firms have many ways to increase the equity portion of their capital structures that sidestep the information asymmetry problem. Fama and French claim, id., at 551: ''[t]he pecking order, as the stand-alone model of capital structure * * * is dead. * * * This does not mean that the asymmetric information problem disappears. But its implications become quite limited: firms do not follow the pecking order in financing decisions; they simply avoid issuing equity in ways that involve asymmetric information problems.'' See also Frank and Goyal, Testing the Pecking Order Theory of Capital Structure, 67 J. Fin.Econ. 217 (2003).

SECTION B. BASIC TERMS AND CONCEPTS

1. INTRODUCTION

(A) BONDS, DEBENTURES, AND NOTES

This Section introduces some principal terms, forms, and practices respecting debt financing by means of the sale of instruments falling into the definition of ''security'' in section 2(a)(1) of the Securities Act of 1933. Section (B) follows with an introduction to some principal terms, forms, and practices respecting debt financing by means of loans.

• **Long–Term Promissory Notes.** Bonds, debentures, and notes are long-term promissory notes. No inherent or legally recognized definition distinguishes one from the other. As a matter of historical practice, bonds and debentures are long-term obligations issued under indentures, bonds generally being secured obligations and debentures being unsecured obligations. Under the historical practice, notes may be long-term or short-term obligations, but in either case are not issued pursuant to an indenture. Recent practice has changed this. Today, ''notes'' often are issued pursuant to indentures as unsecured long term obligations. But they tend to be intermediate term securities, coming due in ten years or less, where ''debentures'' tend to mature in ten years or more.

A bond, debenture, or note is simply a promise by the borrower to pay a specified amount on a specified date, together with interest at specified times, on the terms and subject to the conditions spelled out in a governing indenture or note agreement. Bonds, debentures, and notes are, then, promissory notes issued pursuant to and governed by longer contracts. Some of the governing terms and conditions will be set out on the face of the promissory note itself. Most terms, however, will be in the contract that governs the instrument and will be merely referred to on its face. The note incorporates the contract by reference.

Historically, bonds were issued in bearer form. Coupons giving the holder the right to each scheduled interest payment literally were attached to the bond to be clipped and turned into the issuer for payment. The benefit of a bearer instrument is anonymity, but it carries a concomitant risk of loss or theft. In the post-war era, the practice in this country changed, and registered bonds became the dominant form. Registered bonds, like common stock, are issued in the owner's name. The issuer, or its agent (usually the indenture trustee), keeps a registry of the owners of the issue, and remits payments of interest, prepayments of principal, and principal payments to the registered owner. Registered bonds are negotiable and transferable, with the concomitant recording of the transfer on the books of the issuer. Under the Internal Revenue Code § 163(f), issuers are denied interest deductions for bearer securities issued after 1982. As a result, new bearer bonds are not issued in this country.

Today publicly-traded bonds and notes are issued in the first instance in registered form to Cede & Co., the nominee of Depository Trust Company (DTC). This issuer creates a single instrument, termed a ''Global Security,'' and transfers it to Cede. The Global Security thereafter may be transferred only at the instance of a registered representative of DTC. Issuance to Cede & Co. facilitates book entry trading and electronic transfer of the bonds amongst members of DTC. See Appendix A, Form 1, Best Buy Indenture, Article III; Appendix A, Form 2, Best Buy First Supplemental Indenture, Exhibit A, reverse page.

Financial and legal writers use ''bond'' as a generic term for all long term debt securities. The practice will be followed here, although ''debenture'' and ''note'' will be used where particular contexts require.

• **Indentures.** An indenture is a contract entered into between the borrowing corporation and a trustee. The trustee administers interest and principal payments, and monitors and enforces compliance with other obligations on behalf of the bondholders. The indenture defines the assorted obligations of the borrower, the rights and remedies of the holders of the bonds, and the role of the trustee.

The borrower contracts with a trustee rather than directly with the bondholders so as to permit the bonds to be sold in small denominations to large numbers of scattered investors. Given widespread ownership in small amounts, unilateral monitoring and enforcement by each holder is not cost effective. The device of the trust solves this problem.

Trust indentures date back to financing of nineteenth century railroads, the earliest large-scale, long-term debt financings. Railroad entrepreneurs were forced to sell mortgage notes to many persons, since no one person was willing or able to furnish all of the funds to be raised. These bonds had to be made marketable and tradable while simultaneously carrying a lien against the mortgaged property. Each of the widely disbursed bondholders had to be given mortgage security on the railroad's assets without at the same time being granted an individual fractional interest in the collateral. The solution was to convey the mortgaged assets, under a trust indenture, to someone as trustee for the equal and ratable benefit of each of the holders. By the turn of the twentieth century, the device of the trust indenture was extended to cover unsecured borrowing by large industrial corporations.

The ''bonds'' and the ''indenture'' need to be conceptually distinguished. The bonds set out a promise to pay that runs to the bondholders. The indenture is a bundle of additional promises (including a backup promise to pay) that run to the trustee. The bondholders are third party beneficiaries of the promises in the indenture. Even though the promises in the bonds run directly to the holders, the bonds are subject to the indenture and therefore may be enforced directly by the holders only to the extent that the indenture allows. Indentures generally constrain the unilateral enforcement rights of small holders, channeling enforcement through the central agency of the trustee. The device of the trust indenture, then, not only facilitates enforcement by the widely scattered holders, but also restrains such enforcement. It facilitates borrowing in small amounts from large numbers of widely scattered lenders not only by constraining the issuer as against the holders, but by protecting the issuer from the holders.

Where, as in a private placement of notes to an insurance company or pension fund or a long-term loan by a bank, the loan is large enough to make direct monitoring and enforcement cost effective, the trust device is not employed. Such a note is issued pursuant to a "note agreement" or "loan agreement" entered into between the borrower and lender directly.

