sions, and for all the other reasons stated above and in our prior Opinion, we chose to follow the holding in *Franklin*.[4]

NOTE: REFUNDING CASES

1. *Following Morgan Stanley v. ADM.*

Harris v. Union Electric Co., 622 S.W.2d 239 (Mo.Ct.App.1981), concerned a refunding limitation similar to that in *Morgan Stanley v. Archer Daniels Midland*. Here the refunding limitation was set out in the supplemental indenture governing an issue of bonds and contained a parenthetical excepting redemptions from a ''maintenance fund.'' This maintenance fund was set up under earlier supplemental indentures and was intended to force a partial redemption to the extent that the issuer failed to devote 15 percent of any year's earnings to property maintenance. Unfortunately for the bondholders, the earlier supplemental indentures limited neither the source of the money that went into the maintenance fund nor the occasion for its use. The issuer sold a new issue of bonds at a lower coupon rate, put the proceeds in the maintenance fund, and redeemed the original bonds at face value out of the maintenance fund. It thereby avoided not only the refunding limitation but a redemption premium also provided for in the supplemental indenture. The court found the language in the supplemental indenture to be unambiguous on its face and ruled for the issuer. The court made this ruling despite the fact that contextual evidence, including the subjective understanding of officers of the issuer, showed that no one involved with the transactions foresaw that the maintenance fund could be used to circumvent the refunding limitation. See also John Hancock Mutual Life Insurance Co. v. Carolina Power & Light Co., 717 F.2d 664 (2d Cir.1983). But cf. Harris v. Union Electric Co., 787 F.2d 355 (8th Cir.1986), where the failure to make the fragility of call protection clear in a prospectus was held to underpin liability for a violation of Rule 10b–5. Similarly, Blanc and Gordon,

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4. We note in this regard that the ''source'' rule adopted in *Franklin* in no sense constitutes a license to violate the refunding provision. The court is still required to make a finding of the true source of the proceeds for redemption. Where the facts indicate that the proposed redemption was indirectly funded by the proceeds of anticipated debt borrowed at a prohibited interest rate, such redemption would be barred regardless of the name of the account from which the funds were withdrawn. Thus, a different case would be before us if ADM, contemporaneously with the redemption, issued new, lower-cost debt and used the proceeds of such debt to repurchase the stock issued in the first instance to finance the original redemption. On those facts, the redemption could arguably be said to have been indirectly funded through the proceeds of anticipated lower-cost debt, since ADM would be in virtually the same financial posture after the transaction as it was before the redemption—except that the new debt would be carried at a lower interest rate. Here, by contrast, there is no allegation that ADM intends to repurchase the common stock it issued to fund the redemption. The issuance of stock, with its concomitant effect on the company's debt/equity ratio, is exactly the type of substantive financial transaction the proceeds of which may be used for early redemption.

Moreover, we fail to see how, on the facts of this case, the redemption could be argued to be a refunding from the proceeds of lower-cost debt. The Zeroes transaction occurred over a year before the redemption and appears completely unrelated to it. The proceeds of that transaction were used to purchase government securities that remain in ADM's portfolio. The Stars transaction, while closer in time, similarly is not fairly viewed as the source of the redemption, given that the proceeds of that transaction were applied directly to reducing ADM's short-term debt. To view the redemption as having been funded *indirectly* ''from the proceeds'' of the Stars transaction would require us to ignore the *direct* source of the refunding, the two ADM common stock issues.

Reforming the Unbargained Contract: Avoiding Bondholder Claims for Surprise Par Calls, 55 Bus. Law. 317 (1999), argues for detailed advance disclosure of all situations in which issuers may call bonds.

Shenandoah Life Insurance Co. v. Valero Energy Corp., 1988 WL 63491 (Del.Ch.), took up another variation on the theme. There the issuer did a debt financing at a lower rate simultaneously with an equity financing. The proceeds of the equity financing were segregated and applied to the redemption of an issue of 16 3/4 percent debt subject to a six year bar of refunding ''by the application * * * indirectly of [borrowed] moneys.'' The court held that the fact that the new equity was integrated with an equally large debt financing did not cause the redemption ''indirectly'' to be funded with cheaper debt. The Chancellor read the word ''indirectly'' narrowly: ''the inclusion of that phrase is intended to reach situations in which the underlying economic reality of the completed transaction is the functional equivalent of a direct loan for the purposes of effectuating a redemption and nothing more.''

