying the same issuer requirement, and the Staff granted the no-action request.[147] In other cases, Offerors acquiring Other Issuers through reverse triangular mergers guaranteed certain securities of such Other Issuers and thereby satisfied the same issuer requirement in subsequent Section 3(a)(9) Exchanges of the Offeror's New Securities for such guaranteed securities.[148] While this technique may prove to be a helpful method of satisfying the same issuer requirement, practitioners should be cognizant of Securities Act Release No. 646,[149] in which the SEC General Counsel stated that he believed that Section 3(a)(9) was "applicable only to exchanges which are bona fide, in the sense that they are not effected merely as a step in a plan to evade the registration requirements of the [Securities] Act."[150] One reason, independent from Section 3(a)(9)

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of issuer' within the meaning of section 3(a)(9)" when a general partnership proposed to amend its partnership agreement to become a limited partnership by issuing limited partnership interests in exchange for general partnership interests); Kanawha Gauley Coal & Coke Co., SEC No-Action Letter (avail. Sept. 4, 1974) (LEXIS, Fedsec library, Noact file) (cited on LEXIS as Kanawha Gaulty [sic] Coal & Coke Co.) (same issuer requirement not satisfied when a corporation changes its legal form to a limited partnership); Recreation Ventures, SEC No-Action Letter (avail. May 14, 1973) (LEXIS, Fedsec library, Noact file) (same issuer requirement not satisfied when a limited partnership changes its legal form to a corporation, even though the partnership agreement provided for such change). Nor is the requirement satisfied in merger or certain other reorganization transactions. *See* 7 J. HICKS, *supra* note 129, § 2.04[3][b], at 2-46; *see also* Hendry County Bank, SEC No-Action Letter (avail. May 28, 1982) (LEXIS, Fedsec library, Noact file) (in formation of a one-bank holding company, no-action request denied because of "two different issuers" despite common control and stockholders, and, according to the no-action request, "reason, logic and justification"); Worldwide Energy Co., *supra* note 140 (must be "same legal entity").

145. *See infra* notes 156-66 and accompanying text.

146. *See infra* notes 167-85 and accompanying text.

147. *See* SEC No-Action Letters cited *infra* notes 165-66 and accompanying text.

148. *See* SEC No-Action Letters cited *infra* notes 175-79 and accompanying text.

149. Securities Act Release No. 646, 1 Fed. Sec. L. Rep. (CCH) ¶ 2136, at 2583-15 (Feb. 3, 1936).

150. *Id.* The SEC General Counsel provided the following guidelines for determining whether a *bona fide* exchange exists for purposes of Section 3(a)(9):

or any reason attributable to a particular transaction, that a parent that is a reporting company under the Exchange Act[151] might assume primary or secondary liability for a new wholly owned subsidiary's debt that has independent operations is that such an assumption could relieve the subsidiary from reporting obligations under the Exchange Act.[152]

Offerors should note that the assumption of the primary obligation of another corporation's securities or the guarantee of the securities of another corporation may, in and of itself, constitute the issuance of a security.[153] The registration requirements of the Securities Act, however,

> In determining whether a particular exchange had been effected merely as a step in a plan to evade the registration requirements of the [Securities] Act, . . . a court would take into account . . . [i] the length of time during which the securities received by the issuer were outstanding prior to their surrender in exchange, [ii] the number of holders of the securities originally outstanding, [iii] the marketability of such securities, and also [iv] the question whether the exchange is one which was dictated by financial considerations of the issuer and not primarily in order to enable one or a few security holders to distribute their holdings to the public.

Id. As intimated by the second and fourth of these "guidelines," the main focus of the SEC General Counsel in Release 646 was the issuance of the New Securities to a single investor or small group of controlling stockholders immediately prior to the Section 3(a)(9) Exchange to justify use of the Section 3(a)(9) exemption. *Id.* ¶¶ 2136-2137, at 2583-15 to -16. In the context of issuing a guarantee or an assumption in connection with pre-existing public securities, it is likely that those pre-existing securities would be held by numerous non-controlling parties. Release 646 is much more broadly cited for the proposition that Section 3(a)(9) is a transaction exemption and that the New Securities issued thereunder carry the same restrictions on post-distribution trading as the Target Securities. See *infra* notes 272-84 and accompanying text, for a discussion of these trading restrictions in the context of Section 3(a)(9) Exchanges.

151. A reporting company is an entity that is required to file periodic reports with the SEC pursuant to sections 13 or 15(d) of the Exchange Act, 15 U.S.C. §§ 78m, 78o(d) (1988).

152. The subsidiary might have reporting obligations under the Exchange Act, for example, if it had registered securities with the SEC pursuant to sections 13 or 15(d), 15 U.S.C. §§ 78m, 78o(d). The Staff has expressed the view, however, that where the issuer of a fully and unconditionally guaranteed security is wholly owned by the guarantor and such wholly owned subsidiary has more than minimal independent operations, and the guarantor is itself a reporting company under the Exchange Act, the issuer of the guaranteed security "would be conditionally exempted . . . from the reporting obligations" of the Exchange Act pursuant to section 12(h), 15 U.S.C. § 78n(h) (1988), thereof. Staff Accounting Bulletin No. 53, 48 Fed. Reg. 28,230, 28,231 & n.2 (June 13, 1983) [hereinafter SAB No. 53]; *see also id.* at 28,231 (the parent-guarantor need not be a reporting company to terminate the reporting requirements of a wholly owned subsidiary that has "essentially no independent operations" and the guarantee of the Target Securities is "full and unconditional."). "In implementing SAB No. 53, the Staff has routinely expressed no objection to the cessation of such reporting by such [wholly owned] subsidiaries," subject to certain conditions. FHC-CompCare, Inc., SEC No-Action Letter (avail. Oct. 12, 1989) (LEXIS, Fedsec library, Noact file) (citing HRI Group, Inc., SEC No-Action Letter (avail. Oct. 11, 1988) (LEXIS, Fedsec library, Noact file); Burroughs Corp., SEC No-Action Letter (avail. Dec. 22, 1986) (LEXIS, Fedsec library, Noact file); Sprague Elec. Co., SEC No-Action Letter (avail. May 3, 1984) (LEXIS, Fedsec library, Noact file)).

153. *See* Securities Act of 1933, § 2(1), (4), 15 U.S.C. § 77b(1), (4) (1988) (definition of "security" includes, among other things, a "guarantee"); *see also* Financial Corp. of Santa Barbara, SEC No-Action Letter (avail. June 22, 1987) (LEXIS, Fedsec library, Noact file) (treating a parent's "joint and several obligation" of a subsidiary's debt as a separate security);

apply to "offers to sell" and "sales of" securities.[154] No-action requests uniformly argue with success that no sale of the assumption or guarantee has occurred when a parent or successor corporation gratuitously takes on liability of another entity's securities; accordingly, there is no registration requirement.[155]

a. primary obligors

The Staff repeatedly has taken no-action positions when an Offeror had assumed joint and several liability for the Target Securities of the Other Issuer and intended to conduct a Section 3(a)(9) Exchange of the Offeror's New Securities for such Target Securities, whether the Offeror became a primary obligor at the initial issuance of the Target Securities[156] or at a later date. Offerors have become the primary obligor at a

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Union Planters Corp., SEC No-Action Letter (avail. Nov. 29, 1982) (LEXIS, Fedsec library, Noact file) (Staff noted that "payment of [certain notes] will be guaranteed by [Union Planters Corp.], and that such guarantee may be deemed a security required to be registered under the 1933 Act, absent an exemption").

154. Securities Act of 1933, § 5, 15 U.S.C. § 77e (1988). The terms "sale" and "sell" are defined in section 2(3) of the Securities Act. *Id.* § 77b(3).

155. *See, e.g.*, W.R. Grace & Co., SEC No-Action Letter (avail. July 25, 1988) (LEXIS, Fedsec library, Noact file); Perpetual Sav. Bank, Perpetual Fin. Corp., SEC No-Action Letter (avail. Feb. 29, 1988) (LEXIS, Fedsec library, Noact file); Midlantic Corp., SEC No-Action Letter (avail. Apr. 27, 1987) (LEXIS, Fedsec library, Noact file); Pacesetter Fin. Corp., SEC No-Action Letter (avail. Nov. 21, 1977) (LEXIS, Fedsec library, Noact file). Counsel often support this argument by pointing out that no sale occurs when the debt holders have no right of consent to the assumption and related changes to the debt. *See* Time-Warner, Inc., SEC No-Action Letter (avail. Jan. 9, 1990) (LEXIS, Fedsec library, Noact file) (Time-Warner voluntarily guaranteed Warner Communication's existing debt); FHC-CompCare, Inc., *supra* note 152 (new parent of acquired corporation guarantees acquired corporation's debt); Corning Glass Works, SEC No-Action Letter, [1987-1988 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 78,707, at 78,013 (Feb. 26, 1988) (Staff noting that the initial issuer "is not required to solicit the consent or vote of the Holders of the Debentures with respect to the . . . assumption of payment obligations under the Debentures"); McKesson Corp., SEC No-Action Letter (avail. Aug. 10, 1987) (LEXIS, Fedsec library, Noact file); Newell Co., SEC No-Action Letter (avail. July 22, 1987) (LEXIS, Fedsec library, Noact file) (Staff noting that "the holders of the Debentures do not have any right to vote upon the . . . assumption of liability"); Inexco Oil Co., SEC No-Action Letter (avail. Mar. 17, 1987) (LEXIS, Fedsec library, Noact file); Motorola, Inc., SEC No-Action Letter (avail. Mar. 5, 1982) (LEXIS, Fedsec library, Noact file); *see also* United Technologies Corp. & Sheller-Globe Corp., SEC No-Action Letter (avail. Feb. 6, 1990) (LEXIS, Fedsec library, Noact file) (counsel did not make the argument related to this point, but Staff took particular note of counsel's representation that original issuer was "not required to solicit the consent or vote of the" debt holders). *Cf.* Recreation Ventures, *supra* note 144 (Staff expressly does "not agree that a 'sale' under Section 2(3) is not involved" in a proposed transaction in which the consent of investors was required). Counsel have also argued that the assumption is occurring for no value. *See, e.g.*, Corning Glass Works, *supra*; Newell Co., *supra*; *see also* Securities Act of 1933 § 2(3), 15 U.S.C. § 77b(3) (defining alternative uses of "sale" or "sell" to require some sort of disposition or attempted disposition of a security "for value").

156. *See, e.g.*, Financial Corp. of Santa Barbara, *supra* note 153 (parent holding company

later date through a subsequent assumption of the obligations of the Other Issuer arising from (1) the merger of the Other Issuer into the Offeror itself[157] or into a subsidiary of the Offeror,[158] or (2) the merger of a subsidiary of the Offeror into the Other Issuer.[159] The assumption of joint and several liability may also arise from other reorganizations, such as the dissolution of a subsidiary[160] or the formation of a holding company.[161]

In each of these situations in which the Staff issued no-action letters, the Offeror had assumed the obligations to pay the principal, premium, if any, and interest on the Other Issuer's existing securities. The assumption may have been of joint liability with the Other Issuer,[162] and it may have been on a subordinated basis consistent with the Other Issuer's obligation.[163]

It appears that an Offeror's assumption or guarantee[164] of payment liability of the Other Issuer's debt is a method of meeting the same issuer requirement when it would not otherwise be met. In response to an initial request by Pacwest Bancorp. (Pacwest), the Staff refused to take a

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assumed joint and several liability for the convertible debentures of its wholly owned subsidiary when they were issued and relied on Section 3(a)(9) to exchange parent's common stock for subsidiary's debentures upon conversion).

157. *See, e.g.*, Heritage Bancorp., SEC No-Action Letter (avail. Feb. 14, 1973) (LEXIS, Fedsec library, Noact file) (surviving corporation assumed all liability and obligation on convertible notes of a previously unaffiliated corporation that it acquired and relied on Section 3(a)(9) to exchange its common stock for the acquired corporation's notes upon conversion).

158. *See, e.g.*, Pacwest Bancorp., SEC No-Action Letter (avail. Nov. 13, 1979) (LEXIS, Fedsec library, Noact file) [hereinafter Pacwest II] (parent company assumed joint and several payment obligation for the convertible debentures of a previously unaffiliated corporation it acquired as an operating subsidiary and relied on Section 3(a)(9) to exchange the parent's common stock for the subsidiary's debentures upon conversion).

159. *See, e.g.*, McKesson, Inc., *supra* note 155; Newell Co., *supra* note 155; Motorola, Inc., *supra* note 155; DPF, Inc., SEC No-Action Letter (avail. Feb. 12, 1979) (LEXIS, Fedsec library, Noact file); Pacesetter Fin. Corp., *supra* note 155.

160. *See, e.g.*, Pan Am World Airways, SEC No-Action Letter (avail. June 30, 1975) (LEXIS, Fedsec library, Noact file) (parent company assumed obligations on convertible debentures of a wholly owned foreign subsidiary when the subsidiary was dissolved and relied on Section 3(a)(9) to exchange the parent's common stock for the subsidiary's debentures upon conversion).

161. *See, e.g.*, Perpetual Sav. Bank, Perpetual Fin. Corp., *supra* note 155 (newly formed holding company assumed obligations on the convertible debentures of an operating company and relied on Section 3(a)(9) to exchange the holding company's common stock for the operating company's debentures upon conversion).

162. *See, e.g.*, McKesson Corp., *supra* note 155 (assumption of joint liability with Other Issuer); Newell Co., *supra* note 155 (assumption of joint liability with Other Issuer); WECO Dev. Corp., SEC No-Action Letter (avail. Feb. 23, 1973) (LEXIS, Fedsec library, Noact file) (assumption of "primary liability" of Other Issuer).

163. *See, e.g.*, Pacwest II, *supra* note 158.

164. *See infra* notes 175-79 and accompanying text.

no-action position when Pacwest stated that it would only assume the obligation of issuing its common stock upon the conversion of existing convertible debentures of a corporation it had acquired and that Pacwest intended to rely on Section 3(a)(9) to avoid registering the shares of its common stock that would be issuable upon conversion.[165] When Pacwest subsequently represented that it would assume the obligations to pay principal, premium, if any, and interest on the subsidiary's debentures, the Staff agreed to the requested no-action position.[166]

b. guarantors

A guarantee and the underlying security that is guaranteed are separate securities.[167] Consequently, a guarantor and an issuer of existing guaranteed securities both will satisfy the same issuer requirement if they jointly offer to exchange new guaranteed securities for the existing guaranteed securities.[168] The requirement is also satisfied if a guarantor offers New Securities other than a guarantee for the existing guarantee (considered the Target Security of the guarantor), and the issuer of the underlying securities offers New Securities that carry no guarantee for the existing underlying securities (considered the Target Security of the Other Issuer).[169]

Where the guarantor is the sole Offeror of New Securities, however, the Staff's position has evolved from its denial of the no-action request of National Can Corporation in 1973,[170] to equating guarantees with as-

165. Pacwest Bancorp., SEC No-Action Letter, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,376, at 82,617-20 (Sept. 24, 1979) [hereinafter Pacwest I].

166. Pacwest II, *supra* note 158; *see also* 7 J. HICKS, *supra* note 129, § 2.04[4][b][iii], at 2-59 (discussing the Pacwest no-action letters).

167. *See* Securities Act of 1933, § 2(1), (4), 15 U.S.C. § 77b(1), (4).

168. In this scenario, the guarantor, such as a parent corporation, would offer a new guarantee in exchange for the existing guarantee, and the issuer of the underlying security, such as a subsidiary corporation, would offer a new underlying security for the existing underlying security. 7 J. HICKS, *supra* note 129, § 2.04[5][a], at 2-61 (citing Grolier, Inc., SEC No-Action Letter (avail. Dec. 2, 1977) (LEXIS, Fedsec library, Noact file)). Although *Grolier* involved the factual scenario described by Hicks, the no-action request relating to the joint exchange of existing guaranteed securities for new guaranteed securities was based on section 4(2) rather than section 3(a)(9).

169. *See* ECL Indus. & Norlin Corp., SEC No-Action Letter (avail. Dec. 16, 1985) (LEXIS, Fedsec library, Noact file) (no-action position granted when a parent's new warrants and its subsidiary's new debentures were offered in exchange for existing subsidiary debentures that were guaranteed by the parent).

170. National Can Corp., SEC No-Action Letter (avail. Oct. 29, 1973) (LEXIS, Fedsec library, Noact file). National Can proposed to exchange its common stock for its subsidiary's convertible debentures that it had guaranteed. The Staff refused to take a no-action position, stating that "[a]lthough the guarantee of [the subsidiary's] Bonds by National may in itself be deemed to be a security of National under Section 2(1) of the Act, the Bonds themselves are

sumptions of joint and several liability in 1989.[171] Starting in 1982, the "[S]taff decided to bury its analysis and conclusion in *National Can Corp.* in favor of a construction of the exemption that is grounded on the *economic reality* of the issuer of the guaranteed securities at the time of their issuance."[172] In response to requests based on this "economic reality" standard, the Staff granted no-action letters where a parent company had guaranteed, upon initial issuance, the securities of a subsidiary issuer that the parent had formed for a special or limited purpose.[173] Nonetheless, prior to 1989, the Staff avoided (and a few joint and several obligation no-action request letters[174] distinguished) situations in which the Offeror had guaranteed Target Securities of another issuer with independent operations, and the Offeror proposed a Section 3(a)(9) Exchange of its New Securities for those Target Securities. In response to the 1989 no-action requests of Daisy Systems Corporation[175] and FHC-CompCare, Inc.,[176]

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not thereby considered a security of National under [Section 3(a)(9)] solely by reason of guarantee." *Id.*

171. *See infra* notes 175-79 and accompanying text.

172. 7 J. HICKS, *supra* note 129, § 2.04[5][b], at 2-64 (emphasis added) (footnote omitted).

173. *See, e.g.*, American Motors Corp., SEC No-Action Letter (avail. July 8, 1982) (LEXIS, Fedsec library, Noact file) (no-action position taken after American Motors, which had formed a finance subsidiary solely for the purpose of offering to foreign nationals outside of the United States debt securities guaranteed by American Motors and convertible into American Motors stock, argued that, for the purposes of exchanging its stock for the subsidiary's securities upon conversion in reliance on Section 3(a)(9), it should be considered the issuer of the subsidiary's securities because "the economic merits of the [subsidiary's] Bonds to an investor lie solely in the Guarantees issued by the [parent company]"); *see also* IMCO Realty Servs., SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,434, at 77,275-76 (Feb. 6, 1990) (debt securities of one wholly owned subsidiary of a partnership could be exchanged for debt securities of another wholly owned subsidiary of a partnership where the partnership guaranteed the securities of both subsidiaries, and both subsidiaries were formed exclusively to act as financing entities and had no economic substance or operations independent from the partnership); Saatchi & Saatchi, SEC No-Action Letter (avail. May 18, 1989) (LEXIS, Fedsec library, Noact file) (special purpose subsidiary with no assets); Svenska Cellulosa Aktiebolaget SCA, SCA Capitol Corp., SEC No-Action Letter (avail. Dec. 15, 1988) (LEXIS, Fedsec library, Noact file) (limited purpose finance subsidiary with some assets); Dynalectron Corp., DFC Inc., SEC No-Action Letter (avail. Nov. 10, 1986) (LEXIS, Fedsec library, Noact file) (special purpose subsidiary with no material tangible assets).

174. *See, e.g.*, Financial Corp. of Santa Barbara, *supra* note 153 (issuer's counsel noting the Staff's different treatment of Target Securities that had been guaranteed by the Offeror *vis a vis* Target Securities for which the Offeror had assumed joint and several liability).

175. Daisy Sys. Corp., SEC No-Action Letter, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,314, at 79,153-57 (Apr. 10, 1989) (parent company transferred substantially all of its operating assets to a merger subsidiary prior to guaranteeing obligations for the convertible debentures of a previously unaffiliated corporation it acquired through a reverse triangular merger with the merger subsidiary, and relied on Section 3(a)(9) to exchange the parent's debentures for the new subsidiary's debentures upon conversion).

176. FHC-CompCare, Inc., *supra* note 152.

however, the Staff took no-action positions on proposed Section 3(a)(9) Exchanges in which parent corporations guaranteed the existing securities of an operating subsidiary that had been acquired through merger.[177] The Staff now appears to equate the guarantee of an obligation with the assumption of primary liability for an obligation,[178] and appears now to permit a parent corporation to guarantee the debt of a subsidiary for the purpose of satisfying the same issuer requirement.[179]

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177. *Id.*; Daisy Sys. Corp., *supra* note 175. Counsel for both *FHC-Comp Care, Inc.* and *Daisy Systems Corp.* abandoned the "economic reality" rationale for satisfying the same issuer requirement, and instead argued, apparently persuasively, that the parent "should be deemed to be an issuer of the [subsidiary's] Debentures [the Target Securities] as well as the issuer of the [parent's New Securities] '[b]ecause the [parent] will in fact be liable under the [subsidiary's] Debentures." FHC-CompCare, Inc., *supra* note 152 (citing, among others, Daisy Sys. Corp., *supra* note 175 (using the same "deemed issuer" rationale); Newell Co., *supra* note 155; MeKesson Corp., *supra* note 155; Pacwest II, *supra* note 158). *Cf.* National Can Corp., *supra* note 170 (Staff's earlier and dramatically opposite analysis). As a result of the overall transaction in Daisy Systems Corp., the parent-guarantor became a holding company and substantially all of the operating assets of the overall corporate entity were owned by the surviving acquired corporation that was the issuer of the convertible debentures. Daisy Sys. Corp., *supra* note 175, at 79,155. As a result, it is arguable that an "economic reality" rationale could have been a basis for the Staff's no-action position in *Daisy Systems Corp.*, although the no-action request did not mention this rationale and put its faith exclusively in the "deemed issuer" rationale. In *FHC-CompCare, Inc.*, however, there was no factual basis for any economic reality rationale for the Staff's no-action position. First Hospital Corporation (FHC) formed a holding company parent, which would hold all of the operating assets of FHC in one subsidiary and all of the operating assets of Comprehensive Care Corporation (CompCare), the company it was acquiring, in a second subsidiary, and would guarantee CompCare's convertible debt after a proposed reverse triangular merger of CompCare with and into the second subsidiary. FHC-CompCare, Inc., *supra* note 152. The Staff issued a no-action letter that would have allowed the parent holding company, despite holding all of FHC's assets in a separate subsidiary, to rely on Section 3(a)(9) to exchange the parent's common stock and debentures for CompCare's debentures upon conversion. FHC-CompCare, Inc., *supra* note 152.

178. In the *Daisy Systems Corp.* no-action request, counsel stated:

> For these purposes, there is no reason to view an assumption of joint and several liability as different from [a guarantee]. Indeed, several no-action letters, and a conversation we had with [a member of the Staff] in late January of this year, indicate that the Staff does not distinguish between assumptions and guarantees in such cases.

Daisy Sys. Corp., *supra* note 175, at 79,156 (citing Southwest Bancorp., SEC No-Action Letter (avail. May 20, 1986) (LEXIS, Fedsec library, Noact file); The Limited Stores, SEC No-Action Letter (avail. May 12, 1982) (LEXIS, Fedsec library, Noact file)).

179. But see *supra* notes 147-48 and accompanying text, discussing the bona fide exchange requirement of Section 3(a)(9) set forth in Securities Act Release No. 646, *supra* note 130. There was no apparent reason for Daisy Systems' guarantee of its new subsidiary's Target Securities other than to satisfy the same issuer requirement. *See* Daisy Sys. Corp., *supra* note 175. In *FHC-CompCare, Inc.*, however, the guarantee also provided the basis for the Staff's taking a no-action position with regard to the acquired subsidiary's termination of filing periodic reports with the SEC pursuant to sections 13 and 15(d) of the Exchange Act, 15 U.S.C. §§ 78m, 78o(d). FHC-CompCare, Inc., *supra* note 152. For a discussion of the basis for this termination, see *supra* notes 151-52 and accompanying text.

