Hedge Fund Activism in the Enforcement of Bondholder Rights

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Hedge Fund Activism in the Enforcement of Bondholder Rights

by

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February 2008

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Abstract

Activist hedge funds have transformed how bondholders respond to violations of their contractual rights. Insurance companies and mutual funds, the traditional investors in bonds, often slept on their rights and turned active only little and late. Hedge funds, by contrast, seek out opportunities for activism in order to make profits. In the wake of their activism, hedge funds have not only benefited themselves, but their fellow bondholders as well.

Alas, the remedy scheme for violations of bondholders rights – in particular, the centrality of the acceleration remedy – introduces its own set of imperfections. When treasury interest rates have increased or the stock price of a company that has issued convertible bonds has declined, acceleration generates a windfall: bondholders receive compensation in excess of the harm associated with the violation. In these cases, activists will spend excessive resources in detecting and pursuing potential claims and companies have excessive incentives to stave off potential violations. When treasury rates have declined, the tables are turned, and bondholder rights are underenforced.

Whether this selective enforcement has generated aggregate benefits for bondholders and companies in the short term is unclear. Over the long term, however, the market will adjust to hedge fund activism by changing other terms in corporate bond indentures. In particular, we suggest that the contractual remedy scheme be revised by giving companies an expanded defeasance option and offering bondholders a make-whole premium upon acceleration, which would reduce, respectively, the incentives for overenforcement and underenforcement.
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Introduction

Hedge funds have caused some of the most significant recent changes in financial markets. Like mutual funds, hedge funds are pooled investment vehicles that invest primarily in publicly traded securities. But unlike mutual funds, hedge funds are open only to rich individuals and institutional investors and are therefore exempt from most regulations. That most individuals cannot invest in hedge funds, however, has not hurt their popularity. The assets under management by hedge funds have grown at stratospheric rates, from $40 billion in 1990 to more than $1.7 trillion in 2007.¹

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

In an earlier article, we examined the involvement of hedge funds, as shareholders, in corporate governance and in corporate control transactions. We


² Bd. of Governors of the Fed. Reserve Sys., Flow of Funds Accounts of the United States [hereinafter Flow of Funds], Third Quarter 2007, tbls. L.118, 119 and 122 (reporting $5.8 trillion, $3.2 trillion and $8.0 trillion in assets for private pension funds, public pension funds and mutual funds, respectively).
argued that hedge fund activism differs in quantity and quality from the activism of traditional institutional investors – it is more strategic, directed to more significant changes, and entails greater expenses – and we analyzed the reasons for these differences and their normative implications.\(^3\)

In this Article, we turn to a different facet of hedge fund activism: their engagement as holders of corporate bonds. We show that the rise of hedge funds and other activist investors\(^4\) has led to a transformation in the way bondholder rights are enforced. In the past, many violations of bondholders’ rights have remained undetected and unsanctioned. This historic underenforcement problem was rooted in the collective action problems facing bondholders; in the lack of substantial incentives for the indenture trustee – the supposed bondholder representative – to represent bondholder interests vigorously; in contractual provisions in the bond indenture – the document that governs most bondholder rights – that provide little help in detecting violations and impose barriers on the ability of bondholders to enforce their rights; and in a relatively accommodating attitude of insurance companies and mutual funds, the traditional holders of corporate bonds.

With the rise of hedge funds, this historic underenforcement problem has given way to a new enforcement paradigm. Unlike traditional investors, activist hedge funds look for bonds where companies have violated, have arguably violated, or are about to

\(^3\) Marcel Kahan & Edward Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Penn. L. Rev. 1021 (2007).

\(^4\) In addition to hedge fund, some private investment managers have also pursued activist strategies as bondholders. For the remainder of this article, references to hedge funds as activist also encompass these private investment managers.
violate, some contractual provisions, buy up a large quantity of the issue, and then pounce. Because hedge funds have the sophistication to detect potential violations; the financial resources to acquire substantial amounts of a single bond issue; the willingness to take on issuers; and, perhaps most importantly, because hedge funds have decided to pursue, and become experienced in pursuing, this strategy, they have been able to greatly ameliorate the historic underenforcement problem.

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

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

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

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

I. Recent Examples of Bondholder Activism

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

A. He Says, She Says ...

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

**Citadel Broadcasting:** On February 21, 2006, a group of 6 hedge funds – Camden, Kamunting, RG Capital, SSI, Whitebox and Zazove – sent a default notice to Citadel Broadcasting Corp.\(^5\) The funds held Citadel’s 1.875% Convertible Subordinated Notes, which traded at a substantial discount to their principal amount (“par”)\(^6\) and the bulk of which they had acquired around the time that they gave the default notice.\(^7\) The


\(^6\) Summons, Citadel Broadcasting Corp. v. Camden Asset Management LP et al., July 17, 2006, at 23.

\(^7\) According to the 13F filings by these funds, they held an aggregate of $46 million in Notes as of December 31, 2005 and an aggregate of $98 million as of March 31, 2006. Since $330 million of notes were outstanding, holders needed $82.5 million to issue a default notice. Curiously, two of the named funds - Camden and SSI - did not disclose any holdings of Notes as of either date. However, Linden Capital, another activist hedge fund, acquired $39.5 million Notes between December 31, 2005 and March 31, 2006.
notice related to the February 6 announcement that Citadel and the Walt Disney Company had entered into a merger agreement. According to that agreement, ABC Chicago FM Radio, Inc., a Disney subsidiary, was to merge with Alphabet Acquisition Corp., a Citadel subsidiary, with ABC shareholders receiving one share of Citadel for each share of ABC (for a total of 52% of Citadel's stock). Prior to the merger, Disney was to distribute its stock of ABC to its shareholders, so that Disney shareholders (rather than Disney itself) would receive the Citadel stock in the merger. Citadel's controlling shareholder, Forstmann Little & Co., had signed a Support Agreement obligating it to oppose any alternative transaction. \(^8\)

The funds claimed that the Disney transaction constituted a “Fundamental Change” under the indenture for the notes – defined to included certain mergers of the “Company” as well as any person becoming the beneficial owner of 50% of more of Citadel’s stock – and thus triggered a right to require Citadel to repurchase the notes at par. \(^9\) On July 17, Citadel filed a declaratory judgment action \(^10\) arguing that no “Fundamental Change” had occurred because Citadel itself did not “merge” and Disney would not become an owner of more than 50% of Citadel’s stock. The holders and the trustee countered that Disney, as a result of the Support Agreement, became a “beneficial owner” of the 67.6% of Citadel stock held by Forstmann under the broad

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\(^8\) Summons, Citadel Broadcasting Corp. v. Camden Asset Management LP et al., July 17, 2006, at 19-29.

\(^9\) Trustee’s Answer to Amended Complaint, Citadel Broadcasting Corp. v. Wilmington Trust Co., March 15, 2007.

definitions of Rule 13d-3 under the Securities Exchange Act, which were incorporated into the indenture. As of November 2007, discovery in the case was completed and motions for summary judgment were pending.

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

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11 17 C.F.R. 240.13d-3(d).

12 Disney had indeed filed a Schedule 13D disclosing that it “may be deemed” to have beneficial ownership of that stock,” though that Schedule also said that it should not be deemed to constitute an admission that Disney was a beneficial owner. Citadel Broadcasting Corp. Schedule 13D, Feb. 6, 2006.


14 By the time of agreement was executed, Sandelman had increased its holdings of the 8-1/2% Notes from $66 million to $150.71 million (out of $350 million outstanding) and together with Sandell held a majority of the outstanding Notes – sufficient to approve the waivers contemplated by the Exchange and Forbearance Agreement. It is unclear what happened to Xerion. Xerion, however, held only $5 million of Notes when the notice of default was given, compared to $26 million for Sandell and $66 million for Sandelman.

15 For $1000 in old Notes, holders were to receive $950 in new Notes and a $50 cash consent payment.
increase semi-annually to 15.25% unless redeemed), in exchange for a waiver of any defaults under the 8-1/2% notes.\(^\text{16}\)

The activism of the hedge funds seems to have been profitable. The old notes traded at around 94% of the principal amount both at the time of the notice of the default and before the exchange offer was announced. On March 12, however, the price shot up by over 6% to 100.25% of par.\(^\text{17}\)

B. Read the Fine Print

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

**Regal Entertainment.** Convertible bonds issued by Regal Entertainment were subject to an indenture clause according to which the conversion price would be reduced according to a specified formula if Regal paid dividends above a threshold

\(^{\text{16}}\) The exchange offer was commenced four days later and by the March 29, the expiration of the solicitation period, 98.52% of the old Notes had been tendered. An additional 0.66% of the old Notes were tendered by April 13, the expiration for the exchange offer. Holders of these notes did not receive the $50 consent payment.

\(^{\text{17}}\) For other examples under this rubric, see, e.g., Energy Corp. of America v. MacKay Shields, 2003 U.S. App. Lexis 25230 (dispute over whether net proceeds of an asset sale defined as “[t]he aggregate cash proceeds received by [ECA] in respect of any Asset Sale ... net of ... taxes paid or payable as a result thereof (after taking into account any available tax credits or deductions and any tax sharing arrangements) ... “ are to be reduced by taxes resulting from the sale or only by taxes that were actually payable (the difference being due to tax credits and deductions unrelated to the asset sale); Moody’s Corporate Finance, SEC Filing Delays and Potential Bond Defaults: What is the Issuer’s Real Promise?, January 2008 [hereinafter Moody’s Report] (reviewing several cases on whether covenant that required filing of copies of SEC reports with trustee within specified number of days after the reports were filed with the SEC is violated when company did not file any reports with the SEC by their due dates).
amount. Regal did in fact pay such dividends and calculated the reduction based on its stock price prior to the ex-dividend date, as provided in conventional indenture clauses. The Regal indenture, however, specified the use of the market price prior to the dividend date, rather than the ex-dividend date. Amaranth LLC, a hedge fund, noticed the problem, purchased around $70 million of notes in early 2005, and then argued that holders were entitled to receive 69.4 shares of Regal stock (rather than 64 shares) when they converted $1000. Regal countered that the wording of the covenant represented a scrivener’s error.

**KCS Energy.** 7-1/8% Senior Notes by KCS Energy Inc. contained a change of control repurchase right which was triggered when a majority of the directors of the “Company” were neither “nominated for election or elected” with the “approval” of a majority of KCS’s pre-merger directors. On July 12, 2006, KCS merged into Petrohawk Energy Corp. with Petrohawk surviving the merger. Prior to the merger, the board of KCS had adopted a resolution “confirm[ing] and approv[ing]” the nomination and election of all the post-merger directors. But only 4 of 9 members of the post-merger board were neither “nominated for election or elected” with the “approval” of a majority of KCS’s pre-merger directors.

