# ACTIVIST DISTRESSED DEBTHOLDERS: THE NEW BARBARIANS AT THE GATE?

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ABSTRACT

*The term "corporate raiders" previously struck fear in the hearts of corporate boards and management teams. It generally refers to investors who target undervalued, cash-flush or mismanaged companies and initiate a hostile takeover of the company. Corporate raiders earned their name in part because of their focus on value extraction, which could entail dismantling a company and selling off its crown jewels. Today, the term often conjures up images of Michael Milken, Henry Kravis, or the movie character Gordon Gekko, but the alleged threat posed to companies by corporate raiders is less prevalent—at least with respect to the traditional use of equity to facilitate a hostile takeover.*

*The growing use of debt rather than equity to cause a change of control at target companies raises new concerns for corporate boards and management teams and new policy considerations for commentators and legislators. Are activist debtholders who employ this investment strategy akin to the corporate raiders of the past? This Article explores these issues by, among other things, presenting in-depth case studies and critically evaluating the value implications of traditional takeover activity and regulation. It compares and contrasts the use of equity and debt in control contests and identifies similarities that suggest some regulation of strategic debt acquisitions is warranted. The Article proposes a proactive approach that better equips corporate boards and management teams to*

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*negotiate with activist debtholders while preserving investment opportunities for debtholders and the governance efficiencies that often flow from activism for the corporate target's other stakeholders.*

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## INTRODUCTION

> The theme of *Barbarians at the Gate* is greed and the dehumanizing effect of the acquisitions mania. No concern is shown for the people who will be hurt by the takeover, for tradition, for preserving a company that has meant so many things to so many people. Making more money is the fix that gets the junk bond junkies through their day.[1]

*Barbarians at the Gate* referred to the activities of equity investors who earned the name "corporate raiders" in the 1980s.[2] This term also reflects a common characterization of activist distressed-debt investors—investors who use a company's debt (rather than equity) to facilitate a change of control at the company.[3] Activist distressed-debt investors typically extend credit to, or purchase the debt of, financially troubled companies and then exploit the leverage associated with the underlying debt instruments to acquire ownership of the company through a debt-for-equity exchange or credit bid in a sale of the company's assets.

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1. Michael Schrader, *Barbarians at the Gate: The Fall of RJR Nabisco*, NATION'S RESTAURANT NEWS, Apr. 2, 1990, *available at* http://findarticles.com/p/articles/mi_m3190/is_n14_v24/ai_8903527.

2. *See generally* ROBERT SLATER, THE TITANS OF TAKEOVER (1999) (exploring transactions pursued by, among others, T. Boone Pickens, Carl Icahn, and Ted Turner in 1980s); Don Chew & Michael Jensen, U.S. Corporate Governance: Lessons from the 1980s (Oct. 9, 2000) (unpublished manuscript), *available at* ssrn.com/abstract=146150 (discussing takeover activity in the 1980s and resulting corporate governance implications). *See also* Roy C. Smith, *Worth Every Last Million*, WASH. POST, Jan. 21, 2007, at B1, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/01/19/AR2007011901363.html (explaining activities of corporate raiders and their influence over management compensation trends, as well as noting that corporate raiders would "cruis[e] the market for likely takeover targets and offer[] hostile bids, at premium prices, on well-known but poorly performing companies"). For historical background on the investment practices of corporate raiders, see generally DIANA B. HENRIQUES, THE WHITE SHARKS OF WALL STREET: THOMAS MELLON EVANS AND THE ORIGINAL CORPORATE RAIDERS (2000).

3. *See, e.g.*, *The Vultures Take Wing*, THE ECONOMIST, May 29, 2007, http://www.economist.com/node/8929289 ("Distressed-debt traders, who buy bonds no one else will touch, and turnaround specialists, who pull companies back from the brink, operate in a topsy-turvy world, where bad times are good and corporate wreckage yields rich rewards."); Richard Bravo & Elizabeth Hester, *KKR Turns Vulture Investor as Distressed Debt Beckons*, BLOOMBERG, Sept. 3, 2009, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5WF1xFH1Awk (explaining the "loan to own" strategy of distressed debtholders); Michael Maiello, *Third Avenue's Distressed Debt Play*, FORBES.COM (Mar. 16, 2009), http://www.forbes.com/forbes/2009/0316/048_distressed_debt_play.html (explaining similar investment strategy employed by Third Avenue Funds). For a general discussion of distressed debt investing, see MARTIN J. WHITMAN & FERNANDO FIZ, DISTRESS INVESTING (2009); *see also* Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703 (2008) (describing activities of distressed-debt investors).

Whether accomplished using debt or equity, takeover activity might impose discipline and much-needed monitoring.[4] On the other hand, such activity can also be disruptive and produce significant profits for the new owner at the expense of the other stakeholders, leaving the impression the investor raided the corporate coffers.[5] That impression is particularly acute in the distressed debt context, where shareholders and junior creditors generally are wiped out and any value created by the investment strategy flows primarily to the activist investor and perhaps the restructured company to a limited extent.

This Article examines the takeover activity of distressed debtholders against the backdrop of traditional corporate raiders and their use of equity to acquire corporate control. Traditional corporate raiders target undervalued, cash-flushed or mismanaged corporations. They seek to unlock value that is underutilized or overlooked by existing management. Several studies suggest that hostile takeovers increase corporate value, which generally flows to existing shareholders through a stock price premium.[6] That value may also benefit the corporation and other corporate

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4. *See generally* Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002) (discussing debate concerning value of corporate takeovers in context of board veto rights and arguing that such rights are unnecessary); John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984) (noting that many commentators view takeovers as promoting efficiency); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (discussing corporate governance efficiencies promoted by takeover activity); Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119 (1992) (discussing various studies and theories suggesting that takeover activity increases firm value).

5. *See* Charles V. Bagli, *A New Breed of Wolf at the Corporate Door: It's the Era of the Civilized Hostile Takeover*, N.Y. TIMES, Mar. 19, 1997, at D1 ("The hostile deals of the 1980's were made by people viewed as bust-up artists and speculators looking for short-term profit. . . ." (quoting Robert Kindler)); Harold M. Williams, *It's Time for a Takeover Moratorium*, CNNMONEY.COM (July 22, 1985), http://money.cnn.com/magazines/fortune/fortune_archive/1985/07/22/66154/index.htm (citing takeover activity as contributing to management ineffectiveness and working against productivity); *see also* Clifford G. Holderness & Dennis P. Sheehan, *Raiders or Saviors? The Evidence on Six Controversial Investors*, 14 J. FIN. ECON. 555, 556 (1985) (noting that criticism of corporate raiders typically involves allegations that they "'prey upon and defraud stockholders,'" "'take[] over and loot[]'" their corporate targets, and pay themselves "'excessive' compensation and perquisites," but not finding empirical support for the "raider" image). *But see* David Carey & Sara Hammes, *Can Raiders Run What They Raid*, CNNMONEY.COM (June 4, 1990), http://money.cnn.com/magazines/fortune/fortune_archive/1990/06/04/73625/index.htm ("[R]are is the raider who can manage the company he has acquired any better than the chief executive whom he vilifies and ousts. . . .").

6. *See, e.g.*, Romano, *supra* note 4 (discussing studies regarding value impact of takeovers); *see also* Robert P. Bartlett, III, *Taking Finance Seriously: How Debt-Financing Distorts Bidding Outcomes in Corporate Takeovers*, 76 FORDHAM L. REV. 1975 (2008). Bartlett emphasizes the need to consider bidders' financing choices in empirical studies concerning the value implications of takeovers. Furthermore, he notes that "the ability of bidders' financing decisions to affect bidder

constituents (including creditors) to the extent that the acquirer continues the business and improves management or operations.[7] The changes imposed by the acquirer, however, may oust existing management, add leverage, strip core assets or otherwise impede long-term value. The latter possibilities lend to the sometimes questionable reputations of traditional corporate raiders.

To address these undesirable possibilities, Congress and state legislatures enacted a variety of takeover-related legislation, starting with the Williams Act in 1968.[8] The Williams Act requires that entities make certain disclosures when intending to pursue a tender offer, or upon acquiring five percent or more of a public company's stock.[9] The Williams Act does not necessarily endorse or condemn hostile takeovers. Rather, its purpose is to provide information to parties involved in the potential transaction to foster better-informed decisions.[10] In contrast, most states enacted "anti-takeover" legislation—measures generally designed to create more protection for management and more obstacles for potential acquirers in the takeover process.[11]

Commentators debate the pros and cons of anti-takeover legislation. Proponents of takeovers point to the governance benefits generated by an active market for corporate control.[12] The actual or even potential threat of

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valuations reveals the inherent difficulty of using a bidder's offer price as a proxy for its ability to put a target's assets to productive use." *Id.* at 2024.

7. *See supra* note 4 and accompanying text; *see also* discussion *infra* Part II.

8. The Williams Act mandates, among other things, disclosures by certain shareholders concerning the amount and purpose of their holdings. It amended the Securities Exchange Act of 1934. *See* Act of July 29, 1968, Pub. L. No. 90-439, § 2, 82 Stat. 454, 454–55 (codified as amended at 15 U.S.C. § 78m(d) (2006)); *see also* Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862 (1985) (explaining the origins of the Williams Act and the major elements of the legislation); discussion *infra* Part II.

9. *See, e.g.*, Johnson & Millon, *supra* note 8, at 1889 (summarizing key elements of Williams Act).

10. *See, e.g.*, WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATIONS AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 193 (10th ed. 2007) ("This 5% threshold establishes an early warning system that gives both the target and other potential bidders time to prepare; thus its practical effect is to promote auctions and increase the takeover premium that a bidder must offer to secure control.").

11. For a thorough discussion of state anti-takeover legislation, see Michael Barzuza, *The State of State Antitakeover Law*, 95 VA. L. REV. 1974 (2009); *see also infra* Part II.

12. *See* ROBERT E. HOSKISSON ET AL., COMPETING FOR ADVANTAGE 317 (2008) (examining the role of takeovers in corporate governance); Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002); *see also supra* note 4 and accompanying text. *But see, e.g.*, Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers*, 55 STAN. L. REV. 791 (2002); James P. Walsh & Rita D. Kosnik, *Corporate Raiders and Their Disciplinary Role in the Market for Corporate Control*, 36 ACAD. MGMT. J. 671, 691 (1993) ("[W]e found little evidence to support the claim that corporate raiders can accurately identify and eliminate ineffective boards of directors and entrenched management teams.").

a hostile takeover can discipline corporate managers and improve accountability. For these reasons, many institutional shareholders have pressed corporate boards to remove defensive measures, such as shareholder rights plans from companies' governance documents.[13]

Despite increased regulation, equity-based takeover activity continues. Recent hostile or uninvited takeover activity includes Air Products & Chemicals' bid for Airgas, Sanofi-Aventis' bid for Genzyme Corp., and Carl Icahn's bid for Lions Gate Entertainment.[14] That activity, however, often is less contentious than in the past and may take different forms. Among other things, potential acquirers may work with or seek allies among the target's shareholders, and "takeover targets are borrowing tactics from the 1980s, but avoiding such a scorched-earth approach."[15]

In addition, an investor who seeks control of a company may forego an equity investment and instead acquire a significant position in the company's debt. A debt investment is not subject to the disclosure requirements of the Williams Act.[16] Likewise, it does not trigger anti-

13. *See, e.g.*, Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018 (1998); *see also* Martin Lipton & Paul K. Rowe, *Pills, Polls, and Professors: A Reply to Professor Gilson*, 27 DEL. J. CORP. L. 1, 9 (2002) (noting that "the decision of most institutional investors that they would not vote for charter amendments designed to deter or regulate hostile takeovers"); Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001) (arguing for more shareholder self-help in the debate regarding anti-takeover protections).

14. *See, e.g.*, Jef Feeley, *Genzyme Sued by Investors Over Sanofi Buyout Bid*, BLOOMBERG, Oct. 12, 2010, *available at* http://www.bloomberg.com/news/2010-10-12/genzyme-sued-by-investors-over-rebuff-of-sanofi-aventis-takeover-attempt.html; Brett Pulley, *Lions Gate Board Rejects Icahn's Hostile Takeover Bid*, BLOOMBERG, Mar. 23, 2010, *available at* http://www.businessweek.com/news/2010-03-23/lions-gate-board-rejects-icahn-s-hostile-takeover-bid-update1-.html; *Airgas to Appeal Ruling on Takeover Fight*, REUTERS, Oct. 11, 2010, *available at* http://www.reuters.com/article/idUSN1110408120101011.