As in the primary obligor context,[180] if an Offeror seeks to satisfy the same issuer requirement through its guarantee of Target Securities issued by another issuer, that Offeror must guarantee the payment of principal, premium, if any, and interest on those Target Securities.[181] The guarantee, however, may be made on a subordinated basis consistent with the subordinated nature of the underlying securities.[182]

The Staff has not addressed the situation in which the issuer of the underlying Target Securities that are guaranteed offers to exchange New Securities without a guarantee for such Target Securities pursuant to Section 3(a)(9). Professor Hicks suggests that if the "guarantee is worthless either because [the guarantor] is defunct or with substantially inadequate assets to honor its obligations . . . , form should yield to substance, as suggested by the language of *National Can*, and the [Section 3(a)(9)] exemption should apply."[183] This logic smacks of the "economic reality" rationale that the Staff clung to when it distinguished between guarantors and primary obligors, and that was apparently abandoned in *FHC—CompCare, Inc.* and *Daisy Systems Corporation*.[184] As in the primary obligor no-action letters, so long as the Offeror is "deemed to be an issuer" of at least some of the Target Securities, it does not seem relevant that attached securities of another issuer, whether valuable or not, that are inseparable from such Target Securities may be extinguished in the exchange.[185]

2. The "exclusively by exchange" requirement

Section 3(a)(9) provides that "any security exchanged by the issuer with its existing security holders *exclusively*" is exempt from registration.[186] As noted above, the SEC has interpreted the word "exclusively" to modify the word "exchanged."[187] If interpretated literally, such lan-

180. *See supra* notes 156-66 and accompanying text.

181. *See* FHC-CompCare, Inc., *supra* note 152; Daisy Sys. Corp., *supra* note 175; The Timken Co. and The Tenax Co., SEC No-Action Letter (avail. Jan. 20, 1986) (LEXIS, Fedsec library, Noact file); American Motors Corp., *supra* note 173.

182. *See, e.g.*, FHC-CompCare, Inc., *supra* note 152.

183. 7 J. HICKS, *supra* note 129, § 2.04[5][b][iii] (citing National Can Corp., *supra* note 170); *accord* H. SOWARDS, *The Federal Securities Act and the Trust Indenture Act of 1939*, in 11 BUSINESS ORGANIZATIONS—SECURITIES REGULATION § 3.10[1], at 3-23, 3-24 (A.A. Sommer, Jr. ed. 1990) (analyzing same hypothetical fact scenario, and concluding that "one issuer" is involved, and that the surrender of a second security (for example, the extinguishment of the guarantee) "was immaterial" to the holder of the Target Securities).

184. *See supra* note 177.

185. For a discussion about the potential inter-relationship of the same issuer requirement and exclusively by exchange requirement in this context, see *infra* at 188.

186. 15 U.S.C. § 77c(a)(9) (emphasis added).

187. *See* Rules 149 & 150, 17 C.F.R. §§ 230.149, 230.150. For a discussion of Securities

guage would preclude any holder of Target Securities from giving the corporation any consideration other than Target Securities for the New Securities, and also would prevent the corporation from offering anything other than New Securities in return for Target Securities.[188] The SEC liberalized this requirement, however, through the adoption of Rules 149[189] and 150[190] under the Securities Act, and through related no-action letters.[191]

a. security holders paying consideration in addition to Target Securities

Rule 149 permits security holders to pay such cash to the corporation, along with Target Securities, in a Section 3(a)(9) Exchange "as may be necessary to effect an equitable adjustment, in respect of dividends or interest paid or payable on the securities involved in the exchange, as between such security holder and other security holders of the same class accepting the offer of exchange."[192] The waiver of interest or dividends accrued on the Target Security as part of the terms of an Exchange Offer is itself an indirect payment by security holders to the issuer.[193] The Staff has confirmed the availability of the Section 3(a)(9) exemption in such exchanges by relying on Rule 149 and upon the argument that the waiver of accrued interest or dividends is incidental to the primary purpose of the exchange of New Securities for Target Securities.[194]

Act Release No. 2029's analysis of the word "exclusively" in Section 3(a)(9) as the justification for the need to conduct an integration analysis in connection with Section 3(a)(9) generally, and for the exclusively by exchange requirement in particular, see *supra* notes 132-42 and accompanying text. For a discussion of what some commentators call the "double duty" that the word "exclusively" serves in Section 3(a)(9), see *supra* note 134 and accompanying text.

188. Of course, an out-of-court restructuring that is structured to entail an exchange of securities is not sufficient to qualify for Section 3(a)(9) in and of itself. As a result of the same issuer requirement, Section 3(a)(9) is also generally not available if the exchange involves New Securities to be issued by an entity other than the issuer of the Target Securities. *See supra* notes 143-85 and accompanying text. In this context, it is interesting that the Staff has not questioned the availability of Section 3(a)(9) on account of the exclusively by exchange requirement when an Offeror proposes to exchange its New Securities for securities that had been issued by another corporation but which had been assumed on a joint and several basis or guaranteed by the Offeror. In such a transaction, the holder of Target Securities is offered New Securities of one corporation (the Offeror) in return for the holder surrendering existing securities of, in effect, two corporations: (i) the Offeror (the assumption of joint and several liability or the guarantee), and (ii) the Other Issuer (the underlying security). Rather than the exclusively by exchange requirement, however, the Staff has focused on the same issuer requirement in this factual scenario. *See supra* notes 156-85 and accompanying text.

189. 17 C.F.R. § 230.149.

190. *Id.* § 230.150.

191. *See* SEC No-Action Letters cited *infra* notes 194-200 & 202-03.

192. 17 C.F.R. § 230.149.

193. *See* 7 J. HICKS, *supra* note 129, § 2.05[2], at 2-78 to 2-83.

194. *See, e.g.*, Seaman Furniture Co., *supra* note 159, at 79,338; The Royale Group, SEC

In addition, the Staff has taken no-action positions in connection with proposed Section 3(a)(9) Exchanges in which the corporation offered New Securities in exchange for Target Securities *and* the following types of consideration other than cash for interest or dividends: (1) the waiver of a cause of action or claims against the corporation with respect to the Target Securities,[195] and (2) the consent of holders of Target Securities to amend Target Securities in a concurrent Consent Solicitation and Section 3(a)(9) Exchange,[196] or an independent Consent Solicitation that is deemed to create New Securities.[197]

b. issuers paying consideration in addition to New Securities

Rule 150 makes it clear that an issuer, consistent with Section 3(a)(9), may make direct or indirect payments to its security holders

No-Action Letter (avail. Nov. 4, 1988) (LEXIS, Fedsec library, Noact file); ECL Indus. & Norlin Corp., *supra* note 169; Shop Rite Foods, Inc., SEC No-Action Letter (avail. Oct. 14, 1981) (LEXIS, Fedsec library, Noact file); Barnett Winston Inv. Trust, SEC No-Action Letter (avail. Feb. 9, 1978) (LEXIS, Fedsec library, Noact file); NJB Prime Investors, SEC No-Action Letter, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,556, at 86,431 (Apr. 14, 1976); Geoscience Tech. Servs. Corp., SEC No-Action Letter (avail. Feb. 9, 1976) (LEXIS, Fedsec library, Noact file); Canrad Precision Indus., SEC No-Action Letter (avail. Sept. 27, 1973) (LEXIS, Fedsec library, Noact file); Diversa-Graphics, Inc., SEC No-Action Letter (avail. July 20, 1972) (LEXIS, Fedsec library, Noact file); *see also* Four-Phase Sys., *supra* note 138 (in the solicitation of consents to an amendment that would extensively modify existing preferred stock, counsel successfully argued—without reference to Rule 149—that issuance of common stock for accrued cash dividends on preferred stock was "not a primary purpose of, but is incidental to, the exchange offer [i.e., the solicitation]"); *cf.* Rapid-Am. Corp., SEC No-Action Letter (avail. Oct. 30, 1981) (LEXIS, Fedsec library, Noact file) (no-action position taken when the exercise price of debenture purchase warrants could consist of either cash or an exchange of outstanding securities plus cash in the amount of accrued interest on the New Securities to be issued upon the exercise of the warrants).

195. *See, e.g.*, Seaman Furniture Co., *supra* note 59, at 79,338; First Pennsylvania Mortgage Trust, SEC No-Action Letter (avail. Mar. 4, 1977) (LEXIS, Fedsec library, Noact file); Metagraphic Sys., SEC No-Action Letter (avail. May 1, 1975) (LEXIS, Fedsec library, Noact file). *But cf.* Snowshoe Co., SEC No-Action Letter (avail. June 23, 1975) (LEXIS, Fedsec library, Noact file) (Staff states it is "unable to express any view as to availability of Section 3(a)(9) for an exchange of notes for" unsecured creditor claims out of bankruptcy, because there were not enough facts presented for Staff to determine whether such unsecured claims were securities).

196. *See, e.g.*, Bayswater Realty & Capital Corp., SEC No-Action Letter (avail. Apr. 30, 1982) (LEXIS, Fedsec library, Noact file) (cited on LEXIS as Baywater [sic] Realty & Capital Corp.); Shop Rite Foods, *supra* note 194. For a discussion of Consent Solicitations conducted in conjunction with Section 3(a)(9) Exchanges, see *infra* notes 304-12 and accompanying text.

197. *See, e.g.*, Four-Phase Sys., *supra* note 138; Daitch Crystal Dairies, SEC No-Action Letter (avail. Nov. 13, 1972) (LEXIS, Fedsec library, Noact file); *see also infra* note 201 and accompanying text (discussing a consent to an asset sale from holders of convertible debentures in exchange for a reduction of the conversion price of the debentures in the context of Rule 150). For a discussion of Consent Solicitations not conducted in conjunction with Section 3(a)(9) Exchanges that are deemed to create New Securities, see *infra* notes 360-81 and accompanying text.

"when such payments are part of the terms of the offer of exchange."[198] For example, the Staff has allowed corporations to pay cash to security holders for accrued dividends on Target Securities[199] and when security holders otherwise would have been entitled to receive a fractional share as part of a Section 3(a)(9) Exchange.[200] In addition, one federal district court would not invalidate the availability of Section 3(a)(9) in a transaction in which the corporation, as a part of an alleged exchange transaction, reduced the conversion price on outstanding convertible debentures as payment for consents from the holders of those debentures to the sale of certain of the corporation's assets.[201]

The Staff has also taken no-action positions when the amount of cash consideration paid to holders of Target Securities was significant in relation to the value of the New Security.[202] Unlike Rule 149, under which the additional consideration the holder of a Target Security can surrender must "effect an equitable adjustment,"[203] Rule 150 contains no implication of any limitation on the amount of payments a corporation can make to holders of Target Securities along with New Securities in a Section 3(a)(9) Exchange. Thus, practitioners can structure Section 3(a)(9) Exchanges without any constraints on the form of consideration offered by the corporation to the holders of the Target Securities.

198. 17 C.F.R. § 230.150.

199. *See, e.g.*, Steiner Am. Corp., SEC No-Action Letter (avail. May 4, 1973) (LEXIS, Fedsec library, Noact file).

200. *See, e.g.*, WestMarc Communications, SEC No-Action Letter (avail. Nov. 20, 1989) (LEXIS, Fedsec library, Noact file); University Patents, SEC No-Action Letter (avail. Apr. 6, 1979) (LEXIS, Fedsec library, Noact file).

201. *In re* Browning Debenture Holders' Comm., [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 95,071, at 97,753, 97,754 (S.D.N.Y. 1975) (relying on Rule 150). See *infra* notes 366 & 375 and accompanying text, discussing *Browning* in the context of amendments to existing securities creating New Securities.

202. *See, e.g.*, Shop Rite Foods, *supra* note 194 (no-action position taken in connection with exchange of payment of $5 in cash plus issuance of $5 in convertible debt for each share of existing preferred stock with a redemption price of $10 per share); Systemedics, Inc., SEC No-Action Letter (avail. Feb. 19, 1976) (LEXIS, Fedsec library, Noact file) (Staff took no-action position in connection with issuance of debentures when the corporation was offering one dollar in cash and one dollar principal amount of debentures for each share of common stock tendered and accepted); Rapid-Am Corp., *supra* note 194 (upon payment of $35 in principal amount of Target Securities, the corporation would issue $45 in principal amount of New Securities and $3.25 in cash). The Section 3(a)(9) exemption also will not be destroyed if a corporation offers holders of Target Securities the option of receiving exclusively cash or substantially exclusively New Securities, *see, e.g.*, WestMarc Communications, *supra* note 200, or the option of different sets of New Securities, *see, e.g.*. Radyne Corp., SEC No-Action Letter (avail. Feb. 6, 1990) (LEXIS, Fedsec library, Noact file).

203. *See supra* note 188.

3. The "no paid solicitation" requirement

The "no paid solicitation" requirement can be violated, and the use of Section 3(a)(9) invalidated, at any time during the Section 3(a)(9) Exchange if any person who is paid by the corporation in connection with the Section 3(a)(9) Exchange engages in any activity that is construed to be a direct or indirect solicitation of the exchange.[204] Such persons include specially compensated employees of the corporation, employees of the corporation's financial advisor and employees of any other entity that is paid by the corporation in connection with the Section 3(a)(9) Exchange.[205]

An analysis of whether a paid solicitation has occurred is, by its nature, fact specific. Therefore, a corporation and its financial advisors must know which activities are permissible and which are not. Furthermore, all parties must remain circumspect even when engaging in activities that are set forth below as permissible activities.

a. activities of the corporation's employees

As a general rule, a corporation, unlike a paid outside party, may solicit holders of Target Securities in connection with a Section 3(a)(9) Exchange without jeopardizing the use of the Section 3(a)(9) exemption.[206] As noted above, however, the corporation cannot pay anyone (including its affiliates), directly or *indirectly*, to make solicitations in connection with the exchange.[207] Consequently, a corporation should be careful how it conducts its own solicitations to guard against a subsequent claim of an indirect paid solicitation. Based on no-action letters published to date, a corporation soliciting holders of Target Securities should adhere to the following guidelines to preserve the "no paid solicitation" element of the Section 3(a)(9) exemption:

- the personnel chosen to contact security holders should have

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204. 15 U.S.C. § 77c(a)(9) (Section 3(a)(9) only exempts exchanges "where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange").

205. These persons may include financial advisors, legal counsel and information and exchange agents. For purposes of this discussion on the no paid solicitation requirement, any reference to "financial advisors" also applies to any other agent, or any employee of financial advisors or any other agent, that a corporation may retain during the process of preparing, commencing and carrying out a Section 3(a)(9) Exchange, unless the context otherwise requires.

206. *See, e.g.*, Chris-Craft Indus., SEC No-Action Letter, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,052, at 82,279 (Sept. 8, 1972); No-Action letters cited *infra* notes 208-10.

207. Chris-Craft Indus., *supra* note 206, at 82,279 (officers, directors and employees received no special compensation in connection with the exchange offer); *see infra* note 209 and accompanying text.

significant responsibilities with the corporation other than solicitation of the offer; such persons may include directors, officers and regular key employees (corporate solicitors);[208]

- no special bonus, commission, fee or any other type of remuneration should be paid to the corporate solicitors for their solicitation activities; they should be paid no more than their regular salary;[209] and
- the corporate solicitors should attend to their regular duties, with their solicitation efforts only being additional assignments.[210]

b. activities of the corporation's financial advisors and other agents

Although paid solicitation of holders of Target Securities is not permitted under Section 3(a)(9), the Staff recognizes that all parties benefit when a corporation hires advisors or other agents to assist in certain aspects of a Section 3(a)(9) Exchange in addition to advising the corporation.[211] The following general guidelines provide a framework for the activities of a corporation's financial advisor in a Section 3(a)(9) Exchange:

- the corporation's financial advisor may not make any recommendation regarding a Section 3(a)(9) Exchange to any security holder or to any advisor or any other representative of any holder of the Target Securities;
- when communicating with security holders, the corpora-

208. *See* Shop Rite Foods, *supra* note 194; Mortgage Investors of Washington, SEC No-Action Letter (avail. Oct. 8, 1980) (LEXIS, Fedsec library, Noact file) [hereinafter MIW I]; URS Corp., SEC No-Action Letter (avail. May 8, 1975) (LEXIS, Fedsec library, Noact file). Corporate solicitors need not be registered as broker-dealers under section 15(b) of the Exchange Act, 15 U.S.C. § 78n(b) (1988). *See* Mortgage Investors of Washington, SEC No-Action Letter (avail. Jan. 31, 1981) (LEXIS, Fedsec library, Noact file); Barnett Mortgage Trust, SEC No-Action Letter (avail. June 9, 1978) (LEXIS, Fedsec library, Noact file).

209. *See, e.g.*, Boston Futures Fund (II) & Boston Futures Fund (IV), SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,467, at 77,544 (Aug. 12, 1987); MIW I, *supra* note 208 (corporate solicitors may be reimbursed for expenses they incur in connection with the solicitation); CIT Fin. Corp., SEC No-Action Letter (avail. Sept. 22, 1975) (LEXIS, Fedsec library, Noact file); URS Corp., *supra* note 208 (corporate solicitors may be reimbursed for expenses they incur in connection with the solicitation); Chris-Craft Indus., *supra* note 206, at 82,279; El Paso Natural Gas. Co., SEC No-Action Letter (avail. Mar. 11, 1971) (LEXIS, Fedsec library, Noact file).

210. *See* Seaman Furniture Co., *supra* note 59, at 79,338; Chris-Craft Indus., *supra* note 206, at 82,278.

211. *See, e.g.*, Chris-Craft Indus., *supra* note 206, at 82,279 (a payment for ministerial assistance is not "for soliciting the exchange but merely to facilitate the publication of the Exchange Offer to [security holders] to whom it is addressed and to make sure that they will not through inadvertence lose the opportunity to accept").

tion's financial advisor may provide only that information which is included in the various communications sent by the corporation to the holders of the Target Securities, such as offering circulars, letters of transmittal, cover letters and any other related documents (the Exchange Materials);

- the corporation's financial advisor should limit its activities to performing functionary services or administrative assistance in the distribution of Exchange Materials and providing information about the mechanics of a Section 3(a)(9) Exchange; and
- the corporation's financial advisor may render advice on the terms of a Section 3(a)(9) Exchange only to the corporation.

i. impermissible activities

It is essential that the corporation's financial advisor not make any recommendation to any holder of the Target Securities, or to any advisor or other representative of any such holder, regarding the acceptance or rejection of a Section 3(a)(9) Exchange.[212] If any security holder or any advisor or other representative to any security holder asks the corporation's financial advisor for his or her opinion on an investment-related attribute of a Section 3(a)(9) Exchange, the corporation's financial advisor should direct the holder of the Target Securities to contact the appro-

212. While all no-action requests that address the no paid solicitation requirement make this point in one form or another, the Staff specifically conditioned its no-action position on this statement in Grolier, Inc., *supra* note 168; Western Pac. Indus., SEC No-Action Letter, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,801, at 87,090 (Sept. 9, 1976); Dominion Mortgage & Realty Trust, SEC No-Action Letter (avail. Oct. 29, 1975) (LEXIS, Fedsec library, Noact file); Alpex Computer Corp., SEC No-Action Letter (avail. July 1, 1974) (LEXIS, Fedsec library, Noact file). *Cf.* American Can Corp., SEC No-Action Letter (avail. May 12, 1980) (LEXIS, Fedsec library, Noact file) (in a proposed Reclassification, which required the affirmative vote of specified percentages of the holders of existing common stock and preferred stock, of existing preferred stock into a right to receive cash or new preferred stock, the information agent may make recommendations to common stockholders who do not hold existing preferred stock); Time, Inc., SEC No-Action Letter, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,095, at 81,863 (Apr. 19, 1979) (in a proposed Reclassification of existing series A preferred stock into new shares of series B preferred stock that required the approval of holders of each of Time's outstanding series A preferred stock, series B preferred stock and common stock, Time intended to rely on Section 3(a)(9) to avoid registering the new shares of series B preferred stock to be issued in the Reclassification, but proposed to hire a proxy solicitor to distribute proxy materials, and to *solicit* and *make recommendations* to holders of outstanding series B preferred stock and common stock if those holders did not also hold series A preferred stock; the Staff specifically conditioned its no-action position on Time's representation that the proxy solicitor would not make any recommendation about voting to any holders of series A preferred stock). But see *infra* notes 245-54 and accompanying text regarding permissible discussions between the corporation's advisors and advisors to committees.

priate officer or employee of the corporation.[213] The financial advisor may respond to questions from holders of Target Securities regarding substantive elements of the Section 3(a)(9) Exchange that are answered in the Exchange Materials by directing the holder to the pertinent portion of the Exchange Materials.[214] The financial advisor, however, cannot convey management's views or recommendations on a Section 3(a)(9) Exchange, even if those views or recommendations or both are contained in the Exchange Materials.[215] In addition, when the corporation's financial advisor has rendered or may render a fairness opinion in connection with a Section 3(a)(9) Exchange, that financial advisor should not have any contact with any holder of the Target Securities or any advisor to or other representative of any such holder.[216]

ii. permissible activities

The corporation's financial advisor and other agents in connection with a Section 3(a)(9) Exchange may assist the corporation by conducting activities that do not constitute paid solicitations. In other words, a financial advisor may conduct activities that are merely designed to effect, but not promote, the exchange.[217] The permissible activities of a financial advisor can be grouped into two broad categories: (1) advice to the corporation with respect to the terms and mechanics of a Section 3(a)(9) Exchange;[218] and, (2) administrative or ministerial services in furtherance of a Section 3(a)(9) Exchange.[219] In addition, the corporation's financial advisor may render a fairness opinion in connection with a Section 3(a)(9) Exchange if such financial advisor will not have any contact with holders of the Target Securities or their advisors or

213. *See* Trans-Sterling, Inc., SEC No-Action Letter (avail. June 16, 1983) (LEXIS, Fedsec library, Noact file); Hamilton Bros. Petroleum Corp., SEC No-Action Letter (avail. Aug. 14, 1978) (LEXIS, Fedsec library, Noact file); Valhi, Inc., SEC No-Action Letter (avail. Feb. 17, 1977) (LEXIS, Fedsec library, Noact file) [hereinafter Valhi II].

214. *See* Trans-Sterling, Inc., *supra* note 213; MIW I, *supra* note 208; Barnett Winston Inv. Trust, *supra* note 194; Barnett Mortgage Trust, *supra* note 208; Shareholder Communications Corp., SEC No-Action Letter (avail. July 6, 1977) (LEXIS, Fedsec library, Noact file) (cited on LEXIS as Shareholder Communication [sic] Corp.).

215. *See* Stokeley-Van Camp, Inc., SEC No-Action Letter, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,404, at 78,466 (Mar. 31, 1983).

216. *See* National City Lines, SEC No-Action Letter (avail. Apr. 11, 1985) (LEXIS, Fedsec library, Noact file); American Can Corp., *supra* note 212; Hamilton Bros. Petroleum Corp., *supra* note 213; Valhi, Inc., SEC No-Action Letter, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,802, at 87,091 (Sept. 15, 1976) [hereinafter Valhi I]; Dean Witter & Co., SEC No-Action Letter (avail. Feb. 24, 1975) (LEXIS, Fedsec library, Noact file) (whether or not the fairness opinion is made public).

217. Letter from the Chief of Securities Division, *supra* note 126, at 2588.

218. *See infra* notes 221-28 and accompanying text.

219. *See infra* notes 229-44 and accompanying text.

other representatives.[220]

(a) advice to the corporation

The corporation's financial advisor may advise the corporation with respect to virtually all aspects of developing and executing a Section 3(a)(9) Exchange. The Staff has taken a no-action position with respect to each of the following advisory services:

- performance of financial analysis for the corporation;[221]
- formulation or assistance in the formulation of a restructuring proposal for the corporation's approval;[222]
- advice on the corporation's capital structure following the restructuring;[223]
- advice on the timing and organization of the restructuring proposal;[224]
- advice on the proposed terms and mechanical procedures for the Section 3(a)(9) Exchange;[225]
- advice on proposed terms for the New Securities;[226]
- assistance in the preparation of the various Exchange Materials to be sent by the corporation to the holders of the Target Securities;[227] and
- advice to employees of the corporation on the procedures to be used in conversations with holders of the Target Securities concerning the Section 3(a)(9) Exchange.[228]

(b) administrative services

In addition to rendering advice to the corporation, the corporation's

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220. *See supra* note 216 and accompanying text.

221. International Controls Corp., *supra* note 59; Seaman Furniture Co., *supra* note 59, at 79,339.

222. Seaman Furniture Co., *supra* note 59, at 79,338; MIW I, *supra* note 208; Hamilton Bros. Petroleum Corp., *supra* note 213; Grolier, Inc., *supra* note 168.

223. Seaman Furniture Co., *supra* note 59, at 79,338.

224. UniCapital Corp., SEC No-Action Letter (avail. Nov. 4, 1974) (LEXIS, Fedsec library, Noact file).

225. International Controls Corp., *supra* note 59; Seaman Furniture Co., *supra* note 59, at 79,338; MIW I, *supra* note 208; Barnett Winston Inv. Trust, *supra* note 194; Barnett Mortgage Trust, *supra* note 208; URS Corp., *supra* note 208; Dean Witter & Co., *supra* note 216; Skinner & Co., SEC No-Action Letter (avail. Nov. 11, 1974) (LEXIS, Fedsec library, Noact file).