• **Terms of Indentures.** In many respects, trust indentures do not change much from decade to decade. The following summary of their contents from 1 A. Dewing, The Financial Policy of Corporations 173–74 (5th ed. 1953), remains accurate:

"* * * This rather elaborate document has, ordinarily, six important sets of provisions, some of which are mere recapitulations or elaborations of statements made in the primary contract, the bond, and some are provisions only indirectly referred to in the bond. There is, first, the set of provisions summarizing the amounts of money and the future date of payment, the interest rate and the time of interest payment—provisions which acknowledge that the bondholder is a creditor of the corporation entitled to the payment of his loan with interest. Furthermore, if the payment of the debt may be anticipated by the corporation, the fact will be clearly stated, together with the specific mechanism of prepayment which shall insure fairness to all the scattered bondholders. The second set of provisions describes the character and the extent of the property against which the bondholder may levy in order to satisfy his debt. If there is no such property, the agreement will categorically state that fact. Thirdly, there is a set of provisions which represents the special covenants accepted by the corporation which insure the preservation of the value of the corporate property, during the long period while the debt shall endure. The corporation will pay its taxes, make the necessary repairs, set aside adequate reserves for depreciation, replace worn-out or obsolete equipment, protect its franchises or patent rights; it will not give a prior lien to the property reserved for the bondholders. The corporation agrees not to permit the wastage or destruction of the property covered by the agreement. Fourthly, there is a set of provisions which defines with a high degree of precision the exact course the bondholders, acting individually or together, must pursue in order to levy on the corporation, as general creditors, or to levy on the specific property, if any, set aside for the security of the bonds issued under the indenture. Again, fifthly, there are provisions describing the duties and the obligations of the trustee. These clauses define with precision what he can and what he cannot do, on behalf both of the corporation and of the individual and collective bondholders. Finally—as a matter of tradition because the trustee could not legally do otherwise—there is a covenant on the part of the bondholders, acting through the trustee, that when the corporation has paid back the original loans—the face of the bonds—and has met the successive payments of interest, the lien or claims of the bondholders will cease and the corporation will no longer be bound by any of the promises of the bonds or the supplementary agreement.''

Traditionally, the third item on Dewing's list—protective provisions—appears in stronger, more complex versions in indentures governing debentures than in indentures governing bonds (narrow definition). The holder of a bond relies on the security of pledged assets in addition to the earning power of the going concern. The holder of a debenture has no mortgage on particular property and relies on the going concern. Provisions of indentures, the so-called ''business covenants,'' protect this reliance and thereby protect the debenture's value. The most important of these provisions limit the issuer's power (a) to pledge its free assets to other creditors, (b) to incur additional debt on a parity with, or superior to, the debentures, and (c) to make dividends or other payments to holders of its stock.

The terms and protective provisions in indentures accreted over a long period, reflecting the accumulated experience of generations of lawyers. Four decades ago the American Bar Foundation sponsored a Corporate Debt Financing Project to reform the complex and convoluted terms of indentures and offered a standardized form of the most conventional covenants and provisions. Its efforts have produced model incorporating forms of indentures, standard or ''model'' indenture provisions (sometimes with alternatives), and ''negotiable'' provisions for terms most likely to vary with particular borrowings. See Model Debenture Indenture (1965) and related Sample Incorporating Indenture; Model Debenture Indenture Provisions—All Registered Issues (1967) and related Sample Incorporating Indenture; Commentaries on both the 1965 and 1967 products. A more recent Model Simplified Indenture (text and accompanying notes in 38 Bus.Law. 741 (1983)), based on a form originally prepared by Morey W. McDaniel, simplifies the language of frequently used provisions. A Revised Model Simplified Indenture has appeared (text and notes in 55 Bus. Law. 1115 (2000)).

Appendix A Form 1 sets out an Indenture between Best Buy Co. and Wells Fargo Bank, N.A., as Trustee, executed and delivered on March 11, 2011 as a part of a shelf registration. Appendix A Form 2 sets out a First Supplemental Indenture between Best Buy Co. and Wells Fargo Bank, N.A., as Trustee, executed and delivered on March 11, 2011, pursuant to which Best Buy issued $350,000,000 3.750% Notes due 2016 and $500,000,000 5.5% Notes due 2021 in an underwritten public offering. The forms descend from the American Bar Foundation Model Debenture Indenture.

• **Duration.** The bond's face states a due date. But ascertaining a bond's maturity often is a complicated matter that cannot be settled by a simple reference to the face of the bond. Most bond issuers must make ''sinking fund'' payments—prepayments of principal in advance of the due date. A bond subject to these mandatory prepayments has, in substance, serial maturities.

Complicating matters, many bonds are redeemable, in whole or in part, at the option of the borrowing corporation. The redeeming issuer is said to "call" the bond. In other words, the indenture provides for prepayments of principal at the option of the issuer in addition to the prepayments of principal that the issuer is required to make. Sinking fund payments disadvantage the borrower, while redemption payments disadvantage the lender. Sinking fund and redemption provisions are treated at greater length infra.

• **Public Offerings and Private Placements.** When bonds are offered to the public, the issuer and underwriters must comply with the registration requirements of the Securities Act of 1933. In addition, the execution of a trust indenture conforming with the requirements of the Trust Indenture Act of 1939 is mandatory for public offerings. The compliance process requires substantial lead time, although large issuers can shortcut the registration process through the shelf registration device provided for in Rule 415 under the 1933 Act. The company registers a large quantity of securities for future issue—up to two years in advance. When it wishes to offer and sell some of these preregistered securities, it files an amendment with the SEC containing details about the securities on offer. Under this system, new debt securities can be publicly marketed in a matter of days. Transaction costs are lowered and the issuer gains timing flexibility. The public debt markets hold out economies of scale respecting flotation costs for large issues of bonds only. Krishnasami, Spindt, and Subramaniam, Information Asymmetry, Monitoring, and the Placement Structure of Corporate Debt, 51 J. Fin. Econ. 407 (1999).

Issuers too small to gain access to the public debt markets and issuers too small to qualify for shelf registrations may issue long-term debt securities in the private placement market. Both the 1933 Act, in section 4(2) and Rule 144 thereunder, and the 1939 Act, in section 304, contain exemptions for securities that are not offered to the general public. Under these sections, registration of the issue and the qualification of a trust indenture can be avoided if the offer and sale of the bonds is limited to a small number of sophisticated institutional investors. In a classic, "old-style" private placement, the borrower's investment banker uses its best efforts to identify purchasers, but does not underwrite the debt securities, which are sold directly to the institutional purchaser or purchasers, pursuant to a contract between the borrower and the purchaser.

These transactions involve face-to-face negotiations between the issuer, its investment banker, and an institutional purchaser or purchasers. The investment banker, with a view to protecting the availability of the 4(2) exemption, will restrict its sales communications to familiar customers and keep a record of contacts made. Counsel delivers an opinion confirming the availability of the exemption at the closing. But, because the institutional purchasers do not intend to resell the debt securities, there is customarily no due diligence procedure involving counsel and no 10b–5 disclosure letter. The process can be concluded quickly and relatively cheaply. The compliance and incidental expenses of public offerings are avoided. Terms can be tailored to meet the borrower's situation and needs. Funds can be disbursed at intervals to meet the borrower's specific financing needs.

Before the development of the junk bond market, described below, private placements, along with long-term loans from banks, were the only available source of long term debt financing for small and medium sized issuers whose debt was rated Ba, B, or below. These issuers remain prominent in the private placement market. As a result, the face amount of each issue of debt sold in a private placement transaction can be smaller than that sold in a public offering. Large corporate borrowers also enter the private placement market—when the available terms are as favorable as those on offer in the public market.