15. Steven M. Davidoff, *A New Kind of Defense Against Hostile Bids*, N.Y. TIMES DEALBOOK (Sept. 29, 2010, 10:50 PM), http://dealbook.nytimes.com/2010/09/29/a-new-kind-of-defense-against-hostile-bids/ ("Companies are adapting strategies for a market where corporate governance is increasingly important, activist and institutional shareholders wield significant power and proxy advisory services like Institutional Shareholder Services can sway up to 20 to 40 percent of the vote through their recommendations."); *see also* Amanda Cantrell, *Do's and Don'ts for Corporate Raiders*, CNNMONEY.COM (Mar. 8, 2006), http://money.cnn.com/2006/03/07/markets/hedge_activists/index.htm (positing that successful corporate raiders work hard to get "big, normally passive institutional investors on board"). Private equity firms and hedge funds also have emerged on the scene as a frequent initiator of hostile takeovers. *See, e.g.*, Joseph A. McCarthy & Erik P.M. Vermeulen, *Private Equity and Hedge Fund Activism: Explaining the Differences in Regulatory Responses*, 9 EUR. BUS. ORG. L. REV. 535 (2008); Emily Thornton & Susan Zegel, *The New Raiders*, BUS. WK. (Feb. 28, 2005), http://www.businessweek.com/magazine/content/05_09/b3922041_mz011.htm (explaining that hedge funds are part of the new breed of corporate raiders that are more aggressive and less reliant on third-party financing than corporate raiders of the 1980s).

16. The disclosure requirements imposed by the Williams Act apply only to persons who

takeover defensive measures facilitated by state law. In fact, relatively little regulation governs the activities of investors acquiring debt in the secondary loan and bond markets.[17]

This lack of regulation provides a significant advantage to an investor making a control play. Among other things, it reinstitutes the element of surprise once prevalent and advantageous to acquirers in the hostile takeover process.[18] Investors generally have no obligation to disclose when they purchase a company's debt. Consequently, management often does not know who holds the company's debt until an investor is already positioned to make its move. Moreover, the investor faces little downside risk because, if the takeover attempt fails, the investor is still likely to receive some return (perhaps even a significant profit) when the company repays the debt.

A debt-based takeover is not feasible, however, in every situation. This strategy works primarily in the distressed company context. Specifically, the investor attempts to identify and purchase the distressed company's "fulcrum security"—i.e., the tranche of debt in the company's capital structure that effectively captures the company's enterprise value.[19] The fulcrum security is similar to equity in that its holders arguably are the residual owners of the company. The distressed debtholder then uses the company's debt restructuring efforts as a takeover opportunity.[20]

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"directly or indirectly [acquire] the beneficial ownership of any equity security. . . ." 15 U.S.C. § 78m(d)(1) (2006). Although debt may constitute a security under the Securities Exchange Act of 1934, it is not included within the scope of section 13(d) of the Act.

17. *See, e.g.*, Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1662 (2008) (discussing lack of pre-bankruptcy regulation over private parties seeking to influence a company's restructuring); Harner, *supra* note 3.

18. *See, e.g.*, JEANNETTE GORZALA, THE ART OF HOSTILE TAKEOVER DEFENCE 12 (2010) (explaining that disclosure regulations "were put in place to limit the element of surprise" in hostile takeovers); *The Future of Tender Offer Regulation*, N.Y. TIMES DEALBOOK (June 6, 2008, 12:40 PM), http://dealbook.nytimes.com/2008/06/06/the-future-of-tender-offer-regulation/ ("At the time [of the enactment of the Williams Act], the corporate bogeyman *du jour* was the 'Saturday Night Special,' in which a bidder would embark on a pre-offer buying raid to establish a substantial beachhead of ownership at a reduced price").

19. *See, e.g.*, Christie Smythe, *"Fulcrum" Deals Rising to Prominence, Experts Say*, LAW360.COM (Oct. 9, 2009), http://www.law360.com/securities/articles/122360/-fulcrum-deals-rising-to-prominence-experts-say ("As companies mired in debt continue to seek refuge in bankruptcy court, popularity is growing in so-called fulcrum investing, a risky bet placed on debt securities bought on the cheap and expected to be converted into equity holdings through the restructuring process . . . ."); David W. Marston, *Distressed Debt: Forget the Vultures, Your Lenders May be Circling*, GIBBONS P.C. (Sept. 8, 2009), http://www.gibbonslaw.com/news_publications/articles.php?action=display_publication&publication_id=2879 ("The fulcrum security is the security most likely to be converted into equity in a reorganized company.").

20. *See, e.g.*, Katalin E. Kutasi, *Distressed Investing—Market Trends and Outlook*, HEDGE FUND MONTHLY (July 2007), http://www.eurekahedge.com/news/07_july_Kellner_Dileo_Distressed_Investing_Markets_Trends_and_Outlook.asp ("Managers [of distressed debt funds] can be control

Debtholders invoke this control strategy in both out-of-court workouts and in-court reorganizations under Chapter 11 of the Bankruptcy Code.[21] Recent examples include CIT Group, Lear Corp., Reader's Digest, and Trump Entertainment.[22] Notably, some investors pursue both traditional takeover strategies and debt-based takeovers.[23]

Similar to traditional takeovers, the value of debt-based takeovers is subject to debate.[24] For example, on the one hand, distressed debtholders may represent a source of liquidity for distressed companies that otherwise may be unavailable. These investors frequently offer debtor-in-possession financing or post-reorganization capital infusions that allow the company

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oriented—taking more of a private equity approach—and investing in debt securities they believe will be the fulcrum security to control the equity (the loan to own model)."); Steven R. Strom, *Hedge Fund Power Plays in the Distressed Arena*, J. CORP. RENEWAL (Dec. 1, 2005), http://www.turnaround.org/Publications/Articles.aspx?objectID=5436 ("The most basic tactic is to acquire large portions of fulcrum security debt in anticipation of converting into post-reorganization equity.").

21. Surveys of distressed-debt investors indicate that the use of the fulcrum security to acquire control of the debtor company is a core investment strategy. *See, e.g.*, Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives*, 16 AM. BANKR. INST. L. REV. 69, 82 (2008) (stating that "of those responding, 32 firms (52.5%) indicated that their primary investment practice is to pursue an exchange of the debt for equity."). Marston reports that "[o]ver 60% of the hedge funds and institutional investors surveyed by *Debtwire* said that distressed-debt is part of their 'core investment strategy.'" Marston, *supra* note 19. Marston furthermore notes that "robust returns are not the real play with distressed debt, the more lucrative jackpot is turning debt into ownership of the company." *Id.* For a discussion of factors that influence the decision to pursue an out-of-court versus in-court workout, see Edith S. Hotchkiss et al., *Bankruptcy and the Resolution of Financial Distress*, *in* 2 HANDBOOK OF EMPIRICAL CORPORATE FINANCE 25 (B. Espen Eckbo ed., 2008) ("Transactions prices, however, are significantly lower than those paid for nonbankrupt firms matched on size and industry.").

22. *See, e.g.*, Bravo & Hester, *supra* note 3 (explaining KKR's debt-for-equity exchanges in Lear Corp. and Reader's Digest); Steven Church & Beth Jinks, *Trump Beats Carl Icahn in Takeover Battle for His Namesake Casino Company*, BLOOMBERG, Apr. 13, 2010, *available at* http://www.bloomberg.com/news/2010-04-12/trump-beats-carl-icahn-in-takeover-battle-for-his-namesake-casino-company.html (explaining Trump's alliance with Avenue Capital Group, which proposed a plan to convert the casino's bond debt into equity); Mike Spector & Kate Haywood, *Icahn Could Become Top Shareholder at CIT Group*, WALL ST. J., Oct. 24, 2009, at B3 (explaining the conversion of Icahn's bond debt into equity).

23. For example, Carl Icahn uses both equity and debt to try to influence governance matters or acquire control of a company. In fact, in his bid for Lions Gate, Icahn first tried to purchase the company's bond debt and only subsequently tried an equity tender offer and takeover. *See, e.g.*, Claudia Eller, *Lions Gate Makes Deal to Keep Bonds Out of Carl Icahn's Hands*, L.A. TIMES, Apr. 21, 2009, http://articles.latimes.com/2009/apr/21/business/fi-ct-lionsgate21 (explaining Icahn's attempts to buy Lions Gate's bond debt); Evan Hessel, *Icahn in the Lionsgate Den*, FORBES.COM (Mar. 27, 2009, 12:01 AM), http://www.forbes.com/2009/03/26/carl-icahn-lionsgate-business-media-icahn.html (explaining Icahn's control efforts with respect to his equity holdings and that "Icahn has also targeted Lionsgate's debt as a mechanism for exerting influence"); Josh Kosman & Claire Atkinson, *Billionaire Eyes Merger of MGM, Lionsgate Studios*, N.Y. POST, Oct. 13, 2010, http://www.nypost.com/p/news/business/icahn_carl_icahn_2zVPQvZG6S8BJWtc0vGJaN (noting that Icahn is Lions Gate's largest shareholder and owns about 13 percent of MGM's debt); *see also supra* note 14 and accompanying text.

24. *See infra* Parts I.B, III.B.

to continue operations. On the other hand, the debtholder's investment may facilitate a restructuring that undervalues the company to the direct detriment of junior creditors and shareholders. Accordingly, the challenge is to preserve the liquidity, discipline, and accountability attributes of debt-based takeovers and to protect the company and its stakeholders against potential raids.

This Article presents the first extensive analysis of debt-based takeovers and their impact on corporate reorganization value. Part I of the Article summarizes the potential issues raised by debt-based takeovers. This summary provides critical context for the remainder of the Article by highlighting similarities among takeover strategies and the potential abuses permitted by regulatory gaps. Part II continues to lay the Article's foundation by reviewing the historical development of traditional takeover strategies and takeover-related regulation. It also describes the increasing use of debt to facilitate a change of control at distressed companies.

Part III then explores several debt-based takeovers and takeover opportunities in the newspaper industry. Specifically, this Part discusses the debt-based takeovers of American Media, Inc.; Freedom Communications, Inc.; the *Star Tribune*; Tribune Co.; and Philadelphia Newspapers. Those examples facilitate an in-depth analysis of debt-based takeovers and their role in the market for corporate control. The discussion identifies and examines factors such as information asymmetry, bargaining inequality, and lack of financial alternatives that contribute to potential raids in the debt-based takeover context.

Part IV offers a regulatory response to help level the playing field in the distressed market for corporate control. This proposal draws on the original approach of the Williams Act; it does not seek to encourage or discourage debt-based takeovers, but rather aims to provide pertinent information to the markets to foster more value-generating activity.[25] The element of surprise that once provided significant leverage to corporate raiders continues in the context of debt-based takeovers and hinders meaningful auctions and control contests that might otherwise enhance value. The Article concludes by urging more disclosure and opportunity for signaling and market participation in debt-based takeovers.

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25. *See, e.g.*, Johnson & Millon, *supra* note 8, at 1897 ("Thus, 'investor protection' properly understood in its narrow 1968 meaning, is a congressional policy, but only about disclosure to shareholders by the principal antagonists in the takeover battle.").

## I. THE EMERGING ROLE OF DEBT-BASED TAKEOVERS

Traditionally, debt represented an extension of credit to a company governed by negotiated contract terms.[26] The lender expected, and indeed wanted, nothing more than repayment of the debt at maturity.[27] The lender made its profits based on the negotiated interest rate and fee structure. Likewise, the company's primary concern upon a potential default under the debt instruments was the cost of obtaining a waiver or forbearance from the lender.[28]

Although some lending relationships follow a traditional structure, many more have evolved into complex capital investments where the parties' expectations and objectives are very different.[29] A company's credit facilities and bond issuances may offer an ownership opportunity for investors, particularly investors in troubled companies.[30] Anecdotal and empirical evidence suggest that certain investors target the debt of distressed companies specifically for this purpose.[31] This Part explains the contours of these investment strategies—commonly referred to as "loan-to-own" investments—and the issues they pose for managers, stakeholders, and overall corporate value.

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26. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 669–71 (2010) (explaining traditional lending relationship); Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 133–35 (2009) (explaining the traditional relationship between a lender and borrower and changes in the dynamics of that relationship); Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 IOWA J. CORP. L. 641, 641–50 (2009) (same).

27. *See, e.g.*, Baird & Rasmussen, *supra* note 26; John Mueller, *The Business Dynamics of Bankruptcy*, 16 AM. BANKR. INST. J., Feb. 1997, at 28, 28 ("A company that is contemplating bankruptcy has long since violated the bank's lending standards, and hence the lender's overwhelming objective is to get its money back and terminate the relationship.").

28. *See, e.g.*, Kenneth C. Henry, *Understanding Crisis Management and Business Workouts*, 14 AM. BANKR. INST. J., Sept. 1995, at 28, 28 (explaining objectives and motivations of debtor and other parties in negotiations concerning a debtor's default or potential default under loan documents); Mueller, *supra* note 27 (same).

29. *See, e.g.*, Baird & Rasmussen, *supra* note 26; Whitehead, *supra* note 26; *see also* Jamie Mason, *Reluctant Proprietors*, DEAL MAG. (Oct. 15, 2010, 12:29 PM), http://www.thedeal.com/magazine/ID/036946/features/reluctant-proprietors.php (explaining and contrasting traditional preferences of banks with those of hedge funds and private equity firms).

30. *See, e.g.*, Harner, *supra* note 3 (explaining debtholder investment strategies); Lipson, *supra* note 17 (exploring nontraditional lending activities in distressed scenarios).