226. International Controls Corp., *supra* note 59; MIW I, *supra* note 208; Dean Witter & Co., *supra* note 216.

227. International Controls Corp., *supra* note 59; MIW I, *supra* note 208; Barnett Winston Inv. Trust, *supra* note 194; Barnett Mortgage Trust, *supra* note 208; URS Corp., *supra* note 208; Dean Witter & Co., *supra* note 216; Skinner & Co., *supra* note 225.

228. MIW I, *supra* note 208.

financial advisor may engage in administrative or ministerial services designed to convey the information in the Exchange Materials to security holders. These activities can be divided into two groups: (1) those in which the financial advisor merely serves as a functionary in disseminating information, and (2) those in which the financial advisor communicates directly with the holders of the Target Securities or their advisors or other representatives. The first group of functionary services is straightforward. The second group of services, however, should be conducted with great care and with a clear understanding of the permissible content of the relevant communications.

(1) functionary services in disseminating information

The Staff has acknowledged in no-action letters that a corporation's financial advisor and other agents may provide each of the following functionary services to its clients:

- obtain a list of the corporation's security holders from the corporation and confirm the accuracy of the addresses of the holders of the Target Securities;[229]
- mail or otherwise assist in the distribution of Exchange Materials;[230]
- maintain records on the Section 3(a)(9) Exchange;[231]
- be named as a financial advisor in the Exchange Materials;[232]
- contact nominees holding Target Securities and ascertain the number of the Exchange Materials needed by each brokerage house for transmittal to beneficial holders;[233]
- deliver sufficient quantities of the Exchange Materials to brokerage houses, trust officers, other banks and other nominees

229. Varco Int'l, SEC No-Action Letter (avail. Mar. 24, 1986) (LEXIS, Fedsec library, Noact file); ECL Indus. & Norlin Corp., *supra* note 169; Hershey Foods Corp., SEC No-Action Letter (avail. Oct. 12, 1984) (LEXIS, Fedsec library, Noact file); Trans-Sterling, Inc., *supra* note 213; MIW I, *supra* note 208; Hamilton Bros. Petroleum Corp., *supra* note 213; Barnett Winston Inv. Trust, *supra* note 194; Barnett Mortgage Trust, *supra* note 208; Shareholder Communications Corp., *supra* note 214; Valhi II, *supra* note 213; Valhi I, *supra* note 216, at 87,092; Frier Indus., SEC No-Action Letter (avail. Nov. 17, 1975) (LEXIS, Fedsec library, Noact file); Alpex Computer Corp., *supra* note 212; Georgeson & Co., SEC No-Action Letter (avail. June 11, 1973) (LEXIS, Fedsec library, Noact file).

230. Hershey Foods Corp., *supra* note 229; Shop Rite Foods, *supra* note 194; Infotronics Corp., SEC No-Action Letter (avail. Apr. 3, 1972) (LEXIS, Fedsec library, Noact file).

231. Trans-Sterling, Inc., *supra* note 213; MIW I, *supra* note 208; Barnett Winston Inv. Trust, *supra* note 194; Barnett Mortgage Trust, *supra* note 208; Shareholder Communications Corp., *supra* note 214; Frier Indus., *supra* note 229; The Carter Org., SEC No-Action Letter (avail. Apr. 7, 1975) (LEXIS, Fedsec library, Noact file).

232. MIW I, *supra* note 208.

233. Dominion Mortgage & Realty Trust, *supra* note 212.

for distribution to beneficial holders of the Target Securities;[234] and

• mail duplicate copies of Exchange Materials to holders of Target Securities who appear to have lost or mislaid those originally sent to them.[235]

(2) communications with holders of Target Securities

Unless the corporation's financial advisor has rendered a fairness opinion in connection with a Section 3(a)(9) Exchange, the financial advisor may contact holders of the Target Securities directly for the following ministerial purposes, subject in all instances to the requirement that no solicitation take place as a result of any such contacts:

• to determine whether the holders of Target Securities received the Exchange Materials;[236]

• to determine whether the holders of the Target Securities understand the procedures for participating in the Section 3(a)(9) Exchange—for example, expiration dates and to whom to forward documents;[237]

• to answer questions or resolve any confusion about the procedures for participating in the Section 3(a)(9) Exchange;[238]

• to contact back-office personnel of nominees who hold securities for the benefit of others to make sure that they promptly

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234. Varco Int'l, *supra* note 229; Hershey Foods Corp., *supra* note 229; American Can Co., *supra* note 212, Time, Inc., *supra* note 212, at 81,863; Instrument Sys. Corp., SEC No-Action Letter (avail. Nov. 3, 1975) (LEXIS, Fedsec library, Noact file); Dominion Mortgage & Realty Trust, *supra* note 212; CIT Fin. Corp., *supra* note 209; URS, *supra* note 208; Skinner & Co., *supra* note 225; UniCapital Corp., *supra* note 224; Georgeson & Co., *supra* note 229.

235. Dominion Mortgage & Realty Trust, *supra* note 212.

236. Varco Int'l, *supra* note 229; ECL Indus. & Norlin Corp., *supra* note 169; Boston Futures Mgmt. Corp., SEC No-Action Letter, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,847, at 79,246 (Oct. 22, 1984); Hershey Foods Corp., *supra* note 229; Trans-Sterling, Inc., *supra* note 213; MIW I, *supra* note 208; Hamilton Bros. Petroleum Corp., *supra* note 213; Barnett Winston Inv. Trust, *supra* note 194; Barnett Mortgage Trust, *supra* note 208; Shareholder Communications Corp., *supra* note 214; Valhi II, *supra* note 213; Valhi I, *supra* note 216, at 87,092; Frier Indus., *supra* note 229; Instrument Sys. Corp., *supra* note 234; The Carter Org., *supra* note 231; Skinner & Co., *supra* note 225; Alpex Computer Corp., *supra* note 212.

237. ECL Indus. & Norlin Corp., *supra* note 169; Dominion Mortgage & Realty Trust, *supra* note 212.

238. Hershey Foods Corp., *supra* note 229; Trans-Sterling, Inc., *supra* note 213; MIW I, *supra* note 208; Hamilton Bros. Petroleum Corp., *supra* note 213; Barnett Winston Inv. Trust, *supra* note 194; Barnett Mortgage Trust, *supra* note 208; Shareholder Communications Corp., *supra* note 214; Valhi II, *supra* note 216; CIT Fin. Corp., *supra* note 209; The Carter Org., *supra* note 231; Skinner & Co., *supra* note 225; UniCapital Corp., *supra* note 224; Alpex Computer Corp., *supra* note 212; Georgeson & Co., *supra* note 229.

forward Exchange Materials to the nominees;[239]

- to urge such back-office personnel to check with the beneficial holders of the Target Securities about whether such holders have received the Exchange Materials, understand procedurally how to participate in the Section 3(a)(9) Exchange, and are generally aware of the relevant dates and deadlines;[240]
- to determine whether the holders of the Target Securities intend to participate in the Section 3(a)(9) Exchange and to communicate the response to the corporation;[241]
- to remind the holders of the Target Securities of all appropriate deadlines;[242] and
- to respond to the questions of holders of Target Securities that do not concern the mechanical aspects of the Section 3(a)(9) Exchange by directing the security holders to the pertinent portion of the Exchange Materials.[243]

As noted above, when a corporation's financial advisor communicates with holders of the Target Securities, under no circumstances may the advisor discuss the merits of the exchange, make any direct or indirect recommendation about whether to participate in the exchange or communicate management's recommendation, *even if* that recommenda-

239. Varco Int'l, *supra* note 229; ECL Indus. & Norlin Corp., *supra* note 169; Hershey Foods Corp., *supra* note 229; Trans-Sterling, Inc., *supra* note 213; MIW I, *supra* note 208; Hamilton Bros. Petroleum Corp., *supra* note 213; Barnett Winston Inv. Trust, *supra* note 194; Barnett Mortgage Trust, *supra* note 208; Valhi II, *supra* note 213; Valhi I, *supra* note 216, at 87,092; Frier Indus., *supra* note 229; The Carter Org., *supra* note 231; Alpex Computer Corp., *supra* note 212; Chris-Craft Indus., *supra* note 206, at 82,277-78.

240. Varco Int'l, *supra* note 229; ECL Indus. & Norlin Corp., *supra* note 169; Trans-Sterling, Inc., *supra* note 213; MIW I, *supra* note 208; Hamilton Bros. Petroleum Corp., *supra* note 213; Barnett Winston Inv. Trust, *supra* note 194; Barnett Mortgage Trust, *supra* note 208; Valhi I, *supra* note 216, at 87,092; Frier Indus., *supra* note 229; Valhi II, *supra* note 213; The Carter Org., *supra* note 231; Alpex Computer Corp., *supra* note 212; Georgeson & Co., *supra* note 229.

241. Varco Int'l, *supra* note 229; ECL Indus. & Norlin Corp., *supra* note 169; Hershey Foods Corp., *supra* note 229; Trans-Sterling, Inc., *supra* note 213; MIW I, *supra* note 208; Barnett Winston Inv. Trust, *supra* note 194; Barnett Mortgage Trust, *supra* note 208; Shareholder Communications Corp., *supra* note 214; Valhi I, *supra* note 216; Frier Indus., *supra* note 229; The Carter Org., *supra* note 231; Alpex Computer Corp., *supra* note 212.

242. ECL Indus. & Norlin Corp., *supra* note 169; Hershey Foods Corp., *supra* note 229; Trans-Sterling, Inc., *supra* note 213; MIW I, *supra* note 208; Hamilton Bros. Petroleum Corp., *supra* note 213; Barnett Winston Inv. Trust, *supra* note 194; Barnett Mortgage Trust, *supra* note 208; Shareholder Communications Corp., *supra* note 214; Valhi II, *supra* note 213; Valhi I, *supra* note 216, at 87,092; Frier Indus., *supra* note 229; CIT Fin. Corp., *supra* note 209; URS Corp., *supra* note 208; The Carter Org., *supra* note 231; Skinner & Co., *supra* note 225; Alpex Computer Corp., *supra* note 212.

243. Trans-Sterling, Inc., *supra* note 213; MIW I, *supra* note 208; Barnett Winston Inv. Trust, *supra* note 194; Barnett Mortgage Trust, *supra* note 208; Shareholder Communications Corp., *supra* note 214.

tion is contained in the Exchange Materials.[244]

In the final analysis, whether a paid solicitation occurs is necessarily fact-specific. Consequently, any and all contact with any holders of Target Securities by a corporation's financial advisor should be closely supervised and undertaken with great care and attention.

c. discussions with advisors to holders of the Target Securities

The Staff has indicated in two no-action letters that it would not recommend enforcement action to the SEC where a corporation's financial advisors were to participate or had participated in discussions with the legal and financial advisors to certain institutional holders of Target Securities that had formed committees in connection with Section 3(a)(9) Exchanges.[245] In the first such no-action request, financial advisors to Seaman Furniture Company participated in meetings between the corporation and legal and financial advisors to the committee while the corporation was considering, but before it had commenced, several forms of restructuring, including a Section 3(a)(9) Exchange.[246] In the second such no-action request, a committee of institutional holders of Target Securities contacted International Controls Corporation after the corporation had commenced a Section 3(a)(9) Exchange. International Controls sought the Staff's advice on whether its financial advisor could discuss the transaction with the financial and legal advisors to the committee.[247] In each of these cases, the Staff sanctioned the corporation's financial advisor's participation in discussions with such committees' advisors in which the corporation's financial advisor, among other things, "presented the company's current proposals," "received and discussed the counterproposals," if any, and "relayed such counterproposals to the Company."[248]

Counsel to the corporation in *Seaman Furniture* represented that the corporation's financial advisor (1) had not communicated to the holders of the proposed Target Securities or their financial advisors its views on (a) the fairness of the proposed debt restructuring or Section 3(a)(9) Exchange, or (b) the value of the New Securities to be issued in connection with the proposed Section 3(a)(9) Exchange; (2) had not made any recommendation to the legal and financial advisors to the hold-

244. *See supra* text accompanying notes 208-12.
245. International Controls Corp., *supra* note 59; Seaman Furniture Co., *supra* note 59, at 79,340.
246. Seaman Furniture Co., *supra* note 59, at 79,336.
247. International Controls Corp., *supra* note 59.
248. International Controls Corp., *supra* note 59; Seaman Furniture Co., *supra* note 59, at 79,338.

ers of the proposed Target Securities with respect to the restructuring or the Section 3(a)(9) Exchange; (3) would not be named as a dealer manager of the proposed Section 3(a)(9) Exchange; (4) would not deliver a fairness opinion with respect to the proposed Section 3(a)(9) Exchange; and (5) would not communicate directly with any holder of the proposed Target Securities with respect to substantive matters relating to any proposed restructuring or Section 3(a)(9) Exchange.[249] Counsel to the corporation in *International Controls* represented that its client's financial advisors would also not conduct any of the activities noted in (1)(b), (3), (4) and (5) above.[250] International Controls' counsel also represented that the corporation's financial advisors would not make any recommendations to holders of the Target Securities; however, it did *not* represent—as did counsel in *Seaman Furniture*—that it would not make recommendations to the legal and financial advisors to the holders of the Target Securities.[251] This is a distinction, however, that should not be relied upon conclusively. The great weight of authority on the no paid solicitation requirement clearly indicates that the corporation's paid agents should not make recommendations to holders of Target Securities *or their advisors*.

Additional facts that may have influenced the Staff's determination in each of these two no-action requests include the following: (1) all the holders of the Target Securities who comprised each committee and had retained the advisors that would be involved in the above-described communications were "institutional investors"; (2) the financial and legal advisors to each committee did not solicit exchanges in connection with the proposed Section 3(a)(9) Exchange; (3) the committees' financial and legal advisors and the corporation's financial advisors were paid fixed fees that were not contingent on the success of the Section 3(a)(9) Exchange; and, (4) the time savings afforded by a Section 3(a)(9) exemption were critical to the financial condition of each corporation.[252] The primary rationale in each of these requests was the need to "facilitate an understanding by the legal and financial advisors to the committees of the financial condition of the Company and the structure of the Ex-

249. Seaman Furniture Co., *supra* note 59, at 79,338.

250. International Controls Corp., *supra* note 59.

251. *Id.* Counsel in *International Controls* did state that

> [t]he *primary purpose* of these contacts [between the corporation's financial advisors and their 'opposite numbers' advising the committee and the committee's lawyers] would be to facilitate an understanding of the Company's financial condition and of the structure of the Exchange Offers in relation to that financial condition, and *not to advocate participation* in the Exchange Offers.

Id. (emphasis added).

252. *Id.* Seaman Furniture Co., *supra* note 59, at 79,338-39.

change Offers."[253] In other words, "the activities of the Company's financial advisors constitute 'effecting' rather than 'promoting' an exchange" and these services "if not mechanical, [are] by [their] nature ancillary to the effective mechanical operation" of the restructuring.[254] Ultimately, these no-action positions may indicate the Staff's recognition of the practical importance of involving paid financial advisors, at least through advisors to committees, in complex restructuring and work-out transactions.

d. suggested fee structures

Although there is nothing in Section 3(a)(9) that mandates that a financial advisor receive a fixed fee for its services, most Section 3(a)(9) no-action letters recite that the financial advisor was to receive a fixed fee, plus reasonable expenses, that was not contingent upon the success of the exchange.[255] A fixed-fee arrangement eliminates one factor which might otherwise support the inference that the financial advisor had an incentive to engage in a solicitation of holders of the Target Securities. Consequently, whenever paid advisors are contacting holders of Target Securities within the guidelines of this section, and especially when there will be substantive discussions between advisors to the corporation and advisors to the holders of the Target Securities, it is advisable that the financial advisor's fees be a fixed amount not tied to the success of the Section 3(a)(9) Exchange.[256] Ultimately, however, determining whether a paid solicitation has occurred is a fact-specific analysis that will turn on the mix of facts present in a particular transaction as measured against the criteria set forth above. This determination is not necessarily based upon the method of payment of fees to the financial advisor and others.[257]

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253. International Controls Corp., *supra* note 59.

254. Seaman Furniture Co., *supra* note 59, at 79,339; *accord* Letter from the Chief of Securities Division, *supra* note 126, at 2588.

255. *See, e.g.*, International Controls Corp., *supra* note 59; Seaman Furniture Co., *supra* note 59, at 79,338; Varco Int'l, *supra* note 229; MIW I, *supra* note 208.

256. *See* Seaman Furniture Co., *supra* note 59, at 79,340 (counsel to Seaman wrote a follow-up letter to its initial letter of inquiry, in which such counsel confirmed, most likely in response to a Staff request, "that the Company has not and will not agree to pay any compensation to the Committee's legal counsel or financial advisors which is contingent on the consummation of the proposed" Section 3(a)(9) Exchange).

257. *Compare* Seaman Furniture Co., *supra* note 59, at 79,338 (where the financial advisor to the corporation communicated with the security holders' advisors on possible structures of a recapitalization, and confirmed that no portion of the compensation to be paid to security holders' advisors was to be contingent on the success of the proposed Section 3(a)(9) Exchange) *with* Hamilton Bros. Petroleum Corp., *supra* note 213 (where financial advisor to corporation was engaged, among other things, to render fairness opinion to the corporation,

C. *Integration with Other Issuances*

As noted above,[258] whenever a corporation is conducting a Section 3(a)(9) Exchange, all participants must be concerned about whether the exchange could be "integrated" with another offering.[259] The effect of integration with another offering could be to destroy the availability of the Section 3(a)(9) exemption for that restructuring.[260] The SEC has established the following general criteria for determining whether offerings for securities should be integrated: (1) whether the sales are part of a single plan of financing; (2) whether the sales of securities involve the issuance of the same class of securities; (3) whether the offerings are made at or about the same time; (4) whether the same type of consideration is received; and, (5) whether the offerings are made for the same general purpose.[261]

Integration most often becomes an issue in the context of Section 3(a)(9) Exchanges when a corporation conducts an offering of securities for cash substantially simultaneously with a proposed Section 3(a)(9) Exchange. If such an offering for cash were integrated with the exchange transaction, the exclusively by exchange requirement would be violated[262] and the Section 3(a)(9) exemption from registration would be unavailable.[263] For example, UST Corporation intended to conduct a

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but was not planning to communicate with any security holders or any advisors or other representatives of any security holders, and Staff took a no-action position although one-third of corporation's financial advisor's fee was to be paid only upon consummation of transaction).

258. See *supra* notes 132-41 and accompanying text, discussing how other commentators on Section 3(a)(9) characterize integration analysis in the context of Section 3(a)(9) as an "exclusively with existing security holders" requirement.

259. Securities Act Release No. 2029, *supra* note 133, at 2584 (the Section 3(a)(9) exemption "is available only to securities constituting part of an issue which, as a whole, is exchanged in conformity with the requirements of the section"). The "issue" referred to is the issuance of securities at a particular point or points in time, not the entire class of such securities.

260. *See supra* note 131 (quoting R. JENNINGS & H. MARSH, *supra* note 14, at 440 (describing integration generally)).

261. *See* Securities Act Release No. 4434, 1 Fed. Sec. L. Rep. (CCH) ¶ 2272 (Dec. 6, 1961). These factors, with a comment that integration analysis depends upon the particular facts and circumstances, have been included in notes to Rules 147 and 502 under the Securities Act for guidance in determining whether offers and sales should be integrated for purposes of the exemptions from the registration requirements of the Securities Act available under Section 3(a)(11) and Regulation D, respectively. *See* Rule 147 preliminary note 3, 17 C.F.R. § 230.147 (1990); Rule 502(a) note, 17 C.F.R. § 230.502(a) (1990) (citing Non-public Offering Exemption, Securities Act Release No. 4552, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 2770 (Nov. 6, 1962)); Securities Act Release No. 2029, *supra* note 131, ¶ 2140, at 2584 (analogizing to integration analyses under Sections 3(b) and 3(a)(11) of the Securities Act in determining whether or not a proposed Section 3(a)(9) Exchange should be integrated).

262. *See supra* notes 186-203 and accompanying text.

263. *See, e.g.*, Release 2029, *supra* note 133, ¶¶ 2140-2141, at 2583-17 to 2584 (SEC General Counsel opining that an issuance of new Series B bonds for existing Series A bonds pursu-

simultaneous Section 3(a)(9) Exchange (of its floating rate notes for its outstanding subordinated notes) and an intra-state offering of floating rate notes for cash,[264] which would be exempt from registration requirements of the Securities Act pursuant to section 3(a)(11) of the Securities Act.[265] The Staff took a no-action position "that the two offerings would not be integrated for the purpose of determining the availability of the section 3(a)(11) exemption" for the cash offering, although UST's counsel conceded that two of the five integration standards existed.[266] The Staff also implicitly took a no-action position on the use of Section 3(a)(9); if the transactions were not integrated for the purpose of section 3(a)(11), the same conclusion should be reached for the purpose of Section 3(a)(9).

The integration of otherwise separate offerings of securities can also invalidate the use of Section 3(a)(9) by violating the "same

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ant to a Section 3(a)(9) Exchange, and an issuance of Series C bonds for cash pursuant to the private placement exemption provided by section 4(1) (now section 4(2)) of the Securities Act should not be integrated because "I do not believe that securities of different classes [the Series B and Series C bonds were "substantially" different with "respect to maturity date, interest rate, redemption prices and default provisions"] can fairly be deemed parts of a single 'issue.' "); Bayswater Realty & Capital Corp., *supra* note 197 (based upon counsel's analysis of the SEC's five integration factors, Section 3(a)(9) Exchange not integrated with simultaneous Section 3(a)(10) Settlement Exchange pursuant to which some class members were required to pay solely cash for New Securities; counsel notes that it "understands that should the two offerings be 'integrated' the result might be the unavailability of the 3(a)(9) exemption"); Model Fin. Co., SEC No-Action Letter (avail. Dec. 27, 1973) (LEXIS, Fedsec library, Noact file) (no-action position taken in connection with the integration of a debt-for-debt Section 3(a)(9) Exchange and an unregistered offering of debt for cash pursuant to Regulation A, 17 C.F.R. § 230.251-63 (1990)); Four-Phase Sys., *supra* note 138 (based upon counsel's analysis of the SEC's five integration factors, no-action position taken when a corporation contemplated a substantially simultaneous Section 3(a)(9) Exchange and private placement of notes for cash pursuant to Section 4(2)); Steiner Am. Corp., *supra* note 199 (no-action position taken when a corporation intended to rely on Section 3(a)(9) in a Reclassification of its preferred stock into common stock, and intended to conduct a registered public offering of its common stock for cash substantially simultaneously).

264. UST Corp., SEC No-Action Letter (avail. Apr. 8, 1977) (LEXIS, Fedsec library, Noact file).

265. 15 U.S.C. § 77c(a)(11) (1988).

266. UST Corp., *supra* note 264. The Staff noted that UST's counsel conceded that the two offerings were to be made at the same time and involved the same class of securities. *Id.* The proposed offerings, however, were not part of a single plan of financing (because, among other things, the two offerings were not cross-conditioned), were not being made for the same type of consideration (because the consideration for the New Securities in the Section 3(a)(9) Exchange was to be existing debt securities, and the consideration for the New Securities in the Section 3(a)(11) offering was to be cash), and were not being made for the same general purpose (because the Section 3(a)(9) Exchange was intended to satisfy a condition to the restructuring of UST's bank debt, and the Section 3(a)(11) offering was intended to generate working capital). *Id.*

issuer" requirement[267] and the "no paid solicitation" requirement.[268] In the latter context, for example, the Staff has taken a no-action position where a corporation had hired an investment bank to act as its placement agent in a section 4(2) private offering[269] of notes for cash, while at the same time the corporation intended to rely on Section 3(a)(9) in an exchange of securities.[270] Counsel represented that the "investment banker will receive a fee in connection with the placement of the Notes but will not solicit the exchange," and reasoned that "[a]s the investment banker will not solicit the exchange, no part of its fee in connection with the placement of the Notes is allocable thereto."[271]

D. Restrictions on Resale of New Securities

One factor that could significantly influence the willingness of a holder of Target Securities to participate in a Section 3(a)(9) Exchange is whether the New Securities will be subject to resale restrictions. Re-

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267. *See, e.g.*, Union Planters Corp., *supra* note 153 (determining that two separate presumably Section 4(2) Private Exchanges of securities issued by different entities as part of a merger transaction should not be integrated with a Section 3(a)(9) Exchange, and therefore did violate the same issuer requirement), *clarified in* Union Planters Corp., SEC No-Action Letter (avail. Jan. 10, 1983) (LEXIS, Fedsec library, Noact file) (noting that no exemption existed for the issuance of a parent guarantee); *cf.* Lacy Sales Inst., SEC No-Action Letter (avail. Aug. 13, 1979) (LEXIS, Fedsec library, Noact file) (Staff refused to take no-action position when the corporation proposed to rely on Section 3(a)(9) to exchange one new share of its stock for every 20 shares presently outstanding, and to exchange one new share of its stock for each share of stock of a company with which it intended to merge), *reconsidered in* Lacy Sales Inst., SEC No-Action Letter (avail. Dec. 10, 1979) (LEXIS, Fedsec library, Noact file) (Staff took no-action position regarding Section 3(a)(9) when the corporation proposed to rely on Section 3(a)(9) to conduct a reverse stock split, and Section 4(2) to conduct a concurrent exchange of stock with stockholders of a corporation with which it intended to merge). For a discussion of the "same issuer" requirement, see *supra* notes 143-85 and accompanying text.