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18 Amaranth Advisors LLC, Form 13F for Dec. 31, 2004 (showing holdings of $6 million of notes); Form 13F for Mar. 31, 2005 (showing holdings of $73 million of notes)

19 As the stock price of Regal was about $20, this difference amounted to about $110 per $1000 principal amount, or $10 million for Amaranth.

20 Regal Entertainment Group v. Amaranth LLC, 894 A.2d 1104 (Del. Ch. 2006). The substantive issue in this case was never conclusively resolved. Regal brought a declaratory action that its interpretation was correct. But Amaranth, which lost $6.5 billion in commodities speculation, essentially went bust in 2006 and agreed to the dismissal of the Regal case without prejudice against any holder other than itself.

21 Petrohawk Energy Corp. v. Law Debenture Trust Co. of N.Y., 2007 WL 2248150 (Del.Ch.), at 8.
board of Petrohawk (the “Company” for purposes of the Indenture) were actual pre-
merger directors of KCS. A group of noteholders, reportedly organized by W. R. Huff
Asset Management22 (a firm specializing in high yield bonds), replaced the indenture
trustee23 and instructed the new trustee24 to file a suit arguing that the merger
constituted a change of control.25 The court ruled in favor of Petrohawk, reasoning that
the noteholders were “attempting to exploit imprecise contract drafting” and to “use a
technicality” to obtain a benefit.26

World Airways, Inc. In October 2003, World Airways announced that it had
reached an agreement with select bondholders to exchange $26 million of their bonds
and that it would redeem the remaining $15 million, held by other bondholders, for cash.
Whitebox, a hedge fund, owned bonds slated for redemption and claimed that World
Airways had violated express indenture provisions as well as an implied covenant of
good faith and fair dealing. When Whitebox sued, World Airways argued that Whitebox
could not institute a suit until it complied with the “no-action clause,” which required
holders of 25% of the outstanding bonds to notify the trustee and then wait for 60 days

22 Telephone Conversation with Joseph McLaughlin, Partner, Simpson, Thatcher & Bartlett, LLP., August 17, 2007. Mr. McLaughlin represented Petrohawk in the
litigation described herein.

23 Petrohawk Energy Corp. v. Law Debenture Trust Co. of N.Y., 2007 WL 2248150 (Del.Ch.).

24 Oral Argument, page 48, 50-51 (counsel for trustee stating that trustee is
acting upon instructions of holders of 70% of Notes to bring lawsuit).

25 See Petrohawk Energy Corp. v. Law Debenture Trust Co. of N.Y., 2007 WL 2248150 (Del.Ch.).

26 Id. at 2, 25. The Delaware Supreme Court affirmed. Law Debenture Trust Co. of New York v. Petrohawk Energy Corp., 2008 WL 223268 (Del.).
before bringing suit. The court rejected this argument, finding that World Airways had made compliance with the no-action clause impossible because the forthcoming redemption was fewer than 60 days from its announcement.\footnote{2006 WL 358270 (N.D. Ga. 2006).}

C. What’s “Substantially” All?

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

Consider, for example, the Jean Couto Group (JCG) which, on August 24, 2006, announced the sale of its U.S. drug stores to Rite Aid Corp. JCG argued that the transaction involved “substantially all” of its assets, with Rite Aid assuming the $850 million of JCG’s 8.5% Senior Subordinated Notes and JCG being released.\footnote{Form 6-K, Exhibit 99.1, Sep. 18, 2006.} A group of noteholders, consisting mostly of hedge funds and asset management companies, however, took the view that the sale did not involve “substantially all” assets, that JCG would remain liable under the indenture, and that another covenant – applicable to the sale of significant, but less than “substantially all,” assets – would kick in and inhibit the transaction. In December 8, 2006, JCG filed a declaratory judgment action in the Southern District of New York. Concurrent with the litigation, JCG made an offer to buy the notes coupled with a solicitation of bondholder consents to remove any troublesome

\footnote{2006 WL 358270 (N.D. Ga. 2006).}

\footnote{Form 6-K, Exhibit 99.1, Sep. 18, 2006.}
covenants. On March 30, 2007, on the eve of trial, JCG and a majority of noteholders struck a deal. JCG agreed to offer to buy the notes at a price determined by discounting the remaining scheduled payments at a treasury yield plus 150 basis points and the noteholders agreed to sell and deliver their consents to the indenture amendments.  

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

29 Jean Couto Group, Press Release, March 30, 2008, JCG’s previous offer involved a discount rate of treasury plus 200 basis points.


D. The Failure to File Boom

Several companies have recently run into problems as a result of their failure to file financial reports with the SEC. Corporate bond indentures inevitably contain a covenant requiring issuers to file with the trustee copies of periodic reports required to be filed with the SEC. When the issuer cannot make the SEC filings, and thus does not provide copies to the trustee within the requisite time period, a default can arise.33

In the Appendix, we have collected 42 companies that have received default notices for a failure to file in the last 5 years or had to seek waivers from their bondholders. The aggregate principal amount of the affected bonds is over $25 billion. In most of the cases, the identity and role of the bondholders in pursuing the defaults was not disclosed. But in the six cases where we could ascertain the identity of the bondholders who issued a default notice or accelerated, they were always hedge funds. (See Table 1.) This suggests that hedge funds account for at least a significant percentage of the other 13 cases where unidentified bondholders gave default notices.

33 The “failure to file” issue also raises another interesting problem. Under 14 (c) of the Securities Exchange Act and the rules promulgated under it, you are not allowed to hold an annual meeting (or special meeting) without having sent out your annual report. Thus, companies which have not filed their 10-Ks, they are barred by federal law from holding shareholder meetings. Delaware law, however, requires companies to hold shareholder meetings every year (in approximate 12 month intervals) for the election of directors. See Newcastle Partners v. Vesta Insurance Group, 887 A.2d 975 (Del. Ch. 2005) aff’d 906 A.2d 807 (Del. 2005)(table); Esopus Creek Value v. Haof, 913 A.2d 593 (Del. Ch. 2006). Federal law has the perverse effect that shareholders cannot replace directors of those companies that have not filed their SEC reports. Delaware has basically taken the view that the SEC can’t be serious.
or accelerated. Moreover, as shown in Table 1, hedge funds played a major role in negotiating the resolution to the default, i.e. what and how much bondholders receive to consent to amendments and waivers that eliminate the default.

Table 1: Failure to File Cases

<table>
<thead>
<tr>
<th></th>
<th>Default Notice or Acceleration</th>
<th>Negotiations/Resolution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hedge Funds</td>
<td>6</td>
<td>1</td>
</tr>
<tr>
<td>Traditional Institutions</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Both HF and Trad. Inst.</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Unidentified Holders</td>
<td>13</td>
<td>3</td>
</tr>
<tr>
<td>Trustee only or Waiver w/out Default Notice</td>
<td>23</td>
<td></td>
</tr>
<tr>
<td>Likely Involvement by Unidentified Holders</td>
<td></td>
<td>11</td>
</tr>
<tr>
<td>Potential Involvement by Unidentified Holders</td>
<td></td>
<td>7</td>
</tr>
<tr>
<td>No Negotiations/Resolution*</td>
<td></td>
<td>17</td>
</tr>
</tbody>
</table>

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

Unlike the earlier examples, most of the failure to file cases involve covenant violations that were obvious and undisputed. What makes these cases notable is not that hedge funds detected “defaults” that others had overlooked but that, once the default had occurred, hedge funds vigorously pursued the rights arising out of these

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

35 In nine cases, litigation arose over whether there had been a default or acceleration was proper. See, e.g., Moody’s Report, supra note 17. In some others, the company disputed that a default had occurred but no litigation arose.
defaults. In the past, when companies were late in filing their SEC reports, bondholders would look the other way – even though the company was technically in default and holders could take steps to seek repayment. Nowadays, activist holders use these defaults to extract significant concessions.

Another example in that vein relates to Metaldyne Corp. which, on August 31, 2006, announced that it had entered into a merger agreement with Asahi Tec Corp. Two of Metaldyne’s bond issues – the 11% Senior Subordinated Notes and the 10% Senior Notes – contained change of control covenants which required the company to offer to purchase the notes at 101% of their principal amount upon a merger. The merger was conditioned on obtaining bondholder consents for the elimination of the covenant.

Prior to the merger announcement, the bonds traded at around 80 cents on the dollar, and Metaldyne had planned to make a tender offer for the bonds at around the pre-announcement market price. After the agreement was announced, hedge funds and other activists banded together. The activists either already had or, more likely, quickly acquired sufficient notes to assure that the change of control provision could not be eliminated without their consent. They then entered into a “lockup agreement” under which they agreed to consent to the elimination of the covenant only if a supermajority –

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36 Hedge Funds Play Hardball With Firms Filing Late Financials, Wall St. J. online, Aug. 29, 2006, at A1; see also The Unexpected Ascent of Covenant Defaults, Richard Aftanas & Yossi Vebman, Financier Wordwide, October 2005 (describing default notices sent due to failure to file SEC reports as a “previously unknown phenomenon”).


holders of 90% of the group for the Senior Subordinated Notes and of 80% for the Senior Notes – agreed.\textsuperscript{39}

Metaldyne was now forced to negotiate. It ended up making a huge consent payment ($127.50 for $1000 principal amount for Senior Subordinated Notes and $80 for the Senior Notes). In addition, it agreed to purchase at least $25 million of the Senior Notes at par, provide security, and tighten other covenants.\textsuperscript{40} Partly due to the added protections, the notes traded at around 108% of par at the end of 2006 - way above both the pre-announcement market price and the exercise price of the change of control put right.

II. Why Hedge Funds? Why Now?

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

A. Why Now?

Two reasons may explain why bondholder activism has recently increased. First, there may be more opportunities for profitable activism than in the past. This clearly

\textsuperscript{39} Majority of Holders of Metaldyne 11% Senior Subordinated Notes Due 2012 Announce Execution of Lockup Agreement, BusinessWire Oct. 13, 2006; Majority of Holders of Metaldyne 10% Senior Notes Due 2013 Announce Execution of Lockup Agreement, BusinessWire Nov. 3, 2006.

\textsuperscript{40} See Metaldyne Corp., Consent Solicitation Statement, Dec. 4, 2006, at 1-8, 31-36.
accounts, at least in part, for the “Failure to File” cases. The Sarbanes-Oxley requirement that CEOs certify their company’s SEC reports\(^4\) has probably injected additional caution and corresponding delay into the preparation of these reports. Moreover, at least 20 of the 42 issuers that received default notice or waivers related to a failure to file were also on a Wall Street Journal list of companies that had come under scrutiny for their stock options.\(^2\) To clear up these problems, issuers often have to delay filing their reports with the SEC.\(^3\)

Second, and more importantly, the assets under management by hedge funds, the prime activists, have grown significantly – from $40 billion in 1990 to $1.7 trillion in 2007.\(^4\) If hedge funds are more likely to become activist – and indeed hedge funds have long engaged in bondholder activism\(^5\) – and hedge funds now manage more assets, the recent increase in activism may be due to the rise of hedge funds.