Private placement note agreements for small and medium sized issuers tend to contain tighter, more complex business covenants than do trust indentures governing public issue debentures and notes. From the lender's point of view, a private placement represents a long-term commitment of capital to a smaller issuer—a less secure investment than those on offer in the public trading market. Such a loan imports high risk; strict covenants lessen the risk. Tighter monitoring does so also. Thus, the private placement lender can be expected to do its own careful study of the borrower before committing to lend. The absence of public disclosure requirements creates an environment conducive to frank discussion of the borrower's prospects. The monitoring continues during the life of the loan: private placement note agreements tend to provide for more extensive periodic reports than do public indentures.

From the borrower's point of view, strict business covenants are not only inconvenient, they also create the possibility of a contractual barrier to beneficial new investment activity. Given such a barrier, and a good new investment, a waiver of the covenant solves the problem. In the case of publicly traded debentures, the costs of collecting the consents requisite for the waiver may be substantial and a consideration often is expected. In contrast, with a single or small group of institutional investors it is mechanically more feasible to obtain the lender's waiver and a consideration generally is not demanded. Indeed, periodic renegotiation of terms according with the changing circumstances of the borrower is not uncommon in private placement relationships. Private placement noteholders are likely to be responsive to changes that the borrower perceives will enhance its economic well being.

Traditionally, life insurance companies have been the largest lenders in the private placement market. Pension funds also participate heavily. The life companies are constrained by credit quality controls imposed by the National Association of Insurance Commissioners. These constitute six credit categories, numbered 1 through 6, with investment grade being 1 and 2. Lender reserve requirements increase as the borrower's credit rating goes down. As a result many life companies do not lend below grades 1 and 2, making such lenders less of a factor in the private placement market.

As between publicly issued debt, bank borrowing, and private placements, there is a rule of thumb as to which borrowers use which mode of financing. The highest quality borrowers go to the public markets; medium quality borrowers go to the banks for term loans; the lowest quality must resort to the private placement market. For empirical verification, see Denis and Mihov, The Choice Among Bank Debt, Non–Bank Private Debt, and Public Debt: Evidence from New Corporate Borrowings, 70 J. Fin. Econ. 3 (2003).

• **Rule 144A.** Rule 144A, promulgated under the 1933 Act in 1990, permits trading of private placement notes among institutional investors meeting stated qualifications (''qualified institutional buyers''). The resulting Rule 144A market imports liquidity to private placement investment, blurring the distinction between publicly-and privately offered debt. Rule 144A also provides foreign issuers an inexpensive means of access to United States debt markets.

Many new issues under Rule 144A come from investment grade firms which find that the Rule 144A market facilitates the sale of debt securities at more advantageous prices, more favorable terms, and at lower transaction costs than do traditional private placements or public offerings. Rule 144A covers resales, but not original issues. It follows that the borrower sells to the underwriter under the 4(2) exemption. Resale into the 144A market can be effected without a registration statement because the Rule provides that an intermediary who resells securities purchased in a private placement is neither deemed a dealer under section 4(3) of the 1933 Act nor an underwriter under section 2(11).

Although 1933 Act registration requirements are dispensed with, federal antifraud rules do apply to any disclosures made in the offering documents. Rule 144A offerings accordingly involve due diligence by the investment bank and its counsel, in addition to the preparation of an offering memorandum and the execution of a purchase agreement between the investment bank and the issuer. The investment bank's counsel issues a 10b–5 disclosure letter stating that counsel has undertaken certain due diligence procedures and, based thereon, has no reason to believe that an offering document contains an untrue statement of material fact or omits to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

The Rule 144A market has become a full-scale third market positioned between the public and private alternatives. As in the public markets, the rating agencies play a critical informational role. In addition, 144A securities may be converted into public securities through *ex post* registrations or exchange offers.

• **Credit Ratings.** Issuers pay three firms, Moody's and Standard & Poor's, and Fitch, to rate their debt for creditworthiness. The firms assess the likelihood of default. The ratings do not cover risk due to changes in interest rates. Under Moody's rating system ''high grade'' is Aaa and Aa; ''medium grade'' is A and Baa; ''low grade,'' or ''junk'' is Ba and B; Caa and Ca is lower still; C is in default. A 1, 2 or 3, added to a Moody's rating functions like a plus or a minus, with a 1 being a plus. Standard & Poor's rates between AAA and D (default). Junk is below BBB.

A firm's credit rating tends to determine its mode of debt finance. Large firms with investment-grade credit ratings tend to borrow at the short and long end of the maturity spectrum. Firms with speculative rating tend to borrow for the intermediate term. Guedes and Opler, The Determinants of the Maturity of Corporate Debt Issues, 51 J.Fin. 1809 (1996); Barclay and Smith, The Maturity Structure of Corporate Debt, 50 J. Fin. 609 (1995).

Credit ratings and credit rating agencies have been much criticized in recent years. See e.g., Partnoy, The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies, 77 Wash.U.L.Q. 619 (1999). The financial crisis brought matters to a head. The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States 118–120 (2011), describes the various facets of the problem:

"Credit ratings have been linked to government regulations for three-quarters of a century. In 1931, the Office of the Comptroller of the Currency let banks report publicly traded bonds with a rating of BBB or better at book value (that is, the price they paid for the bonds); lower-rated bonds had to be reported at current market prices, which might be lower. In 1951, the National Association of Insurance Commissioners adopted higher capital requirements on lower-rated bonds held by insurers. But the watershed event in federal regulation occurred in 1975, when the Securities and Exchange Commission modified its minimum capital requirements for broker-dealers to base them on credit ratings by a 'nationally recognized statistical rating organization' (NRSRO); at the time, that was Moody's, S & P, or Fitch. Ratings are also built into banking capital regulations under the Recourse Rule, which, since 2001, has permitted banks to hold less capital for higher-rated securities. For example, BBB rated securities require five times as much capital as AAA and AA rated securities, and BB securities require ten times more capital. Banks in some countries were subject to similar requirements under the Basel II international capital agreement, signed in June 2004, although U.S. banks had not fully implemented the advanced approaches allowed under those rules.

"Credit ratings also determined whether investors could buy certain investments at all. The SEC restricts money market funds to purchasing 'securities that have received credit ratings from any two NRSROs . . . in one of the two highest short-term rating categories or comparable unrated securities.' The Department of Labor restricts pension fund investments to securities rated A or higher. Credit ratings affect even private transactions: contracts may contain triggers that require the posting of collateral or immediate repayment, should a security or entity be downgraded. Triggers played an important role in the financial crisis and helped cripple AIG.