268. For a discussion of the "no paid solicitation" requirement, see *supra* notes 204-57 and accompanying text.

269. 15 U.S.C. § 77d(2) (1988).

270. Four-Phase Sys., *supra* note 138. This "exchange" actually involved a solicitation of consents to modify its preferred stock so significantly that the issuer's counsel considered the solicitation to be an exchange of old preferred stock for new preferred stock. *Id.* See *infra* notes 360-81 and accompanying text, describing when modifications to existing securities can be deemed to create, for Federal securities law purposes, New Securities.

271. Four-Phase Sys., *supra* note 138. Practitioners should note that the Staff appears to be liberalizing its integration analysis in the context of multi-step out-of-court restructurings involving sophisticated institutional investors. *See* Backman & Gervis, *Integration Revisited: The Black Box Restructuring*, INSIGHTS, Feb. 1991, at 3 (citing and analyzing Black Box, Inc., SEC No-Action Letter (avail. June 26, 1990) (LEXIS, Fedsec library, Noact file), in which the Staff took a no-action position in connection with a Section 4(2) Private Exchange that was entered into pursuant to "Recapitalization Agreement" prior to a contemplated registered public offering of New Securities for cash, but was conditioned upon the completion of the public offering).

stricted securities[272] may be resold only in compliance with Rule 144,[273] Rule 144A,[274] through registration under the Securities Act or an applicable exemption,[275] such as Section 4(1) of the Securities Act.[276]

Although the exemptions contained in section 3 of the Securities Act generally exempt certain *securities* from the Securities Act's registration requirements,[277] Section 3(a)(9) is considered to be a transaction exemption; therefore, New Securities issued in a Section 3(a)(9) Exchange are not, simply because of Section 3(a)(9), permanently exempt from the registration requirements of the Securities Act.[278] This created some confusion about the restrictions on the resale of New Securities issued in a Section 3(a)(9) Exchange. In response to the 1984 no-action request of Clevepak Corporation, however, the Staff clarified the issue when it stated that it is "the view of [the SEC's Corporate Finance] Division that resales of [securities] received in [a Section 3(a)(9) E]xchange would be subject to the same restrictions, if any, applicable to the securities surren-

272. Restricted securities, as defined by Rule 144, are securities acquired in a "transaction or chain of transactions not involving any public offering . . . or securities that are subject to the resale limitations of Regulation D and are acquired in a transaction or chain of transactions not involving any public offering." Rule 144(a)(3), 17 C.F.R § 230.144(a)(3) (1990).

273. Rule 144(b), 17 C.F.R. § 230.144(b) (1990). *See generally* Resale of Restricted and Other Securities; Interpretations of Rules, Securities Act Release No. 6099, 1 Fed. Sec. L. Rep. (CCH) ¶ 2705H (Aug. 2, 1979) (setting forth Staff views on various interpretive questions relating to the resale of restricted and certain other securities); J. WILLIAM HICKS, RESALE OF RESTRICTED SECURITIES (Clark Boardman Securities Law Series) (1989). Rule 144 generally requires that affiliates and non-affiliates of the issuer hold restricted securities for two years before they may begin to be resold. Rule 144(d)(1), 17 C.F.R. § 230.144(d)(1) (1990). Sales of restricted securities held by non-affiliates generally are subject to volume limitations between the second and third years after such non-affiliates acquire the restricted securities. Rules 144(e)(2), 144(k), 17 C.F.R. § 230.144(e)(2), .144(k) (1990). Sales of restricted *and* nonrestricted securities by affiliates of the issuer are always subject to volume limitations. Rule 144(e)(1), 17 C.F.R. § 230.144(e)(1). For a brief discussion of how a Section 3(a)(9) Exchange affects these time periods, see *infra* note 283. Rule 148, 17 C.F.R. § 230.148 (1990), is similar to Rule 144 and "provides a safe harbor for the resale of securities issued under a plan in bankruptcy proceedings, as well as securities held in the debtor's portfolio." Securities Act Release No. 6099, *supra*, at 2819-27. "If all applicable conditions of the rule under which [restricted securities] are sold are satisfied, the purchaser receives unrestricted securities." *Id.* at 2819-25.

274. 55 Fed. Reg. 17,945 (to be codified at 17 C.F.R. § 230.144A). Rule 144A permits persons other than issuers to privately resell restricted securities to institutions. *Id.*

275. Rule 144(j), 17 C.F.R. § 230.144(j) (1990); Rule 144A(e), 55 Fed. Reg. 17,945 (to be codified at 17 C.F.R. § 230.144A(e)).

276. 15 U.S.C. § 77d(1) (1988) ("The provisions of Section 5 shall not apply to . . . transactions by any person other than an issuer, underwriter, or dealer.").

277. *See* 15 U.S.C. § 77c(a) (1988) ("[T]he provisions of this subchapter shall not apply to any of the following classes of *securities*." (emphasis added)).

278. *See* Securities Act Release No. 646, *supra* note 130, at 2583-16 to -17 (citing H.R. Rep. No. 1838, 73d Cong., 2d Sess. 40 (1934)); *In re* Thompson Ross Sec. Co., 6 S.E.C. 11 (1940).

dered."[279] For example, if the Target Securities were originally issued in a registered offering (as they were in the Clevepak Corporation no-action request) and thereby are not subject to resale restrictions (other than those Target Securities held by affiliates of the issuer),[280] the New Securities exchanged for such Target Securities would be free of resale restrictions if held by non-affiliated persons.[281] Conversely, if the Target Securities are restricted securities,[282] the New Securities will be restricted[283] and may be resold only by meeting the requirements of Rule

279. Clevepak Corp., SEC No-Action Letter (avail. Mar. 23, 1984) (LEXIS, Fedsec library, Noact file) (shares of new common stock were to be issued in a Section 3(a)(9) Exchange for existing shares of preferred stock registered under the Securities Act).

280. Unlike persons other than an issuer, affiliate, underwriter or dealer, who can freely resell unrestricted securities (such as registered securities) pursuant to Section 4(1), 15 U.S.C. § 77d(1), affiliates may only resell unrestricted securities if they comply with the provisions of Rule 144, 17 C.F.R. § 230.144 (1990), absent registration or another appropriate exemption. *See* Securities Act Release No. 6099, *supra* note 273, at 2819-5. Rule 144 generally permits affiliates to sell restricted securities in limited amounts. Rule 144(e)(1), 17 C.F.R. § 230.144(e)(1). Moreover, Rule 144(k) does not apply to the resale of securities held by affiliates. *See* Rule 144(k), 17 C.F.R. § 230.144(k) (three-year holding provision of Rule 144 expressly excludes affiliates); *supra* note 273. For a discussion of securities sales by affiliates, see C. JOHNSON, CORPORATE FINANCE AND THE SECURITIES LAWS 9-14 (1990); L. LOSS, *supra* note 126, at 350-76.

281. *See, e.g.*, Terminal Data Corp., SEC No-Action Letter (avail. Nov. 19, 1990) (LEXIS, Fedsec library, Noact file); Financial Corp. of Santa Barbara, *supra* note 153; Clevepak Corp. *supra* note 279; Storage Equities, SEC No-Action Letter (avail. Feb. 1, 1983) (LEXIS, Fedsec library, Noact file); Solid State Technology, SEC No-Action Letter (avail. July 11, 1975) (LEXIS, Fedsec library, Noact file). Affiliates, however, may resell such New Securities only in compliance with Rule 144 absent registration or another appropriate exemption. *See supra* note 276.

282. For example, Target Securities would be restricted if they were originally issued pursuant to the private placement exemption provided by section 4(2) of the Securities Act, *see* Rule 144(a)(3), 17 C.F.R. § 230.144(a)(3), and the securities had not become freely transferable through the passage of time. *See, e.g.*, Rules 144(d)(1) & 144(k), 17 C.F.R. § 230.144(d)(1), 230.144(k). Section 4(2) exempts "transactions . . . not involving any public offering." 15 U.S.C. § 77d(2) (1988).

283. *See, e.g.*, Lehigh Valley Indus., SEC No-Action Letter (avail. Nov. 18, 1985) (LEXIS, Fedsec library, Noact file); Dawson Well Servicing, SEC No-Action Letter (avail. Aug. 8, 1984) (LEXIS, Fedsec library, Noact file); Intercontinental Energy Corp., SEC No-Action Letter, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,795, at 87,078 (Sept. 14, 1976); Wright Air Lines, SEC No-Action Letter (avail. Sept. 24, 1973) (LEXIS, Fedsec library, Noact file).

If the Section 3(a)(9) Exchange qualifies as a "recapitalization" under Rule 144, the New Securities are deemed to have been acquired at the same time as the Target Securities for purposes of calculating the two-year holding period of Rule 144(d)(1) and the three-year period of Rule 144(k). Rules 144(d)(4)(A) & 144(k), 17 C.F.R. § 230.144(d)(4)(A), 230.144(k). Although the term "recapitalization" is not defined in Rule 144, the Staff has allowed tacking the holding period of the Target Securities to the New Securities in Section 3(a)(9) Exchanges. *See, e.g.*, Radyne Corp., *supra* note 202 (exchange of convertible debentures for a choice of new convertible debentures or different new convertible debentures and common stock); Discovery Oil, SEC No-Action Letter (avail. Feb. 7, 1986) (LEXIS, Fedsec library, Noact file)

144, Rule 144A, or through registration or an applicable exemption.[284]

E. *Disclosure and Filing Requirements*

There are no specific disclosure or filing requirements for offerings of securities made pursuant to Section 3(a)(9). However, an exemption from Section 5 of the Securities Act by virtue of Section 3(a)(9) does not exempt the offering from the anti-fraud provisions of the Federal securities laws.[285] In addition, the structure of a Section 3(a)(9) Exchange may trigger filing requirements under various other securities laws.[286] Although there are certainly limits to the extent of disclosure that the corporation and timing constraints will permit when there are no statutory requirements, liability concerns suggest that holders of Target Securities should be provided approximately the same information in the Exchange Materials for a Section 3(a)(9) Exchange as they would in a Registered Exchange.[287]

Notwithstanding the exemption from section 5, the particular structure of a Section 3(a)(9) Exchange might generate other filing and disclosure requirements. For example, when a Section 3(a)(9) Exchange involves a concurrent solicitation of consents or proxies from holders of

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(exchange of common stock and common stock warrants for existing preferred stock); Lehigh Valley Indus., *supra* (exchange of common stock for existing preferred stock); Newpark Resources, SEC No-Action Letter (avail. Aug. 15, 1985) (LEXIS, Fedsec library, Noact file) (exchange of preferred stock for existing preferred stock); Dawson Well Servicing, *supra* (exchange of common stock for debentures); Canrad Precision Indus., *supra* note 194 (exchange or a stockholder vote involving new non-cumulative preferred stock and existing cumulative preferred stock).

284. *See supra* notes 273-76 and accompanying text.

285. *See, e.g.*, Rule 10b-5, 17 C.F.R. § 240.10b-5 (1990).

286. *See supra* note 37 & *infra* notes 288-301 & 382-464 and accompanying text.

287. This practice is advisable as a general rule, but is subject to a case-by-case materiality analysis. Most Registered Exchanges are filed with the SEC on a registration statement on Form S-4, 17 C.F.R. § 239.25(c) (1990). Form S-4 "may be used for registration under the Securities Act . . . of securities to be issued . . . (3) in an exchange offer for securities of the issuer or another entity." General Instruction A.1, Form S-4, *reprinted in* 2 Fed. Sec. L. Rep. (CCH) ¶ 7161, at 6261 (June 1, 1988). Form S-4 follows the Form "S-1-2-3 approach." Registrants qualified to use Form S-3, *see* General Instruction 1, Form S-3, 17 C.F.R. § 239.13 (1990), *reprinted in* 2 Fed. Sec. L. Rep. (CCH) ¶ 7152, at 6251 (Aug. 15, 1990), may incorporate by reference into the prospectus certain company-specific information previously included in Exchange Act reports. Registrants qualified to use Form S-2, *see* General Instruction 1, Form S-2, 17 C.F.R. § 239.12 (1990), *reprinted in* 2 Fed. Sec. L. Rep. (CCH) ¶ 7142, at 6231 (Aug. 8, 1990), may present certain information either by concurrently delivering an annual report to security holders or reiterating that level of information in the prospectus. Registrants who do not qualify to use Form S-2 or Form S-3 must include most information required by Form S-1, 17 C.F.R. § 239.11, *reprinted in* 2 Fed. Sec. L. Rep. (CCH) ¶ 7122 (Aug. 8, 1990), in the Form S-4. *See generally* Securities Act Release No. 6578, 6 Fed. Sec. L. Rep. (CCH) ¶ 72,418, at 62,066 (Apr. 23, 1985) (the adopting release for Form S-4).

Target Securities that is subject to Regulation 14A,[288] the offering document must be filed with the SEC for review at least ten days prior to mailing the first solicitation document to such holders[289] and is normally in the form of a combined offering circular and proxy statement in compliance with Schedule 14A.[290] If the New Security is qualifying public debt, the issuer must meet the disclosure and filing requirements of the TIA.[291] If the Section 3(a)(9) Exchange is a tender offer and the Target Security is convertible debt or any other equity security,[292] the issuer must comply with Rule 13e-4[293] and file a Schedule 13E-4 with the SEC.[294] If the Section 3(a)(9) Exchange is for any and all of a class of equity securities, including convertible debt, or otherwise constitutes a "going private" transaction, the issuer may need to comply with Rule 13e-3[295] and file a Schedule 13E-3[296] with the SEC.

If the New Security is capital stock that is not authorized by the corporation's charter, state law will probably require a stockholder vote to amend the charter.[297] Moreover, if the New Security is common stock or securities convertible into or exercisable for common stock that would represent a substantial portion of the corporation's "voting power outstanding" after the Section 3(a)(9) Exchange, the national securities exchange on which the corporation's voting common stock is traded may condition approval of the additional listing application for such New Securities on the corporation's stockholders' approval of the Section 3(a)(9) Exchange.[298] Either of these events may again invoke the proxy rules.[299]

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288. See *infra* notes 303-81 & 448-57 for a discussion of Consent Solicitations and the proxy rules, respectively.

289. Rule 14a-6(a), 17 C.F.R. § 240.14a-6 (1990).

290. 17 C.F.R. § 240.14a-101 (1990). If the transaction were a Registered Exchange, Form S-4 may be used instead of Schedule 14A to fulfill both the informational and filing requirements of the Securities Act and the proxy rules. Rule 14a-3(a), 17 C.F.R. § 240.14a-3(a) (1990); Rule 14c-2(a), 17 C.F.R. § 240.14c-2(a) (for Regulation 14C); Instruction E, Form S-4, *reprinted in* 2 Fed. Sec. L. Rep. (CCH) ¶ 7162, at 6263; *see supra* note 287.

291. Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1988), *as amended by* Trust Indenture Reform Act of 1990, Pub. L. No. 101-550 (Nov. 15, 1990); *see infra* notes 458-64 and accompanying text.

292. See *infra* note 383 for the guidelines to the "definition" of a tender offer; *see* Securities Exchange Act of 1934, § 3(a)(11), 15 U.S.C. § 78c(a)(11) (1988) (definition of "equity security" under the Exchange Act).

293. 17 C.F.R. § 240.13e-4 (1990).

294. Schedule 13E-4, 17 C.F.R. § 240.13e-101 (1990); *see infra* notes 399-417 and accompanying text.

295. 17 C.F.R. § 240.13e-3 (1990).

296. 17 C.F.R. § 240.13e-100 (1990); *see infra* notes 418-25 and accompanying text.

297. *See, e.g.*, CAL. CORP. CODE § 903 (West 1990); DEL. CODE ANN. tit. 8, § 242 (1990); MODEL BUSINESS CORP. ACT §§ 6.01(a), 10.03(b) (1990).

298. *See infra* note 452.

299. *See infra* notes 448-57 and accompanying text.

In the few cases where exemptions are not available, the proper state filings must be made under the "blue-sky" laws of the states in which holders of the Target Securities reside.[300] Finally, any financial advisor that a corporation retains in connection with a Section 3(a)(9) Exchange may be required to have their compensation arrangements, along with other relationships with the corporation, reviewed and cleared by the NASD.[301]

The TIA, Rule 13e-4, Rule 13e-3, the proxy rules and applicable rules of the different national securities exchanges are discussed in more detail elsewhere in this Article. If some or all of these regulations are invoked, more disclosure, filings and reviews of filings are required. These processes could add to the time required to commence and, therefore, complete the Section 3(a)(9) Exchange.[302]

IV. CONSENT SOLICITATIONS

A. Background: The Need for Consents

A corporation may seek amendments of its existing securities for a variety of reasons. The corporation may no longer be able to meet covenants because of financial difficulties or may desire to pursue a course of action prohibited by such covenants (for example, to incur additional indebtedness, pay dividends on equity securities or repurchase equity securities, or conduct other transactions contemplated by an overall financial restructuring).

Although Consent Solicitations are often conducted independent from any other transaction,[303] a corporation conducting a Consent Solicitation concurrently with an Exchange Offer may have an additional reason for seeking amendments: to reduce the attractiveness of a holdout position[304] in the Target Securities by eliminating or modifying certain existing restrictions contained in the indenture, certificate of designation

300. *See supra* note 33.

301. Absent an exemption, the NASD must review the compensation paid to the financial advisor that is a NASD member prior to the commencement of the Section 3(a)(9) Exchange. If such financial advisor beneficially owns more than 10% of the voting securities of the issuer, or owns more than 10% of the Target Securities, Schedule E may also need to be complied with. *See supra* note 35.

302. For a discussion of the frequent importance of minimizing the time required to complete a restructuring, see *supra* notes 37-38 and accompanying text.

303. *See, e.g.*, SCI HOLDINGS, INC., AMENDED CONSENT SOLICITATION STATEMENT (Oct. 21, 1988); NORTHERN PACIFIC CORP., CONSENT SOLICITATION STATEMENT (Mar. 21, 1987); PAY 'N SAVE, INC., CONSENT SOLICITATION STATEMENT (Feb. 12, 1988).

304. For a discussion of the issue of "holdouts" in all voluntary exchanges of securities, see *supra* notes 45-50 and accompanying text.

or other documents relating to those Target Securities,[305] thereby encouraging the holders of such securities to participate in the Exchange Offer. The consents sought in these types of Consent Solicitations are commonly called "exit consents."

A corporation can increase the effectiveness of the exit consents in motivating holders of Target Securities to participate in the exchange by conditioning the Exchange Offer on the corporation's receipt of the requisite consents to effect the proposed amendments.[306] Most indentures require the holders of at least two-thirds or a majority of the aggregate principal amount of the outstanding indenture securities to consent to an amendment, supplement or waiver of most indenture provisions.[307] Unlike the Exchange Offer itself, which affects only those holders of Target Securities who voluntarily exchange their Target Securities for New Se-

305. For example, a corporation pursuing a Section 3(a)(9) Exchange of New Securities that are debt for Target Securities that are debt could seek to remove from the indenture underlying the Target Securities certain covenants restricting the incurrence of indebtedness, *see, e.g.*, Eaton Corp., SEC No-Action Letter (avail. Jan. 30, 1981) (LEXIS, Fedsec library, Noact file), or prohibiting the declaration or payment of dividends on capital stock, *see, e.g.*, Leasco Corp., SEC No-Action Letter (avail. Oct. 22, 1982) (LEXIS, Fedsec library, Noact file).

306. *See, e.g.*, SAVIN CORPORATION, PROSPECTUS AND CONSENT SOLICITATION (May 12, 1988); HOLIDAY INNS, INC., OFFERING CIRCULAR AND CONSENT SOLICITATION (Oct. 20, 1987); PAY 'N SAVE, INC., OFFERING CIRCULAR AND CONSENT SOLICITATION (Dec. 23, 1987). Exit Consent Solicitations have also been used in connection with offers to purchase existing securities for cash. *See, e.g*, MARY KAY CORPORATION, OFFER TO PURCHASE AND CONSENT SOLICITATION (Sept. 28, 1990) (amended by three supplements, the last of which is dated Nov. 20, 1990).

307. *See* AMERICAN BAR FOUND., CORP. DEBT FIN. PROJECT, COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS, 1965 MODEL DEBENTURE INDENTURE PROVISIONS, ALL REGISTERED ISSUES 1967 AND CERTAIN NEGOTIABLE PROVISIONS 305-07 (1986) [hereinafter COMMENTARIES ON INDENTURES]; C. JOHNSON, *supra* note 280, at 747-48. If a corporation would like to modify Target Securities that are capital stock, most jurisdictions provide that such amendments must be approved by at least a majority of shares entitled to vote thereon. *See* 3 MODEL BUSINESS CORP. ACT ANN. § 10.03, at 1174 (Supp. 1990) (listing 37 jurisdictions that provide for majority votes, unless the articles require otherwise, plus four other jurisdictions that allow majority votes in certain circumstances and 12 jurisdictions that require two-thirds votes); *see, e.g.*, CAL. CORP. CODE §§ 152, 902(a) (West 1990); DEL CODE ANN. tit. 8 § 242(b) (1983); N.Y. BUS. CORP. LAW § 802(b) (McKinney 1986). In additon, almost all classes of stock with limited voting rights (such as most preferred stock) provide for separate class voting rights when the amendment generally would "affect them adversely." *See, e.g.*, DEL. CODE ANN. § 242(b) (requiring a class vote when a proposed "amendment would increase or decrease the aggregate number of authorized shares of such class, increase or decrease the par value of the shares of such class, or alter or change the powers, preferences, or special rights of the shares of such class as to *affect them adversely*." (emphasis added)); see also 3 MODEL BUSINESS CORP. ACT ANN. § 10.04, at 1176.1-1177, 1183 (Supps. 1989-1990) (enumerating nine kinds of modifications that trigger class votes in place of the "adversely affects" language, and noting that all but 11 states follow the Model Acts' approach).

curities, an affirmative vote of the holders of the requisite principal amount or number of the Target Securities will be binding on all holders of the Target Securities, both those who consent and those who do not consent to any proposed amendment.[308]

B. The Mechanics of Exit Consents

Practitioners should be particularly careful in following the amendment procedures of an indenture governing Target Securities for which exit consents are being sought in a combined Exchange Offer/Consent Solicitation. All trust indentures following the Model Indenture and many private trust indentures provide that bonds held by the issuer or its affiliates will not be considered "outstanding" for purposes of voting in favor of any amendment to, or waiver of, the terms of the indenture.[309] Consequently, a corporation typically would allow the consents it receives to be withdrawn prior to the execution of the supplemental indenture affecting the proposed amendments and would time such execution so that it does not occur after the corporation accepts any Target Securities pursuant to the concurrent Exchange Offer.

While discussing the implied covenant of good faith and fair dealing, the court in *Katz v. Oak Industries*[310] analyzed what it characterized as an indenture provision prohibiting the corporation from voting "treasury

308. In the case of indentures governed by or following the TIA, the consent process can be used to modify all indenture provisions except changes in interest rate, principal amount and maturity that require the consent of all holders affected. Trust Indenture Act of 1939, § 316(b), 15 U.S.C. § 77ppp(b) (1988), *as amended by* Trust Indenture Reform Act of 1990, Pub. L. No. 101-550 (Nov. 15, 1990) (providing that, with certain exceptions, "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security . . . shall not be impaired or affected without the consent of such holder."). *But see* Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987) (arguing that, in light of "a future economic recession" and antiquated policies that generated its enactment in 1939, TIA § 316's prohibition on "majority action clauses" for such provisions should be repealed to facilitate beneficial bond workouts).