\(^{41}\) Sarbanes-Oxley Act, section 302.


\(^{43}\) Moreover, options back-dating seems to be concentrated in the high tech industry. David Walker, Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal, 87 Boston University Law Review 561 (2007). Many high tech companies also issue convertible bonds. Convertible bonds have a low coupon (i.e., they pay a low interest rate), and when the stock price of these is low these bonds trade below par. This means that pursuing a failure to file can be highly profitable. See infra Part IV.

\(^{44}\) See supra note 1.

\(^{45}\) See, e.g., Elliott Assoc. v. Bio-Response, 1989 WL 55070 (Del. Ch. 1989) (suit by hedge fund bondholder arguing that company defaulted under the terms of the indenture because it is unable to provide an assurance that the company will be able to satisfy the put option in indenture).
B. Why Hedge Funds?

To place hedge fund activism in perspective, it is important to note that hedge funds are not the only activist bondholders. Traditional institutional investors in corporate bonds – insurance companies and mutual funds - also engage in activism. One of the best-known historic instances of activism involved Metropolitan Life Insurance Co. – among the bluest of blue-chips – which argued that RJR Nabisco’s leveraged buyout in 1988 violated its bond indentures. More recently, it was a group of insurance companies that sued Tyco and argued that its split-up was a transfer of substantially all assets.

The activism of hedge funds, however, differs from the activism by traditional institutions. In this respect, it is interesting to compare the activism of hedge funds as bondholders – the topic of this Article – to the activism of hedge funds as shareholders – the topic of a prior article by us. In our prior article, we argued that shareholder activism by hedge funds differs from shareholder activism by traditional institutional investors in several respects. First, per dollar invested, hedge funds engage in more activism than traditional institutional investors. But although most of the activism comes


47 See Section I.C. Other cases discussed in text in which traditional institutions as well as hedge funds were involved include Wendy’s and probably KCS. See also Equity Office Sweetens Bond Tender Offer After AIG Block, Reuters, Jan. 10. 2007 (noting the opposition by bondholder American International Group, an insurance company, and other holders, to terms of consent solicitation forced company to improve terms); Bell Canada Debenture Holders Unveil Litigation Strategy, available at http://prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/09-19-2007/0004666174&EDATE= (noting that “‘blue chip’ roster of life insurance companies and money managers” is leading litigation effort in Bell Canada bondholder dispute).
from hedge funds, most hedge funds do not engage in activism. Rather, a few hedge funds seem to specialize in pursuing activist strategies and several others pursue activism occasionally, while a large majority of hedge funds are never or rarely activist.

Second, hedge funds pursue different (and more aggressive) tactics than traditional institutions (e.g., running proxy contests as opposed to sending letters to the company). Third, activism by hedge funds is strategic, whereas activism by traditional institutions is incidental.48

In the bondholder context, we observe a similar pattern. First, hedge funds engage in more activism than traditional institutional investors. The available evidence clearly indicates that it is hedge funds that are in the forefront of bondholder activism, while traditional institutions remain the owners of the bulk of outstanding corporate bonds.49 Moreover, several hedge funds seem to specialize in pursuing bondholder activist strategies (and they are not the same ones who are also shareholder activists) and several others pursue activism occasionally, while a large majority of hedge funds are never or rarely activist.50

Unlike in the shareholder context, however, traditional institutions that become activist pursue the same strategies as hedge funds: they issue default or acceleration

48 See Kahan & Rock, supra note 3, at 1042-47.

49 According to data compiled by the Federal Reserve Board, banks and insurance companies held over 30% of corporate and foreign bonds, mutual funds held around 15%, pension funds about 5%, and foreign residents close to 30%. Flow of Funds, supra note 2, Table L.212.

50 The repeated appearance of certain funds in the examples in text and the appendix above is likely due to the fact that these funds have developed a specialty in bondholder activism.
notices; they commence or threaten litigation; they form groups to oppose consent
solicitations and negotiate for higher payments. This is probably due to the limited
arsenal available to bondholders. As we explain below, issuing a default notice is a pre-
requisite to most remedies, and if no agreement can be reached with the company,
bondholders have few alternatives besides a lawsuit.

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

By contrast, activism by traditional institutions is incidental to their investment
activities. Traditional institutions tend to become active when an investment they hold
for different reasons suffers a significant decline in value and their activism is designed

51 Marcel Kahan & Bruce Tuckman, Do Bondholders Lose from Junk Bond
Covenant Changes?, 66 J. Bus. 499 (1993) (noting formation of bondholder groups to
negotiate for higher consent payments).

52 See discussion of Spectrum, Citadel, Regal in Part I. Moreover, in each of the
four instances in the Appendix where we were able both to identify the bondholder who
gave a default notice or accelerated and to obtain holdings data from 13F filings, the
filings indicated that the fund involved raised its stakes before or around the time when
they became active.
to recoup some of these losses.\footnote{Traditional institutions also become active when the company, on its own, seeks consents for an indenture amendment and in those cases try to obtain gains. See Kahan & Tuckman, supra note 51. As in the instances were institutions become active when an investment suffers a decline in value, this “activism” is fundamentally reactive.} That was how it was in 1989, when Met Life sued RJR Nabisco over its LBO, which led to a precipitous drop in the value of their RJR bonds.\footnote{Metropolitan Life Insurance Co. v. RJR Nabisco, Inc., 716 F.Supp. 1504 (S.D.N.Y. 1989).} It remains largely true today, when large, institutional holders of blue-chip companies like Tyco\footnote{Who needs junk? Loose Tyco bond rules force suit - Angry holders of investment-grade bonds fight losses in court, Marion Cole, Financial Week, July 16, 2007, available at http://www.financialweek.com/apps/pbcs.dll/article?AID=/20070716/REG/70713022/1006/TOC (noting that bondholder sued “in hopes of stemming losses from a spin-off that effectively strips their holdings of much of their underlying assets.”).} and Bell Canada\footnote{See Bell Canada Debenture Holders Unveil Litigation Strategy, available at http://prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/09-19-2007/0004666174&EDATE= (noting that bondholders believe that the proposed Bell Canada LBO would result in “significant losses.”)} bring suit after the announcement of major transactions with significant impact on bond values. As a result, activism by traditional institutions is rare (large drops are not all that common), relate to major transactions involving major companies (only those result in major dollar losses), and are pursued by the largest financial institutions\footnote{MetLife Inc, for example, the public holding company of Metropolitan Life Insurance Co., had total assets of $563 billion on Sep. 30, 2007, almost a third of the total assets of all hedge funds combined. MetLife Inc., Form 10-Q, Nov. 11, 2007.} (which tend to be the biggest investors and suffer the largest losses), rather than specialized boutiques.

These differences between hedge fund activism and activism by institutional
investors, in turn, suggest why it is that hedge funds engage in *strategic* activism: activism requires specialization. There must be some investment professional who knows how to analyze bond indentures, who can detect actual, potential, or expected defaults that the market is not yet aware of, who has a good sense of the probability of winning, who has experience in negotiating with issuers, and who has the proper monetary incentives to become activist. Activist hedge funds have such professionals working for them. Traditional bondholders generally do not. The reason is not that they cannot, but rather that they are not set up to do so. Traditional institutions invest in bonds is to earn yield. For life insurance companies, the largest group of institutional bond investors, the payoff structure of bonds matches the expected payout structure on life insurance policies the have underwritten. The professionals working for them concentrate on making sure that their bond portfolio has the right term structure and risk profile, rather than on squeezing profits out of a potential default. Mutual funds, similarly, are designed to provide diversification for individuals who want to hold fixed income securities that offer a higher yield than treasury bonds. Neither of these types of institutions sees activism as integral to their business success; and neither pays their professionals incentive fees similar to the ones paid by hedge funds.\(^5\)\(^8\) Their institutional structure does not lend itself to the pursuit of strategic activism, and they do not engage in it.

\(^5\)\(^8\) See Kahan & Rock, supra note 3, at 1050-54 (discussing comparative incentives of hedge funds to engage in shareholder monitoring
III. The Underenforcement Problem

In this Part, we explain why bondholder rights historically have been underenforced. Our discussion here, as in the rest of this paper, focuses on violations, or potential violations, of bondholder rights other than a failure to make required interest or principal payments. As we will argue, the historic underenforcement has three causes: bondholders may not be aware of a violation; bondholders face significant barriers if they want to enforce their rights without the cooperation of the trustee; and the trustee has limited incentives to enforce bondholder rights vigorously.

To clarify, when we argue in this Part that bondholder rights have been underenforced, and in the next Part that they are now selectively enforced, we are comparing the actual level of enforcement to a baseline enforcement level that would prevail under two conditions: first, the absence of enforcement impediments that result from collective actions or agency problems; second, the absence of incentives to enforce, or not to enforce, bondholder rights that are related to extraneous market developments, rather than to the right being enforced. That is, we consider as baseline the enforcement level that would prevail if all bonds were held by a single person and the remedy for violations of a right corresponded to the damages related to the violation.59

A. The Detection Scheme

Before the issue of any enforcement of a bondholder right even arises, one must be aware of a violation. In some instances – for example, if the company fails to make
a scheduled interest payment – the violation will be evident. But with respect to other provisions, this may not be so. Consider for example the standard debt covenant which limits the ability of a company to incur indebtedness depending on the ratio of its current income relative to its interest expense and other fixed charges and contains numerous special rules and exceptions. The information required to determine whether additional debt can be incurred tends to be complex and usually cannot be easily gleaned from the company’s publicly filed financial statements.

How then do bondholders learn about these violations? There are basically two ways. First, the company is generally obligated to furnish the trustee with an annual certificate which state whether the company has complied with all its covenants. But since these certificates contain no background information that would enable the trustee to confirm their conclusions, companies will be inclined to issue a clean certificate whenever there is some plausible interpretation leading to the conclusion that no violation has occurred. And because these certificates must generally be delivered only once a year, bondholders may learn of a violation only several months after it occurred.

Second, bondholders can perform their own investigation. However the incentives and the ability of bondholders to investigate are reduced by the collective action problems, by the lack of access to non-public information, by the fact that public information may not be sufficient to determine whether a covenant has been violated, and by the complexity of the analysis even if all the necessary information can be obtained. As a result, a violation or potential violation may be detected late or never.
B. The Enforcement Scheme

Once bondholders learn of any violation, a complex enforcement scheme kicks in. Violations of bondholder rights (other than failures to pay principal or interest when due) generally constitute a so-called “default.” Before any enforcement action can be

Covenants are sometimes designed to serve as triggers - that is, a violation is a symptom of a problem, rather than the cause of the problem. To that extent, a damage rule or baseline according to which bondholders are only compensated for the damages caused by a violation would be too narrow. By taking as a baseline any damages related to a violation, we mean to include damages caused by problem of which a covenant violation is a symptom.