31. *See, e.g.*, Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511 (2009); Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially-Distressed Firms: Empirical Evidence*, 72 WASH. U. L.Q. 1005 (1994); Harner, *supra* note 21 (presenting findings of survey of distressed-debt investors); M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low*, 101 NW. U. L. REV. 1543 (2007).

### *A. Examples of Loan-to-Own Investments*

Purchasing the debt of a troubled company to earn an enhanced return is not a new investment strategy.[32] Distressed-debt investors, also commonly called "vulture investors" or "grave dancers," have long employed this strategy.[33] The strategy is receiving greater attention, however, as debtholders use loan-to-own investment techniques to generate returns not through the payoff of the debt, but rather through converting the debt into ownership of the company itself. Investors employ these techniques in both the in- and out-of-court restructuring contexts in the United States and abroad.[34]

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32. For example, in their seminal work THE MODERN CORPORATION AND PRIVATE PROPERTY, Adolf Berle and Gardiner Means discuss creditor activism and creditors' potential influence over corporate boards. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 78–84 (1932) (using the Fox Films and Fox Theatre Corporation as an example of creditor influence). *See also* Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims & Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 12–13 (1990) (explaining early examples of creditor control strategies under the Bankruptcy Code). Distressed debt deals reportedly were valued at $84.4 billion in 2009, and similar valuations are expected in 2010 and 2011. *See Distressed-Debt Deals in 2009 Reach $84.4 Billion*, REUTERS, Aug. 11, 2009, *available at* http://www.reuters.com/article/idUSTRE57A0SD20090811; *Firms' Distressed Debt Cycle Not Over, Pimco Says*, N.Y. TIMES DEALBOOK (May 27, 2010, 2:47 AM), http://dealbook.nytimes.com/2010/05/27/distressed-debt-cycle-not-over-for-firms-pimco/; *Investors Bullish for 2010, Finds Fifth Annual North American Distressed Debt Market Outlook Survey*, PR NEWSWIRE, Jan. 26, 2010, *available at* http://www.prnewswire.com/news-releases/investors-bullish-for-2010-finds-fifth-annual-north-american-distressed-debt-market-outlook-survey-82682842.html.

33. *See, e.g.*, *The Vultures Take Wing*, *supra* note 3 (explaining the "vulture tag" given to distressed-debt investors); Daniel Fisher & Matthew Craft, *Junk Time*, FORBES.COM (Sept. 29, 2008, 6:00 PM), http://www.forbes.com/forbes/2008/0929/090.html ("Vulture funds . . . buy large stakes in companies they expect to fail, with plans to gain control during bankruptcy. The so-called loan-to-own strategy usually pays off after a company emerges from Chapter 11. Lots of vultures still hover on the sidelines."); Miles Weiss, *Zell Returns to Grave Dancing with $625 Million Distressed Fund*, BLOOMBERG, Sept. 1, 2009, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aiM0qVKDpGP8 (explaining that investor Sam Zell "dubbed himself the 'Grave Dancer' for turning profit on troubled assets").

34. Loan-to-own strategies often are used in prepackaged or traditional Chapter 11 bankruptcy cases. Past examples include Trans World Airlines, Kmart and Macy's. *See* Joe Bel Bruno, *Is There a Raider Lurking? Past Bankruptcies Have Opened Door to Takeovers*, CINCINNATI POST, Sept. 16, 2005, at A20 (discussing Trans World Airlines and Kmart); Michael Marray, *Macy Cool to Takeover Move by Federated*, INDEPENDENT (U.K.) (Jan. 4, 1994), http://www.independent.co.uk/news/business/macy-cool-to-takeover-move-by-federated-deal-would-create-huge-store-chain-1404700.html (discussing Macy's). Debt-based takeovers in the bankruptcy context are discussed throughout this Article, including *infra* Parts I.A, III and IV. For an example of an out-of-court loan-to-own strategy in the United States, see Jonathan Marino, *The Next Breed of Hostility? American Greetings' Loan-to-Own Play for Its Private Rival Could Be the Next Big Thing in Hostile Takeovers*, INVESTMENT DEALERS' DIGEST, Nov. 10, 2008, *available at* 2008 WLNR 21466443 (explaining how American Greetings Corp.'s purchase of $44 million of the debt of its competitor, Recycled Paper Greetings, surprised both observers and Recycled Paper Greetings and sparked litigation). For discussion of loan-to-own strategies in European markets, see Donal O'Donovan & Emmet Oliver, *York Buys Quinn*

For example, in the United States, KKR & Co. invested in the debt of Lear Corp., an automotive industry supplier, and ultimately agreed to exchange its debt for a significant ownership interest in the reorganized company.[35] The Lear Chapter 11 case that facilitated the debt-for-equity exchange was relatively quick and painless, with Lear emerging from bankruptcy in just four months.[36] Lear's stock also performed strongly post-emergence.[37] The Chapter 11 cases of Reader's Digest and CIT evidence similar investment strategies by creditors, with similar relatively positive results.[38]

This type of debt-for-equity play is not a traditional investment strategy for private equity firms like KKR, but "they are [increasingly] making loans to the neediest borrowers and muscling in on turf traditionally dominated by so-called vulture investors."[39] New players in the distressed debt space have intensified turf wars, and conflicts among private equity firms, hedge funds, and other creditors appear to be on the rise. In

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*Debt in Suspected Loan-to-Own Bid*, INDEPENDENT.IE (Sept. 16, 2010), http://www.independent.ie/business/irish/york-buys-quinn-debt-in-suspected-loantoown-bid-2339287.html ("The Irish Independent has learned that York Capital has been buying up Quinn Group debt that is being sold at prices more than 40pc below face value."); Helia Ebrahimi, *New Debt-for-Equity Deals Put Lenders in Charge as Companies Struggle to Meet Repayments*, TELEGRAPH (June 7, 2009, 11:42 PM), http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/5470223/New-debt-for-equity-deals-put-lenders-in-charge-as-companies-struggle-to-meet-repayments.html (explaining creditor takeover strategies in Europe); Tom Freke, *Lenders Mount Loan-to-Own Bid for Monier*, REUTERS, June 9, 2009, *available at* http://in.reuters.com/article/idINTRE55833420090609 ("Lenders to French roofing company Monier Group have launched a takeover bid to oust current private equity owner PAI Partners . . . ."); Anousha Sakoui & Martin Arnold, *Vulture Funds Circle as Debt Fears Bite*, FT.COM (Feb. 17, 2009, 11:34 PM), http://www.ft.com/cms/s/0/982b9f0e-fd2a-11dd-a103-000077b07658.html#axzz1DJwTIqI3 (explaining activity of U.S. distressed-debt investors in European markets).

35. *See, e.g.*, Bravo & Hester, *supra* note 3 ("KKR & Co. . . . is part of a group converting loans made to Lear Corp. into a controlling stake in the bankrupt car-seat maker."). In addition to using unsecured or undersecured bond or bank debt, distressed debt investors also can pursue loan-to-own strategies with senior secured debt, which often serves or can serve as debtor in possession financing for the target company—i.e., it becomes the company's restructuring lifeline. That type of financing potentially gives the investor additional leverage over the company. *See, e.g.*, David Peress & Thomas C. Prinzhorn, *Nontraditional Lenders and the Impact of Loan-to-Own Strategies on the Restructuring Process*, AM. BANKR. INST. J., Apr. 2006, at 48, 57–58.

36. *See* Press Release, Lear Corp., Lear Receives Approval of First Day Motions (July 8, 2009), *available at* http://www.lear.com/InTheNews/1066/1/Lear-Receives-Approval-of-First-Day-Motions.aspx; Press Release, Lear Corp., Lear Completes Financial Reorganization and New Common Shares Will Begin Trading on the NYSE (Nov. 9, 2009), *available at* http://www.lear.com/InTheNews/1064/1/Lear-Completes-Financial-Reorganization-and-New-Common-Share.aspx.

37. *See More Companies Go Public Soon After Bankruptcy*, REUTERS, Jan. 12, 2010, *available at* http://www.reuters.com/article/idUSTRE60B4V320100112 (noting that Lear's post-bankruptcy stock price increased by 26 percent).

38. *Id.*; *see also* Bravo & Hester, *supra* note 3 (discussing Reader's Digest); Spector & Haywood, *supra* note 22 (discussing CIT).

39. *See* Bravo & Hester, *supra* note 3.

addition, a debtor's management may not be aware of potential conflicts within the debtor's capital structure, and they consequently may align with the interests of one stakeholder group prematurely or be unprepared for, and become paralyzed by, the resulting conflict.[40]

Conflict among distressed-debt investors over control of the reorganized debtor prolongs the company's Chapter 11 case, distracts management from the debtor's core business operations, and increases overall restructuring costs.[41] For example, several investors holding pre-petition debt or offering new investments participated in an $8 billion debtor-in-possession financing facility for Lyondell Chemical with the expectation that at least part of their debt holdings would be converted into equity of the reorganized company.[42] After the Chapter 11 petition was filed, however, junior creditors contested the claims of certain lenders, and the bankruptcy court appointed an examiner to investigate the allegations of prepetition misconduct raised by those claims.[43] The junior creditors also filed a lawsuit asserting fraudulent conveyance claims against some of the senior lenders and certain other parties relating to a pre-petition leveraged buyout.[44] Ultimately, after approximately fifteen months in bankruptcy, Lyondell emerged with the senior creditor group receiving a majority ownership position, but at a greater cost to the company.[45]

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40. *See* discussion *infra* Part III.

41. *See generally* Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations*, 64 VAND. L. REV. 749 (2011).

42. *See, e.g.*, Shasha Dai, *KKR Getting on DIP Financing Bandwagon Too*, WSJ.COM (July 7, 2009, 7:26 PM), http://blogs.wsj.com/privateequity/2009/07/07/kkr-getting-on-dip-financing-band wagon-too/ ("KKR has provided DIP financing to several companies in recent times, according to a person familiar with the situation. Other deals include ones for Lyondell Chemical Co., Smurfit-Stone Container Corp., Calpine Corp., Delphi Corp., Delta Airlines Inc., Quebecor World Inc. and UAL Corp."); Bravo & Hester, *supra* note 3 (suggesting that Apollo Management was part of a syndicate providing Lyondell debtor-in-possession financing facility); *see also* Vipal Monga & John Blakeley, *Rigors of Rehab*, DEAL MAG. (Apr. 17, 2009, 1:29 PM), http://www.thedeal.com/newsweekly/ features/rigors-of-rehab.php (explaining the details of Lyondell's debtor-in-possession financing facility).

43. *See, e.g.*, *Judge Approves Examiner for Lyondell*, REUTERS, Nov. 2, 2009, *available at* http:// www.reuters.com/article/idUSN0244196820091102.

44. *See* Emily Chasan, *Judge: Lenders Can Intervene in Lyondell Lawsuit*, REUTERS, Aug. 18, 2009, *available at* http://www.reuters.com/article/idUSN1842417420090818 (explaining fraudulent conveyance lawsuit filed by the committee of unsecured creditors and the interests of certain senior lenders holding the fulcrum security, including KKR and Ares Management); *New Storm Clouds Over Tribune Co. Bankruptcy Case*, TRADINGMARKETS.COM (Sept. 27, 2010), http://www.trading markets.com/news/stock-alert/trb_new-storm-clouds-over-tribune-co-bankruptcy-case-1192752.html (explaining the allegedly antagonist role of Aurelius Capital Management as a junior creditor in the Lyondell Chemical Chapter 11 cases and suggesting that Aurelius used aggressive tactics to hold up settlement and plan of reorganization).

45. *See, e.g.*, Lindsey Bewley, *LyondellBasell's Exit Strategy*, CHEM. WEEK, May 10, 2010, at 33

Similar patterns emerged in the Chapter 11 cases of Adelphia Communications, Inc. and Tribune Co., among others.[46]

Control contests arise in Chapter 11 cases because who gets to own the reorganized company often turns on how the company is valued and who, under those valuations, holds the fulcrum security.[47] A distressed-debt investor may buy a senior tranche of debt expecting the value of the company to be insufficient to pay that debt in full, which would give the investor a potential opportunity to convert its debt holdings to equity. If that investor's valuations are inaccurate or if the company's valuation changes before the restructuring is completed, a junior class of creditors may actually hold the fulcrum security and be entitled to the company's equity.[48] In that case, senior creditors may be cashed out or may be forced to continue to extend their pre-petition debt to the company under pre-petition terms—a concept known as reinstatement under the Bankruptcy Code. This scenario became a reality for senior creditors in the Chapter 11 case of Charter Communications.[49]

In addition to debt-for-equity exchanges, a distressed investor may accumulate debt and then credit bid the value of that debt in a sale of the company or its assets.[50] Carl Icahn has used this investment strategy with

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(explaining that Apollo Management owns approximately 25 percent of reorganized company and Ares Management owns approximately 7 percent of reorganized company); Ana Campoy & Marie Beaudette, *Lyondell's U.S. Arm in Chapter 11*, WALL ST. J., Jan. 6, 2009, at B2, *available at* http://online.wsj.com/article/SB123127968554958711.html (reporting filing of Chapter 11 case); Tiffany Kary & Linda Sandler, *Lyondell Says Its Plan Is Superior to Reliance Bid*, BLOOMBERG, Mar. 8, 2010, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aLgTaDw.2AgA (explaining terms of proposed plan of reorganization); Tiffany Kary, *Lyondell's Reorganization Plan Approved, Will Exit Bankruptcy by April 30*, BLOOMBERG, Apr. 24, 2010, *available at* http://www.bloomberg.com/news/2010-04-23/lyondell-s-chapter-11-reorganization-plan-approved-by-bankruptcy-judge.html.