309. *See* COMMENTARIES ON INDENTURES, *supra* note 307, at 41-44 (noting that the definition of an "outstanding" security in the Model Indenture "expand[s] on TIA § 316(a) by not permitting [securities owned by an issuer or any of its affiliates to be counted in any] vote with respect to '*any* request, demand, authorization, direction, notice, consent or waiver' " (emphasis added)). Trust Indenture Act of 1939, § 316(a), 15 U.S.C. § 77ppp(a) (1988), *as amended by* Trust Indenture Reform Act of 1990, Pub. L. No. 101-550 (Nov. 15, 1990), only provides that such "treasury securities" cannot be voted in a referendum

> (A) to direct the time, method, and place of conducting any proceeding for any remedy available to such trustee, or exercising any trust or power conferred upon such trustee, under such indenture, or (B) on behalf of the holders of all such indenture securities, to consent to the waiver of any past default and its consequences.

310. 508 A.2d 873 (Del. Ch. 1986).

securities" in the context of exit consents.[311] The *Oak Industries* court reasoned that the prohibition was intended to prevent the issuer from voting the bonds itself for its own benefit, and that as long as only "those with a financial interest to maximize their return in their investment" are able to grant or withhold consents, and that "the incentive to consent is equally available to all members of each class of bondholders," providing bondholders an incentive to give their consent does not subvert the purposes of "treasury voting" prohibition.[312]

C. *Legality of Exit Consents*

Practitioners should be prepared to analyze whether exit consents constitute a breach of either a fiduciary duty owed to holders of the Target Securities or an implied covenant of good faith and fair dealing. While the court in *Oak Industries* is the only court we are aware of that has addressed these issues explicitly in the context of exit consents,[313] the otherwise extensive general law on fiduciary duties owed to non-common stockholders and the implied covenant of good faith and fair dealing should apply equally to this narrow area.

1. Fiduciary duty of corporations, their directors and their controlling stockholders to non-common stockholders

a. *the general Delaware law*

Oak Industries is part of an extensive line of Delaware jurisprudence that holds that a corporation, its directors and its controlling stockhold-

311. *Id.* at 881.

312. *Id.* (the "incentive to consent" referred to is the New Securities offered in the Section 3(a)(9) Exchange); *see* Kass v. Eastern Air Lines, Nos. 8700, 8701, 8711, slip op. (Del. Ch. Nov. 14, 1986) (in a Consent Solicitation not conducted in conjunction with any other transaction, the Delaware Chancery Court, in *dictum*, stated that a payment for consents may have been considered to breach the implied covenant of good faith and fair dealing, and to be "vote buying" and voidable as against public policy, if the consideration for the consents was not offered to all holders of the Target Securities); Weingarten, *supra* note 55, at 168. See *infra* notes 343-45 & 353-59 and accompanying text, for a discussion of *Eastern Air Lines* in the context of the implied covenant of good faith and fair dealing and vote buying, respectively.

313. Katz v. Oak Indus., 508 A.2d 873, 879 (Del. Ch. 1986). See *infra* notes 324-30 & 339-42 and accompanying text for a discussion of *Oak Industries*. We are aware of only two other courts that have confronted claims of a breach of the implied convenant of good faith and fair dealing and of the public policy against "vote buying" in connection with Consent Solicitations not in conjunction with any other transaction, therefore not involving exit consents. *See* Kass v. Eastern Air Lines, Nos. 8700, 8701, 8711, slip op. (Del. Ch. Nov. 14, 1986); Pisik v. BCI Holdings Corp., No. 14593/87, slip op. (N.Y. Sup. Ct. June 21, 1987) (concurring and relying on *Oak Industries* and *Eastern Air Lines*, but applying New York law); *cf. Eastern Air Lines*, Nos. 8700, 8701, 8711, slip op. at 10 n.4 (in *dictum*, noting that debtholders are not owed fiduciary duties, as are stockholders).

ers do not owe an independent fiduciary duty to holders of the corporation's debt securities,[314] even if the debt securities are convertible into common equity.[315] The Delaware Chancery Court recently put it very

314. *See Oak Indus.*, 508 A.2d at 879. "It has now become firmly fixed in our law that among the duties owed by directors of a Delaware corporation to holders of that corporation's debt instruments there is no duty of the broad and exacting nature characterized as fiduciary duty." Simons v. Cogan, 542 A.2d 785, 786 & n.1 (Del. Ch. 1987) [hereinafter *Simons I*] (citing *Oak Industries* among an extensive list of cases), *aff'd*, 549 A.2d 300 (Del. 1988). The Delaware Chancery Court, in *Simons I*, stated that "courts of this state have consistently recognized that neither an issuer of debentures nor a controlling shareholder owes to holders of the company's debt securities duties of the special sort characterized as fiduciary in character." *Id.* at 788; *accord* Shenandoah Life Ins. Co. v. Valero Energy Corp., No. 9032, slip op. at 10 n.2 (Del. Ch. June 21, 1988); Continental Ill. Nat'l Bank & Trust Co. v. Hunt Int'l Resources Corp., No. 7888, slip op. at 9 (Del. Ch. Feb. 27, 1987) ("the relationship between a corporation and its directors and debenture holders is contractual, not 'fiduciary,' in nature is well settled in this state"); *Eastern Air Lines,* Nos. 8700, 8701, 8711, slip op.; Norte & Co. v. Manor Healthcare Corp., Nos. 6827, 6831, slip op. at 10-11 (Del. Ch. Nov. 21, 1985) [hereinafter *Norte I*]; *see also* MacAndrews & Forbes Holdings v. Revlon, Inc., 506 A.2d 173, 182 (Del. 1986) (in *dicta*); Mann v. Oppenheimer & Co., 517 A.2d 1056, 1063 (Del. 1986) (by implication); Harff v. Kerkorian, 324 A.2d 215, 222 (Del. Ch. 1974) (by implication), *aff'd in part and rev'd in part*, 347 A.2d 133 (Del. 1975).

315. Plaintiffs in several cases involving convertible debt securities have argued that their contingent equity ownership interest in the corporation created a fiduciary interest at least to the extent that corporate action impacts on that interest. *See, e.g., Oak Indus.*, 508 A.2d at 880; *Norte I*, Nos. 6827, 6831, slip op. at 10-11; *Harff*, 324 A.2d at 221. In each of these cases, Delaware courts dismissed the fiduciary duty claim on the theory that "[u]ntil the debenture is converted into stock the convertible debenture holder acquires no equitable interest, and remains a creditor of the corporation whose interests are protected by the contractual terms of the indenture." Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988) [hereinafter *Simons II*]; *accord* Note, *Fiduciary Obligations to Holders of Convertible Debentures:* Simons v. Cogan, 58 U. CIN. L. REV. 751 (1989); *see also* Norman v. Paco Pharmaceutical Servs., [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,739, at 93,998 (Del. Ch. Sept. 22, 1989) (relying on the Delaware Supreme Court's decision in *Simons II* in dismissing a convertible debentureholder's claim of breach of fiduciary duty); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524 (S.D.N.Y. 1989) (applying New York law, which it found "less than dispositive," but found the Delaware Supreme Court's ruling in *Simons II* "persuasive, and believes that a New York court would agree with that conclusion"). This analysis dates back at least to an 1899 opinion by Justice (then Judge) Holmes. Parkinson v. West End Street Ry., 53 N.E. 891, 892 (Mass. 1899) (A conversion right "is simply an option to take stock as it may turn out to be when the time for choice arrives. The bondholder does not become a stockholder, by his contract, in equity any more than at law." (citation omitted)). *But see* Glinert v. Wickes Cos., No. 10487, slip op. at 21-25 (Del. Ch. Mar. 27, 1990) (in dicta, assumes, "without deciding," that a warrantholder maybe owed a fiduciary duty if the subject warrant is convertible *automatically* into common stock, without action or investment by the holder of the warrant). *Cf. In re* Worlds of Wonder Securities Litigation, [Current] FED. SEC. L. REP. (CCH) ¶ 95,689, at 98,239 & n.6 (N.D. Cal. Oct. 19, 1990) (in determining whether convertible debtholders could sue corporate insiders for allegedly selling *stock* with knowledge of material non-public information in violation of Rule 10b-5, 17 C.F.R. § 240.10b-5 (1990), district court found that "[d]ebenture purchasers as well as stock purchasers have the fiduciary relationship to corporate insiders and their tippees that the Supreme Court has required . . . for standing under Rule 10b-5.") (citing Chiarella v. United States, 445 U.S. 222 (1980); Dirks v. SEC, 463 U.S. 646 (1983); Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R. Co., 680 F.2d

simply: "(i) a debentureholder has no independent right to maintain a claim for a breach of fiduciary duty in this context, and (ii) in the absence of fraud, insolvency or statutory violation, a debentureholder's rights are defined by the indenture."[316]

The primary rationale for the absence of a fiduciary duty in this context is that "[u]nlike shareholders, to whom such [fiduciary] duties are owed, holders of debt may turn to documents that exhaustively detail the rights and obligations of the issuer, the trustee under the indenture, and the holders of the securities."[317] Consequently, " '[c]ourts traditionally have directed bondholders to protect themselves against . . . self-interested issuer action with explicit contractual provisions. Holders of senior securities, such as bonds, are outside the legal model of the firm for protective purposes: a heavy black-letter line bars the extension of corporate fiduciary protections to them.' "[318]

Delaware courts have also held that a corporation does not owe an independent fiduciary duty to holders of their preferred stock with respect to the "preferential" rights of preferred stock specifically designated in the corporation's charter.[319] The preferential rights of preferred

933, 941 (3d Cir. 1982)); see *infra* note 323, presenting an argument for why Rule 10b-5 standing cases should not be relevant to state fiduciary duty claims.

316. *Continental Ill. Nat'l Bank & Trust Co.*, No. 7888, slip op. at 9.

317. *Simons I*, 542 A.2d at 786.

318. *Id.* at 789 (quoting Bratton I, supra note 66, at 668 (footnote omitted); and citing AMERICAN BAR FOUND., COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS 527 (1971)). Chancellor Allen in *Simons I* concluded that "[t]o introduce the powerful abstraction of 'fiduciary duty' into the highly negotiated and exhaustively documented commercial relationship between an issuer of convertible securities and the holders of such securities would, or so it now appears to me, risk greater insecurity and uncertainty than could be justified by the occasional increment of fairness that might be hoped for." *Id.* at 791 (citing Bratton *I*, *supra* note 66, at 730-39).

319. *Rosan v. Chicago Milwaukee Corp.*, No. 10,526, slip op. at 14-17 (Del. Ch. Feb. 6, 1990); Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986). In *Jedwab*, the plaintiff, a preferred stockholder, was to receive $4.00 per share less than common stockholders in the sale/merger of MGM Grand to Bally's. *Id.* at 590. The defendants claimed that all rights of preferred stockholders were contractual in nature; therefore, analogizing to the rights of bondholders, they claimed that no fiduciary duty was owed to preferred stockholders. *Id.* at 593. The *Jedwab* court agreed only to a point, noting that preferred stock could essentially be broken into two sets of rights: (i) " 'preferential' rights (and special limitations)" and (ii) "rights associated with all stock." *Id.* at 593. All classes of stock of a corporation are equal except as specified in the certificate of incorporation. *Id.* (citing Shanghai Power Co. v. Delaware Trust Co., 316 A.2d 589 (Del. Ch. 1974)). Thus, the *Jedwab* court split the attributes of, and duties triggered by, preferred stock into two categories: (1) all aspects of preferred stock addressed in the certificate of incorporation are contractual in nature and therefore imply no fiduciary duty, while (2) all aspects of preferred stock not specifically mentioned in the certificate would share those rights with common stock, imposing a fiduciary duty on the corporation as to those rights. *Id.* at 594. In *Jedwab*, the court found that (a) the fair allocation of the proceeds in a merger, (b) the exercise of appropriate care in negotiating

stockholders, like the rights of debtholders, are based on contract law.[320] In contrast, the rights of common stockholders are based on the trust relationship between the board of directors of the corporation and the common stockholders as the ultimate owners of the corporation.[321]

It should be noted that isolated federal district courts or federal judges construing state law have attempted to expand fiduciary duties to debtholders in certain limited circumstances.[322] Most of these rulings have been actually or effectively overruled by higher courts.[323]

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the merger and (c) the alleged overreaching by the controlling stockholder of MGM Grand (as to timing) were not addressed in the charter, and therefore "fairly implicate fiduciary duties." *Id.* Conversely, the *Jedwab* court found that the plaintiff's claim that the merger was a wrongful attempt to circumvent the preferred stock's $20 per share redemption provision did "relate to a negotiated preference and must be evaluated strictly as a contract right." *Id.* at 594 n.6; *accord* Kirschner Bros. Oil v. Natomas Co., 185 Cal. App. 3d 784, 795, 229 Cal. Rptr. 899, 908 (1986) (applying a similar contractual analysis and reaching a similar conclusion under California law regarding fiduciary duties owed to preferred stockholders).

320. It is well established in Delaware law that "the provisions of the certificate of incorporation govern the rights of preferred shareholders, the certificate of incorporation being interpreted in accordance with the law of contracts, with only those rights which are embodied in the certificate granted to preferred shareholders." Judah v. Delaware Trust Co., 378 A.2d 624, 628 (Del. 1977) (citing Ellingwood v. Wolf's Head Oil Refining Co., 38 A.2d 743 (Del. 1944)); *accord* Rothschild Int'l Corp. v. Liggett Group Inc., 474 A.2d 133, 136 (Del. 1984) ("[p]referential rights are contractual in nature and therefore are governed by the express provision of a company's certificate of incorporation"); Wood v. Coastal States Gas Corp., 401 A.2d 932, 937 (Del. 1979) ("as to the conversion privilege, it has been said that the rights of a preferred shareholder are 'least affected by rules of law and most dependent on the share contract,'" *i.e.*, the certificate of designation) (quoting Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CAL. L. REV. 243, 279 (1954)).

321. *See Norte I*, Nos. 6827, 6831, slip op. at 10-11 (directors, managing the business and affairs of the corporation, act as fiduciaries for the corporation and its stockholders who are the equitable owners of the assets; by contrast, debentureholders are creditors of the corporation).

322. *See, e.g.*, Green v. Hamilton Int'l Corp., No. 76-5433, slip op. at 17 (S.D.N.Y. July 14, 1981). In *Green*, a Federal court, sitting in New York and applying Delaware law, found that any corporate act that "impinged upon the equity aspects" of a convertible debt security (i.e., the conversion feature and any act that would depress the market for the common stock of the corporation and thereby make a conversion uneconomic) would implicate a fiduciary duty to the holders of the convertible debt. *Id. But see infra* note 323 (Delaware Supreme Court effectively overruling *Green*). Some debtholders also have unsuccessfully attempted to "bootstrap" *allegations* of fraud into *establishing* a fiduciary duty. *See* cases cited *infra* note 348.

323. The Supreme Court of Delaware expressly disavowed the ruling in *Green*, stating that "a mere expectancy interest does not create a fiduciary relationship." *Simons II*, 549 A.2d at 304 (citing Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171 (Del. 1988)). "In relying on an expectancy interest created by the conversion feature of the debenture the *Green* court misperceives the type of interest required for the imposition of fiduciary duties, under Delaware law." *Id.* While acknowledging that there is some Federal judicial sentiment to extend fiduciary duties at least to holders of convertible debt securities, the Delaware Chancery Court in *Simons I* noted that "[t]hese seeds . . . have fallen upon stones. None of the appellate opinions actually represent a holding so extending that concept [of fiduciary duty] and, indeed, each of those cases evidence the fact that prevailing judicial opinion remains to

b. Consent Solicitations and exit consents

Particularly relevant to Exchange Offers conducted in conjunction with Consent Solicitations is *Katz v. Oak Industries*,[324] the seminal case that specifically addressed the issue of whether a corporation owes any fiduciary duty to the holders of its debt securities in the context of a solicitation of exit consents.[325] In this case, Oak Industries commenced

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the contrary." *Simons I*, 542 A.2d at 790; *see, e.g.*, Broad v. Rockwell Int'l Corp., 642 F.2d 929 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981) (vacating lower court's ruling on other grounds with dicta indicating disapproval of lower court's extension of fiduciary duty to holders of convertible debt securities under New York law); Van Gemert v. Boeing Co., 553 F.2d 812 (2d Cir. 1977) (disavowing analysis from earlier proceeding that holders of convertible debt were owed a fiduciary duty under New York law); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989) (applying New York law and finding that the Supreme Court of Delaware's ruling in *Simons II* on the fiduciary duties owed to bondholders "persuasive and believes a New York court would agree with that conclusion"). One federal appellate court has held to the contrary, however, and stated that it "would be very much surprised if Maryland or any other state would today hold that no such [fiduciary] obligations were owed by an issuer of such [convertible] securities and its directors." Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R. Co., 680 F.2d 933, 941 (3d Cir. 1982). Delaware and other states clearly would surprise the author of the *Pittsburgh Terminal* opinion; moreover, two other members of the panel in *Pittsburgh Terminal* expressly disavowed any such conclusion. *Id.* at 943 (Garth, J., concurring); *id.* at 954 (Adams, J., dissenting). *See also In re* Worlds of Wonder Securities Litigation, [Current] FED. SEC. L. REP. (CCH) ¶ 95,689, at 98,239 & n.6 (N.D. Cal. Oct. 19, 1990) (lower Federal court decision, discussed more fully *supra* note 315); *see generally* McDaniel II, *supra* note 66, at 265-308 (analyzing certain of these and other cases to expound the view that there are, or should be, fiduciary duties owed to bondholders); Mitchell, *supra* note 67, at 1169 n.11 (stating that "McDaniel . . . overstates the extent to which courts have provided fiduciary rights for bondholders"; but, otherwise presents a case for extending fiduciary rights to bondholders) (citations omitted); Bratton II, *supra* note 66, at 119 (noting that "the decisions set out this fiduciary duty very tentatively. Discussion of the source and nature of the duty tends to be fragmentary, and the duty's precise relationship to contract terms unclear . . . . In most cases . . . the duty remains subject to the contract terms; it takes a breach of contract to breach the duty." (footnote omitted)).

It has been argued that Entel v. Guilden, 223 F. Supp. 129 (S.D.N.Y. 1963) (perpetual warrantholders allowed standing in a derivative suit pleading a private right of action under Section 17(e) of the Investment Company Act of 1940), and Hoff v. Sprayregan, 52 F.R.D. 243 (S.D.N.Y. 1971) (convertible debtholders allowed standing in a Rule 10b-5 case), are examples of Federal law applying the expansive Federal view of fiduciary duties owed to non-stockholders. *See, e.g.*, Kessler v. General Cable Corp., 92 Cal. App. 3d 531, 540, 155 Cal. Rptr. 94, 100 (1979). *Entel* and *Hoff*, however, interpreted the word "shareholder" in the federal standing statute to include holders of convertible securities based on the principle that courts "should strive to construe the federal rules [of civil procedure] so as to harmonize them with substantive Federal statutes . . . ." Markowitz v. Brody, 90 F.R.D. 542, 551 (S.D.N.Y. 1981). Because federal securities law defines convertible debt securities, warrants and preferred stock as equity securities, Securities Exchange Act of 1934, § 3(a)(11), 15 U.S.C. § 78c(a)(11) (1988), this line of cases should not be applicable to state law. *See Kessler*, 92 Cal. App. 3d at 545, 155 Cal. Rptr. at 103 (discussing each of those Federal cases and dismissing their relevance to state fiduciary claims).

324. 508 A.2d 873 (Del. Ch. 1986).

325. *Eastern Air Lines*, which did not involve exit consents, is the only other Delaware case

tender offers to exchange New Securities for its six classes of outstanding debt securities and concurrently sought bondholders' consents to amendments to the underlying indentures.[326] The exchange offers were conditioned on certain minimum amounts of each class of existing debt securities being tendered. In order to tender their securities, bondholders were required to consent to the amendments to the relevant indenture.[327] The amendments to the indentures would have had adverse consequences to bondholders who did not tender pursuant to the offers.[328]

The Delaware Chancery Court pointed out that the relationship between a corporation and its bondholders is contractual in nature, that neither the corporation nor its directors are in a fiduciary relationship with the bondholders, and that the "high standard of fidelity required of fiduciaries when they act with respect to the interests of the beneficiaries of their trust" was not involved in this case.[329] To the contrary, "[t]he terms of the contractual relationship agreed to . . . define the corporation's obligation to its bondholders."[330] This analysis is wholly consistent with the jurisprudence described above concerning whether and when a corporation, its directors and its controlling stockholders owe

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of which we are aware that has addressed whether fiduciary duties are owed to debtholders in a Consent Solicitation; however, it dismissed such liability only in dictum in a footnote. *Eastern Air Lines*, Nos. 8700, 8701, 8711, slip op. at 10 n.4.

326. *Oak Indus.*, 508 A.2d at 876.

327. *Id.* at 877.

328. The "amendments would, if implemented, have the effect of removing significant negotiated protections to holders of [Oak Industries'] long-term debt including the deletion of all financial covenants." *Id.* The plaintiff complained that bondholders who did not consent and tender in the exchange offers would be left holding securities that were stripped of financial covenant protections and for which there would be no ready market. *Id.* at 878.

329. *Id.* at 879. The court noted that the relationship is contractual even when the debt securities are convertible. *Id.*

330. *Id.* The court noted that:

> Arrangements among a corporation, underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.

Id. at 879. "[C]entral to plaintiff's own articulation of his theory of recovery" in *Oak Industries* was the characterization of the combined Section 3(a)(9) Exchange and Consent Solicitation as "coercive." *Id.* The court in *Oak Industries*, however, determined that "for purposes of legal analysis, the term 'coercion' itself—covering a multitude of situations—is not very meaningful." *Oak Indus.*, 508 A.2d at 880. The real analysis is whether the transaction is " 'inappropriately coercive' or 'wrongfully coercive,' " and that the standard by which the "adverb modifying" the term is determined is based on contract law and the implied covenant of good faith and fair dealing. *Id.* *But see* Coffee, *Coercive Debt Tender Offers*, N.Y.L. J., July 19, 1990, at 5 (analyzing and criticizing the use of exit consents). For a discussion of how the court in *Oak Industries* ruled on the *contractual* claim of the implied covenant of good faith and fair dealing, see *infra* notes 339-42.

fiduciary duties to non-common stockholders. Consequently, all of that jurisprudence, not just *Oak Industries*, should apply equally to other challenges of exit consents.

c. *"special circumstances"*

Courts look outside the four corners of the contract instruments to determine the rights of the debtholders and preferred stockholders in the same "special circumstances" common in general contract and debtor/creditor law. Such instances are limited to: (1) violation of statute; (2) fraud in the inducement; and, (3) breach of fiduciary duty owed to creditors in insolvency or bankruptcy.[331] The first two of these "special circumstances" arise in quite particular factual situations. Financially troubled corporations, however, are often exposed to the very real risk of being deemed insolvent. It has been held that when a corporation becomes insolvent, "the fiduciary duty of the directors shifts from the stockholders to the creditors."[332] While there is a bright line for determining when a bankruptcy occurs,[333] there are a number of methods for determining when a corporation is insolvent.[334] Directors of a troubled

331. *See Simons II*, 549 A.2d at 303; *Continental Ill. Nat'l Bank & Trust Co.*, No. 7888, slip op. at 9; *Norte I*, Nos. 6827, 6831, slip op. at 11; *Harff*, 324 A.2d at 222.

332. FDIC v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982), *cert. denied*, 461 U.S. 928 (1983); *accord* Davis v. Woolf, 147 F.2d 629, 633 (4th Cir. 1945) (citing Arnold v. Knapp, 75 W. Va. 804, 810, 84 S.E. 895, 899 (1915)); Xonics Medical Sys. v. Haverty, 99 Bankr. 870, 872 (N.D. Ill. 1989) (applying Delaware law); Wieboldt Stores v. Schottenstein, 94 Bankr. 488, 507-10 (N.D. Ill. 1988); Official Secured Creditors' Comm. of Amfesco Indus. v. Greenblatt, 215 A.D.2d 215, 217, 548 N.Y.S.2d 476, 478 (App. Div. 1989) (creditors' committee, authorized by bankruptcy court to maintain the action, did not lack standing to bring an action against directors for breach of duty owed to the creditors). This "shift" is only the "majority rule," with several states maintaining a "minority rule" that "precludes suits by injured creditors of an insolvent corporation." *In re* STN Enters., 779 F.2d 901, 904-05 (2d Cir. 1985) (citing 3 A.W. FLETCHER, FLETCHER CYCLOPEDIA CORPORATIONS § 1181, at 417 (perm. ed. 1986)). *Compare Davis*, 147 F.2d at 633 (following the "law by the great weight of authority") *with* Conway v. Bonner, 100 F.2d 786, 787 (5th Cir.), *cert. denied*, 307 U.S. 632 (1939) (citing Texas law for the proposition that "a corporation is not held to be insolvent so long as it continues to be a going concern . . . without some positive act of insolvency"); *see also* New York Credit Men's Adjustment Bureau v. Weiss, 305 N.Y. 1, 110 N.E.2d 397 (1953) ("shift" in fiduciary duty may occur shortly *before* insolvency).