"Importantly for the mortgage market, the Secondary Mortgage Market Enhancement Act of 1984 permitted federal- and state-chartered financial institutions to invest in mortgage-related securities if the securities had high ratings from at least one rating agency. 'Look at the language of the original bill,' Lewis Ranieri told the FCIC. 'It requires a rating. . . . It put them in the business forevermore. It became one of the biggest, if not the biggest, business.' As Eric Kolchinsky, a former Moody's managing director, would summarize the situation, 'the rating agencies were given a blank check.'

"The agencies themselves were able to avoid regulation for decades. Beginning in 1975, the SEC had to approve a company's application to become an NRSRO—but if approved, a company faced no further regulation. More than 30 years later, the SEC got limited authority to oversee NRSROs in the Credit Rating Agency Reform Act of 2006. That law, taking effect in June 2007, focused on mandatory disclosure of the rating agencies' methodologies; however, the law barred the SEC from regulating 'the substance of the credit ratings or the procedures and methodologies.'

"Many investors, such as some pension funds and university endowments, relied on credit ratings because they had neither access to the same data as the rating agencies nor the capacity or analytical ability to assess the securities they were purchasing. As Moody's former managing director Jerome Fons has acknowledged, 'Subprime [residential mortgage-backed securities] and their offshoots offer little transparency around composition and characteristics of the loan collateral. . . . Loan-by-loan data, the highest level of detail, is generally not available to investors.' Others, even large financial institutions, relied on the ratings. Still, some investors who did their homework were skeptical of these products despite their ratings. * * *

"Notably, rating agencies were not liable for misstatements in securities registrations because courts ruled that their ratings were opinions, protected by the First Amendment. Moody's standard disclaimer reads 'The ratings . . . are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell, or hold any securities.' Gary Witt, a former team managing director at Moody's, told the FCIC, 'People expect too much from ratings . . . investment decisions should always be based on much more than just a rating.' "

Under the Credit Agency Reform Act of 2006, 15 U.S.C. § 78o–7, the SEC implemented registration, record keeping, financial reporting, and oversight rules. Sections 931 to 939 of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111–203, H.R. 4173, expand and tighten regulations governing NRSROs. They increase internal controls, require greater transparency of rating procedures and methodologies, extend a private right of action to investors, and provide enforcement and examination tools to the SEC. The Act also removes a long series of references to credit ratings in federal statutes toward the end of making their use optional rather than mandatary.

Governance rules figure prominently in the Dodd–Frank scheme. Each NRSRO must create and maintain an internal control structure. Subject to regulations to be issued by the SEC, each NRSRO must have a board of directors with at least one-half independent directors, a portion of whom must be users of credit ratings. In addition, each NRSRO must have a compliance officer who has no involvement with the generation or marketing of ratings and whose compensation is unlinked to the company's financial performance. Disclosure rules also are relied upon. For example, employment of an actor formerly employed by a client must be reported to the SEC.

The SEC is instructed to make (1) rules assuring separation of the analytical and marketing department of the business, (2) rules barring service provision to clients by employees of credit rating agencies, and (3) rules ensuring that ratings are developed and determined in accordance with approved procedures and methodologies. Toward the end of standardizing the meaning of ratings made by different agencies, the SEC will be issuing rules requiring the agencies to establish policies and procedures that assess the probability a future issuer payment default. The SEC is also charged to promulgate rules laying down qualification and testing standards for analysts.

New SEC rules will also impose public disclosure burdens on NRSROs. They will be required (1) to disclose performance information of initial ratings and of subsequent changes; and (2) to fill out a form to accompany each rating presenting information about the rating's underlying assumptions, methodologies, and data.

There are several liability provisions. The Act nullifies the SEC rule that exempted credit ratings from being considered a part of a registration statement prepared or certified by a person within the meaning of 1933 Act sections 7 and 11. As a result, an issuer wishing to include an NRSRO rating in a registration statement will need to procure the NRSRO's permission. Such consent holds out potential liability for the NRSRO as an expert under section 11 in respect of material misstatements or omissions. More broadly, the enforcement and penalty provisions of the securities laws will apply to credit rating agencies to the same extent that they apply to accounting firms and securities analysts. Moreover, statements of credit rating agencies will not be treated as forward-looking for purposes of the safe harbor in section 21E of the 1934 Act.

• **Variations on the Fixed–Interest, Investment Grade Bond. (a)** ***Floating rate bonds.*** A floating interest rate reduces the risk of interest rate volatility, and such issues are particularly likely to appear during inflationary periods. A floating rate is adjusted periodically to keep current with changes in the lender's short term cost of funds. Coupon payments are a function of the value of a stated interest rate index, such as the Treasury bill interest rate, the 30–year treasury bond rate, or LIBOR (the London interbank offered rate) at the time the payment is due. The floating rate can be subject to a floor or a ceiling. There are many variations on the theme. In recent years, floating rate corporate lending has concentrated in the riskier sectors—loans to private equity buyouts or distressed firms.

(b) ***Zero coupon bonds.*** These are bonds that pay a lump sum at maturity and no interest at all. They therefore are offered at very deep discounts. As single-payment vehicles, they are attractive to investors wishing to lock up yield over a specified period or wishing to obtain a precise duration instrument. ''Original issue discount bonds,'' are similar.

These bonds are issued at a very low interest rate and hence also sell at a deep discount at original issue.

(c) *Convertible bonds*. Convertible bonds are debentures or notes that can be changed at the holder's option into a specified number of shares of the issuer's common stock. These ''hybrid'' securities combine the downside protection of senior status with the upside potential of common stock. See infra Part III.B.

(d) *Junk bonds*. Fifty years ago the private placement market was the only alternative to bank borrowing for small and medium sized issuers looking for long-term debt capital. The public markets were foreclosed to these lower grade companies. This changed with the development of a ''junk bond'' market constituted of publicly traded low-grade debt.

In the bond market, ''junk'' means ''below investment grade.'' All junk bonds are high yield/high risk instruments. There are two subcategories, ''fallen angels'' and original issue junk bonds. Fallen angels are bonds that had investment grade status at the time of original issue but that suffer later down-grading due to increased default risk respecting their issuers.

Junk bonds have been controversial. During the 1980s they were associated with Michael Milken and the Drexel Burnham Lambert firm. Together Milken and Drexel put together an extensive network of junk bond issuers and purchasers, and, in the mid- and late-1980s Drexel junk issues became the financing engine for the period's high leverage corporate restructurings. But the junk bond market collapsed in 1989, due to a wave of defaults, an impending recession, and new regulatory constraints on the portfolios of institutional bond purchasers. The junk bond default rate went from 4 percent of issues in 1989 to 10 percent in 1990–1991. New issues dried up. In February 1990, Drexel went down as well, under pressure from government regulators for securities law violations. Milken, pursued by Rudolph Giuliani, then a Manhattan U.S. Attorney, spent time in jail.

Unlike Drexel, the junk bond market recovered. New issues began to reappear in 1992, and the market grew steadily until the collapse of the credit markets commenced in the summer of 2007. At this writing, the market has bottomed out and is back on the upswing. See infra, Part II.E.