46. *See, e.g.*, Randall Chase, *Noteholders Not Backing Down in Opposing Trib Plan*, ABCNEWS.COM (Dec. 6, 2010), http://abcnews.go.com/Business/wireStory?id=12325965 (explaining conflict in Tribune Co. Chapter 11 case).

47. *See* discussion of fulcrum security *supra* notes 19–20 and accompanying text.

48. *See* Mason, *supra* note 29 (explaining role of valuation in determining fulcrum security); *see also* Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 95–96 (2010) (explaining use of fulcrum security in debt-based takeovers).

49. Apollo Management LP began purchasing Charter Communication's debt in 2008 and led the group of noteholders (holding $1.6 billion of debt) that sought and obtained ownership of Charter Communications through its Chapter 11 case. *See* Chris Nolter, *Distress Calls*, DEAL MAG. (Jan. 22, 2010, 11:57 AM), http://www.thedeal.com/newsweekly/2010/jan-25-2010/distress-calls.php. Charter Communication's plan of reorganization proposed leaving approximately $11.8 billion of bank debt in place after confirmation of the plan without the bank's consent. *Id.* Apollo reportedly received "a 31% economic stake and 20% of the voting stock" under the plan of reorganization. *Id.*

50. *See* STUART C. GILSON & EDWARD I. ALTMAN, CREATING VALUE THROUGH CORPORATE RESTRUCTURING 29–30 (2010) (explaining use of credit bidding to facilitate loan-to-own investment strategy). Section 363(b) of the Bankruptcy Code allows a debtor to sell its assets free and clear of all

several companies, including Tropicana Casino & Resort and Fontainebleau Las Vegas Holdings LLC.[51] A key concern with credit bidding is that it chills any competitive bidding process for the company, thereby giving the creditor or stakeholder group a supposedly unfair advantage to the detriment of junior creditors. Accordingly, a debtor's management and other creditors often oppose tactical credit bidding, as in the Chapter 11 case of Philadelphia Newspapers.[52]

### *B. Potential Issues with Loan-to-Own Investments*

As described above, the objective of debtholders in a loan-to-own scenario is ownership of the company either through a credit bid in an asset sale or a debt-to-equity exchange. For public companies, the latter typically requires a Chapter 11 filing under the Bankruptcy Code to extinguish the interests of public shareholders.[53] For both private and public companies, Chapter 11 also may prove useful for facilitating a sale free and clear of other claims, liens, and encumbrances asserted against the company and its assets.[54] Accordingly, bankruptcy frequently plays an important role in the loan-to-own strategy.

At first glance, a debtholders' willingness to invest in a troubled company—whether in or outside of bankruptcy—appears admirable and desirable from a policy perspective.[55] The capital infusion represented by

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claims, liens and encumbrances upon notice, hearing and bankruptcy court approval. 11 U.S.C. § 363(b) (2006); *see also id.* § 363(f) (authorizing sales "free and clear of any interest in such property" if one of five conditions is met). Section 363(k) in turn permits secured creditors to bid using the amount of their secured claims under certain circumstances in a sale of the debtor's assets under section 363(b). *Id.* § 363(k).

51. *See* John Blakeley, *Bust and Buy*, DEAL MAG. (Jan. 22, 2010, 12:00 PM), http://www.thedeal.com/newsweekly/features/special-reports/bust-and-buy.php (discussing Tropicana and Fontainebleau acquisitions); *see also* Jamie Mason, *Cheap Trick*, DEAL MAG. (Sept. 18, 2009, 1:57 PM), http://www.thedeal.com/magazine/ID/030200/features/hard-times-1/cheap-trick.php (explaining the role of credit bidding in loan-to-own strategy and listing examples of strategy in action, including "Elliott Management Corp. and Silver Point Capital LP's $3.4 billion credit bid for Delphi Corp").

52. *See In re* Phila. Newspapers, LLC, 599 F.3d 298, 318 (3d Cir. 2010) (holding that secured creditors did not have an absolute right to credit bid in a sale conducted in connection with a debtor's plan of reorganization under section 1129 of the Bankruptcy Code).

53. *See* Mason, *supra* note 29 (explaining the difference in private versus public company debt-for-equity exchanges).

54. *See supra* notes 36–38 and accompanying text.

55. *See, e.g.*, Martin Eisenberg, *When Hedge Funds Invest in Distressed Debt*, 238 N.Y. L.J. 11 (2007) ("A balanced assessment of the impact of distressed investing in bankruptcy proceedings demonstrates that distressed investors are beneficial to the reorganization process contributing, among other things, substantial resources in the form of capital, financial acumen and expertise."); *see also* discussion *supra* note 4 (discussing corporate governance and other positive attributes of takeover activity, which can apply in the distressed context).

the "loan" part of the equation may provide the company with much-needed liquidity to keep the doors open, employees at work, and customers satisfied.[56] Moreover, the company's management may have limited alternatives and view the proposed investment as the best option under the circumstances.[57] In most instances, management negotiating with its back against the wall is rarely productive.

Consequently, the devil often is in the details of the loan commitment or the terms of the debtholders' investment.[58] For example, the debt instrument may impose overly stringent covenants, provide the lenders with control or veto rights, or otherwise set up the company for eventual failure.[59] Alternatively, the investor may purchase the debt after the fact at an extremely deep discount and have different valuation objectives than holders who bought the debt at face value or have junior claims against the company.[60] A debtholders' ownership agenda can create challenging issues for the company and its other stakeholders.

These issues are similar to those presented to the management of a solvent company that is a takeover target. Accordingly, the remainder of this Article considers the similarities and differences in equity-based and debt-based takeovers. Specifically, it discusses the different regulatory approaches to each takeover strategy and evaluates greater regulation in the debt context. As regulation of equity-based takeovers suggests, this requires a delicate balancing act.

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56. *See, e.g.*, GILSON & ALTMAN, *supra* note 50, at 55 ("[D]istressed investors can be a valuable source of new money and new ideas to troubled companies in need of both." (citing $8 billion debtor-in-possession financing facility for Lyondell Chemical, funded in part by distressed-debt investors)).

57. *See, e.g.*, Kelli A. Alces, *Strategic Governance*, 50 ARIZ. L. REV. 1053 (2008) (discussing challenges faced by management of distressed companies); Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 AM. BANKR. L.J. 103, 107–10 (1998) (same); *see also* Matthew M. McDonald & Jennifer J. Kolton, *Transactions with Distressed Companies: Key Questions for Directors*, ENTREPRENEUR.COM (Summer 2009), http://www.entrepreneur.com/tradejournals/article/206357289.html (posing questions and issues for managers to consider in the context of buying and selling distressed assets).

58. *See, e.g.*, Michael Corkery, *Kodak and KKR: Distressed Debt Investing 101*, WSJ.COM (Sept. 17, 2009, 10:46 AM), http://blogs.wsj.com/deals/2009/09/17/kkr-and-kodak-distressed-debt-investing-101/ (explaining tight covenants and high interest rates associated with loan from distressed-debt investor).

59. *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1237–42 (2006); George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 22–23 (2004); David A. Skeel, *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 918, 923–27 (2003).

60. *See* Harner, *supra* note 3, at 718–20, 725–27 (discussing Allied Holdings and Kmart Chapter 11 cases—both involving takeovers by distressed debtholders who purchased the majority of their debt at steep discounts after the Chapter 11 filings).

## II. THE EVOLUTION OF TAKEOVER STRATEGIES

The American corporation generally is characterized by the separation of ownership and management.[61] Shareholders are the residual owners of the company, but the board of directors and the officers selected by the board manage the company's affairs.[62] The separation of ownership and control often is cited as the source of agency costs in corporate governance, including concerns regarding inefficient and unaccountable management.[63] It also, however, exposes management to a loss of control through various corporate takeover strategies.

This Part summarizes the development of corporate takeover strategies and the regulation of that activity in equity-based takeovers. This discussion highlights the potential benefits of corporate takeover activity and the potential detriments that spawn regulation. The history of equity-based takeovers foreshadows the increasing use of debt-based takeovers and the potential problems with that practice.

### *A. From Proxy Contests to Tender Offers*

A shareholder's primary rights with respect to the corporation are to receive dividends, elect members to the board of directors, vote on extraordinary transactions, and sell their shares.[64] Shareholders also may bring derivative litigation, and in some cases, direct litigation to protect

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61. *See* BERLE & MEANS, *supra* note 32, at 120.

62. For a discussion of shareholders' rights as the residual owners of a corporation, see Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007) (explaining existing rights and urging more comprehensive rights for shareholders); Theresa A. Gabaldon, *Like a Fish Needs a Bicycle: Public Corporations and Their Shareholders*, 65 MD. L. REV. 538, 541–42 (2006) ("According to [options] theory, once a firm has issued debt, debtholders and holders of equity both share contingent control and bear residual risk."); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 804–05 (2007) ("[W]hile shareholders may share in the wealth when the corporation does well and suffer when the firm does poorly, so may employees, creditors, and other stakeholders."). For examples of the authority granted boards of directors, see DEL. CODE ANN. tit. 8, § 141(a) (2011); MODEL BUS. CORP. ACT § 8.01(b) (2007).

63. *See* BERLE & MEANS, *supra* note 32, at 121–25 (discussing agency cost concerns); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (same); William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737 (2001) (discussing agency costs and the contributions of Berle and Means to that analysis); Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 235–36 (2007) ("The result of our system of dispersed share ownership is a collective action problem that leads inexorably to rational shareholder apathy.").

64. *See generally* Julian Velasco, *The Fundamental Rights of Shareholders*, 40 U.C. DAVIS L. REV. 407 (2006) (discussing four general categories of shareholders' rights, economic rights, control rights, information rights, and litigation rights).

the interests of the corporation or the shareholders.[65] Accordingly, shareholders have limited ability to impact directly most management and operational decisions relating to the corporation.

In theory, the shareholders' right to elect directors should enable them to guide the direction of the company by removing directors who deviate from a desired path and replacing them with a new board of directors.[66] The new directors could be individuals identified by the shareholders, thus giving the shareholders some confidence in and control over the management of the company. The corporate proxy process facilitates such shareholder-sponsored slates of directors.[67]

Initially, parties wanting to gain control of a company without the support of existing management tried to invoke the proxy process to achieve their objectives.[68] These individuals encountered the same types of issues with the proxy process faced by all shareholders—the process is expensive, tedious, and tends to be slanted in favor of existing management.[69] Even after the Securities and Exchange Commission (SEC) adopted federal rules to govern the proxy process, parties had little success using proxies in control contests.[70]

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65. *See, e.g.*, Allan B. Cooper et al., *Too Close for Comfort: Application of Shareholder's Derivative Actions to Disputes Involving Closely Held Corporations*, 9 U.C. DAVIS BUS. L.J. 171, 175–76 (2009) (explaining distinction between derivative and direct suits as "[i]f the harm was to the corporation (so that any shareholder harm was indirect), shareholders could pursue the claim only as a derivative action" but "where the corporation infringed a shareholder's direct right, the shareholder could pursue the case as a direct action").

66. *See, e.g.*, Harding v. Heritage Health Prods., 98 P.3d 945, 947 (Colo. App. 2004) (asserting "fundamental principle that shareholders ultimately have the power to elect the board, remove the board, and modify the corporation's bylaws").

67. *See, e.g.*, Kara Scannell, *SEC Set to Open Up Proxy Process*, WALL ST. J., Aug. 5, 2010, at B1, *available at* http://online.wsj.com/article/SB10001424052748704741904575409680246527908.html ("Currently, if shareholders want to propose a slate of directors, they need to pay out of their own pockets for a separate proxy fight. Under the new rule allowing them to put their own nominees next to the company's, the company would foot the cost.").

68. *See, e.g.*, Philip N. Hablutzel & David R. Selmer, *Hostile Corporate Takeovers: History and Overview*, 8 N. ILL. U. L. REV. 203, 203–06 (1988) ("Before the Williams Act was passed . . . the method of a hostile takeover was to conduct a proxy fight."); *see also* 1 MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS & FREEZEOUTS 1–57 (2003) (explaining general use of proxy process in takeover attempts).

69. *See, e.g.*, Richard W. Barrett, Note, *Elephant in the Boardroom?: Counting the Vote in Corporate Elections*, 44 VAL. U. L. REV. 125, 168 (2009) (highlighting problems in the proxy process because "its complexity, the need for behind-the-scenes adjustment of the vote, and lack of verification assure a significant incidence of errors, and they create opportunities for abuse"); *see also* David F. Larcker & Brian Tayan, Proxy Access: A Sheep, or Wolf in Sheep's Clothing? 1 (July 7, 2010) (unpublished manuscript) (on file with *Washington University Law Review*) ("The shareholder must bear the full cost of preparing and distributing this set of materials, obtaining the list of shareholders, and soliciting support for its candidates. Because of the considerable cost involved, proxy contests occur infrequently and in many cases are not successful.").