333. In contrast to the divided law on insolvency, it has been clearly established that the fiduciary duties of directors of a corporation in bankruptcy no longer run solely to stockholders and the corporation. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 307 (1939).

334. *See, e.g.*, Bankruptcy Code, 11 U.S.C. § 101(31)(A) (1988) ("sum of [corporation's] debts is greater than all such entity's property, at a fair valuation"); MODEL BUSINESS CORP. ACT ANN. § 6.40 (Harcourt Brace Jovanovich 1990) (inability of a corporation to pay its debts as they mature; or total assets less than sum of total liabilities); CAL. CORP. CODE § 501 (West 1988) (inability to meet liabilities as they mature); N.Y. BUS. CORP. LAW § 102(8) (McKinney 1988) (inability to pay debts as they mature); *see also* DEL. CODE ANN. tit. 8, § 291 (1983) (receivers for insolvent corporations; appointment and powers). Insolvency under section 291

company, therefore, face an extremely difficult situation if their company has drifted into insolvency, but not yet into bankruptcy: to whom does their fiduciary duty lie in a context in which they often must negotiate between debtholders and stockholders?[335]

2. Implied covenant of good faith and fair dealing and other contractual remedies

Absent special circumstances, holders of debt securities are limited to contractual remedies. Therefore, they have attacked corporations as having violated an implied covenant of good faith and fair dealing as an alternative claim to an allegation of a breach of fiduciary duties.[336] This remedy has been generally recognized in modern contract law.[337] In the context of debt securities, Delaware courts have held that "the contractual documents creating the debenture[s] and the duties of the issuer may, in *narrow circumstances*, be held to imply obligations arising from an implied covenant of good faith and fair dealing."[338]

The *Oak Industries* court set out the general test of this "implied" covenant in Delaware: "[I]s it clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter?"[339]

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of the Delaware General Corporation Law may arise "where liabilities exceed assets, or where the corporation is unable to meet its current obligations arising in the ordinary course of business." 2 E. FOLK, R. WARD & E. WELCH, FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 291.2 (2d ed. 1988) (citation omitted). Insolvency under section 291 is a question of fact "that 'must be free from doubt' and proof thereof should be 'clear and convincing.' " *Id.* (citation omitted).

335. *See* Milmoe, *supra* note 69, at 200-09 (discussing this dilemma and directors' business judgment).

336. *See, e.g., Van Gemert*, 553 F.2d 812 (applying New York law); *Simons II*, 549 A.2d 300; *Oak Indus.*, 508 A.2d 873; Waverly Prods. v. RKO Gen., 217 Cal. App. 2d 721, 32 Cal. Rptr. 73 (1963).

337. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); 3 CORBIN ON CONTRACTS § 540 (Kaufman ed. 1984).

338. *Simons I*, 542 A.2d at 787 (emphasis added).

339. *Oak Indus.*, 508 A.2d at 880. In California, the elements of the implied covenant of good faith and fair dealing are as follows:

> "(1) the implication must arise from the language used or it must be indispensable to effectuate the intention of the parties; (2) it must appear from the language used that it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it; (3) implied covenants can only be justified on the grounds of legal necessity; (4) a promise can be implied only where it can be rightfully assumed that it would have been made if attention had been called to it; and (5) there can be no implied covenant where the subject is completely covered by the contract."

Kessler v. General Cable Corp., 92 Cal. App. 3d 531, 541, 155 Cal. Rptr. 94, 101 (1979)

In *Oak Industries*, the bondholder, who sought to enjoin the concurrent Section 3(a)(9) Exchanges and Consent Solicitation on fiduciary duty grounds also claimed that the allegedly coercive nature of the exit consents breached the corporation's implied covenant of good faith and fair dealing.[340] The court determined that (1) indenture provisions granting bondholders the power to veto modifications did not prevent the issuer from offering inducements to consent on the same terms to all bondholders;[341] and, (2) indenture provisions prohibiting the issuer from voting debt securities it held did not prevent the issuer from inducing bondholders to concurrently consent to modifications and transfer their bonds to the issuer.[342]

Citing the test set forth in *Oak Industries*, the Delaware Chancery Court in *Kass v. Eastern Air Lines*[343] ruled that Eastern's Consent Solicitation, in which it offered to pay bondholders for their consents, was not a breach of the implied contractual obligation of good faith and fair dealing. An apparently important factor in the Court's analysis was that the

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(quoting Hinckley v. Bechtel Corp., 41 Cal. App. 3d 206, 211, 116 Cal. Rptr. 33, 36 (1974)). *See* Hartford Fire Ins. Co. v. Federated Dept. Stores, Inc., 723 F. Supp. 976, 919 (S.D.N.Y. 1989) (in dismissing plaintiffs' claim that Campeau Corporation's leveraged buy-out of Federated "prejudiced the security underlying" plaintiffs' debt securities and thereby violated the implied covenant of good faith and fair dealing, the District Court noted that under New York law the " 'implied covenant . . . derives its substance directly from the language of the Indenture, and "cannot give the holders . . . any rights inconsistent with those set out in the Indenture," ' " and that a court cannot "imply a covenant to supply additional terms for which the parties did not bargain") (quoting Gardner & Florence Call Cowles Found. v. Empire, Inc., 589 F. Supp. 669, 673 (S.D.N.Y. 1984) (quoting Broad v. Rockwell Int'l Corp., 642 F.2d 929, 957 (5th Cir.), *cert denied.*, 454 U.S. 965 (1981)), *vacated for lack of subject matter jurisdiction*, 754 F.2d 478, 479 (2d Cir. 1985)) (citing Metropolitan Life Ins. Co. v. RJR Nabisco, 716 F. Supp. 1504, 1519 (S.D.N.Y. 1989) (dismissing an existing debt security holders' claim of a breach of the implied covenant of good faith and fair dealing because of the leveraged buy-out of RJR Nabisco)).

340. *Oak Indus.*, 508 A.2d at 881. The court examined the specific provisions of the indentures to determine whether the parties "would have expressly agreed to prohibit contractually the linking of the giving of consent with the purchase and sale of the security." *Id.* at 880-81. See *supra* note 330 for a discussion of the court's view in *Oak Industries* that the word "coercive" was analytically meaningless.

341. *Oak Indus.*, 508 A.2d at 881.

342. *Id.* The court found that the purpose of the restriction on Oak Industries voting the debt securities it held was to protect bondholders "against the issuer voting as a bondholder in favor of modifications that would benefit it as issuer, even though such changes would be detrimental to bondholders." *Id.* The court reasoned that this financial conflict of interest was not present even when the bondholders' consents were to be given "concurrently with the transfer of the bond to the issuer." *Id.* "Not only will the proposed consents be granted or withheld only by those with a financial interest to maximize the return on their investment in Oak's bonds, but the incentive to consent is equally available to all members of each class of bondholders." *Id.*

343. Nos. 8700, 8701, 8711, slip op. (Del. Ch. Nov. 14, 1986). See *infra* notes 347-54 and accompanying text for a more complete discussion of the facts and allegations in this case.

offer was made to all bondholders on the same terms.[344] However, the court noted in *dicta* that a private consent payment made only to a sufficient number of bondholders to carry the election would probably be a breach of the implied obligation of good faith and fair dealing.[345]

Although not mentioned in the opinions in *Oak Industries* and *Eastern Air Lines*,[346] fraud in the inducement has often been alleged as a second contractual cause of action accompanying alleged breaches of fiduciary duties owed to non-common stockholders in contexts other than consent solicitations.[347] Although plaintiffs frequently have attempted to bootstrap allegations of fraud into establishing a foundation for a fiduciary duty owed to non-common stockholders,[348] Delaware courts have clearly held that a claim of fraud is wholly independent from, and does not create any sort of fiduciary duty.[349] "In Delaware, '[t]he elements of "actionable fraud" consist of a false representation of a material fact knowingly made with intent to be believed to one who, ignorant of its falsity, relies thereon and is thereby deceived.' "[350]

3. Vote buying

The anti-democratic implications of providing consideration for

344. *Eastern Airlines*, Nos. 8700, 8701, 8711, slip op. at 11. Eastern Air Line's Consent Solicitation was not conducted in conjunction with a Section 3(a)(9) Exchange, and therefore did not involve exit consents.

345. *Id.*; *see* Pisik v. BCI Holdings Corp., No. 14593/87, slip op. at 3 (N.Y. Sup. Ct. June 21, 1987) (reaching the same conclusion under New York law on essentially the same facts as *Eastern Air Lines*).

346. *Oak Indus.*, 508 A.2d 873; *Eastern Air Lines*, Nos. 8700, 8701, 8711, slip op.; *see also Pisik*, No. 14593/87, slip op. (also no claim of fraud in the inducement).

347. *See, e.g.*, *Simons II*, 549 A.2d at 301-03; *Harff*, 347 A.2d at 134; *Continental Ill. Nat'l Bank & Trust Co.*, No.7888, slip op. at 2; *Norte I*, Nos. 6827, 6831, slip op. at 11; *Green*, No. 76-5433, slip op. at 2.

348. A few plaintiffs have attempted to utilize the reversal of the *Harff* lower court decision (on grounds that fraud had been sufficiently pled to give rise to a triable issue of fact as to that issue) to construct an argument that a claim for breach of fiduciary duty owed to non-common stockholders may exist when pled in conjunction with a claim of fraud. *See Simons II*, 549 A.2d at 301-02; *Continental Ill. Nat'l Bank & Trust Co.*, No. 7888, slip op. at 2; *Simons I*, 542 A.2d at 788; Norte & Co. v. Manor Healthcare Corp., Nos. 6827, 6831, slip op. at 2 (May 30, 1986) [hereinafter *Norte II*]; *Norte I*, Nos. 6827, 6831, slip op. at 7-8. This is also one of the foundations of the *Green* decision in New York. *Green*, slip op. at 16.

349. The courts in *Norte II*, *Continental Ill. Nat'l Bank & Trust* and, finally and emphatically, in the *Simons I* and *Simons II* cases repudiated this argument, making clear that fraud is an independent claim that in no way relates to or creates any fiduciary duty. *Simons II*, 549 A.2d at 302-04; *Simons I*, 542 A.2d at 790-92; *Continental Ill. Nat'l Bank & Trust*, slip op. at 8-10; *Norte II*, slip op. at 2-3; *Norte I*, slip op. at 13-14.

350. *Continental Ill. Nat'l Bank & Trust Co.*, slip op. at 14 (quoting Harman v. Masoneilan Int'l, Inc., 442 A.2d 487, 499 (Del. 1986)); *see Harff*, 347 A.2d at 134.

votes has long been against public policy in certain contexts.[351] Consent Solicitations that involve payments for the consents have been attacked on these grounds. For example, in *Eastern Air Lines*, the airline offered a choice of cash or airline ticket vouchers to the holders of its five classes of debt securities who consented to the removal of certain financial conditions from the underlying indentures.[352] Bondholders who did not consent would receive no consideration even if the corporation received the requisite consents, and the amendments became effective.[353]

Certain bondholders sought to enjoin the implementation of the amendments to the indentures.[354] They asserted two theories: (1) that the consent payments constituted vote buying that, as a matter of public policy, was void per se; and (2) that the payment of consideration only to consenting bondholders was a breach of Eastern Air Line's implied contractual obligation of good faith and fair dealing.[355] Under Delaware law, vote buying in the corporate stockholder setting[356] may be "void or against public policy" if the purpose of the arrangement is fraud or the disenfranchisement of other stockholders.[357] The court passed over the fraud element of this test[358] and found that there was no disenfranchisement purpose in Eastern Air Line's offer, and in so doing noted that "the offer [was] made publicly to all voters on the same terms" and "each bondholder [was] free to accept or reject it."[359]

351. *See, e.g.*, N.Y. CONST. art. 2, § 3; N.Y. ELEC. LAW § 17-142 (Consol. 1990); N.Y. BUS. CORP. LAW § 609(e) (Consol. 1990); DEL. CONST., art. V, § 3; Chew v. Inverness Management Corp., 352 A.2d 426 (Del. Ch. 1976) (public policy prohibits stockholder from selling vote for consideration personal to that stockholder).

352. *Eastern Air Lines*, Nos. 8700, 8701, 8711, slip op. at 3.

353. *Id.*

354. *Id.* at 1.

355. *Id.* at 6; *see Pisik*, No. 14593/87, slip op. at 2-3 (plaintiff asserted identical two theories based on New York law). See *supra* notes 343-45 for a discussion of the implied contractual obligation of good faith and fair dealing in *Eastern Air Lines*.

356. The court noted that *Eastern Air Lines* involved bondholders, not stockholders, and that the duty owed to bondholders is not fiduciary in nature as is the duty owed to stockholders. *Eastern Air Lines*, Nos. 6827, 6831, slip op. at 10 n.4. Nonetheless, the court applied the law as developed in the stockholder setting. *Id.* at 10.

357. *Id.* at 9-10 (citing Schreiber v. Carney, 447 A.2d 17, 25 (Del. Ch. 1982)).

358. "The gist of the complaint is not that Eastern is not being candid but that it is being wrongfully coercive and unfair." *Id.* at 9. For a description of the view of the court in *Oak Industries* that the term "coercive" has little legal utility, see *supra* note 330.

359. *Eastern Air Lines*, Nos. 8700, 8701, 8711, slip op. at 11. The court suggested that the outcome might be different if the consent payment had not been made to all bondholders on the same terms. *Id.*; *see also Pisik*, No. 14593/87, slip op. at 3 (reaching same conclusion, based on New York law, where corporation offered only cash, not cash or ticket vouchers, only to security holders who consented to proposed amendments to a debt agreement).

D. Amendments Creating New Securities—Availability of Section 3(a)(9)

Generally, a Consent Solicitation by itself does not involve the offer or sale of a security, and therefore does not require registration under the Securities Act. If, however, the amendments sought in a Consent Solicitation substantially affect the rights of holders of Target Securities, the amendments of the Target Securities may be deemed to constitute the issuance of New Securities[360] requiring registration under the Securities Act[361] and possibly qualification under the TIA,[362] unless an exemption from each such statute is available.

Traditionally, the "substantially affects" standard has been met, and a New Security deemed created, when modifications would alter the "ba-

360. L. LOSS, *supra* note 128, at 248 ("There is always the question . . . whether the rights of security holders have been so substantially affected by the particular change in the terms of the outstanding security that it becomes a new security."); H. SOWARDS, *supra* note 183, § 2.02[4], at 2-130 ("A modification in the terms of a security that makes a fundamental change in the nature of the investment it represents is a disposition of the modified security for value, and a resultant 'sale' of that security."); McGuigan & Aiken, *supra* note 118, at 935 ("In determining whether the amendment of a security constitutes the sale . . . of a new security, the generally accepted test is whether the alteration has substantially affected the legal rights and obligations of the holders of the outstanding securities.").

361. "[I]f an alteration of a security effectively creates a new security, the transaction is in essence an exchange of an old for a new security, and hence a sale, even though no actual exchange of one security for another may have occurred." McGuigan & Aiken, *supra* note 118, at 935. *See supra* notes 118-19 and accompanying text. *See also* Rule 145(a)(1), 17 C.F.R. § 240.145(a)(1) (1990) ("A reclassification of securities of [a] corporation . . . which involves the substitution of a security for another security" that has been consummated after a plan for such a reclassification has been "submitted for the vote or consent of [the corporation's] security holders" shall be deemed to involve an "offer," "offer to sell," "offer for sale" or "sale" within the meaning of Section 2(3) of the Securities Act); L. LOSS, *supra* note 128, at 292-95 (discussing Rule 145, its history and its relationship to the "perceived presence of a 'sale' in exchanges of securities and significant alterations of their terms" (footnote omitted)).

362. The TIA does not specifically define the term "security," and section 303(1) of the TIA incorporates all definitions set forth in section 2 of the Securities Act if the term is not otherwise defined in the TIA. Trust Indenture Act of 1939, § 303(1), 15 U.S.C. § 77ccc(1) (1988), *amended by* Trust Indenture Reform Act of 1990, Pub. L. No. 101-550 (Nov. 15, 1990), including the definition of the term "security" in Securities Act of 1933, § 2(a)(16), 15 U.S.C. § 79b(a)(16) (1988). Therefore, the outcome of the analysis of whether the amendments to debt securities result in the creation of New Securities under the Securities Act is dispositive under the TIA. *See* Lockheed Aircraft, SEC No-Action Letter (avail. Feb. 14, 1975) (LEXIS, Fedsec library, Noact file) (no-action position taken in response to a request asserting that qualification of the supplemental indenture under the TIA should not be required because the qualification provisions of the TIA relate only to "securities" that are defined in the TIA by reference to the Securities Act). See *infra* notes 380-81 and accompanying text, noting that a supplemental indenture must be qualified under the TIA even if Section 3(a)(9) is available to exempt the issuance of the New Security deemed to be created by the amendment from the registration requirements under the Securities Act.

sic financial terms" of existing debt securities[363] or the "basic nature" of existing equity securities.[364] In the leading case of *SEC v. Associated Gas & Electric*,[365] for example, a corporation submitted to holders of its investment certificates a proposal to pay twenty percent of the principal coming due and extend the maturity date of the remaining principal either for one year or for five years at each holder's option.[366] As an inducement to extend the maturity date for five years, the corporation offered an additional "interest advance" of two percent to the holders.[367] The court held the extension of the maturity date of investment certificates, evidenced by a legend stamped on the outstanding certificates, to involve the sale of a new "security" within the meaning of the Public Utility Holding Company Act of 1935 (the HCA).[368]

Since the *Associated Gas & Electric Co.* decision, published SEC pronouncements and Staff no-action letters that address this issue have employed a fact-intensive analysis of whether the proposed modifications alter the "basic financial terms" or "basic nature" of the securities, or

363. The American Bar Foundation describes the "basic financial terms" of a debt security as "the payment of the principal amount, the interest rate, the redemption premium, the maturity, the place of payment, the currency in which payable and the right to institute suit for any default in such payment." COMMENTARIES ON INDENTURES, *supra* note 307, at 307. It describes the "essence" of an issue of debt securities as "the promise to pay a sum of money on a future date together with interest on such sum, payable semi-annually at a specified rate at a specified place." *Id.* at 111. These "intrinsic rights" under the security, *id.* at 125, are essentially equivalent to the "basic financial terms." *See* Leasco Corp., *supra* note 305 (no-action position taken in response to a request noting that the proposed amendments would not affect the provisions of the indenture relating to payment of principal and interest, interest rate, interest payment date, maturity date, redeemability or the sinking fund provisions). But see *infra* notes 371-75 and accompanying text for a discussion of limited exceptions to this rule.

364. Alteration of voting rights, dividend rights or liquidation rights constitutes a change to the "basic nature" of equity securities. *See Rochester Gas & Elec. Co.*, 21 S.E.C. 633, 634-36 (1945) (alteration of the priorities, preferences, voting power and other rights of preferred and common stockholders, including reduction of the dividend rate and establishment of cumulative dividend rights, resulted in a substantial alteration of the rights of the preferred and common stockholders); L. LOSS, *supra* note 128, at 248; H. SOWARDS, *supra* note 183, § 2.02[4], at 2-132 (alteration of voting rights).

365. 99 F.2d 795 (2d Cir. 1938).

366. *Id.* at 796.

367. *Id.*

368. *Id.* at 797. Because the definition of "security" under the HCA, § 2(a)(16), 15 U.S.C. § 79b(a)(16) (1988), is coextensive with that under the Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1988), the rationale of *Associated Gas & Electric* applies equally to the Securities Act. *Cf.* L. LOSS, *supra* note 128, at 247 n.3 (noting that the HCA defines the term "sale" more broadly than does the Securities Act, but concluding that the rationale of *Associated Gas & Electric* applies equally to the Securities Act). The Staff has also taken the view that an "offer to extend the maturity date of . . . outstanding debentures at a higher interest rate would constitute an 'offer to sell' and 'sale' of a new security." Allied-Carson Corp., SEC No-Action Letter, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,434, at 86,146 (Feb.12, 1976).

whether the amendments constitute mere adjustments of the contractual rights embodied by the underlying indenture or certificate of designation.[369] For example, and particularly relevant to exit consents, to date the Staff consistently has issued no-action letters in connection with proposed amendments that would alter or eliminate covenants or definitions in an indenture.[370] Moreover, not all changes to basic financial terms have been deemed to create a New Security. Certain changes that are favorable to the security holder, and therefore do not increase the holder's investment risk, have not been characterized as a sale of a New Security.[371] For example, while some commentators appear to regard

369. *See, e.g.*, Leasco Corp., *supra* note 305 (no-action position taken); Susquehanna Corp., SEC No-Action Letter (avail. June 27, 1979) (LEXIS, Fedsec library, Noact file) (modification to debt securities "relaxing" stock payment limitation covenants and increasing the interest rate "constitute merely a modification of contractual provisions contained in the Indentures, made in accordance with the procedures provided in the Indentures"); *cf.* Minneapolis Gen. Elec. Co., 2 S.E.C. 57 (1937) (SEC found that a new security was created under the HCA as a result of the extensive changes to the existing mortgage indenture, including minor changes in collateral).

370. *See, e.g.*, Leasco Corp., *supra* note 305 (proposed amendments would eliminate covenant that, among other things, prohibited the issuer from declaring or paying dividends on capital stock); Susquehanna Corp., *supra* note 369 (proposed amendments would relax covenants restricting the issuer's ability to make so-called 'stock payments,' including the payment of dividends); Sheraton Corp., SEC No-Action Letter (avail. Nov. 24, 1978) (LEXIS, Fedsec library, Noact file) (no-action position taken in response to a request that asserted that proposed amendments to indentures that would "permit the return [to the parent corporation of $170 million in] capitalized advances and [would] increase the rate of interest payable on the Debentures." merely modified certain contractual provisions of the indenture pursuant to which debt securities previously registered under the Securities Act were issued); *see also* Tennessee Forging Steel Corp., SEC No-Action Letter (avail. Jan. 21, 1977) (LEXIS, Fedsec library, Noact file) (Staff takes no-action position, without necessarily agreeing with counsel's legal conclusion that a New Security would not be created, when corporation sought bondholder consent to a waiver of a default in a net worth covenant, among other things); McGuigan & Aiken, *supra* note 118, at 938 (it is "reasonable to conclude that when a company amends indenture provisions to change definitions and remove financing restrictions, . . . no sale of a new security will have occurred."). But see *infra* note 377 for a description of the Staffs' yet unpublished and informal lowering of the standards that determine when a New Security is created when covenants are modified or eliminated in a Consent Solicitation.

371. *See* Browning Debenture Holders' Comm. v. DASA Corp., [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,071, at 97,753 (S.D.N.Y. 1975). In *Browning*, the court stated that "the plaintiffs' assertion that a reduction in the conversion price of the debentures resulted in the issuance and sale of a new security is without merit." *Id.* at 97,754. Plaintiffs' authorities, including *Associated Gas & Electric Co.*, were "no support for this position since they involve amendments to the disadvantage of the indenture [sic] holder," unlike the changes in *Browning*, which were beneficial to the holder. *Id.* at 97,754 n.*; *see also* Adee, *Creating a New Security*, INSIGHTS, Apr. 1989, at 23 (interprets New Security analyses as, generally, those modifications that are adverse to a holder will create a New Security and those modifications that are beneficial to a holder do not create a New Security); McCoy & McGlynn, Current Interpretations of §§ 3(a)(9) and 3(a)(10) of the Securities Act of 1933 and Other Significant No-Action and Interpretive Positions 7-8 (Oct. 12, 1990) (presented at the 23rd Annual Rocky Mountain State-Federal-Provincial Securities Conference) (courts review whether or not the

any change in interest rate of a debt security as a change in the "basic financial terms" of a debt security,[372] the Staff has taken no-action positions in several instances where a corporation *increased* the interest rate of existing debt securities without registration under the Securities Act or qualification under the TIA.[373] The Staff has also taken a no-action position when a series of proposed modifications to a series of debt securities would, among other things, accelerate the maturity date.[374] A United States District Court also has found that an amendment to a convertible debt security that *reduces* the conversion price did not create a New Security.[375]

The foregoing analysis is unaffected by the fact that holders of Target Securities may receive cash or other consideration in return for their consent to the amendments.[376] Indeed, "the provisions of the security

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proposed changes "are adverse to the holder," citing Ingenito v, Bermec Corp., 376 F. Supp. 1154, 1181 (S.D.N.Y. 1974); *Associated Gas & Electric Co.*, 99 F.2d 795, and "[S]taff review focuses less upon whether the changes are simply adverse to security holders and more upon whether the changes are made pursuant to the terms of the original indenture.").