See Model Simplified Indenture, 38 Bus. Law. 741 (1982) [hereinafter Model Indenture], Section 4.03.

In these respects, compliance certificates for public bonds differ markedly from their equivalent for bank agreements or private placements of debt securities. In those agreements, certificates must be furnished quarterly and must contain detailed calculations showing compliance with financial covenants. In addition, companies are usually obligated to notify holders of any default within a few days after they become aware of a default or after they receive notice of a debtholders alleging that a default has occurred. Finally, lenders are entitled to seek additional information, which includes the right to receive any financial report or date that they may reasonably request, to examine the company’s books of account, reports and other papers, and to inspect the company’s properties, and to discuss the company’s affairs with its officers, employees, and accountants as often as may be reasonably requested. See Marcel Kahan & Bruce Tuckman, Private versus Public Lending: Evidence from Covenants, in THE YEARBOOK OF FIXED INCOME INVESTING 1995 253 - 274.

The trustee, in the absence of bad faith, is entitled to rely conclusively on such compliance certificates, and has neither the duty nor any incentives to determine independently whether any violation has occurred. See Model Indenture, supra note 61, Section 7.01.

taken, however, the “default” must be converted into an “Event of Default.” To do this, the trustee or holders of 25% of the bonds typically must give a "Notice of Default" to the company and afford the company a specified period of time to cure the default (the “cure period”).

Once an Event of Default has occurred, an indenture typically provides for two categories of remedies. First, the bonds can be accelerated: that is, the principal and any accrued interest become immediately payable. Generally, either the trustee or holders of 25% of the outstanding bonds can accelerate.

Second, any other remedy may be pursued. The second category includes suits to collect principal that has become due as a result of acceleration. The trustee is entitled to bring such suits, and, if directed by the holders of a majority of the outstanding bonds, is generally obligated to do so. Bondholders, however, can only bring such suits after they comply with the “no-action clause.” This clause requires, among others, that holders of at least 25% of the bonds request that the trustee pursue a remedy; offer indemnity, satisfactory to the trustee, against any loss, liability and expense; and then wait for 60 days to give the trustee a chance to bring the suit itself.

Thus, to enforce covenant violations without the active cooperation of the trustee,

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65 See, e.g., Model Indenture, supra note 61, Sections 6.02 and 6.03.
66 See, e.g., Model Indenture, supra note 61, Sections 6.01.
67 See, e.g., Model Indenture, supra note 61, Section 6.02.
68 See, e.g., Model Indenture, supra note 61, Section 6.03.
69 See, e.g., Model Indenture, supra note 61, Section 6.05.
70 See, e.g., Model Indenture, supra note 61, Section 6.06.
holders either must organize a group holding a majority of the outstanding bonds (which can issue the requisite notices and direct the trustee to take actions), or a group holding 25% of the bonds (which can issue the requisite notices) and be willing to write a black-check offer of indemnification to the trustee and wait 60 days.

The difficulty of overcoming these barriers obviously depends on the concentration of bondholdings. Historically, even though bondholdings are concentrated relative to share ownership, it was rare for a single holder to own 25% of the bonds. According to ownership data assembled by Best’s Market Guide Corporate Bonds for 1995, the five largest holders held more than 25% of the outstanding bonds in seven of twelve issued sampled and more than 50% of the bonds in only two of twelve issues sampled. This suggests that it would usually be necessary to assemble a group of bondholders, albeit not necessarily a large group, to pass the 25% threshold.

C. The Trustee

As discussed above, enforcement becomes much easier if the trustee is willing to act as an effective enforcement agent. Alas, the trustee has little incentives to act. First, the initial indenture trustee is selected by the company before the bonds are issued. A different trustee is appointed only if the initial trustee resigns or holders of a

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71 1995 was the last year this guide as published.

72 In addition to the advantages mentioned above, the trustee (but not bondholders) is entitled to indemnification of its "reasonable" out-of-pocket expenses (e.g. to pay outside legal counsel) by the company as well as from any funds collected for the bondholders. See, e.g., Model Indenture, supra note 61, Section 7.07.

majority of outstanding bonds demands the trustee’s removal.\textsuperscript{74} Second, until an Event of Default occurs, the trustee has virtually no legal obligations towards the bondholders.\textsuperscript{75} Specifically, the trustee has no general fiduciary duty to act in the interest of bondholders and no obligation to give a "notice of default" to the company, which could cause the default to ripen into an Event of Default.\textsuperscript{76} Third, the trustee has no direct monetary incentives to act as an effective agent. Typically, the trustee receives a fixed annual fee\textsuperscript{77} and is entitled to be reimbursed for its out-of-pocket expenses,\textsuperscript{78} but receives no extra compensation for its own efforts or if its duties increase as a result of an Event of Default. Thus, before an Event of Default has occurred, and often when the company disputes that an Event of Default has occurred, the trustee’s fundamental economic incentive is to do nothing. Though trustees may sometimes do more,\textsuperscript{79} the economic incentive structure indicates that trustees cannot

\textsuperscript{74} See, e.g., Model Indenture, supra note 61, Section 7.08 (establishing removal rights); Interlake Indenture §608(c) (same).

\textsuperscript{75} See, e.g., Elliott Associates v. J. Henry Schroder Bank & Trust Co., 655 F.Supp. 1281 (S.D.N.Y.), aff’d 838 F.2d 66 (2d Cir. 1988) (holding that indenture trustee owes no general fiduciary duty to bondholders and that only implied duty is to avoid conflicts of interest). Once an Event of Default has occurred, the trustee must comply with a “prudent man” standard. Trust Indenture Act, §315(c), 15 U.S.C. §77iii(c) (1994). This increase in duties creates a disincentive for the trustee to generate an Event of Default, e.g. by giving a notice of default.

\textsuperscript{76} See, e.g., Model Indenture, supra note 61, at 796 (note 3 to Sections 7.01, 7.02). The only substantive pre-Event of Default obligation of the trustee is to inform bondholders of any default known to the trustee unless the trustee determines that withholding such notice from the bondholders is in their interest. Id., Section 7.05.

\textsuperscript{77} See Amihud et al., supra note 64, at 479, note 111.

\textsuperscript{78} See, e.g., Model Indenture, supra note 61, Section 7.07.

\textsuperscript{79} Trustees sometimes take actions to enforce bondholder rights when the
be relied on to represent bondholders effectively.  

D. Evident, Opaque, and Ambiguous Defaults

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

An example of a relatively evident default is the failure of the company to supply the trustee with the reports that the company is required to file with the SEC.  

An example of a default that can be both opaque and ambiguous relates to whether a transaction involves the transfer of substantially all assets. Such defaults are often opaque as one may need to obtain detailed information both about the assets involved in the transaction and about the company's finances. In some of these cases, the trustee may have acted at the direction of bondholders.

See generally Amihud et al., supra note 64.

The wording of some of the filing covenants has generated disputes over whether the covenant is violated if the company never makes any filings with the SEC. For alternate wordings of the filing covenant, a failure to file generates an evident default. See Moody’s Report, supra note 17.

See supra Section I.C.
transferred (in terms of market value and earnings potential)\ref{footnote:1} and the assets not transferred; and they are ambiguous as the term “substantially all” is not precisely defined.

Although far from perfect, the detection and enforcement schemes work tolerably well for evident defaults. By definition, evident defaults are easy to detect and unambiguous. Once alerted to such a default, the trustee may be willing to send a default notice and pursue a remedy. Even if the trustee remains passive, coordination among bondholders to form a group holding 25% of the bonds is easier when the existence of a default is evident.

For opaque and ambiguous defaults, by contrast, the detection and enforcement schemes involve much greater imperfections. Without significant bondholder investigation, these defaults may never become known. For ambiguous defaults, the company will invariably want to take the position that no default has occurred, and thus sign a clean compliance certificate. For opaque default, the company may either not discover the default itself,\ref{footnote:2} or be able to cure the default before the compliance certificate is due. The opacity and ambiguity of these defaults, of course, also makes it

\footnote{See \textit{Sharon Steel}, 691 F.2d 1039 (discussing percentage of operating revenue, operating profits, and book value accounted for by sold assets to determine whether transaction involved substantially all assets).}

\footnote{The company’s incentive is to make the initial compliance review as cursory as it can get away with. If that initial review reveals no problem, the company’s incentive is to stop and have the compliance certificate issued. If the initial review reveals a problem, the company’s incentive is to investigate further to see whether, upon more careful analysis, the problem remains. If the problem disappears, the incentive is again to stop. If it remains, the company may engage in further review. Only if, at each stage of the review process, the company concludes that a covenant has been violated will even a honest company be forced to report so in its compliance certificate.}
harder for a bondholder to detect the default on its own. Finally, even once a bondholder has detected such a default, it will be harder to persuade the trustee to take action or to form the requisite bondholder group.

IV. The Selective Enforcement Problem

A. Why Have Things Changed?

In the preceding Part, we discussed the reasons why bondholder rights have generally been under enforced. The rise of hedge funds, however, has lead to a fundamental change. Bondholder rights, we believe, are no longer systematically underenforced. How and why did this change happen?

The fundamental barriers – investigation difficulties, collective action problems, under-incentivized trustees, barriers to bondholder self-help – have not changed. What has changed is that hedge funds have taken a pro-active approach and have overcome these barriers. Compared to traditional investors, they are more likely to specialize in activism and to acquire bonds after they have determined that they have (and in order to pursue) a potential claim. Due to their efforts and expertise, hedge funds are more likely to detect opaque and ambiguous defaults. Because they acquire bonds in order to become active, they tend to have higher stakes which both make it easier for hedge funds to overcome the collective action problem and provide the incentives to detect defaults to start with. Finally, the professionals at activist hedge funds will tend to know each other, which makes it easier for them to cooperate and further reduces collective action costs.
As a result of hedge fund activism, we now face a mix of under-enforcement and over-enforcement – a phenomenon to which we refer to as “selective enforcement” of bondholder rights. In this Part, we explain what accounts for this selective enforcement.

B. The Remedy Scheme: The Central Role of Acceleration

The key feature of the remedy scheme for bonds is the right to accelerate the payment of the outstanding principal and all accrued interest. In effect, acceleration ends the lending relationship, with bondholders getting their money back (assuming the company pays) and bidding good-bye. Acceleration is the principal remedy provided for defaults: it is the only remedy specifically stated to be available and the only remedy regularly sought if an Event of Default has occurred. Though technically the trustee or the bondholders (after compliance with the no-action clause) could seek others remedies, such as damages from breach, this is rarely done and damages are typically difficult to prove. The threat of acceleration thus forms the baseline for negotiations between the company and bondholders about the terms on which bondholders will consent to waivers and amendments that eliminate the default.