Mutual Savings Life Insurance Co. v. James River Corp., 716 So.2d 1172 (Ala.1998), shows that repurchase by tender offer also provides the issuer a means to circumvent application of a clause restricting refunding ''directly or indirectly'' from the proceeds of cheaper borrowing. The trust indenture containing the clause governed an issue of 10.75 percent debentures due 2018. The indenture did not, however, explicitly prohibit or otherwise regulate bond repurchases, by tender offer or otherwise. Taking advantage of this omission, the issuer made a ''simultaneous tender and call'' (or ''STAC'')—that is, it made a tender offer for the bonds priced slightly above the call price and simultaneously called the bonds. The tender offer was funded by the proceeds of a new issue of 6.75 percent medium term notes. Unsurprisingly, given the simultaneous call at a slightly lower price, the tender offer was accepted by the holders of 98 percent of the outstanding bonds. The remaining 2 percent of the bonds then were redeemed pursuant to the call, the call being funded with the proceeds of the sale of a new issue of preferred stock, a source of funds not prohibited under the refunding limitation.

The bondholder plaintiff asked the court to take a substance over form approach, viewing the STAC as a single transaction and thereby establishing a basis for applying the refunding limitation. The court, however, put the burden of showing specific language in the contract on the bondholder and refused to collapse the two transactions into one. The result of finding two separate transactions was, of course, to place the tender offer funded by lower cost borrowing outside of the purview of the refunding limitation. The court also held that the combination of the call and tender offer did not amount to impermissible coercion.

2. *Ruling for the Bondholders*.

In **In re Hennepin County 1986 Recycling Bond Litigation**, 540 N.W.2d 494 (Minn.1995), the bondholders got the benefit of the doubt. The case concerned the interplay of two redemption provisions. The first was a conventional provision for issuer call at a premium. The right was to become exercisable only on the tenth anniversary of the bonds' original issue, with the bonds to be nonredeemable prior to that time. The second was tied to the bonds' security arrangements. The bonds, issued in 1986, were secured by a bank letter of credit scheduled to expire in 1992. The contract provided for mandatory redemption in the event that a new letter of credit was not provided in 1992. In 1992, the municipal issuer determined not to renew the letter of credit for the purpose of effecting redemption and refunding at a substantially lower interest rate.

The Minnesota Supreme Court held the bond contract to be ambiguous on the critical point whether a redemption triggered by the security provision could be used to circumvent the ten year redemption prohibition. The Court resolved the ambiguity in the bondholders' favor. It reasoned that the mandatory redemption tied to the letter of credit was ''intended for the protection of the bondholders'' in the event an unforeseen contingency put their investment at risk. Meanwhile, the other redemption provisions manifested an apparent risk allocation respecting interest rate changes. Upsetting that allocation, said the court, made no sense. See also Trident Center v. Connecticut General Life Insurance Co., 847 F.2d 564 (9th Cir.1988).

NOTE: BONDHOLDER REMEDIES UPON DEFAULT

Best Buy Indenture, Appendix A, Form 1

Article V (Defaults and remedies)

These provisions determine the bondholders' rights in the event of the issuer's failure to perform one or more of its promises to pay.

The provisions make distinctions between payment defaults, section 501(1)–(3), and failure to perform other promises in the indenture, such as business covenants, section 501(4). First, under section 502, in order for acceleration of the bonds to follow as the result of the ''default,'' the default must be an ''event of default,'' and, under section 501(4), covenant defaults are not events of default unless the issuer has failed to cure the default 90 days after receipt of notice from the trustee.

Second, payment defaults may be the subject of a direct lawsuit by an individual bondholder, pursuant to section 5.08. This section is declaratory of a bondholder right provided for in section 316(b) of the Trust Indenture Act. But this unwaivable provision for a direct bondholder action goes only to separate skipped payments of interest and principal. It does not carry into a unilateral bondholder right to accelerate in respect of a payment default so as to perfect a right to sue for the entire principal amount of the issue. See section 502. Direct bondholder actions in respect of defaults other than payment defaults are subject to the ''no action'' clause in section 507. This requires that, as a prerequisite to a direct action, the plaintiff bondholder (1) assemble a group of the holders of 25 percent of the outstanding bonds, (2) make a group demand on the trustee that the trustee pursue the action, and (3) that the trustee fail to comply with the bondholders' demand. Such ''no action'' clauses are enforceable, although they are strictly construed. See Cruden v. Bank of New York, 957 F.2d 961 (2d Cir.1992). Courts also excuse compliance with the provision in the rare case where the bondholder can make out a showing of trustee incompetence, whether by virtue of negligence or a conflict of interest. See, e.g., Rabinowitz v. Kaiser–Frazer Corp., 111 N.Y.S.2d 539 (1952) (compliance excused where trustee loans to issuer facilitated the transaction that caused the event of default). In addition, no action clauses do not block bondholder suits against the trustee itself. Cruden v. Bank of New York, supra.

For a set of default provisions drafted for a private placement, see Appendix A, Form 3, Note Purchase Agreement, sections 11 and 12.