70. *See* Hablutzel & Selmer, *supra* note 68, at 204–05 ("It was said during the 1950s that

A different tactic eventually emerged as the preferred course for facilitating unsolicited changes in corporate control—the tender offer.[71] Rather than soliciting the votes of shareholders in support of a new slate of directors, parties seeking control pursued the shares themselves.[72] As described below, many parties adopting this approach were dubbed "corporate raiders," and commentators continue to debate the value of their takeover practices, as well as the utility of takeover regulation.

*1. Corporate Raiders and Hostile Takeovers*

A takeover typically references a change of control at the corporation.[73] Most modern takeovers are accomplished through some type of tender offer. Those offers may involve different consideration (e.g., cash, securities, or some combination of both); they may be self-financed by the offeror or through another means, including high-yield bonds; and they may proceed in multiple steps or in a contingent form.[74] "Whether takeovers are considered friendly or hostile generally is determined by the reaction of the target company's board of directors."[75]

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insurgents were not likely to win such a fight unless dividends had not been paid for several years."). The proxy provisions of the 1934 Securities Exchange Act and the related rules passed by the SEC were intended to level the playing field in the proxy process. *See* Securities Exchange Act of 1934, ch. 404, § 14, 48 Stat. 881, 895 (codified as amended at 15 U.S.C. § 78n (2006)); 17 C.F.R. § 240.14 (2010).

71. *See* Hablutzel & Selmer, *supra* note 68, at 205–06. A tender offer generally is defined as "a public offer to all shareholders to tender their shares at a particular price." 1 LIPTON & STEINBERGER, *supra* note 68, at 24. Tender offers and corporate mergers and acquisitions did not develop in the 1960s; rather, the first notable wave of such transactions dates to the late 1800s. *See* STEVEN M. DAVIDOFF, GODS AT WAR 10–19 (2009) (explaining history of mergers and acquisitions); PATRICK A. GAUGHAN, MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURING 29–57 (4th ed. 2007) (same). The 1960s and 1970s saw increasing use of these tactics in the hostile takeover context. *See infra* Part II.A.1.

72. "A tender offer can be a means of obtaining that which an offeror cannot otherwise obtain by negotiation." 1 LIPTON & STEINBERGER, *supra* note 68, at 1–17; *see also* Alexander R. Hammer, *M-G-M Is Cautious on Tender Offer*, N.Y. TIMES, Sept. 19, 1969, at 69 ("Mr. Kerkorian, the financier who already owns almost a quarter of the common stock of M-G-M, moved to increase his holdings in the company by making a tender offer to buy 620,000 M-G-M shares at $42 each.").

73. "A takeover is an attempt by a bidder ('raider') to acquire control of a subject company ('target') through acquisition of some or all of its outstanding shares." 1 LIPTON & STEINBERGER, *supra* note 68, at 1–10.1.

74. *See, e.g.*, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1250 (1973) ("Sections 14(d) and 14(e) of the Securities Exchange Act (1934 Act) regulate 'tender offers,' but at no point do they define what a 'tender offer' is. As a result the Securities and Exchange Commission (SEC), courts, and practitioners have had the task of determining, in an increasing number of instances, whether particular securities transactions are tender offers and thus subject to the rather extensive regulatory requirements of these sections."); Hammer, *supra* note 72.

75. GAUGHAN, *supra* note 71, at 55.

An unwelcome or hostile takeover places the board of directors and management in a difficult situation. Unlike most shareholders, the party pursuing the takeover has a unified message—frequently with an anti-management slant—and the resources to make that message heard. For example, Carl Icahn launched an expensive and provocative takeover bid for Yahoo targeted at management's decision not to pursue a merger with Microsoft.[76]

Accordingly, hostile takeovers place existing management on the defensive. The offeror's challenges to management's skills or policies may be warranted. In these cases, the hostile takeover attempt may discipline management, give voice to the concern of other shareholders, and increase value—either through a change in management's policies or a sale of the company to the offeror or a competing bidder.

Alternatively, if the offeror's challenges are meritless or based on issues on which reasonably prudent business people could differ, the hostile takeover may be an expensive distraction for management and its shareholders. In these cases, management is required to divert attention and resources from company operations and address the allegations and tactics of management. The value of shareholders' stock may suffer and the company's products and reputation may be publicly tarnished, at least for a short period of time. Although those consequences seem counterproductive, they may be profitable for an offeror depending on its ultimate motives, including arbitrage plays and competing investments.

Regardless of whether the offeror's allegations have merit, the offeror's objectives, investment horizon, or post-acquisition agenda may prove detrimental to the long-term interests of the company. The "buy and bust" or "raiding" concerns associated with takeovers relate to the practice of buying a company and selling off its "crown jewel" or other assets in a manner that generates short-term profit for the investor, but really destroys any long-term opportunities or value for the company and its other

76. *Sincerely Yours, Carl*, N.Y. TIMES DEALBOOK (June 4, 2008, 2:50 PM), http://dealbook.nytimes.com/2008/06/04/sincerely-yours-carl/ ("'I am amazed at the length Jerry Yang and the Yahoo board have gone to in order to entrench their positions and keep shareholders from deciding if they wished to sell to Microsoft. . . . I and many of your shareholders believe that the only way to salvage Yahoo in the long if not short run is to merge with Microsoft.'" (quoting Icahn's letter to Yahoo chairman Roy Bostock)); Miguel Helft, *Yahoo Deal Wards Off Proxy Fight*, N.Y. TIMES, July 22, 2008, http://www.nytimes.com/2008/07/22/technology/22yahoo.html ("Mr. Icahn agreed to drop his proxy bid to replace Yahoo's directors in exchange for three seats on an expanded board. . . . Mr. Icahn bought about 69 million shares of Yahoo, or roughly 5 percent of the company, at about $25 each.").

stakeholders.[77] These practices are also a concern in the debt-based takeover context.

The term "raiding" also describes a situation where the offeror does not necessarily intend to take over the company, but launches a takeover attempt to receive a higher return on its shares of the target. Those enhanced returns may flow from the payment of greenmail, market movement created by rumors of the offeror's activities, or the involvement of a "white knight" or other competing bidder. For example, Paul Bilzerian—who engaged in hostile takeover activity primarily in the 1980s—made significant profits through these "takeover attempts" before he completed his first acquisition in 1988.[78] This type of profit seeking is referenced above in the context of questionable challenges to existing management, but certainly is not limited to those situations.

*2. The Mechanics of a Hostile Takeover*

As noted above, equity-based takeovers may take a variety of forms. The offeror may offer to purchase the target's shares for cash, the debt or equity securities of itself or another company, or some combination of cash and securities.[79] The form of the takeover and the tactics used to approach the target's management and shareholders largely turn on the offeror's identity and objectives.

For example, the offeror may try to bypass management and go directly to shareholders through a tender offer. An offeror may even be able to start this process under the radar, quietly buying up the target's shares on the open market or in private transactions. Many offerors have used this

77. *See, e.g.*, Johnson & Millon, *supra* note 8, at 1863 (explaining "bust-up" takeovers and observing that "[t]akeovers motivated by such objectives are believed to threaten jobs, established customer and supplier relationships, tax revenues, charitable contributions, and other economic and social benefits provided by resident companies to local communities"); *see also* Holderness & Sheehan, *supra* note 5, at 556 ("[T]he most prevalent view is that [corporate control investors] reduce the wealth of their fellow stockholders.").

78. *See* Alison Leigh Cowan, *Corporate Raider: Paul Bilzerian; A Scrappy Takeover Artist Rises to the Top*, N.Y. TIMES, May 24, 1987, http://www.nytimes.com/1987/05/24/business/corporate-raider-paul-bilzerian-a-scrappy-takeover-artist-rises-to-the-top.html.

79. *See supra* Part II.A; *see also* 1 LIPTON & STEINBERGER, *supra* note 68, at 119–20, 139–40 (explaining different consideration exchanges possible in takeovers and observing that many all-cash offers are consummated through multi-step transactions). A general breakdown of takeover strategies and consideration might include six broad categories: tender offers; exchange offers; open market accumulation; creeping tender offers; bear hug letters; and proxy contests. *See* DAVID C. JOHNSTON & DANIEL JOHNSTON, INTRODUCTION TO OIL COMPANY FINANCIAL ANALYSIS 266 (2006). These approaches can overlap and some are discussed in more detail below. For an explanation of creeping tender offers, see LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITY REGULATION 628 (2004).

approach, with notable past examples including Carl Icahn in his acquisition of Trans World Airlines and T. Boone Pickens in his acquisition of Unocal.[80] An offeror often benefits from the element of surprise accompanying this type of "secret accumulation." Management is unaware of the offeror's presence until the offeror has a foothold in the company's stock, often placing management in a defensive stance.

Although the element of surprise still exists in equity-based takeover activity, the federal regulations discussed below require, among other things, disclosure once an offeror has accumulated five percent of the target's stock. These regulations mitigate the complete surprise and often helpless management that resulted in "Saturday Night Specials," which were popular prior to and for a short time after the enactment of the Williams Act in 1968.[81] In a Saturday Night Special, an offeror would accumulate as much of the target's stock as possible over the weekend, making the takeover almost inevitable once the markets opened again on Monday.[82] The target's management frequently had no defense or meaningful response and shareholders who did not sell their stock during the weekend frenzy often received a lower price. As discussed below,

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80. *See* Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 12, n.42, 16 (1987) (discussing strategy of quiet stock accumulation and noting examples of strategy).

81. *See, e.g.*, Steven M. Davidoff, *The SEC and the Failure of Federal Takeover Regulation*, 34 FLA. ST. U. L. REV. 211, 216 (2007) ("The 'Saturday Night Special' was a favorite: in one form, a bidder would embark on a pre-offer buying raid to establish a substantial beachhead of ownership at a reduced price."). After the enactment of the Williams Act, the structure of "Saturday Night Specials" changed slightly to mitigate the effect of the original seven day waiting period imposed for tender offers. *See id.* at 216–18 (explaining the use of "Saturday Night Specials" both before and after the Williams Act and the origins of the term). For example, the offeror would announce the tender offer at the start of the weekend, reducing the time for management to react or impose defensive measures before the expiration of the seven days and the launch of the tender offer. *See, e.g.*, GAUGHAN, *supra* note 71, at 51–53 (providing examples of Saturday Night Specials after 1969); Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621, 631 n.48 (2003) ("A Saturday Night Special is a tender offer that is open for only a short period of time, typically just a few days, thereby forcing shareholders to decide quickly whether or not to tender."). The SEC amended certain provisions of the Williams Act in 1976 to increase the waiting period applicable to tender offers to twenty days, which significantly reduced the effectiveness of Saturday Night Specials in the equity-based context. *See* Davidoff, *supra*, at 223 ("The SEC changes effectively eliminated all vestiges of the old 'Saturday Night Special' for any and all tender offers: new Rule 14e-1 lengthened the minimum offering period to twenty business days from the *de facto* seven calendar days required by old Rule 14d-5.").

82. *See, e.g.*, Davidoff, *supra* note 81, at 216 (explaining mechanics of Saturday Night Specials); Robert A. Prentice, *Front-End Loaded, Two-Tiered Tender Offers: An Examination of the Counterproductive Effects of a Mighty Offensive Weapon*, 39 CASE W. RES. L. REV. 389, 391 (1989) (stating that "the offer was typically announced on a Friday afternoon, giving target shareholders only a week to ten days to decide whether to tender their shares. The timing of the announcement prevented any effective response from target management until the following Monday, when part of the offering period had already expired.").

debt-based takeovers have many of the characteristics of the original Saturday Night Specials.

Offerors also may use a "bear hug" approach to achieve their objectives.[83] In this approach, the offeror approaches management about an acquisition while simultaneously announcing its offer for the target's shares. "The publicity of a bear hug is . . . meant to stir shareholders to apply pressure to the company's board."[84] This approach also can be used as a scare tactic with management, invoking "[a]n 11th-hour approach by the acquiring company's executives, who go to the target's head office late on Friday afternoon to say something like, 'We'd love to work out a deal over the weekend, but if we can't come to an agreement, here's the press release that will go out first thing Monday morning outlining the terms of our hostile takeover.'"[85]

Moreover, a takeover may be characterized as hostile if the offeror enters the picture after the company announces a consensual deal. The offeror's presence often initiates an auction and competitive bidding process for the company, or otherwise tries to force a change of control on the company. Offerors or parties seeking control may use a combination of tactics, including the proxy process. The success or value of their tactics often is in the eye of the beholder.

### *B. Regulation of Equity-Based Takeovers*

Prior to 1968, tender offers and most other takeover activities were largely unregulated.[86] The increased use of all-cash tender offers and the development of other tactics like the Saturday Night Special in the 1960s

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83. *See, e.g.*, 1 LIPTON & STEINBERGER, *supra* note 68, at 1-36, 1-35–1-38 ("In the 'simple' bear hug, the raider notifies the target of a proposed tender offer or business combination at a specified price and upon specified terms, which may include any warranties or conditions the offeror desires.").