Whether acceleration is attractive to bondholders – and conversely, whether the threat of acceleration can be used to extract consent payments of other concessions from the company – depends on the hypothetical value of the bonds assuming that bondholders had no right to accelerate – the “non-accelerated bond value.” In

85 See Model Indenture, supra note 61, Section 6.02. The only notable exception are breaches of anti-dilution provisions are generally enforced specifically, not via acceleration. See infra TAN.

86 See supra Part I.
acceleration, if the company has sufficient assets to pay, bondholders gain the
difference between the non-accelerated bond value and the principal amount of the
bonds (“par”). Economically, the acceleration remedy resembles a “liquidated
damages” clause where the amount of liquidated damages is equal to the difference
between par and the non-accelerated bond value. Acceleration is thus attractive only if
par – that is, the liquidated damages equivalent to acceleration – exceeds the non-
accelerated bond value, and then becomes increasingly attractive the lower the non-
accelerated bond value. The more attractive acceleration is for bondholders, and the
more costly it is for the company, the higher are usually the payments bondholders
receive to consent to a waiver of the default.87

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

- Changes in the Risk-Free (Treasury) Interest Rate: Most corporate bonds are
issued at fixed interest rates. Their value is thus subject to changes in market interest
rates after the bonds are issued. The interest rate payable on treasury securities issued
by the United States forms a benchmark for interest rates on other bonds. Other things
being equal, when the rate payable on treasury securities with a maturity similar to the
bond in question has declined since the bond was issued, the non-accelerated bond
value will increase. If the rate payable on treasury securities with a maturity similar to
the bond in question has increased, the non-accelerated bond value will decrease.88

87 We were able to obtain information on bond prices for some of the cases listed
in Appendix A. that resulted in a negotiated resolution. We then classified the resolution
as involving trivial, small, modest, or significant benefits to bondholders. In all 10
instances where benefit was trivial or small, the pre-default market price of the bonds
was above 98% of par. Out of the 8 instances where the resolution involved modest or
significant benefits, the market price was above 98% of par in 2, between 90% and 98%
in 3, and below 90% in 3.

88 See, e.g., William A. Klein & John C. Coffee, Jr., Business Organization and
Finance 325 (10th ed. 2007)
Changes in the Default Risk Premium: Unlike treasury bonds, most corporate bonds entail more than a minimal risk of default. To compensate holders for this risk, corporate bonds carry a yield that is higher than the yield of a treasury security with a similar maturity (i.e., they are issued at a higher interest rate). We will refer to this difference as the default risk premium. The risk of default and the associated risk premium vary over time. When the risk premium increases, the non-accelerated bond value declines reflecting the higher likelihood of non-payment. When it declines, the non-accelerated bond value increases.

Stock Price Movements and Convertible Bonds: For convertible bonds, there is a third reason why the non-accelerated bond value may change. Convertible bonds carry, in addition to the right to payment of principal and interest, the right to convert the bonds into stock at a specified conversion price. Because of this right, convertible bonds have a lower yield (i.e., they are issued at a lower interest rate) than otherwise equivalent non-convertible bonds. At issuance, the conversion price of a convertible bond is generally at a premium over the market price for the stock. Conversion becomes only attractive if the market price increases. For convertible bonds to maintain their market value, the market price for the stock must, over time, increase sufficiently so that the expected gains upon conversion equal the loss from the lower interest rate. If the market price of the company’s stock increases by a greater amount, the non-accelerated bond value will tend to increase. If it increases by a lesser amount or declines, the non-accelerated bond value will decline.89

C. Acceleration and Selective Enforcement

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

89 A convertible bond can be viewed as a combination between a non-convertible bond and warrant to purchase common stock. The Black-Scholes option pricing formula, in turn, can be used as a basis to value the warrant element of a convertible bond. Under that formula, the value of the warrant decreases as (i) the time to expiration decreases and (ii) the value of the stock into which the warrant can be converted decreases. See Marcel Kahan, Anti-Dilution provisions in Convertible Securities, 2 Stan. J. L., Bus. & Fin. 147, 162 (1995).
The relationship between the liquidated damages equivalent of acceleration and a violation is strongest when the non-accelerated bond value declined due to an increase in default risk. The principal function of protective covenants is to protect bondholders against certain actions by the company or other events that increase the default risk. Thus, when the company has violated a covenant and the default risk after the violation is higher than it was when the bonds were issued, there is a prima facie case that the covenant violation is related to the increase in default risk. To the extent that the non-accelerated bond value has declined due to an increase in default risk, acceleration constitutes a proper remedy.

Unlike changes in default risk, changes in treasury interest rates are unrelated to a violation. There is thus no good reason why the liquidated damages equivalent of acceleration ought to vary with changes in the treasury interest rates. Changes in treasury interest rates thus add a random element to the attractiveness of acceleration as a remedy.

Whether movements in the stock price are related to the non-accelerated value


91 To be sure, even with respect to changes in default risk, acceleration is not a perfect remedy. The default risk of a bond could have changed for reasons completely unrelated to the covenant violation. But although acceleration does not always work perfectly in these instances, it is hard to devise a superior remedy. When the default risk of the company has increased, it is practically impossible to determine to what extent the decline is related to a covenant violation. This difficulty is enhanced because covenants sometimes function as trip-wires. That is, they are designed to be more likely to be violated by companies where the default risk has increased substantially, even though the specific act that causes the violation did not directly increase the default risk by all that much.
of convertible bonds is more complex. The answer to this question turns in part on the distinction between indenture provisions related to default risk (“protective covenants”) and provisions specifically designed to protect the value of the conversion feature (“anti-dilution” provisions). Anti-dilution provisions often address actions that reduce the share price, such as stock splits or dividends. Unlike most protective covenants, anti-dilution provisions do not prohibit these actions, but instead provide for an adjustment of the conversion price if the company takes these actions (e.g., they provide that the conversion price be halved if the company’s stock is split 2-for-1).92

Acceleration is a problematic remedy for breaches of anti-dilution provisions. Fortunately, however, acceleration is in practice not used to rectify these breaches. Consider first the case where bondholders, upon conversion, stand to receive stock with a value in excess of par. In that case, acceleration would not be an effective remedy for breach. But rather than acceleration, bondholders can and do seek specific performance of the anti-dilution provision.

Now consider the case where bondholders stand to receive stock with a value below par even if the conversion price is calculated the way they deem proper. In these cases, acceleration would clearly overcompensate bondholders. Bondholders may seek to trigger a default by tendering, say, $1000 of bonds for conversion, accepting the lower number of shares that the company deems proper, and then issuing notices of default and acceleration. But the company could simply pay holders the higher number

92 See generally Kahan, supra note 89, at 149-158. More rarely, provisions designed to protect the value of the conversion right offer bondholders a special right to put the bonds (e.g. when the stock into which the bonds are convertible is converted into cash in a merger). See id., at 160-161.
of shares (i.e. the number that the bondholders deem proper), and then either do nothing further or sue holders for a repayment of the extra shares. By doing that, the company would not only avoid generating a default; it would also call the bondholders’ bluff because, in their (futile) attempt to generate the default, they would have converted their bonds into shares with a value below their principal amount.\textsuperscript{93} For one reason or another, then, disputes involving anti-dilution provisions are not likely to result in acceleration.

For protective covenants, however, there is no reason why the liquidated damages equivalent of acceleration ought to vary with the effect of stock price movements on the value of the conversion right. Both changes in market interest rates and, for convertible bonds, stock price movements will thus distort enforcement incentives. When treasury rates increase or the stock price declines, the liquidated damages equivalent of acceleration overcompensates bondholders. Bondholders thus have incentives to expend excessive resources in detecting defaults and to pursue claims of dubious merit. Companies have excessive incentives to avoid triggering a potential default and defend even against meritorious claims. When treasury rates have decreased, the situation is reversed. Bondholders have \textit{insufficient} incentives to investigate and pursue defaults. Companies will tend to be overly lax in their covenant

\textsuperscript{93} This is a bluff only if the market value of the share is less than the unconverted value of the bonds under the company’s interpretation of the indenture. If the value of the bonds under the company’s interpretation is less than par, but the value of the shares into which the bonds can be converted under the bondholders’ interpretation is more than the value of the bonds under the company’s interpretation, the strategy of trying to generate a default by converting some bonds is sensible for the bondholders. This situation, however, is relatively infrequent and the company could still pay the higher number of shares and sue for a repayment. Moreover, as shown below, even
A special situation arises when the stock price of a company that has issued a convertible bond has increased to make the conversion feature more valuable than anticipated. In theory, this could lead to the same dynamic as a decline in treasury rates. In practice, however, it will not usually generate a significant underenforcement problem. It is unlikely that the stock price has increased sufficiently to make the conversion feature more valuable while, at the same time, the default risk of the company has deteriorated such that bondholders suffered damages associated with a covenant violation.

V. Who Benefits from Increased Enforcement - Ex Post Effect

The activism by hedge funds raises the question of who – besides the activists themselves – benefits from the increased enforcement of bondholder rights. In particular, does increased enforcement benefit other bondholders? And if so, does it benefit bondholders and companies in the aggregate?

As in the shareholder context, there is at least a theoretical possibility that hedge fund activism comes at the expense of their fellow bondholders. An activist could, for example, detect a default and then seek a payment from the company – the bondholder equivalent of “greenmail” – in exchange for a promise not to expose the default. Or it could acquire a majority of bonds and then approve an amendment, which would be this situation would be remedied by our proposals below.

94 See Kahan & Rock, supra note 3, at 1070-91 (examining whether hedge fund activism benefits fellow shareholders).
binding on all bondholders, in exchange for a consent payment made only to the majority holder.\textsuperscript{95}

In our research, we have found no instances of such practices. To the contrary, whenever activist hedge funds obtained benefits, other bondholders were offered the chance to obtain the same pro rata benefits. Thus, for example, when hedge funds negotiated the terms of the exchange offer in Spectrum Brands (which entailed an amendment that removed any potential default), all bondholders had equal rights to participate in the offer. Though we did find instances where activist funds obtained a separate payment as reimbursement of expenses, these instances were rare and the amounts involved modest.\textsuperscript{96} Since there were many more instances where activist funds incurred expenses that were not reimbursed, it seems that, if anything, other bondholders were able to free-ride on the activism by hedge funds.

Moreover, compared to underenforcement, selective enforcement increases the incentives of companies to avoid covenant violations, or actions that may in the future result in such violations. This deterrence effect associated with a higher enforcement level is likely to benefit bondholders at large.