• **Commercial Paper.** Many firms require outside financing to handle short intervals in which cash inflows fall short of cash outflows. Large, highly rated firms requiring short term financing can issue commercial paper. This consists of promissory notes maturing within 270 days, and so exempted under section 3(a)(3) of the 1933 Act. Some commercial paper is issued through a handful of major dealers, who purchase it and resell it in a market dominated by institutional investors. The largest issuers bypass the dealers and sell to the institutions directly. Rates are lower than those prevailing on bank lines of credit.

(B) LOANS

The 1933 Act effects a fundamental distinction between debt ''securities'' and loans, the latter usually but not necessarily being made by banks. The former are subject to registration requirements (unless exempted) and antifraud rules while the latter are not. Economically speaking, the distinction is not nearly as fundamental as the federal securities laws would lead one to believe. Institutionally speaking, the distinction made sense when the 1933 Act was enacted: Mom and pop bond buyers needed an assist from mandated disclosure where powerful bank lenders did not. The institutional distinction has gotten more and more blurred as time has passed. Today's bond purchasers are almost uniformly sophisticated investors. While perhaps not as powerful as banks, they are not without means of self-protection. The same actors participate as lenders in syndicated bank loans. As the lines between the players lose clarity, the debt markets converge even as the securities laws continue to divide them into different substantive categories.

The descriptions that follow draw on Taylor and Sansone, The Handbook of Loan Syndications & Trading (2007) and Wight, The LSTA's Complete Credit Agreement Guide (2009).

- **Revolving Credit Loans.** Under a revolving credit arrangement, a lender or group of lenders makes a commitment (a ''line of credit'') to loan up to a stated ceiling amount for a stated period. The borrower pays an annual fee (the facility fee) in exchange for the lenders' commitment to provide funds. The borrower may or may not draw down on the commitment; when it does, it may or may not borrow up to the limit of the commitment. The borrower may borrow, repay, and reborrow during the commitment period, so long as the lending limit is not exceeded and lending conditions are met. This in-and-out arrangement makes sense, say, for a manufacturer that incurs cash costs of production in advance of its principal selling season. The manufacturer needs to manage a lag between the time the expenses have to be paid and the time the sales revenues that cover them are realized. Short term borrowing under a revolving credit facility is a financial solution to the problem.

Many revolving credit commitments run for 364 days. Here the bank takes advantage of a capital regulation pursuant to which a commitment extended for a year or more triggers additional capital requirements. A 364 day facility thus costs the bank less and carries a lower facility fee. Companies in the higher tier of investment grade borrowers line up these facilities, often as a back up to borrowing in the commercial paper market. That is, the commitment is made and the facility fee is paid, even as the borrower expects never to draw on the line of credit, assuming that the public markets will provide for its short term borrowing requirements. (These back-up lines were drawn down in large volume in 2007–2008 in the wake of a sharp contraction of the commercial paper market.) Given credit availability in public markets, actual draw downs under revolving credit facilities tend to be made by the lower tier of investment grade companies.

If a revolving credit borrower is not an investment grade company, then the loan is likely to be secured by security interest in the borrower's receivables and inventories. In this secured transaction, the lending cap will be a function of both a dollar limit and a test keyed to the amount of available assets providing security. For example, the commitment could have a $200 million limit, provided that at the time of any borrowing the amount of pledged receivables and inventories exceed the outstanding principal amount by a specified percentage, with pledged receivables providing satisfactory security to the extent of 80 cents per dollar of book value and pledged inventories providing satisfactory security to the extent of 50 cents on the dollar of book value. Such a loan is described as ''asset based;'' the available collateral is the ''borrowing base.'' The discount built into the test provides the lender a cushion of over-security.

With bonds and private placement notes, interest tends to be set at a constant rate. Bank credit agreements tend to employ a floating rate be set out as the sum of a base component, either the bank's prime rate or, more often, LIBOR, plus a margin that is usually fixed, but in some cases is made subject to periodic adjustment. Thus might interest be set at LIBOR plus 1½ percent, with the rate's float stemming from the rise and fall of LIBOR

There are many variations on the basic theme. A revolving credit facility can be ''evergreen;'' that is, the borrower is conceded an annual option to extend the facility for an additional year, and, with the lenders' consent, for further one-year periods.

A revolving credit facility also can include a ''swingline''—a smaller overnight credit line. Draw downs under revolving facilities tend to require a one-day or three-day notice and are subject to minimum amount restrictions. Given a syndication, the entire group of lenders participates pro rata in accordance with their commitments. Swingline loans come from the lead lender on shorter notice, in a smaller allowed amount, and with shorter durations (a week or two).

A highly-rated borrower can get a ''competitive bid option.'' Here the borrower gets to go to the lenders in the syndicate and solicit bids for loans. The bank offering the money at the lowest cost wins the auction.

A ''term out'' gives the borrower an option to convert the loan under the revolving credit agreement into a term loan on a stated conversion date. Term outs tend to automatic; that is, at the facility's expiration date, the outstanding principal amount automatically becomes a term loan to be repaid in accordance with a set amortization schedule. With an automatic term out, borrowing under a 364 day facility will be treated as long term rather than short term.

The borrower can get an option to draw down in currencies other than U.S. dollars. This is likely to occur where the borrower has assets and liabilities and revenues and expenses in nondollar currencies. The borrower thereby reduces transaction costs of currency conversion and hedges against exchange rate fluctuations.

• **Letters of credit.** A revolving credit facility may include a commitment to issue letters of credit. Hypothesize a purchase of goods abroad from a seller who demands payment upon delivery to a carrier abroad. A letter of credit effects the payment. The bank (the issuer) issues a letter of credit to the borrower (the account party) agreeing to pay the third party seller (the beneficiary) a stated sum on the condition that the beneficiary delivers specified documents, such as a bill of lading proving that the goods have been delivered to the carrier, along with proof of insurance and whatever else is needed to assure the free and clear arrival of the goods. The issuer assumes an unconditional duty to honor the commitment upon presentation of the specified documents. The account party thereupon has a duty to reimburse the issuer.

• **Term loans–tranche A.** Term loans do not revolve. Once a sum is borrowed and repaid, the transaction is complete with no possibility for further borrowing. Tranche A term loans usually are structured as installment loans to be repaid in a scheduled series of amortized payments, often over three years with payments made quarterly. Durations rarely exceed six years. Alternatively, the borrower can make a one-time lump sum repayment at maturity (a bullet).

The tranche A denomination signals that the term loan is extended by a group of lenders as pro rata participants in a syndication. Usually, the term loan is packaged together with a revolving credit facility. Tranche A lenders usually are banks (as opposed to other institutional investors). The lenders who extend the loans under the revolving credit facility make a ratable contribution to the term loan.