84. CHRIS ROUSH, SHOW ME THE MONEY: WRITING BUSINESS AND ECONOMIC STORIES FOR MASS COMMUNICATION 133 (2d ed. 2011). Roush provides several examples of the "bear hug" takeover tactic, including EchoStar Communication's bid for Hughes Electronics. Furthermore, he notes that "[s]ince EchoStart made its bear hug, four lawsuits have been filed against G.M. [Hughes' parent company] by shareholders effectively pushing the company to consider EchoStar's offer." *Id.*; *see also* ANDREW ROSS SORKIN, TOO BIG TO FAIL (2009); David Whitford, *When a Takeover Battle Goes Nuclear*, CNNMONEY.COM (July 14, 2009, 10:10 AM), http://money.cnn.com/2009/07/06/news/companies/exelon_nrg_electric_utilities.fortune/ ("'I guess this is what they say is sort of a classic bear-hug situation . . . a gradual, rolling dispiriting of the opposition. The whole idea of a bear hug is that it becomes an inevitable, self-fulfilling prophecy. And, uh, it's succeeding pretty well on that path.'" (quoting David Crane, CEO of NRG Energy)).

85. Madhavi Acharya-Tom Yew, *Insider Trading Trial Gave a Slice of Bay Street Life*, INVESTORVOICE.CA (July 15, 2005, 1:00 AM), http://www.investorvoice.ca/Scandals/Rankin/AR23.htm.

86. *See, e.g.*, LOSS & SELIGMAN, *supra* note 79, at 615.

caused regulators to take notice. The result was the Williams Act, which is a combination of disclosure requirements and certain procedural rules applicable in the equity-based takeover context.[87]

This Part explores certain provisions of the Williams Act and related state anti-takeover statutes.[88] It also summarizes the debate concerning the value of takeover activity and the propriety of takeover regulation. Although this debate is not directly applicable to debt-based takeovers, it informs the discussion of appropriate regulation in that context.

*1. The Williams Act*

The Williams Act amended the 1934 Securities Exchange Act to regulate certain stock purchases and tender offers.[89] The legislative history to the Williams Act suggests that Congress did not view it specifically as anti-takeover legislation.[90] As Senator Williams explained, "[the bill] avoids tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid."[91] Accordingly, a primary purpose of the Williams Act appears to be providing more information and time to investors to facilitate more thoughtful decisions in the context of equity-based takeovers.[92]

To that end, the Williams Act introduced mandatory disclosure requirements for persons acquiring five percent or more of a company's

87. Some commentators describe the Williams Act as substantive regulation as well. *Compare* Davidoff, *supra* note 81, at 219 (describing the Williams Act as imposing "substantive and procedural requirements"), *with* Johnson & Millon, *supra* note 8, at 1890 ("[B]esides implementing provisions aimed at transmitting information to shareholders, the Williams Act and related SEC regulations establish procedural guidelines governing the conduct of tender offers."). The distinction between substantive and procedural securities regulation is not relevant to the focus of this Article.

88. Specifically, this section discusses sections 13(d) and 14(d) of the Williams Act. For a more thorough exploration of the Williams Act, see 1 LIPTON & STEINBERGER, *supra* note 68, at 1–12–1–14; LOSS & SELIGMAN, *supra* note 79, at 615–45.

89. The Williams Act does not define the term "tender offer." *See* 2 LIPTON & STEINBERGER TAKEOVERS & FREEZEOUTS 2–24. One commentator suggests that Congress intended to use the commonly-accepted meaning of tender offer, which is "a public offer to all shareholders to tender their shares at a particular price." *Id.* For a thorough discussion of the elements of a tender offer and the courts' analysis of the same, see LOSS & SELIGMAN, *supra* note 79, at 629–32.

90. *See* HARRISON A. WILLIAMS, FULL DISCLOSURE OF CORPORATE EQUITY OWNERSHIP AND IN CORPORATE TAKEOVER BIDS, S. REP. NO. 90-550, at 3 (1967); HARLEY O. STAGGERS, DISCLOSURE OF CORPORATE EQUITY OWNERSHIP, H.R. REP. NO. 90-1711 (1968). This balanced approach to takeover regulation is in contrast to the title and approach of Senator Williams' original bill, "Protection Against Corporate Raiders." *See* Davidoff, *supra* note 81, at 217.

91. *See* 113 CONG. REC. 854–56, 24,664–65 (1967).

92. *See* John H. Matheson & Brent A. Olson, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1437 (1991) ("The Act relieves the undue pressure on shareholders by ensuring investors have more time to make informed and rational decisions.").

equity securities. Under the current version of section 13(d) of the Securities Exchange Act, "[a]ny person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 78l . . . is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition, send" a statement of such ownership to the SEC, any exchanges on which the company is listed, and the company itself.[93] Section 13(d) and Rule 13d-1 detail the type of information that a purchaser must disclose in the statement.[94] These provisions were intended to "alert investors in securities markets to potential changes in corporate control and to provide them with an opportunity to evaluate the effect of these potential changes."[95]

In the context of debt-based takeovers, section 13(d) has two important qualifiers. First, it applies only to the acquisition of equity securities of public companies.[96] Second, it uses the concept of "acquiring directly or indirectly the beneficial ownership" and defines "person" broadly to try to capture all potential acquisitions that might lead to a tender offer or takeover attempt.[97] These provisions try to deter investment schemes

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93. 15 U.S.C. § 78m(d) (2006). The disclosure trigger originally was ten percent beneficial ownership, with [seven] days to file the appropriate statement. These provisions were subsequently amended. *See* Davidoff, *supra* note 81, at 219.

94. This statement, referred to as a Schedule 13D, must include, among other things, the identity of the beneficial owner, the source of funds used to purchase the stock, and the purpose of the acquisition. § 78m(d)(1). Rule 13d-1 permits certain persons to file a shorter version of Schedule 13D, known as a Schedule 13G, if that person:

> has acquired such securities in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect, including any transaction subject to Rule 13d-3(b).

17 C.F.R. § 240.13d-1(b)(1)(i) (2010). Rule 13d-1, as well as the types of parties excluded from the requirements of section 13(d), underscores the regulations' focus on increased disclosures from parties anticipating a takeover.

95. Wellman v. Dickinson, 682 F.2d 355, 365–66 (2d Cir. 1982); *see also* Letter from Wachtell, Lipton, Rosen & Katz to Ms. Elizabeth M. Murphy 2–3 (Mar. 7, 2011) (on file with Washington *University Law Review* and *available at* www.sec.gov/rules/petitions/2011/petn4-624.pdf) (describing investor focus of the disclosure rules).

96. The 1934 Securities Exchange Act defines "equity security" as

> any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

15 U.S.C. § 78c(a)(11) (2006).

97. 15 U.S.C. §§ 78m(d)(1), (3) (2006). Section 13(d)(3) provides that "[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring,

designed to avoid the section 13(d) disclosure triggers, which also is a potential issue in debt-based takeovers.

The Williams Act also regulates tender offers in sections 14(d) and (e).[98] For example, section 14(d) and Rule 14d-6 require the filing of a disclosure statement in connection with any tender offer that specifies, among other things, the identity of the offeror and target company, the amount of equity securities being sought through the tender offer, the amount and type of consideration being offered, and any applicable deadlines.[99] Section 14(d) also gives shareholders who tender their stock certain rights, including the right to withdraw their tenders and to receive a pro rata distribution when the tender offer is oversubscribed.[100] Finally, section 14(e) provides that it is

> unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices in connection with any tender offer.[101]

### *2. Anti-Takeover Legislation and Defensive Tactics*

The Williams Act failed to deter hostile takeover activity. In fact, aided by creative financing alternatives, takeover activity spiked during the 1970s.[102] This increased activity prompted a majority of states to enact anti-takeover legislation.[103] State regulation of tender offers has generated rich commentary regarding federalism and the value of takeovers.[104]

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holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for the purposes of this subsection." § 78m(d)(3); *see also* Rule 13d-5. Moreover, Rule 13d-3 explains that

> a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: [v]oting power which includes the power to vote, or to direct the voting of, such security; and/or [i]nvestment power which includes the power to dispose, or to direct the disposition of, such security.

17 C.F.R. §§ 240.13d-3(a)(1)-(2) (2010).

98. 15 U.S.C. §§ 78n(d), (e) (2006).

99. 15 U.S.C. § 78n(d)(1) (2006); 17 C.F.R. § 240.14d-6 (2010).

100. 15 U.S.C. §§ 78n(d)(5), (7) (2006); *see also* 17 C.F.R. §§ 240.14d-7, d-10.

101. 15 U.S.C. § 78n(e) (2006).

102. *See, e.g.*, Matheson & Olson, *supra* note 92, at 1437 ("Despite the Williams Act, by the mid-1970s the takeover boom had begun an extended expansion that would carry through the megamergers of the late 1980s.").

103. *See* 1 LIPTON & STEINBERGER, *supra* note 68, at 1–14 (stating that this increase in takeover activity "[r]esulted in more than thirty-five states enacting laws to regulate tender offers by 1982"). For a thoughtful discussion of the non-shareholder interests that arguably motivate state anti-takeover

The substance of state anti-takeover regulation has evolved over time. These regulations first focused on enhanced disclosure, longer deliberation periods, and overall fairness, which the Supreme Court invalidated in *Edgar v. MITE Corp*.[105] Subsequent statutes have focused on the corporate governance aspects of takeover activity, such as limitations on ownership or voting rights of stock above a certain percentage (e.g., no voting rights for shares in excess of 20 percent or not permitted to acquire more than 20 percent) and moratoriums on the consummation of certain transactions.[106] In addition, states have enacted statutes authorizing boards of directors to implement takeover defenses and clarifying the board's fiduciary duties in the takeover context (e.g., no heightened standard of care or an ability to consider the interests of constituents other than shareholders).[107]

Takeover defenses have garnered a lot of attention, both in the courts and in the investor community. Common defenses include shareholders' rights plans, voting rights plans, staggered boards, greenmail, the use of white knights, and the pac-man response.[108] Commentators and investors

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legislation, see Johnson & Millon, *supra* note 8, at 1863–64. They explain non-shareholder interests at stake such that:

> With the threat to incumbent corporate managements, these concerns have occupied the legislators' attention as they respond to heightened takeover activity. Thus, for obvious economic and political reasons, deterrence of tender offers, not 'investor protection,' is emerging as the states' principal motivation in passing takeover laws, a fact state legislators are beginning to acknowledge more candidly.

*Id.*

104. *See, e.g.*, Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1169–70 (1999) (citing articles discussing corporate law and federalism beginning with Bill Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974)). For a general discussion of the evolution of state anti-takeover statutes, see Matheson & Olson, *supra* note 92, at 1438–52.

105. 457 U.S. 624 (1982); *see also* 1 LIPTON & STEINBERGER, *supra* note 68, at 1–15.

106. *See* SANJAI BHAGAT & RICHARD H. JEFFERIS, JR., THE ECONOMETRICS OF CORPORATE GOVERNANCE STUDIES 8 (2002); 1 LIPTON & STEINBERGER, *supra* note 68, at 1–15–1–16; Barzuza, *supra* note 11.

107. *See* Barzuza, *supra* note 11, at 1989 ("Thirty-five states have adopted directors' duties statutes, also known as 'other constituency' statutes. Typically, these statutes allow directors to take into account the interests of constituencies other than shareholders and/or the long-term value of the firm. Sometimes, in addition, they apply weaker fiduciary duties on managers' use of defensive tactics.").

108. For a general discussion of common takeover defenses, see PATRICK A. GAUGHAN, MERGERS: WHAT CAN GO WRONG AND HOW TO PREVENT IT 246–49 (2005). A shareholders' rights plan, commonly called a poison pill, typically gives

> target shareholders the right to buy shares of the target (a 'flip-in' provision), the acquirer (a 'flip-over' provision), or both at a substantially discounted price in the event that a single shareholder, or an affiliated group of shareholders, acquires more than a specified percentage of the company's shares (typically between ten and twenty percent)."

*See* Subramanian, *supra* note 81, at 625. In a voting rights plan, "managers use a defensive tactic that interferes with shareholder voting rights, to circumvent the hostile bidder's attempt to use the proxy

debate the value impact of takeover defenses, which directly relates to the utility of takeovers themselves.[109] Investors tend to ebb and flow on the issue depending on the economic environment.[110]

Notwithstanding the valuation debate and anti-takeover legislation, hostile takeovers remain an eminent feature of the corporate landscape. They arguably are more difficult to consummate in the current regulatory environment, but that may change as the United States and other countries reevaluate their proxy access and other shareholders' rights and governance mechanisms. Indeed, giving shareholders greater access to the corporate proxy may renew the prominence of proxies in control contests. As policymakers consider their stance on proxy access and takeover regulation more generally, they also need to consider the impact of debt-based takeovers. The remainder of this Article explores this issue and offers some guidance for policymakers in that endeavor.