There are, however, some caveats to our conclusion that hedge fund activism

\textsuperscript{95} Some indentures contain covenants requiring that all bondholders have the same opportunity to deliver the consent and receive the consent payment. See, e.g., Indenture for Freeport-McMoran Copper & Gold Inc. 10-1/8% Senior Notes, Jan. 29, 2003, Section 9.07.

\textsuperscript{96} For example, the settlement agreement between Riverstone Networks, Inc., the trustee and bondholders related to a alleged default included a reimbursement of $675,000 in attorneys’ fees and administrative costs incurred by the noteholders as a result of the litigation, in addition to a offer to redeem up to $65.875 million of the bonds. See Riverstone Networks, Inc. Form 8-K, May 5, 2005.
benefits other bondholders. First, it may be that we just failed to discover cases of bondholder “greenmail.” After all, neither a greenmailed company nor a greenmailing activist would have an incentive to reveal such payments. By the same token, however, a company would have incentives to reveal a request for greenmail that it refused. Moreover, greenmail leaves tracks – in the company’s financial statements, in the bondholder’s trading pattern, in the knowledge of other participants – that should eventually lead to the discovery of some such payments. We thus believe that bondholder greenmail payments, if they are made at all, represent at most isolated occurrences.97

Second, hedge funds could, through their ownership of other securities or derivatives, benefit from activism even if the activism harms other bondholders.98 For example, a hedge fund that is short on the company’s stock or that is long on a credit default swap could benefit from accelerating a bond and pushing the company into bankruptcy – even if a bankruptcy filing reduces bond values. It is quite possible that activist funds have held derivatives that generated gains from activism beyond any gains they derived directly, as a result of their bondholdings. But we did not find any cases where it was plausible that activist suffered losses in their bondholdings, but nevertheless derived overall gains because of their other investments. Thus, on the whole, there is a strong case that hedge fund activism benefits fellow bondholders from an ex post perspective.

97 Cf. Kahan & Rock, supra note 3, at 1082-83 (finding no evidence that hedge funds as shareholders seek greenmail and discussing reasons).

98 See Kahan & Rock, supra note 3, at 1073-77 (discussing similar concerns for shareholder activism by hedge funds).
A more difficult question is whether activism increases the aggregate benefits of bondholders and the company. On one hand, covenants are included in bond indentures because they generate such aggregate benefits by reducing agency costs of debt, and, once included, they ought to be enforced. On the other hand, hedge fund activism entails transaction costs (such as lawyer’s fees) and disruption cost for the company, and the merits of the claims asserted varies in strength. More disconcertingly, covenants that were written during a period of underenforcement were arguably designed to be optimal given such underenforcement and may thus not be optimal for a systematically higher enforcement level. But then again, underenforcement was generated by exogenous factors, and was not a contractual choice, and it is highly unlikely that it is optimal for covenants to be underenforced. On the whole, therefore, we cannot definitively conclude whether bondholders and the company, in the aggregate, are better off with bond indentures designed to be underenforced that are in fact underenforced, or with like provisions that are selectively enforced.

VI. The Ex Ante Effects of Selective Enforcement

From an ex ante perspective, selective enforcement has neutral effects on bondholders. When issued, bonds are priced given an anticipated enforcement pattern; and once bonds are anticipated to be selectively enforced, selective enforcement should have no systematic effect on bondholder wealth.100

99 Brealey & Myers, supra note 90, at 494.

100 Since selective enforcement is, other things being equal, more beneficial to
Selective enforcement may, however, affect the way indentures are drafted. In particular, provisions that may have been desirable (or at least harmless) when bonds were underenforced may be undesirable when bonds are selectively enforced. In this Part, we explore several possible adjustments to bond indentures.

A. Weaker Covenants

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

At least with respect to the covenant requiring a company to file reports with the trustee – a covenant that has recently caused trouble for several companies – there is evidence that covenants have already become weaker. For example, in May 2007, Rayonier Inc. filed forms of senior and subordinated indentures with the SEC that provided for a (relatively conventional) 60 day cure period for covenant violations in general, but a special – and by conventional standards very long – 180 day cure period applicable to failure to file reports with the trustee.¹⁰¹

¹⁰¹ Rayonier TRS Holdings Inc., Form S-3, May 22, 2007, Exhibit 4.2 (Rayonier Inc. Form of Senior Indenture), Section 6.1(d); see also CACI International Inc., Form 8-K, May 16 2007, Exhibit 4.1 (Indenture for 2-1/8% Convertible Senior Subordinated Notes), Section 7.02 (providing that, at company’s election, remedy for Event of Default caused by such a failure to file shall not be acceleration, but for the first 90 days right to

As discussed above, one category of activism has involved technical flaws or imprecisions in indenture terms. Such flaws may have mattered less when bondholder rights were underenforced. With selective enforcement, however, such flaws are more likely to generate costly disputes. From an ex ante perspective, selective enforcement increases the incentives to avoid flaws when indenture terms are drafted – that is, to draft “better” indentures.

C. Improving Enforcement Incentives

Systematic underenforcement of bondholder rights was, to a large extent, caused by exogenous factors, such as the dispersion of bondholdings and the behavior of traditional bondholders. As such, it was difficult to revise the contractual terms of bond indentures to reduce the underenforcement problem.\(^{102}\) By contrast, selective enforcement is caused by imperfections in the remedy scheme. Accordingly, a promising approach would be to revise the remedy scheme to generate more optimal enforcement of bondholder rights. In this Section, we will propose a set of modifications

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\(^{102}\) Certain contractual terms – such as the lack of access to non-public information and the no-action clause – aggravated the underenforcement problem. These terms, however, served other functions (preserving the confidentiality of information and limiting non-meritorious lawsuits) and were thus difficult to change. For further analysis of these issues, see generally Marcel Kahan, Rethinking Corporate Bonds: The Tradeoff Between Individual and Collective Rights, 77 N.Y.U. L. Rev. 1040 (202) and Amihud et al., supra note 64,
that would fix most of the selective enforcement problems described above.  

1. The Underenforcement Problem

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

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103 Another possibility suggested to us is to make acceleration available only upon material defaults. There are several problems with this approach. First, it is likely to generate a lot of litigation over whether any default is material. Second, for covenants that serve as triggers – where a violation is the symptom, rather than the cause of a problem – materiality of default is difficult to judge. Third, even for material defaults, the acceleration remedy would result in selective enforcement. For the first two of these reasons, it would also be inadvisable to replace the acceleration remedy with a regular damage remedy (where holders would only be entitled to actual damages caused by a violation, rather than acceleration).

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

105 Make-whole provisions often also apply to the amount the company must pay when it redeems its debt securities. To fix the underenforcement problem, however, the make-whole approach must apply only to acceleration, not to redemption. If a company has the right to redeem the bonds at a price below the make-whole amount, bondholders should be entitled to receive about acceleration only the lower redemption price, not the make-whole amount.
upon acceleration.\textsuperscript{106} 

Make-whole clauses have long been included in most agreements related to privately placed debt securities.\textsuperscript{107} More recently, some publicly issued bonds have started to use these clauses.\textsuperscript{108} Consider, for example the $400 million 5.75\% Notes due 2012 issued by Simon Property Group, LP. Assume the notes had been accelerated on May 2, 2007. At that point, the scheduled remaining payments are $11.5 million each on November 1 of 2007 through 2011 and on each May 1 of 2008 through 2011, and $411.5 million on May 1, 2012. These payments are discounted at a rate equal to the yield on treasury securities with a maturity equal to the remaining life of the principal (here 5 years) plus 0.2\%. Table 2 below contains hypothetical calculations of the discounted value for different discount rates.

\textsuperscript{106} See Kahan & Tuckman, supra note 62, at 253 - 274 (describing make-whole clauses).

\textsuperscript{107} Kahan & Tuckman, supra note 62 (finding that 87\% of private placements from 1986 to 1990 used make-whole clauses for acceleration).

\textsuperscript{108} For example, in 2006, Simon Property Group, LP issued $400 million each in 5.75\% Notes due 2012 and 6.1\% Notes due 2016 which must be paid off with a make-whole amount if redeemed or accelerated; and Iron Mountain Inc. issued $200 million in 8-3/4\% Senior Subordinated Notes due 2018 which must be paid off with a make-whole amount if redeemed prior to 2011 or if accelerated after a willful action by the company with the intention of avoiding the payment of the make-whole amount.
Table 2

<table>
<thead>
<tr>
<th>Discount Rate</th>
<th>Discounted Value of Scheduled Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.00%</td>
<td>$432,176,636</td>
</tr>
<tr>
<td>4.50%</td>
<td>$423,073,291</td>
</tr>
<tr>
<td>5.00%</td>
<td>$414,217,973</td>
</tr>
<tr>
<td>5.50%</td>
<td>$405,602,687</td>
</tr>
<tr>
<td>5.75%</td>
<td>$401,382,638</td>
</tr>
</tbody>
</table>

As the table shows, this method yields a payment in excess of par for discount rates below the interest rate on the notes which declines to par as the discount rate approaches that interest rate.\(^{109}\)

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

Make-whole clauses typically provide for a discount rate that represents only a small premium over treasury rates.\(^{110}\) At these levels, make-whole clauses generate a payment over par upon acceleration (in an amount that is declining over time) even when treasury rates remain constant. The limited excess payment that make-whole

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\(^{109}\) The reason why the payment is not exactly equal to par at a 5.75% discount rate is that the semi-annual interest payment are based on the arithmetic average of the interest due for a year (i.e. half the annual 5.75% interest due) but are discounted at a rate based on the geometric average of the annual discount rate (i.e. at \((1+.0575)^\frac{1}{2}\)).

\(^{110}\) See Kahan & Tuckman, supra note 62 (finding average premium of 33 basis points for a sample of 34% investment grade and 66% junk bonds); Simon Properties, supra note 108 (premium of, respectively, 20 and 25 basis points).
clauses generate in the event of an acceleration can serve as an incentive for bondholders to incur the expenses involved in detecting and pursuing a default. However, if no such incentive (or only a smaller one) is desirable, make-whole clauses can employ a discount rate that incorporates a higher premium over treasury bonds.

2. The Overenforcement Problem

The overenforcement problem arises when treasury rates have increased or, in the case of convertible bonds, when the stock has failed to appreciate sufficiently, and the non-accelerated bond value for these reasons – and not (just) because of an increase in the default risk – is below par. Conceptually, the overenforcement problem can be addressed by providing bondholders with assurances that they will receive the scheduled principal and interest payments – thus in effect compensating them for any increase in the default risk – but changing neither the required timing of these payments nor any conversion rights.