372. *See* H. BLOOMENTHAL, SECURITIES REGULATIONS § 2.26[4], at 2-234 (rev. ed. 1985) (change in interest rate of debt security would most likely involve sale of a New Security); L. LOSS, *supra* note 126, at 248 (change in interest or dividend rate or liquidation preference would seem quite clearly to result in New Security); H. SOWARDS, *supra* note 183, § 2.02[4], at 2-130 (modification of interest rate on debenture results in "sale" of debenture); McGuigan & Aiken, *supra* note 118, at 938. Bloomenthal, Loss and Sowards cite no direct authority for their positions. McGuigan and Aiken base their view on several no-action letters that, in fact, stated that the proposed transactions were exempt from registration requirements under Section 3(a)(9). McGuigan & Aiken, *supra* note 117, at 938.

373. *See* PLM Companies, SEC No-Action Letter (avail. Sept. 14, 1987) (LEXIS, Fedsec library, Noact file); Time, Inc., SEC No-Action Letter (avail. Dec. 9, 1983) (LEXIS, Fedsec library, Noact file); Eaton Corp., *supra* note 305; J. Ray McDermott & Co., SEC No-Action Letter (avail. Sept. 10, 1979) (LEXIS, Fedsec library, Noact file); Susquehanna Corp., *supra* note 369; Sheraton Corp., *supra* note 370; *cf. Rochester Gas & Elec.*, 21 S.E.C. at 634-36 (reduction in preferred stock dividend rate, among other changes, held to be a sale of a New Security); *In re* American Util. Serv., 6 S.E.C. 825 (1940) (reduction in interest rate held to be an issuance of a New Security under the HCA).

374. Wilson Foods Corp., SEC No-Action Letter (avail. Aug. 6, 1984) (LEXIS, Fedsec library, Noact file) (Counsel's "no new security" analysis was one of two arguments for its opinion that the modified debt securities did not have to be registered pursuant to the Securities Act or qualified under the TIA, and the Staff did not specify which it relied upon in taking its no-action position).

375. *Browning Debenture Holders' Comm.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 97,754 (also relying on Section 3(a)(9)); *see infra* note 379.

376. See Kass v. Eastern Air Lines, Nos. 8700, 8701, 8711, slip op. (Del. Ch. Nov. 14, 1986), discussed *supra* notes 343-45 & 353-59 and accompanying text; PLM Companies, *supra* note 373 (increase in interest rate in return for waiver of restrictive covenant prohibiting the transfer of assets); Eaton Corp., *supra* note 301 (increase in interest rate in return for elimination of certain financing restrictions); Time, Inc., *supra* note 373 (increase in interest rate in return for modification of restrictions on financing and dispositions of assets); J. Ray McDermott & Co., *supra* note 373 (increase in interest rates in return for amendments to financing restrictions); Susquehanna Corp., *supra* note 369 (increase in interest rate in return for amend-

instrument itself may give some indication as to what changes should be considered 'substantial.' Changes that require unanimous consent of security holders are generally most important, whereas changes requiring only a majority or two-thirds vote may be relatively 'insubstantial.' "[377]

Although neither the SEC nor the Staff has published any pronouncements on changes of the foregoing New Security analysis, the authors understand that the Staff is considering expanding the circumstances under which it would deem an amendment to an existing debt security to constitute the issuance of a New Security.[378] The Staff position under consideration would represent a clear reversal of long-held judicial, SEC and Staff positions, and would contradict the solid reasoning for these well-established positions.

Nonetheless, when a Consent Solicitation is conducted in conjunction with an Exchange Offer, Section 3(a)(9) is likely to exempt the alleged New Securities created by a successful Consent Solicitation from the registration requiements of the Securities Act. In fact, the Staff has often relied on Section 3(a)(9) to grant no-action requests when it was asked to determine whether a New Security would be created by a proposed amendment.[379]

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ments to restrictions on dividend payments to common stockholders); Sheraton Corp., *supra* note 370 (increase in interest ratè in return for amendment permitting return of capital advances to obligor's parent).

377. McGuigan & Aiken, *supra* note 118, at 937. Section 316(b) of the Trust Indenture Act of 1939, 15 U.S.C. § 77ppp(b) (1988), *amended by* Trust Indenture Reform Act of 1990, Pub. L. No. 101-550 (Nov. 15, 1990), provides that the right of any holder of an indenture security to receive payment of the principal of and interest on such indenture security on or after the respective due dates shall not be impaired or affected without the consent of such holder. *Id.* This section protects holders against amendment of the "basic financial terms" of the security. *See* COMMENTARIES ON INDENTURES, *supra* note 307, at 307. However,

> the provisions of Section 316(b) were not designed to prevent a majority of bondholders from binding dissenters to changes in the indenture that do not relate to principal or interest payments, nor to prevent a majority from waiving defaults other than non-payment, even if the waivers indirectly affect the assets available for payment.

H. SOWARDS, *supra* note 183, § 8.18[3], at 8-120. Therefore, changes to these other terms may be viewed as relatively insubstantial.

378. *See* Adee, *Update: Creating a New Security*, INSIGHTS, Nov. 1990, 23, 29 (Staff recently has been informing counsel representing various parties involved in combined Consent Solicitation/tender offers that proposed amendments that eliminate or change covenants in existing debt securities so materially alter the "bundle of rights" of the debtholders that the Staff now deems such modifications to covenants as creating a New Security; notes that "the exact test the staff is now using to determine whether a new security exists is unclear . . . [and that it is unclear] whether the change must be fundamental or merely material to result in a new security; states that this new analysis has, "in effect, overruled the prior line of no-action letters," although its new "position has not been publically announced in any release, no-action letter or otherwise"); McCoy & McGlynn, *supra* note 371, at 9.

379. *See, e.g.,* Eaton Corp., *supra* note 305; Barber-Coleman Co., SEC No-Action Letter, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,400, at 76,653 (Apr. 3, 1980); J. Ray

Practitioners should also note the registration exemption provided by Section 3(a)(9) is one of the few section 3(a) exemptions that the TIA has not incorporated.[380] Consequently, if it is determined that a New Security is created by the amendment of an outstanding public debt security, the supplemental indenture affecting that amendment would have to be filed with the SEC and qualified under the TIA even if no filing is required pursuant to the Securities Act because of Section 3(a)(9).[381]

V. CERTAIN ADDITIONAL APPLICABLE FEDERAL SECURITIES LAWS

A. *The Tender Offer Rules*

If an Exchange Offer is characterized as a tender offer, the tender offer rules under the Exchange Act are triggered.[382] Consequently, practitioners should analyze the proposed restructuring against the eight-factor *Wellman* test to determine whether the Section 3(a)(9) Exchange constitutes a tender offer.[383] All tender offers are subject to Regulation

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Dermott & Co., *supra* note 373; Liberty Loan Corp., SEC No-Action Letter (avail. Oct. 7, 1974) (LEXIS, Fedsec library, Noact file); Daitch Crystal Dairies, *supra* note 197; Magic Marker Corp., SEC No-Action Letter (avail. July 30, 1971) (LEXIS, Fedsec library, Noact file); *see also Browning Debenture Holders' Comm.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. at 97,754 (United States District Court reaching the same conclusion).

380. *See* Trust Indenture Act of 1939, § 304(a)(4)(A), 15 U.S.C. § 77ddd(a)(4)(A) (1988), *amended by* Trust Indenture Reform Act of 1990, Pub. L. No. 101-550 (Nov. 15, 1990). *See* McGuigan & Aiken, *supra* note 118, at 941 ("If registration is not required under the Securities Act, the provisions of the [TIA] do not apply, except when the Securities Act exemption is derived from Section 3(a)(9) or 3(a)(10) . . . .").

381. *See* Allied-Carson Corp., *supra* note 368, at 86,147; Magic Marker Corp., *supra* note 379 (Section 3(a)(9) available to exempt New Securities deemed to be created by modifications from registration under Securities Act, but supplemental indenture still must be qualified under TIA).

382. Regulation 14E, 17 C.F.R. § 240.14e-1 to -3 (1990) (governing all tender offers); Regulation 14D, 17 C.F.R. § 240.14d-1 to -10 (1990) (governing tender offers for an issuer's equity securities by affiliates and non-affiliates of the issuer); Rule 13e-4, 17 C.F.R. § 240.13e-4 (1990) (governing tender offers by an issuer or its affiliate for the issuer's own equity securities).

383. Wellman v. Dickinson, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979), *aff'd on other grounds*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983). The term "tender offer" is not defined in either the Exchange Act or the rules adopted thereunder. Courts, however, have generally analyzed whether a transaction constitutes a tender offer by comparing the transaction to the eight-factor test set forth in *Wellman* (commonly referred to as the *Wellman* test). These eight factors are as follows:

(1) active and widespread solicitation of public shareholders for the shares of an issuer;
(2) solicitation made for a substantial percentage of the issuer's stock;
(3) offer to purchase made at a premium over the prevailing market price;
(4) terms of the offer are firm rather than negotiable;
(5) offer contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased;
(6) offer open for only a limited period of time;
(7) offeree subject to pressure to sell his or her stock; and

14E.[384] Additionally, Rule 13e-4[385] governs tender offers by an issuer (and certain affiliates of that issuer) for that issuer's equity securities,[386] and Regulation 14D[387] governs most tender offers for equity securities by affiliates and nonaffiliates of the issuer.[388]

1. Regulation 14E

The procedural and antifraud provisions of Section 14(e) of the Exchange Act and Regulation 14E,[389] adopted thereunder, are applicable to all tender offers,[390] including any Exchange Offer that constitutes a

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(8) publicity preceding or accompanying the rapid accumulation of stock.

Id. at 823-24. "Not all factors need be present to find a tender offer; rather, they provide some guidance as to the traditional indicia of a tender offer." SEC v. Carter Hawley Hale Stores, 760 F.2d 945, 950 (9th Cir. 1985) (citations omitted). Alternative approaches to the definition of tender offer have been employed by some courts. *See* S-G Sec., Inc. v. Fuqua Inv. Co., 466 F. Supp. 1114, 1126-1127 (D. Mass. 1978) (a tender offer involves "(1) a publicly announced intention by the purchaser to acquire a substantial block of the stock of the target company for purposes of acquiring control thereof; and (2) a subsequent rapid acquisition by the purchaser of large blocks of stock through open market and privately negotiated purchases."); Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 57 (2d Cir. 1985) ("the question of whether a solicitation constitutes a 'tender offer' . . . turns on whether . . . there appears to be a likelihood that unless the [tender offer rules] are followed there will be a substantial risk that solicitees will lack information needed to make a carefully considered appraisal of the proposal"); *see also* R. JENNINGS & H. MARSH, *supra* note 14, at 658-76; L. LOSS & J. SELIGMAN, *supra* note 14, at 2198-2208.

The SEC has taken the position that a definition of tender offer is neither appropriate nor necessary in view of "the dynamic nature of these transactions and the need . . . to remain flexible." Exchange Act Release No. 12,676, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,659, at 86,696 (Aug. 2, 1976); *see* 5 L. LOSS & J. SELIGMAN, *supra* note 117, at 2198; *see also* Hoover Co. v. Fuqua Indus., [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,107, at 96,145, 96,148 & n.3 (N.D. Ohio June 11, 1979) (discussing the eight factors enumerated in *Wellman* and claiming, without citation, that they were initially formulated by the SEC); Securities Act Release No. 6159, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,374, at 82,600, 82,601 & n.4 (Nov. 29, 1979) (proposing amendments—still not adopted or withdrawn—to the tender offer rules to adopt a definition for "tender offer," and commenting that the SEC "has been continually involved in the development of the meaning of the term but has not adopted a definition").

384. Rule 14d-1(a), 17 C.F.R. § 240.14d-1(a).

385. Rule 13e-4, 17 C.F.R. § 240.13e-4.

386. "The term 'equity security' means any stock or similar security; or any security convertible . . . into such a security . . . ." Securities Exchange Act of 1934, § 3(a)(11), 15 U.S.C. § 78c(a)(11) (1988). For a discussion of Rule 13e-4, see *infra* notes 399-417 and accompanying text.

387. 17 C.F.R. §§ 240.14d-1 through .14d-101.

388. Rule 14d-1(a), 17 C.F.R. § 240.14d-1(a). See *infra* note 405, discussing whether Regulation 14D or Rule 13e-4 would apply to a tender offer for an affiliate's equity securities.

389. Securities Exchange Act of 1934, § 14(e), 15 U.S.C. § 78n(e) (1988); Regulation 14E, 17 C.F.R. §§ 240.14e-1 to .14e-3.

390. Section 14(e) provides, in pertinent part, that:

> It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the

tender offer. Regulation 14E is the only tender offer rule that is applicable to an Exchange Offer that constitutes a tender offer if the Target Securities are not equity securities.[391]

Rule 14e-1 requires the following:

(a) tender offers must remain open for at least twenty business days[392] from the date the offer is first published or sent to security holders;[393]

(b) tender offers must remain open for at least ten business days after the date of publishing or sending notice to security holders of an *increase or decrease* in (i) the percentage of the class of securities being sought,[394] (ii) the consideration offered, or (iii) the dealer's soliciting fee;[395]

> light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with *any tender offer* or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation.

Securities Exchange Act of 1934, § 14(e), 15 U.S.C. § 78n(e) (emphasis added). Rule 14e-1 applies to a "person who makes a tender offer." Rule 14e-3 applies if "*any* person has taken a substantial step or steps to commence, or has commenced a tender offer." Rule 14e-1, 17 C.F.R. § 240.14e-1; Rule 14e-3, 17 C.F.R. § 240.14e-3 (emphasis added); *see also* Rule 14d-1(a), 17 C.F.R. § 240.14d-1(a) (scope and definitions of Regulations 14D and 14E).

391. *See* Rule 13e-4(a)(2), 17 C.F.R. § 240.13e-4(a)(2) (1990); Rule 13e-4(b), 17 C.F.R. § 240.13e-4(b) (1990); Rule 14d-1(a), 17 C.F.R. § 240.14d-1(a) (referring to Securities Exchange Act of 1934, § 14(d)(1), 15 U.S.C. § 78n(d)(1) (1988)).

392. Rule 14d-1(b)(6) defines the term "business day" for both Regulation 14D and 14E as:

> any day, other than Saturday, Sunday or a federal holiday, and shall consist of the time period from 12:01 a.m. through 12:00 midnight Eastern time. In computing any time period under . . . Regulation 14E, the date of the event which begins the running of such time period shall be included *except that* if such event occurs on other than a business day such period shall begin to run on and shall include the first business day thereafter.

Rule 14d-1(b)(6), 17 C.F.R. § 240.14d-1(b)(6) (emphasis in original). The term "business day" has essentially the identical definition in Rule 13e-4(a)(3), 17 C.F.R. § 240.13e-4(a)(3).

393. Rule 14e-1(a), 17 C.F.R. § 240.14e-1(a).

394. An exception applies when there is an *increase* in the maximum amount of securities sought in the tender offer that is equal to or less than two percent of the class of outstanding Target Securities, as calculated pursuant to section 14(d)(3) of the Exchange Act. Rule 14e-1(b), 17 C.F.R. § 240.14e-1(b).

395. *Id.* In addition, the SEC prohibits the expiration of a tender offer for at least five business days following the dissemination of a "material" amendment of the terms of the tender offer. Interpretative Release Relating to Tender Offer Rules, Exchange Act Release No. 24,296, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,285J (Apr. 3, 1987) (noting that waiver of a minimum tender condition was a material change). For a discussion of the purpose of minimum tender conditions, see *supra* note 47 and accompanying text. Ultimately, the minimum period a tender offer must remain open will depend upon the facts and circumstances, including the importance of any changes during the pendency of the tender offer and the manner of dissemination of the Exchange Materials disclosing the changes.

> If material changes are made with respect to information that approaches the significance of price and share levels [*i.e.*, changes of the type specified by the ten-day-notice rule], a minimum of ten business days may be required to allow for adequate

(c) the person making the tender offer must pay for or return Target Securities tendered promptly after the termination or withdrawal of the tender offer;[396] and,

(d) the party making the tender offer must give public notice of any extension of the length of the tender offer.[397]

Section 14(e) and Regulation 14E do not require any filings with the SEC.[398]

2. Rule 13e-4: issuer tender offers

The SEC adopted Rule 13e-4[399] and Schedule 13E-4[400] to regulate issuer tender offers.[401] The Rule applies to tender offers for Target Securities that are equity securities[402] by issuers that (1) have a class of equity securities registered pursuant to Section 12 of the Exchange Act[403] or are required to file periodic reports pursuant to Section 15(d) of the Exchange Act,[404] or, (2) are closed-end investment companies registered under the Investment Company Act of 1940.[405]

> dissemination and investor response. Moreover, the five-business-day period may not be sufficient when revised or additional materials are required because disclosure disseminated to security holders is found to be materially deficient.

Id.

396. Rule 14e-1(c), 17 C.F.R. § 240.14e-1(c).

397. Rule 14e-1(d), 17 C.F.R. § 240.14e-1(d) (The notice must include the number of securities deposited to date, and must be made "no later than the earlier of: (i) 9:00 a.m. Eastern time, on the next business day after the scheduled expiration date of the offer, or (ii) if the [Target Securities are] registered on one or more national securities exchanges the first opening of any one of such exchanges on the next business day after the scheduled expiration date of the offer.").

398. Other aspects of an exchange transaction may trigger separate filing, disclosure and dissemination requirements under, for example, the TIA, the Securities Act, the proxy rules or the NASD rules.

399. 17 C.F.R. § 240.13e-4.

400. 17 C.F.R. § 240.13e-101.

401. Tender Offers by Issuers, Exchange Act Release No. 16,112, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,182 (Aug. 16, 1979).

402. See *supra* note 386 for the definition of "equity securities" for purposes of the Exchange Act, including Rule 13e-4.

403. 15 U.S.C. § 78*l* (1988).

404. 15 U.S.C. § 78o(d) (1988).

405. Rule 13e-4(a)(1), 17 C.F.R. § 240.13e-4(a)(1), Rule 13e-4(a)(2), 17 C.F.R. § 240.13e-4(a)(2). Although unlikely to be relevant to Section 3(a)(9) Exchanges because of the same issuer requirement, *see supra* notes 143-85 and accompanying text, Rule 13e-4 also applies to tender offers by affiliates of issuers when such issuers have a class of equity securities registered pursuant to section 12 of the Exchange Act or are required to file periodic reports pursuant to section 15(d) of the Exchange Act. *See* Rule 13e-4(a)(2), 17 C.F.R. § 240.13e-4(a)(2). Rule 13e-4(g)(4), 17 C.F.R. § 240.13e-4(g)(4), exempts from Rule 13e-4 tender offers that are subject to section 14(d) of the Exchange Act. A corporation that makes a tender offer for its affiliates' equity securities that are registered pursuant to section 12 of the Exchange Act is subject to section 14(d) of the Exchange Act, 15 U.S.C. § 78n(d)(1), and therefore is exempt

Rule 13e-4 and Schedule 13E-4, which were modeled after the third-party tender offer requirements of Regulation 14D[406] and Schedule 14D-1,[407] contain antifraud, filing, disclosure and dissemination requirements.[408] *In addition* to the antifraud measures of Regulation 14E set forth above,[409] Rule 13e-4 subjects applicable tender offers to the following general requirements:

(a) a holder of Target Securities who has tendered any such securities to the offeror pursuant to the tender offer may withdraw such tenders at *any* time while the tender offer is open;[410]

(b) a holder of Target Securities who has tendered any such securities to the offeror pursuant to the tender offer may also withdraw such tenders at any time after forty business days after the commencement of the tender offer if that holder's Target Securities have not previously been accepted for payment;[411]

(c) if the tender offer is for less than all of the outstanding Target Securities, and the number of shares of stock or principal amount of debt tendered pursuant to the tender offer exceeds the maximum number or amount specified in the tender offer, the issuer must acquire Target Securities from each tendering holder, *pro rata*, based on the number or principal amount each holder actually tendered while the tender offer was open;[412]

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from most provisions of Rule 13e-4. Thus, the vast majority of Rule 13e-4 applies to an affiliate of an issuer only when such affiliate makes a tender offer for Target Securities that are not registered pursuant to section 12, but the issuer has other equity securities registered pursuant to section 12, or must report under section 15(d), and not section 13. In Rule 13e-4's adopting release, the SEC noted that most issuer affiliates are exempt from Rule 13e-4 because they are subject to Regulation 14D. Tender Offers by Issuers, Exchange Act Release No. 16,112, *supra* note 401, at 1. Nonetheless, issuers *and* all of their affiliates must comply with Rule 13e-4(f)(6), which prohibits purchases otherwise than pursuant to the tender offer for at least 10 business days after the date of termination of the tender offer. *Id.* at 82,207 n.21, 82,210-11. See *infra* notes 415 and accompanying text for a description of Rule 13e-4(f)(6).

406. 17 C.F.R. § 240.14d-1 to -10.

407. 17 C.F.R. § 240.14d-100 (1990).

408. Exchange Act Release No. 16,112, *supra* note 401, at 82,204.

409. *See supra* notes 389-97 and accompanying text. These Regulation 14E provisions, other than the Extension Notice Rule, are duplicated in Rule 13e-4 in the following provisions: Rule 13e-4(f)(1)(i), 17 C.F.R. § 240.13e-4(f)(1)(i) (the twenty-business-day rule); Rule 13e-4(f)(1)(ii), 17 C.F.R. § 240.13e-4(f)(1)(ii) (the ten-day-notice rule); and Rule 13e-4(f)(5), 17 C.F.R. § 240.13e-4(f)(5) (the prompt return rule).

410. Rule 13e-4(f)(2)(i), 17 C.F.R. § 240.13e-4(f)(2)(i).

411. Rule 13e-4(f)(2)(ii), 17 C.F.R. § 240.13e-4(f)(2)(ii).

412. Rule 13e-4(f)(3), 17 C.F.R. § 240.13e-4(f)(3) (providing exceptions for rounding and

(d) the issuer must pay all holders of Target Securities the highest amount of "consideration" *paid* pursuant to the tender offer, regardless of the consideration offered when a particular holder tenders his or her Target Securities;[413]

(e) the tender offer must be made to *all* holders of the Target Securities;[414] and

(f) for ten full business days after the termination date of the tender offer, neither the issuer, nor any affiliate of the issuer, can purchase (other than pursuant to the tender offer) either the Target Securities or any New Securities, "or any security of the same class and series" of either of the Target Securities or New Securities, or any right to purchase any such security.[415]

The issuer making the tender offer must file copies of Schedule 13E-4 and all exhibits thereto "prior to or as soon as practicable on the

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odd lots, and allowing the offeror to provide each holder of Target Securities the option of receiving no New Securities unless all of the holder's tendered Target Securities are accepted, *i.e.*, unless no more than the maximum amount sought in the tender offer is validly tendered).

413. Rule 13e-4(8)(ii), 17 C.F.R. § 240.13e-4(8)(ii). The adopting release for this rule states that the "issuer . . . could reduce the consideration offered to security holders during the tender offer." Exchange Act Release No. 23,421, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,016, at 88,186, 88,193 (July 11, 1986). *But see* Rule 13e-4(f)(4), 17 C.F.R. § 240.13e-4(f)(4) ("In the event the issuer or affiliate making the issuer tender offer increases the consideration *offered* after the tender offer has commenced, such issuer or affiliate shall pay *such* increased consideration to all security holders whose tendered securities are accepted for payment by such issuer or affiliate." (emphasis added)); *cf.* Rule 13e-4(f)(1)(ii), 17 C.F.R. § 240.13e-4(f)(1)(ii) (ten-day-notice rule triggered by increases *and decreases* in the consideration offered). In addition, a corporation may offer alternative types of consideration for the Target Securities. Rule 13e-4(f)(10), 17 C.F.R. § 240.13e-4(f)(10).

414. Rule 13e-4(f)(8)(i), 17 C.F.R. § 240.13e-4(f)(8)(i). The tender offer may, however, exclude security holders in a particular state if the corporation making the tender offer has made a good faith effort to comply, but cannot comply, with that state's laws and therefore cannot make the offer in that state. The person making the tender offer may offer alternative consideration in such a state in order to comply with that state's laws. Rule 13e-4(f)(9)(ii), 13e-4(f)(11), 17 C.F.R. § 240.13e-4(f)(9)(ii), .13e-4(f)(11). See *infra* note 33 briefly discussing the applicability of state blue sky laws.