## III. THE MECHANICS OF DEBT-BASED TAKEOVERS

Equity-based takeovers often focus on realizing untapped value at the target company.[111] In pursuing that objective, the offeror tries to acquire control of the target company at the lowest possible price, although that generally involves paying fair market value for the stock. The fair market

machinery." Barzuza, *supra* note 11, at 1987; *see also* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 670 (Del. Ch. 1988) (holding that there must be a compelling justification for blocking shareholders from exercising their voting rights). Staggered boards "provide antitakeover protection both by (i) forcing any hostile bidder, no matter when it emerges, to wait at least one year to gain control of the board and (ii) requiring such a bidder to win two elections far apart in time rather than a one-time referendum on its offer." Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 887 (2002); *see also* Dynamics Corp. of Am. v. WHX Corp., 967 F. Supp. 59, 64–65 (D. Conn. 1997) (upholding business judgment rule to staggered board defensive tactic). Greenmail "refers to payments made by the target company to buy back shares owned by a potential acquirer at a premium over their fair market value. In exchange, the acquirer normally agrees to rescind its hostile takeover bid." Soo-Jeong Ahn et al., *Asia/Pacific*, 43 INT'L LAW. 1007, 1022–23 n.118 (2009); *see also* Kors v. Carey, 158 A.2d 136, 58–59 (Del. Ch. 1960) (finding no breach of fiduciary duty when corporate funds were used to purchase shares of acquired corporate stock). A white knight is a means of avoiding the takeover bid "by selling to a friendly buyer." Barzuza, *supra* note 11, at 1980; *see also* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 181 (Del. 1986) (requiring a higher standard involving sale to highest bidder when "white knight" is implicated). In a pac-man response, the goal is for the targeted business to turn the tables: eat the other before being eaten. *See* Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 875 n.11 (2002).

109. *See, e.g.*, Barzuza, *supra* note 11 (supporting enhanced fiduciary duties of *Unocal*, *Revlon*, and *Blasius*); Bebchuk et al., *supra* note 108.

110. *See, e.g.*, GAUGHAN, *supra* note 71, at 213 (noting that Goldman Sachs helped pioneer the recapitalization anti-takeover defense).

111. *See supra* Part II.

value threshold stems from market demand, state law appraisal rights, management fiduciary duties, and the other protections discussed above for shareholders in the tender offer and takeover contexts.[112]

Conversely, investors who use debt-based takeovers to gain control of undervalued companies can typically do so at bargain prices.[113] Part of the bargain relates to the distressed financial condition of the target company.[114] The other part, however, arises from the secrecy and lack of transparency associated with the distressed debt market. As one commentator observed, these investors "[q]uietly buy up as much cheap, delinquent debt as possible and then fight it out in bankruptcy court for a lucrative settlement that transforms the debt into a large share of company stock."[115] Notably, this strategy works outside of bankruptcy as well, particularly in the private company context where the parties do not need to invoke the Bankruptcy Code to facilitate a debt-for-equity exchange.[116]

To appreciate the consequences of the lack of transparency in the debt-based takeover context, this Part examines a series of debt-based takeovers in the newspaper industry.[117] Although the target companies in these transactions are all in the newspaper industry, investors employ similar loan-to-own investment techniques in the manufacturing, retail, service, and other industries.[118] This Article uses the newspaper industry solely as an example of the potential for gamesmanship and abuse in debt-based takeovers. The case studies also lay the groundwork for the discussion in Part IV of disclosure requirements to protect all of a target's stakeholders both in and outside of bankruptcy.

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112. *See supra* note 108 and accompanying text.

113. *See* Hotchkiss et al., *supra* note 21, at 25 ("Transactions prices, however, are significantly lower than those paid for nonbankrupt firms matched on size and industry.").

114. STEPHEN G. MOYER, DISTRESSED DEBT ANALYSIS: STRATEGIES FOR SPECULATIVE INVESTORS 6 (2005) (categorizing distressed debt by reference to Moody's and S&P, with BB as "speculative" grade on a "10-grade scheme ranging from AAA to D").

115. Michael Oneal, *New Breed of Newspaper Owners Writing a Different Story*, CHI. TRIB., June 6, 2010, http://articles.chicagotribune.com/2010-06-06/business/ct-biz-0606-angelo-gordon--20100606_1_new-owners-newspaper-industry-angelo-gordon.

116. For example, Platinum Equity reportedly purchased the *San Diego Union-Tribune* for a bargain price in an out-of-court sale. *See* PEW PROJECT FOR EXCELLENCE IN JOURNALISM & POYNTER INST., THE STATE OF THE NEWS MEDIA 2010, http://stateofthemedia.org/2010/newspapers-summary-essay/ownership/ (last visited Aug. 21, 2011); *see also* Thomas Kupper, *Union-Tribune Sold to Platinum Equity*, SIGNONSANDIEGO.COM (Mar. 18, 2009, 1:17 PM), http://www.signonsandiego.com/news/2009/mar/18/bn18sale105226/ (explaining details of sale).

117. For an overview of a similar strategy in the casino entertainment industry, see Janet Morrissey, *Why Carl Icahn Is Wagering Big on Casinos*, TIME.COM (Mar. 23, 2010), http://www.time.com/time/business/article/0,8599,1974104,00.html.

118. *See supra* Part I.A.

### *A. A Case Study of Industry-Specific Debt Opportunities*

The advent of the Internet and evolution of communication technologies pose significant challenges for the newspaper industry.[119] In the United States, newspaper sales have dropped significantly, as people increasingly turn to the Internet and their wireless devices for news, information, and entertainment.[120] "Between 2008 and early 2010, eight major newspaper chains declared bankruptcy, several big city papers shut down, and many laid off reporters and editors, imposed pay reductions, cut the size of the physical newspaper, or turned to Web-only publications."[121]

Faltering business models and profit margins often present opportunities for distressed-debt investors. An investor's decision to seize any particular opportunity may depend on that investor's investment strategies, existing portfolio, and in-house expertise. Some investors choose to concentrate their efforts in certain industries. Angelo, Gordon & Co. (Angelo Gordon), Alden Global Capital, Avenue Capital, and Oaktree Capital Management (Oaktree), among others, selected the newspaper industry.[122]

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119. John Gardner, *Newspaper Industry Facing Huge Challenges*, POST INDEP. (Colo.), Jan. 5, 2009, http://www.postindependent.com/article/20090105/VALLEYNEWS/901059997. Gardner explains issues facing the newspaper industry and notes that "[m]ore and more people are going online or using wireless devices to get news and information. That could be the surest sign that the printed medium is on its way out." *Id.* This trend exists not only in the United States, but also to varying degrees in other countries. *See, e.g.*, ORG. FOR ECON. CO-OPERATION & DEV., THE EVOLUTION OF NEWS AND THE INTERNET (2010), http://www.oecd.org/dataoecd/30/24/45559596.pdf (last visited Aug. 21, 2011) ("Only five OECD countries for which data is available have experienced a decline [in the newspaper market in the period 2004-2008], the United States being particularly affected (-20%), followed by Japan (-9%), the United Kingdom (-7%), Canada (-2%) and The Netherlands (-1%).").

120. *See* Tim Arango, *Fall in Newspaper Sales Accelerates to Pass 7%*, N.Y. TIMES, Apr. 27, 2009, at B3, *available at* http://www.nytimes.com/2009/04/28/business/media/28paper.html ("[D]eclines [in print circulation] ranged from 20.6 percent for The New York Post, to a slight 0.4 percent drop for The Chicago Sun-Times."). The industry's problems became evident as early as 2004 and 2005. *See* Frank Ahrens, *Hard News*, WASH. POST, Feb. 20, 2005, at F1, *available at* http://www.washingtonpost.com/wp-dyn/articles/A37138-2005Feb19.html ("The venerable newspaper is in trouble. Under sustained assault from cable television, the Internet, all-news radio and lifestyles so cram-packed they leave little time for the daily paper, the industry is struggling to remake itself.").

121. SUZANNE M. KIRCHHOFF, CONG. RESEARCH SERV., R40700, THE U.S. NEWSPAPER INDUSTRY IN TRANSITION (2010), *available at* http://www.fas.org/sgp/crs/misc/R40700.pdf.

122. *See* Michael Oneal, *Hedge Funds Gain Clout in Newspaper Industry*, L.A. TIMES, June 6, 2010, http://articles.latimes.com/2010/jun/06/business/la-fi-tribune-20100606 ("Over the last year, bankrupt newspaper companies including Tribune Co., owner of the Los Angeles Times, KTLA-TV Channel 5 and other news organizations, have been overrun by a category of stealthy 'distressed debt' hedge funds. These include Angelo, Gordon & Co. and Alden Global Capital, both of New York, and Oaktree Capital Management of Los Angeles."); *Popular U.S. Tabloids in Trouble?*, CBSNEWS.COM, Nov. 1, 2010, http://www.cbsnews.com/stories/2010/11/01/business/main7011590.shtml (noting that Angelo Gordon and Avenue Capital are bondholders of ailing American Media, Inc.).

Distressed-debt investors largely invoke similar tactics, and many commentators debate the value of their activities. This Article analyzes one of these tactics—the loan-to-own strategy—and uses Angelo Gordon's investments in the newspaper industry to illustrate the use and consequences of the tactic.[123] Angelo Gordon's activities in the newspaper industry facilitate analysis of both in- and out-of-court debt-based takeovers, disputes relating to loan-to-own acquisitions, and management critiques of the strategy. This Part of the article first explains the circumstances of each takeover and then discusses the common elements of, and similar issues raised by, all of the transactions.

*1. American Media, Inc.*

American Media, Inc. publishes several print news magazines, including *The National Enquirer*, *Star*, and *Muscle & Fitness*.[124] Unlike many newspaper publishers, American Media's primary publications do not rely on subscriptions, but rather one-off sales at stores and newspaper stands. Nevertheless, it has encountered many of the same challenges facing others in the newspaper industry.[125]

American Media started aggressively pursuing refinancing options in 2008.[126] In early 2009, reports suggested that American Media found a solution—an out-of-court debt-for-equity exchange with its senior bondholders.[127] This restructuring reduced American Media's debt "from $1.1 billion to $825 million," and distributed approximately 70 percent of its common stock to Angelo Gordon, Avenue Capital, Capital Research &

123. ANGELO, GORDON & CO., http://www.angelogordon.com/ (last visited Aug. 21, 2011) ("Angelo, Gordon & Co. is a privately-held registered investment advisor dedicated to alternative investing. The firm was founded in 1988 and currently manages approximately $23 billion. We seek to generate absolute returns with low volatility by exploiting inefficiencies in selected markets and capitalizing on situations that are not in the mainstream of investment opportunities. We creatively seek out new opportunities that allow us to remain a leader in alternative investments.").

124. *See, e.g.*, Jonathan Stempel, National Enquirer *Publisher Files for Bankruptcy*, REUTERS, Nov. 17, 2010, *available at* http://www.reuters.com/article/2010/11/17/us-americanmedia-bankruptcy-idUSTRE6AG42G20101117 (identifying publications housed at American Media).

125. *See The Ur-Text of a Tabloid Age*, NEWSWEEK, Sept. 29, 2008, at 40, *available at* http://www.newsweek.com/2008/09/20/the-ur-text-of-a-tabloid-age.html (explaining American Media's challenges and observing that "[t]he Internet, the ideal medium for salacious, unconfirmed gossip, has been eating away at the tabloid's circulation for years").

126. *Id.*

127. *See* Form 8-K from Am. Media Operations, Inc., to U.S. Sec. & Exch. Comm'n, File No. 001-11112 (Feb. 2, 2009), *available at* http://www.sec.gov/Archives/edgar/data/853927/000119312509020116/d8k.htm ("On January 30, 2009, American Media Operations, Inc. . . . successfully completed its cash tender offers . . . and receipt of requisite consents in the related consent solicitations . . . in respect of its outstanding senior subordinated notes . . . .").

Management Co., and Credit Suisse Securities.[128] These investors also continued to hold approximately 78 percent of the company's subordinated bond debt.

American Media's out-of-court debt reduction, however, proved inadequate, and in July 2010 the company announced that it intended to file a prepackaged plan of reorganization involving another debt-for-equity exchange.[129] It completed solicitation of its prepackaged plan and filed a Chapter 11 bankruptcy case on November 17, 2010.[130] Under the plan, American Media exchanged its senior subordinated notes for approximately 98 percent of its new common stock, providing those bondholders a return of approximately 53.5 percent.[131] Angelo Gordon, Avenue Capital, Capital Research, and Credit Suisse received 79 percent of American Media's common stock under the plan of reorganization.

The bankruptcy court approved American Media's plan on December 20, 2010.[132] The plan contemplates $565 million of new financing, but focuses primarily on the company's capital structure.[133] It provides little insight regarding the company's business model or future plans.