As currently drafted, most indentures already contain a provision - called “defeasance”[^1] – that, in principle, enables the company to do just that. To effect a defeasance, a company must deposit with the trustee treasury securities that generate sufficient cash to make all scheduled interest and principal payments.[^2] As a result of a defeasance, the company is no longer obligated to comply with protective covenants

[^1]: Indentures sometimes distinguish between legal defeasance and covenant defeasance. For purposes of our argument, either type of defeasance would reduce the overenforcement problem.

[^2]: See, e.g., Model Indenture, supra note 61, Section 8.01.
and violations of these covenants no longer constitute grounds for an acceleration.\textsuperscript{113} But, in the case of convertible bonds, the company remains obligated to honor its conversion obligations.\textsuperscript{114}

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

Consider, for example, a 5% bond maturing five years from now. Further assume that treasury rates have increased from 3% when the bonds were issued to 8% today and that the premium over treasury rates at which the company can borrow has increased from 2% to 2.5%. The non-accelerated value of these bonds would be around 79%. Purchasing treasury securities to defease the bonds would cost the

\textsuperscript{113} See, e.g., MCMS, Inc., Indenture for 9-3/4% Senior Subordinated Notes, Feb. 26, 1998, Section 8.02(c).

\textsuperscript{114} Id. (providing that conversion obligations in article 10 of indenture survive defeasance).
company around 88% of par,\textsuperscript{115} more than the non-accelerated bond value but still way less than paying off the bonds\textsuperscript{116} after acceleration.\textsuperscript{117}

As currently drafted, however, defeasance provisions usually contain conditions that greatly limit their usefulness. Some indentures permit the company to effect a defeasance only if no default has occurred.\textsuperscript{118} Thus, once a default has occurred – the very context we are most interested in – defeasance is unavailable. Others permit

\textsuperscript{115} The non-accelerated bond value and the defeasance costs were calculated by discounting the scheduled principal and interest payments by 10.5\% and 8\%, respectively.

\textsuperscript{116} Obviously, the company would have to finance the purchase of these treasury securities at its new borrowing rate of 10.5\%, which is higher than the interest rate on its bonds. The refinancing rate, however, will not affect the choice between defeasance and payment upon acceleration.

\textsuperscript{117} As the example illustrates, bondholders would still receive a windfall due to the fact that defeasance \textit{eliminates} any default risk, rather than reduces it to a bargained-for level. In our example, this windfall is represented by the difference between the post-defeasance value of the bonds (88\% of par) and the value of the bonds had treasury rates increased as they did and the default premium staid at 2\% (81\% of par). This windfall is analogous to the excess payments incorporated into make-whole clauses, see supra Section VI.C.1, and justifiable for the same reasons.

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

\textsuperscript{118} See MCMS Indenture, supra note 113, Section 8.03(d).
defeasance only of bonds that mature within one year.  

119 For those bonds, defeasance would be effective post-default, but only if the default occurs shortly before the bonds mature.  

120 Neither of these conditions, however, serves an important function — and indeed, most bond indentures do not contain one or the other.  

121 Modifying the standard defeasance clauses to permit defeasance up until the time the bonds are accelerated, even if a default has occurred, and without any limitation related to when the bonds mature would greatly reduce the overenforcement problem.  

119 See, e.g., Model Indenture, supra note 61, section 8.01.  

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

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

122 See MCMS Indenture, supra note 113, Sections 8.03 and 8.04 (no requirement that notes mature within one year); Model Indenture, supra note 61, Section 8.01 (no requirement of absence of default).  

123 This would force companies to chose whether to defease or dispute the validity of an acceleration and would be beneficial to the extent that companies assert non-meritorious defenses or want to delay payment (e.g. because the pre-judgment interest rate is set at the contractual rate which is, by definition, lower than the market rate when there is a potential overenforcement problem.  

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

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

This more aggressive enforcement promises to generate better incentives for companies to comply with their contractual obligations to start with. But we have shown that the remedy scheme for violations of bondholder’s rights – and the centrality of the acceleration remedy – has introduced its own set of imperfections. Whether acceleration is attractive to bondholders, and how attractive it is, depends significantly on two factors that have nothing to do with the harm associated with the violation: changes in treasury interest rates and, for convertible bonds, changes in the price of the shares into which the bonds can be converted. Specifically, when treasury rates have increased or the share price has declined, acceleration would generate a windfall. This windfall, in turn, results in the overenforcement of potential violations by bondholders and overcompliance by companies to avoid any potential violations. When treasury
rates have declined, acceleration would result in insufficient compensation. This, in turn, can result in underenforcement by bondholders and insufficient compliance incentives for companies.