• **Term loans–tranche B.** These are distinct term loan facilities created for participation by nonbank institutional investors—mutual funds, hedge funds, insurance companies, and, most prominently in the run up to the financial crisis, collateralized loan structures (CLOs). These nonbank institutions are distinguished from banks for their ability to make longer term debt investments. Accordingly, tranche B loans tend to have longer maturities than tranche A loans. Five to seven years is the usual range. Tranche B loans also tend to have back-ended principal repayment features—the loan may provide for a nominal principal repayment of one percent per year until the final year or period, at which time the entire principal amount becomes due. There is no custom of pro rata participation within the group of lenders.

Tranche B loans are a relatively recent phenomenon. They first appeared in the early 1990s, at roughly the same time as the 144A market, but did not play a major role in corporate finance until the recession of 2000–2002, when they made up for reduced lending capacity at the banks.

• **Leveraged loans.** This is a term of art denoting a syndicated loan made to a non-investment grade borrower. The ''leverage'' in a leveraged loan is not the loan itself, but the state of the borrower's capital structure, which happens to be leveraged. The low credit rating and degree of leverage show in the interest rate, the spread of which will lie between 1½ percent over LIBOR at the narrow end and then widen up to 4 percent as the borrower's credit rating goes lower. There is an overlap between leveraged loan borrowers and junk bond issuers. But the correspondence is not one-to-one. Companies too weak to gain access to the junk bond market often manage to find leveraged loans.

• **Syndication.** Syndication is a variant of underwriting. The syndicator is the lead bank. It ''arranges'' the loan and takes a fee from the borrower in exchange. In an underwritten deal, the syndicator guarantees the entire loan commitment and then syndicates the loan, which in effect means bringing other lenders in to take pieces. If the syndicator cannot find lenders sufficient to take up all the pieces on offer, it is stuck with the difference. A best-efforts syndication works differently. Here the syndicator commits to take less than the full amount of the loan and uses its best efforts to find lenders for the rest. If the market yield less than a full complement, the deal may require revision.

During the life of a syndicated loan, the syndicator is likely to act as the loan's administrative agent. As such, it receives and passes on notices from the borrower; it receives and distributes funds both to and from the borrower; it takes title to the security. Note that it acts as the lenders' agent and not the borrower's. Its duties are ministerial, rather than fiduciary. An analogy to the function performed by a bond issue's indenture trustee is noted. But an important difference also is noted—here the agent is also likely to the largest lender and acts in different capacities.

Most revolving credit and term loan facilities are effected as syndications. Smaller loans—in the $25 to $100 million range—sometimes are done as ''club deals.'' Here the loan is marketed to selected and small group of lenders each of whom takes an equal piece of the loan and the finder's fee. A direct analogy to the set up of a classic private placement is noted.

(C) POINTS OF COMPARISON

Debt ''securities''—bonds, debentures, and notes—tend to have longer maturities than do bank loans, sometimes much longer. Tranche A term loans and tranche B term loans, viewed as a single class, have a durational spread that clumps between three and seven years, with only a few loans going for a longer term. Private placements tend to have a weighted average duration of between seven and ten years with a portion of the loan extending for fifteen years. Bond maturities vary from three to five years to thirty or forty years.

Debt ''securities'' also tend to pay interest at a fixed rate. Sharp conflicts of interest arise between the borrower and the lender as a result. If interest rates drop, the borrower wants to pay down the loan early in order to take advantage of cheaper money. If interest rates increase, the lender has an interest in getting the principal back in order to be able to relend it at a higher rate. Unsurprisingly, fixed rate loans tend to be accompanied by complicated contractual arrangements concerning early payment (prepayment), including onerous financial penalties in some cases. Bank loans, in contrast, pay at a floating rate. It follows that prepayment terms are not an issue. Bank loans tend to be prepayable at any time at a nominal penalty or at no penalty.

Bank loans are particularly susceptible to renegotiation. Roberts and Sufi, Renegotiation of Financial Contracts: Evidence from Private Credit Agreements, 93 J. Fin. Econ. 159 (2009), looks at 1,000 bank credit agreements and finds that 75 percent have a major financial term (maturity, principal, interest rate) adjusted before maturity. The figure rises to 96 percent for the subset having a maturity of three years or longer. Only 18 percent of the renegotiations follow from covenant or payment defaults. In most of the cases, borrowers whose financial condition is improving go back to the bank for better terms.

The bond and loan markets thus feature different products, products made available to all types of corporate borrowers. An AA credit might have a back up revolving credit facility even as it issues commercial paper for short term funding and issues bonds for long term funding. At the opposite end of the spectrum lie smaller borrowers, companies with less than $500 million in sales and earnings before interest, tax, depreciation and amortization (EBITDA) in the range of $25 to $50 million. These companies will not have access to the bond market and, indeed, are unlikely to be rated, but can look for funding from either the syndicated loan market or the private placement market.

Decades ago, private placements and bank loans had an important thing in common—there was no public trading market in either. To buy the note or make the loan was to hold the paper to maturity. Today, there are trading markets on both sides of the line. The 144A market facilitates liquidity in unregistered debt securities. The bank loan market, although unstructured as regards securities law compliance, looks very similar. Meanwhile, all of the markets suffer from illiquidity when compared to the equity market. See, e.g., Bao et al., The Illiquidity of Corporate Bonds, 66 J. Fin. 911 (2011)(showing that illiquidity is more important than credit risk in accounting for changes in bond yield spreads).

2. CORPORATE TRUST AND THE TRUST INDENTURE ACT OF 1939

Elliott Associates v. J. Henry Schroder Bank & Trust Co.

United States Court of Appeals, Second Circuit, 1988.
838 F.2d 66.

■ ALTIMARI, CIRCUIT JUDGE:

[The case involved an indenture which required the issuer to give 50 days notice to the Trustee of an issue of convertible debentures before redeeming the debentures, ''unless a shorter notice shall be satisfactory to the [t]rustee.'' The provision was designed to give the Trustee enough time to handle the mechanics of sending notice of redemption to the debenture holders within the time prescribed for such notice to them. If the Trustee required less time for the mechanics, it was authorized to waive—that is, shorten—the 50 day period within which the issuer was to inform the Trustee of its proposed redemption; the notice period for the bondholders would not be affected by the waiver. In this case, if the Trustee did not shorten the 50 day period, the redemption would have occurred on a date *after* an interest payment was due on the debentures; on the other hand, if the Trustee shortened the 50 day period, the issuer could redeem *before* the interest payment date, and thus save itself one semi annual interest payment. The Trustee shortened the notice period because the mechanics of the particular redemption were simple and could easily be handled within a shorter period. The notice provision, including the waiver clause, was modeled on the American Bar Foundation Model Indenture, and it apparently was the regular practice of Trustees to shorten the notice period in circumstances in which they did not need the full period to handle the mechanics. In a debenture holder's class action against the Trustee for shortening the notice period, the Court of Appeals affirmed the holding of the District Court that ''the trustee's waiver did not constitute a breach of any duty owed to the debenture holders—under the indenture or otherwise—because a trustee's pre-default duties are limited to those duties expressly provided in the indenture.'' The court of Appeals (Altimari, J.) went on as follows.]