415. Rule 13e-4(f)(6), 17 C.F.R. § 240.13e-4(f)(6); *see also* Rule 10b-6, 17 C.F.R. § 240.10b-6 (1990) (prohibiting persons "interested in a distribution," during such persons' participation in the distribution, from trading in *any securities* (a) which are being distributed, such as New Securities, (b) which are the same class or series as such New Securities, or (c) which constitute any right to purchase any such New Security, such as the Target Securities because of the tender offer); Rule 10b-13, 17 C.F.R. § 240.10b-13 (1990) (prohibiting persons making tender offers or exchange offers, *i.e.*, tender offers in which the consideration is something other than "all cash," from purchasing the Target Securities that are *equity securities* other than pursuant to the tender offer or exchange offer from the time of its public announcement to the "expiration of the period . . . securities tendered . . . may by the terms of such offer be accepted or rejected.").

date of commencement" of the tender offer.[416] In addition, a corporation filing a Schedule13E-4 must also report any material changes in the information contained in Schedule 13E-4 by "promptly" filing an amendment to the Schedule.[417]

B. Rule 13e-3: Going Private Rules

1. Definition of a "going private" transaction

Rule 13e-3 was adopted in response to Congress' and the SEC's perception that "going private" transactions could be detrimental to investors.[418] A Rule 13e-3 transaction consists of any transaction or series of transactions[419] involving at least one of the transactions specified in Rule 13e-3(a)(3)(i) that has either the *purpose* or *reasonable likelihood* of (A) reducing the number of holders of the equity Target Securities below 300; or (B) causing the equity Target Securities to no longer be listed on a national securities exchange nor authorized for quotation on an inter-dealer quotation system.[420]

The transactions specified in paragraph (a)(3)(i) of Rule 13e-3 are: (A) the purchase of an equity security[421] of the issuer; (B) a tender offer for an equity security of the issuer; and (C) a solicitation subject to Regulations 14A or 14C in connection with "a merger, consolidation, reclassification, recapitalization, reorganization or similar corporate

416. Rule 13e-4(c)(1), 17 C.F.R. § 240.13e-4(c)(1).

417. Rule 13e-4(c)(2), 17 C.F.R. § 240.13e-4(c)(2).

418. Rule 13e-3, 17 C.F.R. § 240.13e-3 (1990), and Schedule 13E-3, 17 C.F.R. § 240.13e-100 (1990), were adopted pursuant to sections 17(a) and 19 of the Securities Act, 15 U.S.C. §§ 77p(a), 77s (1988), and sections 3(b), 10(b), 13(e), 14(a), 14(c), 14(e) and 23(a) of the Exchange Act, 15 U.S.C. §§ 78c(b), 78j(b), 78m(e), 78n(a), (c), (e), 78w(a) (1988). *See* HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, DISCLOSURE OF CORPORATE EQUITY OWNERSHIP, H.R. REP. NO. 1711, 90th Cong., 2d Sess., *reprinted in* 1968 U.S. CODE CONG. & ADMIN. NEWS 2811. For an explanation of the purposes of Rule 13e-3, see Exchange Act Release No. 17,719, 3 Fed. Sec. L. Rep. (CCH) ¶ 23,709, at 17,304 (Apr. 13, 1981); Exchange Act Release No. 16,075, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,166 (Aug. 2, 1979) (adopting release for Rule 13e-3); Going Private Transactions by Public Companies or Their Affiliates, Exchange Act Release No. 14,185, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,336, at 88,736-39 (Nov. 17, 1977).

419. *See* Exchange Act Release No. 17,719, *supra* note 418, at 17,307; M. BORDEN, GOING PRIVATE 10-13 (1989).

420. Rule 13e-3(a)(3), 17 C.F.R. § 240.13e-3(a)(3). A corporation must comply with Rule 13e-3 even if the issuer continues to have other classes of section 12 or section 15(d) securities held by more than 300 persons. *See* Exchange Act Release No. 17,719, *supra* note 418, at 17,306-07. However, "delisting of a class of equity securities from an exchange would not trigger the application of Rule 13e-3 if the securities were nevertheless authorized to be quoted on an inter-dealer quotation system of a registered national securities association." Exchange Act Release No. 16,075, *supra* note 418, at 82,125.

421. See *supra* note 386, for the definition of "equity security" under the Exchange Act.

transaction,"[422] or a sale of substantially all assets to an affiliate, or certain reverse stock splits.[423] As this list indicates, practitioners should note that Rule 13e-3 is not limited to tender offers, as are Rule 13e-4 and Regulation 14E.[424]

The "reasonable likelihood" phrase of Rule 13e-3 has been construed quite liberally.[425] Consequently, in determining whether a transaction has a reasonable likelihood of causing one of the specified "effects," the contemplated transaction should be given its full effect—it should be assumed that the issuer will acquire all of the securities or consents it seeks. Practitioners are well advised to regard an Exchange Offer for "any or all" Target Securities as having a "reasonable likelihood" of producing the described effects and as evidence of a "purpose" of producing such effects.

2. Exception to Rule 13e-3

A commonly relied-upon Rule 13e-3 exemption in many out-of-court restructurings, including Exchange Offers, is found in paragraph (g)(2) of Rule 13e-3.[426] This exemption applies when holders of Target Securities are "offered or receive only an equity security" either (i) with "substantially the same rights" as the Target Securities or (ii) that is common stock of the issuer.[427] It is often unclear whether a New Security has "substantially the same rights" as the Target Security.[428] The

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422. Rule 13e-3(a)(3)(i)(C), 17 C.F.R. § 240.13e-3(a)(i)(C). "Rule 13e-3 is intended to apply to a merger, consolidation or similar multi-party reorganization transaction of an issuer only if an affiliate of the issuer is also a party to the transaction." Exchange Act Release No. 17,719, *supra* note 418, at 17,306 (footnote omitted).

423. Rule 13e-3(a)(3)(i)(A)-(C), 17 C.F.R. § 240.13e-3(a)(3)(i)(A)-(C).

424. In fact, Rule 13e-3 can be triggered by, among other things, Exchange Offers, Section 3(a)(10) Settlement Exchanges, Reclassifications, Consent Solicitations, recapitalizations and most other restructuring transactions.

425. *See, e.g.*, Shamrock Assoc. v. Horizon Corp., 632 F. Supp. 566, 572 (S.D.N.Y. 1986) (holding that "conclusionary allegations of a reasonable likelihood would probably suffice to withstand a motion to dismiss a claim under Rule 13e-3").

426. Rule 13e-3(g)(2), 17 C.F.R. § 240.13e-3(g)(2).

427. Rule 13e-3(g)(2)(i), 17 C.F.R. § 240.13e-3(g)(2)(i). In addition, the (g)(2) exception requires that holders of the Target Securities continue to be entitled to Exchange Act reporting information from the issuer and that the New Securities continue to be listed on an exchange or authorized for quotation on an inter-dealer system. Rule 13e-3(g)(2)(ii)-(iii), 17 C.F.R. § 240.13e-3(g)(2)(ii)-(iii). The New Security need not be listed or quoted on the same exchange or system as the Target Security to satisfy this requirement. *See id.*; *cf.* First Fidelity Savings & Loan Ass'n, SEC No-Action Letter (avail. Aug. 28, 1984) (LEXIS, Fedsec library, Noact file) (Staff declined to take a no-action position because the New Security itself would neither be registered pursuant to section 12 nor subject to the reporting requirements of section 15, although counsel had represented that the issuer was a section 12(g) reporting company that made the requisite information available to the public in its periodic filings).

428. The exception itself states that the rights contemplated include, but are "not limited to,

SEC has stated, however, that the protection of Rule 13e-3 is not needed when the security holders "are on an equal footing and are permitted to maintain an *equivalent* or *enhanced* equity interest."[429]

In a Registered Exchange proposed by Savin Corporation, the Staff took a no-action position in connection with the proposed use of the (g)(2) exception for Savin's exchange of new convertible preferred stock for existing convertible debt securities and existing convertible preferred stock.[430] The new convertible preferred stock had an enhanced conversion rate over the Target Securities, voting rights equal or superior to the Target Securities and liquidation rights only slightly lower than to the Target Securities.[431] The dividend rate of the new preferred stock was lower than that of the target preferred stock and was payable in additional shares of new preferred stock.[432] The corporation, however, had been unable to pay any cash dividends on the target preferred stock or interest on the debt securities.[433] The redemption price of the new preferred stock was also lower than that of the target preferred stock, reflecting the "distressed financial condition of the [c]orporation."[434]

In another no-action letter concerning the (g)(2) exception, Trans World Airlines proposed to exchange any or all outstanding subordinated convertible debentures for a new issue of subordinated convertible debt with a different interest rate, maturity date, conversion ratio, and sinking fund and optional redemption terms.[435] The Staff took a no-action position, noting that the new debt securities would be similar to the old securities in that both would "be entitled to an annual interest payment, convertible into Trans World Common Stock, subject to sinking fund requirements, subordinated to Senior Debt, listed on the New

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voting, dividends, redemption and liquidation rights." Rule 13e-3(g)(2)(i), 17 C.F.R. § 240.13(g)(2)(i) (1990).

429. Exchange Act Release No. 16,075, *supra* note 418, at 82,127 (emphasis added). A number of no-action letters issued by the Staff support this statement—even when the New Securities differ greatly from the Target Securities. *See, e.g.*, Snyder Oil Partners L.P., SEC No-Action Letter (avail. Sept. 18, 1987) (LEXIS, Fedsec library, Noact file) (exemption for exchange of new common stock of a new corporation for old common units of predecessor limited partnership); First Pennsylvania Corp., SEC No-Action Letter (avail. July 12, 1984) (LEXIS, Fedsec library, Noact file) (exemption for exchange of new convertible depository preferred stock for old convertible debentures).

430. Savin Corp., SEC No-Action Letter (avail. June 28, 1988) (LEXIS, Fedsec library, Noact file).

431. *Id.*

432. *Id.*

433. *Id.*

434. *Id.*

435. Trans World Airlines, SEC No-Action Letter (avail. Nov. 2, 1980) (LEXIS, Fedsec library, Noact file).

York Stock Exchange and subject to an indenture qualified under the Trust Indenture Act of 1939."[436] The Staff apparently accepted the representations that the variations in the particular terms of these rights were designed to give the New Securities a slight premium over the market value of the Target Securities.[437]

In contrast, the Staff refused to take a no-action position regarding an exchange proposed by Damson Oil Corp.[438] In a proposed Section 3(a)(9) Exchange, Damson proposed to offer new convertible preferred stock for outstanding convertible preferred stock.[439] The conversion features of both the Target Securities and the New Securities did not activate for a period of time after the initial issuance of each series of securities; however, the Target Securities had become convertible by the time the Staff responded to Damson's no-action request.[440] The conversion of the New Securities could have been delayed by Damson up to eighteen months from the time the Target Securities became convertible. In its response to Damson's no-action request, the Staff noted that the Target Securities were then presently convertible, and that the New Securities would not be convertible when issued.[441]

3. Disclosure and filing requirements

Corporations must file a Schedule 13E-3 with the SEC concurrently with the commencement of an Exchange Offer whenever Rule 13e-3 applies, and no exemption is available under the Rule.[442] Many of the disclosure items of Schedule 13E-3 are similar or identical to those of Schedule 13E-4 and Schedule 14D-1. Unlike the other self-tender offer disclosure rules, however, Item 8 to Schedule 13E-3 requires the issuer (of its affiliate, if applicable) to state whether it "reasonably believes that

436. *Id.*; *see also* American Midland Corp., SEC No-Action Letter (avail. Sept. 21, 1986) (LEXIS, Fedsec library, Noact file) (no-action position granted for use of the Rule 13e-3(g)(2) exemption in an exchange of new convertible subordinated debentures for old convertible subordinated debentures).

437. Trans World Airlines, *supra* note 435. For a brief discussion of some of the features of New Securities that can create this premium, see *supra* text accompanying notes 39-41.

438. Damson Oil Corp., SEC No-Action Letter (avail. May 4, 1984) (LEXIS, Fedsec library, Noact file).

439. *Id.*.

440. *Id.*

441. *Id.*

442. Schedule 13E-3, General Instruction A, 17 C.F.R. § 240.13e-100 (1990). When the transaction is also subject to, for example, requirements under Regulation 14E or Rule 13e-4, the Schedule 13E-3 need only contain a cover sheet, a cross-reference sheet indicating where the information required by Schedule 13E-3 may be found in the other material, a copy of such other material, and a signature page. Schedule 13E-3, General Instruction F, 17 C.F.R. § 240.13e-100; Exchange Act Release No. 16,075, *supra* note 418, at 82,128.

the Rule 13e-3 transaction is fair or unfair to unaffiliated security holders"[443] and to discuss "in reasonable detail the material factors upon which the belief . . . is based."[444] Item 9 requires a summary of any "report, opinion (other than an opinion of counsel) or appraisal from an outside party which is materially related to the Rule 13e-3 transaction" including any report relating to the fairness of the transaction or the fairness of the consideration.[445] Additionally, the person filing the Schedule must state whether a majority of outside directors retained an unaffiliated representative to report on the fairness, or negotiate the terms, of the transaction on behalf of the unaffiliated security holders.[446] All of these items must be prominently set forth in a "special factors section . . . in the forepart of the disclosure document furnished to security holders."[447]

C. The Proxy Rules

Section 14(a) of the Exchange Act[448] and the rules and regulations enacted thereunder[449] govern the solicitation of proxies for votes and consents of holders of securities that are registered under section 12 of the Exchange Act.[450] The proxy rules apply to Exchange Offers primarily in the following situations: (1) a corporation conducts a Consent Solicitation to modify terms of Target Securities registered under section 12 of the Exchange Act;[451] (2) the securities exchange on which the corporation's common stock is listed conditions approval of an additional list-

443. Schedule 13E-3, Item 8(a), 17 C.F.R. § 240.13e-100.

444. *Id.* Item 8(b), 17 C.F.R. § 240.13e-100.

445. *Id.* Item 9(a), (b), 17 C.F.R. § 240.13e-100. Such report, opinion or appraisal must be made available to holders of the Target Securities for inspection and copying. *Id.* Item 9(c), 17 C.F.R. § 240.13e-100.

446. *Id.* Item 8(d), 17 C.F.R. § 240.13e-100.

447. Exchange Act Release No. 16,075, *supra* note 418, at 82,129. The information called for in Item 7, regarding the purpose(s), alternatives, reasons and effects of the transaction must also be set forth in the "special factors" section. Schedule 13E-3, Item 7(a)-(d), 17 C.F.R. § 240.13e-100.

448. Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n(a) (1988). The proxy rules define the term "proxy" as including "every proxy, consent or authorization." Rule 14a-1(f), 17 C.F.R. § 14a-1(f) (1988).

449. Regulation 14A, 17 C.F.R. §§ 240.14a-1 to .14a-102, 240.14b-1, .14b-2 (1990). Regulation 14C governs transactions in which every holder of a class of securities registered pursuant to section 12 of the Exchange Act is entitled to vote or consent to a given transaction but from whom proxies or consents are not solicited. Rule 14c-2, 17 C.F.R. § 240.14c-2 (1990). Regulation 14C basically parallels Regulation 14A. *See supra* note 25.

450. 15 U.S.C. § 78*l* (1988). Section 12 securities are equity securities, including debt securities convertible into equity securities, held by more than 500 holders, and equity and debt securities (including non-convertible debt securities) listed on a national securities exchange. Securities Exchange Act of 1934, § 12(b)(g), 15 U.S.C. § 78*l*(b), (g). See *supra* note 386 for the definition of "equity securities" under the Exchange Act, including the proxy rules.

451. Modifications may be sought to permit a contemplated restructuring or other transac-

ing application for any common stock that may be offered as New Securities in an Exchange Offer (or common stock issuable upon conversion of such New Securities) on stockholder approval if that new common stock would represent a significant percentage of the outstanding voting power of the corporation;[452] or (3) the New Securities that would be issued in the Exchange Offer are shares of stock that require an amendment to the corporation's current charter to be properly authorized.[453]

A corporation conducting an Exchange Offer and Consent Solicitation that is subject to the proxy rules will have to present information to security holders in the form of a proxy statement that complies with Schedule 14A under the Exchange Act and that must be filed with the SEC.[454] Rule 14a-6 of the Exchange Act requires that a corporation furnish preliminary proxy materials to the SEC at least ten calendar days

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tion, or to create an inducement for holders of Target Securities to participate in a Section 3(a)(9) Exchange. *See supra* notes 44 & 303-08 and accompanying text.

452. The New York Stock Exchange, Inc. (the NYSE) requires such stockholder approval as a "prerequisite to listing when":

> [c]ommon stock or securities convertible into or exercisable for common stock are to be issued in any transaction or series of related transactions, other than a public offering for cash, (i) if the common stock has or will have upon issuance voting power equal to or in excess of 20% of the voting power outstanding* before the issuance of such stock or securities convertible into or exercisable for common stock, or (ii) the number of shares of common stock to be issued is or will be equal to or in excess of 20% of the number of shares of common stock outstanding before the issuance of the stock.

NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 312.03(c) (2d ed. 1990) (" 'Voting power outstanding' refers to the aggregate number of votes which may be cast by holders of those securities outstanding which entitle the holders thereof to vote generally on all matters submitted to the company's security holders for a vote.' "). The NYSE rules allow for exemption from this rule when the delay caused by a stockholder vote "would seriously jeopardize the financial viability of the enterprise," and the company audit committee endorses that conclusion. *Id.* (omitting other requirements).

The American Stock Exchange also requires stockholder approval for the sale or issuance by the issuer of common stock (or securities convertible into common stock) equal to 20% or more of presently outstanding stock for less than the greater of book or market value of the stock. AMERICAN STOCK EXCHANGE COMPANY GUIDE § 713 (1988); *cf.* Schedule D to the By-Laws, Part III § 5(i), NASD Manual (CCH) ¶ 1812, at 1573-1 (1990) (requiring stockholder approval of issuances of common stock or securities convertible into common stock by NASDAQ traded corporations if the issuance will result in a change of control of the issuer; if the issuance is in connection with the acquisition of another corporation and represents 20% or more of the common stock or voting power outstanding; or if the issuance is in connection with a non-public offering transaction and represents 20% or more of the common stock or voting power outstanding).

453. The most obvious examples of this would occur when the class or series of new securities which would be capital stock are not currently authorized, or there is not sufficient remaining authorized but not issued shares of an authorized class or series of capital stock should the maximum number of shares be issued in the Exchange Offer.

454. Schedule 14A, 17 C.F.R. § 240.14a-101 (1990).

before definitive copies are sent to security holders.[455] This filing is intended to give the SEC time to review and comment on the proxy statement prior to initial mailing; however, the SEC usually takes significantly longer to review proxy material relating to restructurings. Consequently, this review process may delay the mailing of a Section 3(a)(9) Exchange if the corporation wants to disseminate an integrated Offering Circular/Consent Solicitation Statement. If the SEC requires revision of the preliminary proxy materials or if a new proposal is added, the ten-day period does not recommence unless the revisions or new proposals are considered a fundamental change in the proxy disclosure.[456] All definitive proxy materials should be sent to the SEC and to each exchange upon which any securities of the corporation are listed no later than the date such materials are first sent or given to security holders.[457]

D. Trust Indenture Act

The TIA applies to restructurings that include the issuance of New Securities that are secured or unsecured publicly issued debt securities in an aggregate principal amount greater than ten million dollars.[458] Although the TIA incorporates most of the Section 3(a) exemptions of the Securities Act, it does not incorporate Section 3(a)(9).[459] Therefore, in every Section 3(a)(9) Exchange, the indenture relating to the New Security must be filed with and qualified by the SEC.[460]

The issuer of debt securities subject to the TIA, but exempt from registration under the Securities Act, is required to file an application to qualify the indenture underlying such debt securities on a Form T-3[461] with the SEC.[462] The Form T-3 need only be filed with the SEC prior to

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455. Rule 14a-6, 17 C.F.R. § 240.14a-6 (1990).

456. *Id.*

457. Rule 14a-6(c), 17 C.F.R. § 240.14a-6(c) (1990).

458. Trust Indenture Act of 1939, §§ 303-05, 15 U.S.C. §§ 77ccc-eee (1988), *as amended by* Trust Indenture Reform Act of 1990, Pub. L. No. 101-550 (Nov. 15, 1990).

459. *Id.* § 304(a)(4)(A), 15 U.S.C. § 77ddd(a)(4)(A).

460. *Id.* §§ 305-06, 309, 15 U.S.C. §§ 777eee-fff, iii (1988). This includes a supplemental indenture that effects an amendment of existing debt securities that is so substantial that it is deemed to effect the issuance of a "New Security," but such an issuance is exempted from Securities Act registration because of Section 3(a)(9). See *supra* notes 360-81 and accompanying text describing how the amendment of existing securities can be deemed to create a "New Security."

461. Form T-3, 17 C.F.R. § 269.3 (1990).

462. Trust Indenture Act of 1939, § 307(a), 15 U.S.C. § 77ggg(a) (1988); Rule 7a-1, 17 C.F.R. § 260.7a-1 (1990); Rule 7a-3(a), 17 C.F.R. § 260.7a-3(a) (1990). In addition, the trustee that will serve under the indenture must file a Form T-1, 17 C.F.R. § 269.1 (1990), or a Form T-2, 17 C.F.R. § 269.2 (1990) with the SEC. Rule 5a-1, 17 C.F.R. § 260.5a-1 (1990); Rule 5a-2, 17 C.F.R. § 260.5a-2 (1990).

the commencement of a Section 3(a)(9) Exchange;[463] however, the qualification must become effective prior to the consummation of the Section 3(a)(9) Exchange and the issuance of the New Securities that are debt.[464]

VI. CONCLUSION

In these tumultuous economic times, both healthy and troubled corporations will continue to search for efficient and cost effective methods of restructuring outside of bankruptcy. Out-of-court restructurings, whether Section 3(a)(9) Exchanges, Consent Solicitations, Registered Exchanges, Section 4(2) Private Exchanges, Section 3(a)(10) Settlement Exchanges, Reclassifications, Prepackaged Bankruptcies, or hybrids and combinations of these transactions, all can offer distinct advantages over the sometimes lengthy, costly and uncertain process of traditional bankruptcy proceedings. In particular, Section 3(a)(9) Exchanges and Consent Solicitations, in combination or separately, provide especially attractive methods of avoiding the problems associated with a bankruptcy proceeding. As a result, these transactions remain important alternatives for a corporation considering a restructuring.

While Section 3(a)(9) Exchanges and Consent Solicitations can be commenced quickly and completed cost effectively, these transactions are not necessarily simple, at least from a legal or logistical analysis perspective, and require a working understanding of many legal specialties. This Article has attempted to highlight and analyze the multitude of securities law issues that arise in these transactions, hopefully giving practitioners—and indirectly their clients—an opportunity to take full advantage of the benefits of these transactions.

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463. Letter to Neal S. McCoy, Esq., Skadden, Arps, Slate, Meagher & Flom, from SEC (June 23, 1989) (cited as Mississippi Chem. Corp., SEC No-Action Letter (avail. June 23, 1989) (LEXIS, Fedsec library, Noact file) (Staff stating that "a solicitation relating to an offer of debt securities exempt from registration pursuant to Section 3(a)(9) of the Securities Act may commence when an application for qualification of an indenture has been filed under the [TIA].") (clarifying Mississippi Chem. Corp., SEC No-Action Letter (Nov. 25, 1988) (LEXIS, Fedsec library, Noact file) (intimating a different conclusion))). *See* Trust Indenture Act of 1939, § 306(c), 15 U.S.C. 7fff(c) (1988) ("It shall be unlawful to offer to sell any [debt] security which is not registered under the Securities Act . . . , unless such security . . . is to be issued under an indenture and an *application* for qualification has been *filed* as to such indenture." (emphasis added)).

464. Trust Indenture Act of 1939, § 306, 15 U.S.C. § 77fff. The Staff, however, has taken a no-action position that persons other than issuers or underwriters can enter into when-issued contracts for the purchase or sale of debt securities to be issued pursuant to a Section 3(a)(9) Exchange after a Form T-3 has been filed but before qualification becomes effective. Jerome L. Coben, Esq., Skadden, Arps, Slate, Meagher & Flom, SEC No-Action Letter (avail. Mar. 12, 1986) (LEXIS, Fedsec library, Noact file). "This no-action position . . . reversed the SEC's prior position that when-issued trading was prohibited prior to the qualification of an indenture." C. JOHNSON, *supra* note 280, at 755-56 n.71.