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

<table>
<thead>
<tr>
<th>Company</th>
<th>Issue</th>
<th>Hedge Fund/Holder Involvement</th>
<th>Outcome</th>
<th>Terms/Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>AES Corp.</td>
<td>various issues ($2.8 billion)</td>
<td>Unclear</td>
<td>Cured</td>
<td>N.A.</td>
</tr>
<tr>
<td>Affiliated Computer Services, Inc.</td>
<td>4.7% Senior Notes due 2015 (250m)</td>
<td>Unidentified holders give default notice and accelerate</td>
<td>Litigation pending</td>
<td>Litigation</td>
</tr>
<tr>
<td>Affiliated Computer Services, Inc.</td>
<td>5.2% Senior Notes due 2015 (250m)</td>
<td>Unidentified holders give default notice and accelerate</td>
<td>Litigation pending</td>
<td>Litigation</td>
</tr>
<tr>
<td>Amkor Technology, Inc.</td>
<td>various issues ($1.62b)</td>
<td>Unclear</td>
<td>Cured</td>
<td>N.A.</td>
</tr>
<tr>
<td>Asyst Technologies Inc.</td>
<td>5.75 Conv Sub Notes due 2008 (85m)</td>
<td>Unclear</td>
<td>Cured</td>
<td>N.A.</td>
</tr>
<tr>
<td>Bally Total Fitness Holding Corp.</td>
<td>10-1/2% Senior Notes due 2011 and 9-7/8% Senior Subordinated Notes (535m)</td>
<td>Unclear</td>
<td>Waivers</td>
<td>Consent Payment</td>
</tr>
<tr>
<td>Bearingpoint Inc.</td>
<td>2.75% Ser B Convertible Subordinated Debentures due 2024 (200m)</td>
<td>Fore, Linden and Whitebox (HF) give default notice and accelerate</td>
<td>Settled/ Amended</td>
<td>Increase in interest rate/ Litigation</td>
</tr>
<tr>
<td>Bearingpoint Inc.</td>
<td>2.5% Ser A Convertible Subordinated Debentures due 2024 (250m)</td>
<td>Likely holder involvement in negotiation</td>
<td>Settled/ Amended</td>
<td>Increase in interest rate</td>
</tr>
<tr>
<td>Bearingpoint Inc.</td>
<td>5% Convertible Senior Subordinated Debentures due 2025 and 0.50% Convertible Senior Subordinated Debentures due 2010 (240m)</td>
<td>Unclear</td>
<td>Settled/ Amended</td>
<td>Consent Payment</td>
</tr>
<tr>
<td>Beazer Homes USA, Inc.</td>
<td>8.625% Senior Notes due 2011 and 4 5/8% Convertible Senior Notes due 2024 (1.525b)</td>
<td>Likely holder involvement in negotiation</td>
<td>Amended</td>
<td>Consent Payment and additional covenants / Litigation</td>
</tr>
<tr>
<td>Bell Microproducts Inc.</td>
<td>3 3/4% Convertible Subordinated Notes due 2024 (110 m)</td>
<td>Unclear</td>
<td>Amended</td>
<td>Company made tender offer at par</td>
</tr>
<tr>
<td>Company</td>
<td>Notes Details</td>
<td>Default Notice</td>
<td>Resolution</td>
<td>Additional Details</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>---------------------------------------------------</td>
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<td>-------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Brocade Comm. Systems Inc.</td>
<td>2% Convertible Subordinated Notes due 2007 (280m)</td>
<td></td>
<td>Defeased</td>
<td>Litigation</td>
</tr>
<tr>
<td>Cablevision System Corp.</td>
<td>8% Series B Senior Notes due 2012 ($1b)</td>
<td>Unidentified holder give default notice</td>
<td>Cured</td>
<td></td>
</tr>
<tr>
<td>Carmike Cinemas Inc.</td>
<td>7.5% Sen Sub Notes due 2014 (150m)</td>
<td>Unidentified holder(s) accelerate</td>
<td>Paid upon acceleration</td>
<td></td>
</tr>
<tr>
<td>CNET Networks Inc.</td>
<td>0.75% Senior Convertible Notes due 2024 (125m)</td>
<td>Unclear</td>
<td>Paid upon acceleration</td>
<td></td>
</tr>
<tr>
<td>Computer Sciences Corp.</td>
<td>3.50% Notes due 2008, 7.375% Notes due 2011 and 5.00% Notes due 2013 (1.1b)</td>
<td>Unclear</td>
<td>Cured</td>
<td></td>
</tr>
<tr>
<td>Computer Sciences Corp.</td>
<td>6.25% Notes due 2009 (200m)</td>
<td>Unclear</td>
<td>Amended</td>
<td>Consent Payment</td>
</tr>
<tr>
<td>Connetics Corp.</td>
<td>2.00% Convertible Senior Notes due 2015 ($200)</td>
<td>Unidentified holder(s) give default notice</td>
<td>Cured</td>
<td></td>
</tr>
<tr>
<td>Connetics Corp.</td>
<td>2.25% Convertible Senior Notes due 2008 ($90)</td>
<td>Unidentified holder(s) give default notice</td>
<td>Amended</td>
<td>Consent Payment and conditional increase in interest rate</td>
</tr>
<tr>
<td>Cyberonics, Inc.</td>
<td>3% Senior Subordinated Convertible Notes due 2012 (125m)</td>
<td>Unclear</td>
<td>Trial court finds no default</td>
<td>Litigation</td>
</tr>
<tr>
<td>Dresser Inc.</td>
<td>9 3/8% Senior Subordinated Notes due 2011 (300m)</td>
<td>Likely holder involvement in negotiation</td>
<td>Amended (twice)</td>
<td>Consent Payment (first) Consent Payment and conditional increase in interest rate (second)</td>
</tr>
<tr>
<td>Emcore Corp.</td>
<td>5% Conv Sen Sub Notes due 2011 (issued 2004 (80m))</td>
<td>Unidentified holder(s) give default notice and accelerate. Both hedge funds and traditional institutions negotiate amendment terms.</td>
<td>Amended</td>
<td>Increased interest rate and reduced conversion price</td>
</tr>
<tr>
<td>Company</td>
<td>Debt Details</td>
<td>Information Provided</td>
<td>Outcome/Action</td>
<td></td>
</tr>
<tr>
<td>-------------------------------</td>
<td>-----------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------</td>
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<td></td>
</tr>
<tr>
<td>Emcore Corp.</td>
<td>5% Conv Sen Sub Notes due 2011 (issued 2005 (17m))</td>
<td>Holder(s) (probably Alexandra (HF)) give default notice and Alexandra negotiates amendment terms</td>
<td>Amended</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Increased interest rate and reduced conversion price</td>
<td></td>
</tr>
<tr>
<td>Ferro Corp.</td>
<td>8% Debentures due 2025 and 7.125% Debentures due 2028 (105m)</td>
<td>Unclear</td>
<td>Paid upon acceleration</td>
<td></td>
</tr>
<tr>
<td>Ferro Corp.</td>
<td>7.375% Debentures due 2015 and 7.625% Debentures due 2013 (50m)</td>
<td>Unidentified holder(s) give default notice (for one of issues)</td>
<td>Paid upon acceleration</td>
<td></td>
</tr>
<tr>
<td>Ferro Corp.</td>
<td>9.125% Senior Notes due 2009 (200m)</td>
<td>Unclear</td>
<td>Cured</td>
<td></td>
</tr>
<tr>
<td>Finisar Corp.</td>
<td>2.5% Conv Sen Sub Notes due 2010, 2.5% Conv Sub Notes due 2010 and 5.25 Conv Notes due 2008 (250m)</td>
<td>Unclear</td>
<td>Litigation pending</td>
<td></td>
</tr>
<tr>
<td>Getty Images Inc.</td>
<td>0.5% Conv Sub Deb due 2013 (265m)</td>
<td>Unidentified holder(s) give default notice</td>
<td>Pending as of 5/20</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Gets credit facility 3/23 1/4 CS $5 failed (2/8)</td>
<td></td>
</tr>
<tr>
<td>HealthSouth Corp.</td>
<td>various issues of senior notes and 10.750% Senior Subordinated Notes due 2008 (2.6b)</td>
<td>HF's part of bondholder group in some or all issues</td>
<td>Amended</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Consent Payment (all issues) and Repurchase Right (some) / Litigation</td>
<td></td>
</tr>
<tr>
<td>KB Home</td>
<td>various senior notes (1.65b)</td>
<td>Unidentified holder(s) give default notice</td>
<td>Amended</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Consent Payment</td>
<td></td>
</tr>
<tr>
<td>KB Home</td>
<td>various senior subordinated notes (750m)</td>
<td>Unclear</td>
<td>Unclear</td>
<td></td>
</tr>
<tr>
<td>Key Energy Services Inc.</td>
<td>8.375% Senior Notes due 2008 (275m)</td>
<td>Unclear</td>
<td>Amended (3 times) then redeemed at premium</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Consent payments (for each of 3 amendments)</td>
<td></td>
</tr>
<tr>
<td>Key Energy Services Inc.</td>
<td>6.375% Senior Notes due 2013 (150m)</td>
<td>Unidentified holder(s) accelerate</td>
<td>Amended (3 times) then paid upon acceleration</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Consent payments (for each of 3 amendments)</td>
<td></td>
</tr>
<tr>
<td>Landry's Restaurants, Inc.</td>
<td>7.5% Senior Notes (400m)</td>
<td>Holder involvement in negotiations</td>
<td>Amended</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Increased interest rate</td>
<td></td>
</tr>
<tr>
<td>Company</td>
<td>Description</td>
<td>Event</td>
<td>Status</td>
<td>Notes</td>
</tr>
<tr>
<td>------------------------------</td>
<td>-----------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------</td>
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<td>----------------------------------------------------------------------</td>
</tr>
<tr>
<td>Medarex Inc.</td>
<td>2.25% Convertible Senior Notes due 2011 ($150m)</td>
<td>Citadel Equity Fund (HF) gives default notice</td>
<td>Amended</td>
<td>Change in redemption provisions</td>
</tr>
<tr>
<td>Mercury Interactive Corp.</td>
<td>4.75% Convertible Subordinated Notes due 2007 (300m)</td>
<td>Likely holder involvement in negotiations</td>
<td>Amended (twice)</td>
<td>Consent payment; then change in repurchase right</td>
</tr>
<tr>
<td>Mercury Interactive Corp.</td>
<td>Zero Coupon Senior Convertible Notes due 2008 (500m)</td>
<td>Likely holder involvement in negotiations</td>
<td>Amended (twice)</td>
<td>Changes in repurchase right</td>
</tr>
<tr>
<td>Metromedia Intl Group Inc.</td>
<td>10 1/2% Senior Discount Notes due 2007 (152m)</td>
<td>Likely holder involvement in negotiations</td>
<td>Amended; then waived conditional on redemption</td>
<td>Consent payment (for amendment) Redeemed</td>
</tr>
<tr>
<td>Navigant Intl Inc.</td>
<td>4.875% convertible subordinated debentures due 2023 (72m)</td>
<td>Both hedge funds and traditional institutions negotiate amendment terms.</td>
<td>Amended</td>
<td>Modification in &quot;Change of Control&quot; provision</td>
</tr>
<tr>
<td>Navistar Int'l Corp.</td>
<td>4.75% Subordinated Exchangeable Notes due 2009 (220m)</td>
<td>Unidentified holder(s) give default notice; likely holder involvement in negotiations</td>
<td>Amended</td>
<td>Tender Offer with exit consents</td>
</tr>
<tr>
<td>Navistar Int'l Corp.</td>
<td>2.5% Senior Convertible Notes due 2007 and 9.375% Senior Notes due 2006 (580m)</td>
<td>Likely holder involvement in negotiations</td>
<td>Amended</td>
<td>Tender Offer with exit consents</td>
</tr>
<tr>
<td>Navistar Int'l Corp.</td>
<td>6.25% Senior Notes due 2012 (400m)</td>
<td>Unidentified holder(s) accelerate</td>
<td>Paid upon acceleration</td>
<td></td>
</tr>
<tr>
<td>Navistar Int'l Corp.</td>
<td>7.5% Senior Notes due 2011 (250m)</td>
<td>Likely holder involvement in negotiations</td>
<td>Amended</td>
<td>Tender Offer with exit consents</td>
</tr>
<tr>
<td>Newpark Resources, Inc.</td>
<td>8 5/8% Senior Subordinated Notes due 2007 (125m)</td>
<td>Unidentified holder(s) give default notice</td>
<td>Redeemed</td>
<td></td>
</tr>
<tr>
<td>Novell Inc.</td>
<td>0.50% convertible senior debentures due 2024 (600m)</td>
<td>Likely holder involvement in negotiations</td>
<td>Amended</td>
<td>Additional interest</td>
</tr>
<tr>
<td>Company Name</td>
<td>Note Details</td>
<td>Negotiators</td>
<td>Outcome</td>
<td>Notes</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>-------------------------------------------------------------------------------</td>
<td>------------------------------</td>
<td>--------------------------</td>
<td>-------</td>
</tr>
<tr>
<td>Riverstone Networks Inc.</td>
<td>3-3/4% Convertible Subordinated Notes due Dec. 1, 2006 (132m)</td>
<td>Highbridge (HF) and Mackay Shields</td>
<td>Negotiate settlement</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Settled/Amended</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Saks Inc.</td>
<td>7 1/2% Notes due 2010, 7% Notes due 2013, 7 3/8% Notes due 2019</td>
<td>Unclear</td>
<td>Amended</td>
<td>Tender Offer with exit consents</td>
</tr>
<tr>
<td>Saks Inc.</td>
<td>2.00% Convertible Senior Notes due 2024 (230m)</td>
<td>Highbridge (HF) gives default notice</td>
<td>Amended</td>
<td>Nominal consent payment</td>
</tr>
<tr>
<td>Saks Inc.</td>
<td>9 7/8% Notes due 2011 and 8 1/4% Notes due 2008 (383m for all notes)</td>
<td>Unclear</td>
<td>Amended</td>
<td>Nominal consent payment</td>
</tr>
<tr>
<td>Sanmina-SCI Corp.</td>
<td>6¾% Senior Subordinated Notes due 2013 and 8.125% Senior Subordinated Notes due 2016 (1b)</td>
<td>Unidentified holder(s) negotiate amendment</td>
<td>Amended</td>
<td>Consent Payment</td>
</tr>
<tr>
<td>Tenet Healthcare Inc.</td>
<td>6 7/8% Senior Notes due 2031 (450m)</td>
<td>Unidentified holder(s) give default notice</td>
<td>Cured</td>
<td></td>
</tr>
<tr>
<td>Terayon Communications System Inc.</td>
<td>5% Conv. Sub Notes due 2007 (65m)</td>
<td>Unidentified holder(s) give default notice</td>
<td>Paid upon acceleration</td>
<td></td>
</tr>
<tr>
<td>United Rentals Inc.</td>
<td>senior and senior subordinated notes (1.9b)</td>
<td>Unidentified holder(s) negotiate amendment terms</td>
<td>Amended</td>
<td>Consent Payment</td>
</tr>
<tr>
<td>United Rentals Inc.</td>
<td>17/8% Convertible Senior Subordinated Notes due October 15, 2023 (144m)</td>
<td>Unidentified holder(s) negotiate amendment terms</td>
<td>Amended</td>
<td>Change in conversion rate</td>
</tr>
<tr>
<td>Unitedhealth Group Inc.</td>
<td>5.80% Subordinated Notes due March 15, 2036 (850m)</td>
<td>Whitebox, Linden, Pandora (HF) give default notice</td>
<td>Litigation pending</td>
<td></td>
</tr>
<tr>
<td>UTStarcom Inc.</td>
<td>7/8% Convertible Subordinated Notes due 2008 (275m)</td>
<td>Likely holder involvement in negotiations</td>
<td>Amended</td>
<td>Additional interest</td>
</tr>
<tr>
<td>Valeant Pharmaceuticals</td>
<td>3% Conv Notes due 2010 and 8.125% Senior Subordinated Notes due 2016 (480m)</td>
<td>Unclear</td>
<td>Cured</td>
<td></td>
</tr>
<tr>
<td>Company</td>
<td>Debt Instrument Description</td>
<td>Event</td>
<td>Status</td>
<td>Description</td>
</tr>
<tr>
<td>---------------------------------</td>
<td>------------------------------------------------------------------</td>
<td>--------------------------------------------</td>
<td>---------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Vitesse Semiconductor Corp.</td>
<td>1.50% Convertible Subordinated Debentures due 2024 (97m)</td>
<td>Holder involvement in negotiations</td>
<td>Amended</td>
<td>Change in repurchase right and conversion price</td>
</tr>
<tr>
<td>Willbros Group, Inc.</td>
<td>2.75% Conv Sen Notes due 2004 (70m)</td>
<td>Whitebox gives default notice</td>
<td>Amended</td>
<td>Extension in call protection and revisions of “fundamental change” provision</td>
</tr>
</tbody>
</table>