Thus, it is clear from the express terms of the Act and its legislative history that no implicit duties, such as those suggested by Elliott, are imposed on the trustee to limit its pre-default conduct.

It is equally well-established under state common law that the duties of an indenture trustee are strictly defined and limited to the terms of the indenture, see, e.g., Green v. Title Guarantee & Trust Co., 223 A.D. 12, 227 N.Y.S. 252 (1st Dep't), aff'd, 248 N.Y. 627, 162 N.E. 552 (1928); Hazzard v. Chase National Bank, 159 Misc. 57, 287 N.Y.S. 541 (Sup.Ct.N.Y.County 1936), aff'd, 257 A.D. 950, 14 N.Y.S.2d 147 (1st Dep't), aff'd, 282 N.Y. 652, 26 N.E.2d 801, cert. denied, 311 U.S. 708 (1940), although the trustee must nevertheless refrain from engaging in conflicts of interest. See United States Trust Co. v. First National City Bank, 57 A.D.2d 285, 394 N.Y.S.2d 653 (1st Dep't 1977), aff'd, 45 N.Y.2d 869, 410 N.Y.S.2d 580 (1978).

In view of the foregoing, it is no surprise that we have consistently rejected the imposition of additional duties on the trustee in light of the special relationship that the trustee already has with both the issuer and the debenture holders under the indenture. See Meckel v. Continental Resources Co., 758 F.2d 811, 816 (2d Cir.1985); In Re W.T. Grant Co., 699 F.2d 599, 612 (2d Cir.), cert. denied, 464 U.S. 822 (1983); Browning Debenture Holders' Comm. v. DASA Corp., 560 F.2d 1078, 1083 (2d Cir.1977). As we recognized in *Meckel,*

> [a]n indenture trustee is not subject to the ordinary trustee's duty of undivided loyalty. Unlike the ordinary trustee, who has historic common-law duties imposed beyond those in the trust agreement, *an indenture trustee is more like a stakeholder whose duties and obligations are exclusively defined by the terms of the indenture agreement.*

758 F.2d at 816 (citing Hazzard v. Chase National Bank, supra) (emphasis added). We therefore conclude that, so long as the trustee fulfills its obligations under the express terms of the indenture, it owes the debenture holders no additional, implicit pre-default duties or obligations except to avoid conflicts of interest.

* * *

* * * It is clear that Schroder complied with the letter and spirit of the indenture when it waived compliance with the full 50–day notice. Schroder

was given the discretion to waive full notice under appropriate circumstances, and we find that it reasonably exercised that discretion.

To support its argument that Schroder was obligated to consider the impact of the waiver on the interest of the debenture holders, Elliott relies on our decision in Dabney v. Chase National Bank, 196 F.2d 668 (2d Cir.1952), as suppl'd, 201 F.2d 635 (2d Cir.), cert. dismissed per stipulation, 346 U.S. 863 (1953). *Dabney* provided that

> the duty of a trustee, not to profit at the possible expense of his beneficiary, is the most fundamental of the duties which he accepts when he becomes a trustee. It is part of his obligation to give his beneficiary his undivided loyalty, free from any conflicting personal interest; an obligation that has been nowhere more jealously and rigidly enforced than in New York where these indentures were executed. "The most fundamental duty owed by the trustee to the beneficiaries of the trust is the duty of loyalty. * * * In some relations the fiduciary element is more intense than in others; it is peculiarly intense in the case of a trust." We should be even disposed to say that without this duty there could be no trust at all.

196 F.2d at 670 (footnotes omitted) (citations omitted); see United States Trust Co. v. First National City Bank, 57 A.D.2d 285, 394 N.Y.S.2d 653, 660–61 (1st Dept.1977), aff'd 45 N.Y.2d 869, 410 N.Y.S.2d 580 (1978) (adopting *Dabney*). *Dabney* arose, however, in an entirely different factual context than the instant case.

The *Dabney* court examined the conduct of a trustee who knew or should have known that the company for whose bonds it served as trustee was insolvent. While possessing knowledge of the company's insolvency, the trustee proceeded to collect loan obligations from the company. The court held that the trustee's conduct in this regard constituted a breach of its obligation not to take an action which might disadvantage the debenture holders while providing itself with a financial advantage, i.e., the trustee engaged in a conflict of interest. See 196 F.2d at 673. Thus, while *Dabney* stands for the proposition that a trustee must refrain from engaging in conflicts of interest, it simply does not support the broader proposition that an implied fiduciary duty is imposed on a trustee to advance the financial interests of the debenture holders during the period prior to default. Because no evidence was offered in the instant case to suggest that Schroder benefitted, directly or indirectly, from its decision to waive the 50–day notice, and thus did not engage in a conflict of interest, it is clear that *Dabney* is inapposite to the instant appeal.

Best Buy Indenture, Appendix A, Form 1

Article VI (Duties of the trustee).

NOTE: CORPORATE TRUST

Notwithstanding the title "trustee," the norms determining the care and fidelity to which indenture trustees were held prior to enactment of the Trust Indenture Act of 1939 derived more from the terms of the Indenture (and its exculpatory clauses) than from any legally imposed fiduciary obligations. The dominance of the ''contract'' over the ''trust'' aspects of the indenture trustee's duties at common law, which is reflected in *Elliott Associates,* has not been uniformly accepted. Since Sturges v. Knapp, 31 Vt. 1 (1858), the leading early case, the decisions reveal wide variations in the conception of the trustee's role. Commentators have summarized the law as follows:

> ''Some courts have held that relationships between Trustees and investors are fiduciary. York v. Guaranty Trust Co. of New York, 143 F.2d 503 (2d Cir.1944), reversed on other grounds, 326 U.S. 99 (1945). Others have resolved controversies by drawing principles from the law of agency, regarding Trustees as agents for investors. First Trust Co. of Lincoln v. Carlsen, 129 Neb. 118, 261 N.W. 333 (1935). A third line of cases sees the indenture as essentially a contract, the terms of which exclusively define the rights and duties of Trustees. Hazzard v. Chase Nat. Bank of the City of New York, 159 Misc. 57, 287 N.Y.S. 541 (Sup.Ct.1936). The fourth approach is to regard Trustees as partaking of the characteristics of more than one relationship, such as those of both depositary and ordinary Trustees. Dunn v. Reading Trust Co., 121 F.2d 854 (3d Cir.1941).
>
> ''An examination of authorities in the corporate trust field reveals a similar divergence of opinion. Some regard Trustees solely as a fiduciary, subject to the rules of trust law in general. G.G. Bogert & G.T. Bogert, The Law of Trust and Trustee, 64–65 (2d ed. 1968); Palmer, Trusteeship under the Trust Indenture, 41 Colum.L.Rev. 193 (1941). Others see the indenture as an instrument *sui generis,* combining elements of various legal relationships, particularly contract and trust, but being identical with none. Kennedy, Corporate Trust Administration 1, note 9, at 18–25; Posner, The Trustee and the Trust Indenture: A Further Study, 46 Yale L.J. 737, 794 (1937).''

Campbell and Zack, Put a Bullet in the Poor Beast * * *. 32 Bus.Law. 1705, 1723, note 56 (1977).

For discussion of the operation of trust indentures, see Landau and Krueger, Corporate Trust Administration and Management (5th ed. 1998). For a *de novo* policy review of the entire institution of corporate trust, see Amihud, Garbade, and Kahan, A New Governance Structure for Corporate Bonds, 51 Stan. L. Rev. 447 (1999). Amihud, Garbade, and Kahan would discard the ministerial trustee of traditional corporate trust in favor of an actor with incentives actively to monitor the firm and the power not only to enforce but to renegotiate the promises in the indenture.

NOTE: THE TRUST INDENTURE ACT OF 1939

The Trust Indenture Act of 1939 (15 U.S.C. § 77aaa, et seq.) protects bondholders by requiring that publicly-issued bonds be issued pursuant to a trust indenture conforming to specific standards. In addition to regulating the terms of trust indentures, the Act sets standards for the eligibility and qualification of trustees, including conflict of interest standards.

Prior to the Act, the trustee's duties were not defined and performed so as effectively to protect the bondholders' interest. According to the Securities and Exchange Commission Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part VI (1936) 3:

'' * * * [A]n examination of the provisions of modern trust indentures and their administration by trustees will show that [the bondholders'] reliance [on the trustee to enforce their rights] is unfounded. It will show that typically the trustees do not exercise the elaborate powers which are the bondholders' only protection; that they have taken virtually all of the powers designed to protect the bondholders, but have rejected any duty to exercise them; and that they have shorn themselves of all responsibilities which normally trusteeship imports. The 'so-called trustee' which is left is merely a clerical agency and a formal instrument which can be used by the bondholders when and if enough of them combine as specified in the indenture.''

The Act was extensively amended in 1990. For critical, commentary on the level of protection for bondholders afforded by the Act, see Lev, The Indenture Trustee: Does It Really Protect Bondholders? 8 U. Miami. Bus. L. Rev. 47 (1999) and Amihud, Garbade & Kahan, supra.

Trust Indenture Act, as amended 1990, section 315, Appendix D

Senate Report No. 101–155

101st Congress, 1st Session, 1989.

Title IV—Trust Indenture Reform Act of 1939

C. Conflicts of interest

[The amended Act] would make significant changes to the Act's method for determining conflict of interest. In the Act's present form, the existence of any of the nine relationships described in section 310(b) at any time indenture securities are outstanding requires the trustee either to remove the conflict or to resign within 90 days. This requirement is an outgrowth of the 1936 Report and reflected Congress' concern about instances of abuses involving relationship between the obligor and the trustee. However, each of the instances of abuse cited in the 1936 Report arose in situations in which there had been a default on the bonds. In the cases described in the Report, the trustees took steps to protect their own financial interests, instead of protecting the interests of the bondholders. There is no indication in the legislation history of the TIA that Congress was concerned about abuses by trustees prior to a default. In its memorandum in support of the legislation, the Commission has stated that, in the absence of default, the indenture trustee's duties are essentially ministerial, consisting largely of maintaining security holders' lists and transmitting interest payments to holders. The Commission has said that prior to default, there is no incentive for a trustee, even one with a technical conflict of interest, to withhold these services. Furthermore, there is no historical evidence showing a trustee in dereliction of its duties in the absence of default.

At the time of default, however, the character of the trustee's duties becomes critically different. At that time, inconsistent loyalties in the trustee, whether to holders of other securities of the obligor, to the obligor or to an underwriter, are unacceptable. Insistence on independence after a default is necessary to permit the indenture trustee to take vigorous action for the enforcement of rights under the indenture.

The Act's current conflicts standard, disqualifying a trustee from service if a conflict exists without regard to default or the character of the trustee's duties, may unnecessarily restrict an institutional trustee's ability both to act as trustee and to engage in other legitimate business activities. * * *

[The amended Act] would recognize the differences in a trustee's duties before and after default by removing these and other restrictions on trustees pre-default conduct. This would be accomplished by making the event of default the time at which conflicts defined by section 310(b) become disabling relationships. To prevent evasion, grace and notice provisions within the indenture would be disregarded for the purpose of determining when a default occurs. In view of the added significance of the existence of a default, the legislation would require the obligor to certify annually whether a default exists under the indenture.

In a significant change from the existing statutory scheme, a creditor relationship would become a prohibited conflict of interest. The omission of the creditor relationship as a disqualification to serve as an indenture trustee has been the source of the criticism under the existing statute. No conflict could be clearer than that between the interests of a trustee with significant loans to a corporate borrower, for example, and that corporation's bondholders. On default, a trustee/creditor may become a competitor for funds of the corporation and, thus, in a relation adverse to the rights of the bondholders. Because most institutional trustees are commercial banks, a creditor relationship with the obligor is an ordinary occurrence. * * *

3. THE BONDHOLDER AND THE GOING CONCERN

(A) THE PROMISE TO PAY

1 Dewing, The Financial Policy of Corporations

(5th Ed. 1953) 172–174.

Attitude Toward Bonded Debt.—The intent of bonds is that they should be paid. The difference between bonded debt and bank loans is merely the period during which the loan shall remain outstanding. The bank expects the loan to be paid when due; the investor expects the bond to be paid when due. Yet, in view of the longer life of the bond, there has [sic] developed, through the years, two distinctly different attitudes which a corporation management may take with reference to long-term debt. In the one case the management may look upon corporate debt, and the bonds issued to represent it, as the evidence of borrowed capital; and inherent in the nature of borrowed capital is the obvious fact that the equivalent in money, once borrowed, must be returned at a later time. Debt, however distant its due date, must be paid. The other point of view ignores the strict legal implication of debt. A corporate management regards the issue of bonds as a device to give investors a favored participation in the fortunes of the enterprise in return for the willingness, on the part of investors, to accept a low fixed return. The explicit implications of the debt can be ignored; in the continuing success of the corporation, new debt can be incurred to refund the old and if the corporation is not a success, the debt