*2. Freedom Communications, Inc. and the "Star Tribune"*

Freedom Communications, Inc. is the parent company of the *Orange County Register* in Irvine, Calif., and several other print publications.[134] Freedom operated as a privately held, family owned company for seventy-five years.[135] It began experiencing liquidity issues in 2004, not only due

128. Russell Adams & Mike Spector, Enquirer's *Parent Plans Chapter 11*, WALL ST. J., Nov. 2, 2010, http://online.wsj.com/article/SB10001424052748704141104575588103839594996.html; *see also* Disclosure Statement Relating to the Debtors' Joint Prepackaged Plan of Reorganization Under Chapter 11 of the Bankruptcy Code at 55, *In re* Am. Media, Inc., No. 10-16140 (Bankr. S.D.N.Y. Oct. 30, 2010).

129. *See* Adams & Spector, *supra* note 128.

130. Press Release, Am. Media, Inc., American Media, Inc. Advances to Next Stage of Financial Restructuring (Nov. 17, 2010), *available at* http://www.americanmediainc.com/press-releases/american-media-inc-advances-next-stage-financial-restructuring.

131. *See* Donald Jeffrey, National Enquirer *Publisher American Media's Bankruptcy Plan Wins Approval*, BLOOMBERG, Dec. 20, 2010, *available at* http://www.bloomberg.com/news/2010-12-20/american-media-chapter-11-exit-plan-approved-in-n-y-bankruptcy-court.html.

132. *See id.*

133. *See, e.g.*, Nat'l Enquirer *Owner Slated to Exit Bankruptcy*, ABCNEWS.COM (Dec. 20, 2010), http://abcnews.go.com/Business/wireStory?id=12444647.

134. *See* Mary Ann Milbourn, *Freedom Communications Exits Bankruptcy*, ORANGE COUNTY REG.COM (Calif.), Apr. 30, 2010, http://ocbiz.ocregister.com/2010/04/30/freedom-communications-exits-bankruptcy/18389/.

135. *See id.* ("Freedom's founding Hoiles family will no longer have an interest in the company, ending more than 75 years of ownership that started with Raymond Cyrus 'R.C.' Hoiles, who

to the changing media environment, but also as the result of a company borrowing $1 billion to cash out some of the existing owners.[136] It filed a Chapter 11 bankruptcy case in September 2009.

Under Freedom's plan of reorganization, the company exchanged $450 million in debt for new common stock, which gave control of the reorganized company to Angelo Gordon, Alden Global Capital, Luxor Capital Group, and a group of lenders led by J.P. Morgan.[137] These investors installed a new board of directors, and Freedom subsequently announced that it was seeking to sell parts of the company.[138] Commentators suggest that the dispositions are designed to allow Freedom to focus on the *Orange County Register* and perhaps consolidate it with the *Los Angeles Times*.[139]

The *Star Tribune* is based in Minneapolis, Minn., and, based on circulation, is one of the largest newspapers in the United States.[140] Similar to Freedom and the Tribune Co., discussed below, the *Star Tribune* experienced a change of control through a leveraged buyout shortly before its bankruptcy filing. Specifically, "Avista Capital Partners[] bought the paper for $530 million," $430 million of which was financed.[141] This $430 million of new debt eventually was converted into common stock under the *Star Tribune*'s plan of reorganization, giving Angelo Gordon, Wayzata Investment Partners, Credit Suisse Group, and other investors control of the company.[142]

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purchased the Register in 1935 as a platform for his libertarian views on individual freedom and limited government.").

136. *See id.* ("Freedom's financial woes date back to 2004 when the company borrowed $1 billion to buy out family members who wanted to cash in their shares and to cover $332 million in existing debt and the deal's transaction costs.").

137. *See id.*

138. *See id.*; *see also* Jerry Sullivan, *Register Owner Freedom Said to Be Looking at Selling Parts of Company*, ORANGE COUNTY BUS. J., Nov. 19, 2010, http://www.ocbj.com/news/2010/nov/19/register-owner-freedom-said-be-looking-selling-par/.

139. *See* Sullivan, *supra* note 138.

140. *See* David Phelps, Star Tribune *Files for Chapter 11 Bankruptcy*, STAR TRIBUNE (Minn.), Jan. 16, 2009, http://www.startribune.com/business/37685134.html.

141. *See* Phelps, *supra* note 140; *see also* David Phelps, Star Tribune's *Largest Lender Is Local*, STAR TRIBUNE (Minn.), Jan. 16, 2009, http://www.startribune.com/business/37749999.html.

142. *See* Jennifer Bjorhus, *New Board of Directors Proposed for* Star Tribune, STAR TRIBUNE (Minn.), Aug. 31, 2009, http://www.startribune.com/local/56275087.html. Unlike American Media and Freedom, the *Star Tribune* also used its Chapter 11 case to modify certain contracts, including its union agreements. *See New Owners for* Star Tribune *Reorganize*, USA TODAY, June 19, 2009, http://www.usatoday.com/news/nation/2009-06-19-star-tribune_N.htm.

*3. Tribune Co.*

The Tribune Co. "is a leading media and entertainment company reaching more than eighty percent (80%) of households in the United States through its newspaper, other publications and websites, its television and radio stations . . . and its other news and entertainment offerings."[143] Its newspaper holdings include the *Chicago Tribune*, the *Los Angeles Times*, and the *Baltimore Sun*.[144] The company filed a Chapter 11 case in December 2008, approximately one year after going private through a leveraged buyout that saddled the company with additional debt.[145]

At the time Tribune Co. filed bankruptcy, Angelo Gordon was the company's third largest creditor, holding $324 million of the company's prepetition debt.[146] Based on the company's balance sheet, this investment—like those in American Media, Freedom, and *Star Tribune*—appeared to give Angelo Gordon the company's fulcrum security that would be converted into equity through the Chapter 11 plan. The reorganization, however, has been consumed with litigation concerning the prepetition leveraged buyout and which tranche of debt should receive control under the plan of reorganization.[147]

The litigation in Tribune Co.'s Chapter 11 case illustrates a control contest among debtholders that is becoming more commonplace as investors invoke debt-based takeover strategies.[148] Four different debtholder groups have proposed a plan of reorganization for the

143. *See* Joint Disclosure Statement for [Multiple] Plans of Reorganization at 7, *In re* Tribune Co., No. 08-13141 (Bankr. D. Del. Dec. 9, 2010) [hereinafter Joint Disclosure Statement].

144. *See id.* at 8–12.

145. *See* Sarah Rabil, *Tribune Bankruptcy 'Stops Clocks,' Eases Debt Burden*, BLOOMBERG, Dec. 9, 2008, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aNnMpmsUNMxQ; Bill Rochelle, *Tribune, Madoff Trustee, Innkeepers, WaMu, Chemtura, Ambac: Bankruptcy*, BLOOMBERG, Nov. 11, 2010, *available at* http://www.bloomberg.com/news/2010-11-11/tribune-madoff-innkeepers-wamu-chemtura-ambac-bankruptcy.html ("Tribune withdrew a prior version of a reorganization in August in the wake of the examiner's report finding a likelihood the second phase of the leveraged buyout in December 2007 could be attacked successfully as a constructively fraudulent transfer.").

146. *See* Rochelle, *supra* note 145.

147. For a summary of some of the litigation relating to the Chapter 11 case, see Steven Church, *Tribune Lawsuit Deadline Passes as Bankruptcy Plods On*, BLOOMBERG, Dec. 9, 2010, *available at* http://www.businessweek.com/news/2010-12-09/tribune-lawsuit-deadline-passes-as-bankruptcy-plods-on.html.

148. *See supra* Part II; *see also* Notice of Filing of Responsive Statement by Aurelius Capital Management et al., *In re* Tribune Co., No. 08-13141 (Bankr. D. Del. Nov. 23, 2010) (providing an example of the discourse among competing creditor groups in the Tribune Co. Chapter 11 case).

company.[149] Each plan proposes a different capital structure for the reorganized company.

Angelo Gordon is aligned with the company, the creditors' committee, Oaktree, and JPMorgan Chase Bank in the plan of reorganization dispute.[150] Under the company's plan, Angelo Gordon, Oaktree, and a group of lenders led by JPMorgan Chase would receive control of the reorganized company, while wiping out a significant portion of the company's other prepetition secured and subordinated debt and proposing to pay general unsecured creditors' claims in full.[151] The plan is opposed by numerous constituents, including unsecured creditors—who suggest the 100 percent payment is illusory—and bondholders seeking percentage ownership of the reorganized company.[152]

*4. Philadelphia Newspapers*

In February 2009, Philadelphia Newspapers, which owns the *Philadelphia Inquirer* and the *Philadelphia Daily News*, filed a Chapter 11 case.[153] The company's initial plan of reorganization contemplated a sale of substantially all of the company's assets to a local group of investors.[154] Although the sale process included a public auction, it prohibited the use of credit bidding as part of a bidder's consideration. The restriction was designed to discourage bids from the company's existing debtholders, which included Angelo Gordon and Alden Global Capital.[155] Whereas

149. *See* Joint Disclosure Statement, *supra* note 143, at 1.

150. *See* Specific Disclosure Statement Relating to First Amended Joint Plan of Reorganization for Tribune Co. & Its Subsidiaries, *In re* Tribune Co., No. 08-13141 (Bankr. D. Del. Dec. 8, 2010).

151. *See id.* at 6–10.

152. The bondholder group opposing Tribune Co.'s proposed plan is led by Aurelius Capital Management. The bondholder plan proposes a seven-member board of directors for the reorganized company comprised of the Chief Executive Officer, four members selected by prepetition senior lenders and two members selected by Aurelius. *See* Specific Disclosure Statement for the Joint Plan of Reorganization for Tribune Co. & Its Subsidiaries Proposed by Aurelius Capital Management, et al., *In re* Tribune Co., No. 08-13141 (Bankr. D. Del. Dec. 9, 2010); *see also* The Ad Hoc Committee of Tribune Subsidiary Trade Creditors' Objection to the Proposed Specific Disclosure Statements Relating to the Plans of Reorganization at 2, *In re* Tribune Co., No. 08-13141 (Bankr. D. Del. Nov. 18, 2010) ("Given the size of the claims pool and the fact that the Plan proponents felt it necessary to impose a 'cap' on the amounts payable on account of the Trade Creditors' claims, the anticipated '100%' cash recovery to Trade Creditors may be illusory.").

153. *See* Harold Brubaker & Chris Mondics, Inquirer's *Owner Begins Court Odyssey*, PHILLY.COM (Feb. 24, 2009), http://articles.philly.com/2009-02-24/news/24984626_1_toll-bros-bruce-toll-investors.

154. *See* Rachel Feintzeig, *Judge Signs Off on Philadelphia Newspapers' Bankruptcy Plan*, WALL ST. J., June 28, 2010, http://online.wsj.com/article/SB10001424052748703964104575335260600723400.html (explaining history of case).

155. *See* Feintzeig, *supra* note 154 ("[T]he media company . . . blazed a new path to confirmation,

Tribune Co. illustrates a control contest among debtholders, Philadelphia Newspapers shows signs of a control contest between management (or a management-backed group of investors) and debtholders.

The debtholders challenged the bidding restriction, but the United States Court of Appeals for the Third Circuit ruled in favor of the company.[156] Nevertheless, the debtholders participated in the auction with a non-credit bid and, in September 2010, ultimately prevailed with the highest and best offer.[157] The debtholders have installed a new board of directors, and the company is focusing on integrating its operations and strengthening its digital platform.[158]

*5. The Makings of a Media Conglomerate*

Common themes run through the debt-based takeovers of American Media, Freedom, *Star Tribune*, Tribune Co., and Philadelphia Newspapers. They involve financially strapped companies with strong platforms and long histories in the newspaper industry, bargain acquisition prices, potential geographic and technology synergies, and management with few viable options. These companies potentially represent a cohesive media portfolio, which likely explains the repeat players in these deals, including Angelo Gordon.[159]

But what do these and similar debt-based takeovers mean for the companies themselves and the stakeholders left behind? These and related questions are addressed in the following Part. Part IV then considers the need for, and substance of, any regulatory responses to the growing practice of debt-based takeovers.

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seeking to fold its sale into the plan of reorganization and block its lenders from bidding their debt in exchange for the assets.").

156. *In re* Phila. Newspapers, LLC, 599 F.3d 298, 305–06 (3d Cir. 2010).

157. *See* Theresa McCabe, *Lenders Win Phila. Newspaper Auction*, THE STREET.COM (Sept. 24, 2010, 1:50 PM), http://www.thestreet.com/story/10861819/philadelphia-newspapers-up-for-auction.html (explaining the sale process, which included two separate auctions, both won by the debtholder group).

158. *See* Christopher K. Hepp, *New Owners Take Control of* Inquirer, Daily News, *and* Philly.com, PHILLY.COM (Oct. 9, 2010), http://www.philly.com/inquirer/breaking/business_breaking/20101008_New_owners_take_control_of_Inquirer__Daily_News_and_Philly_com.html (explaining the post-sale changes implemented by the debtholder group).

159. *See, e.g.*, Murray Coleman, *Distressed Investor Grabs Stake in* Register *Parent*, ORANGE COUNTY BUS. J., Apr. 4, 2010, http://www.ocbj.com/news/2010/apr/04/distressed-investor-grabs-stake-register-parent/ ("'The company's prospects are vastly underappreciated . . . . The hunger for information and entertainment hasn't gone away.'" (quoting former chief executive officer of Freedom Communications)); Bjorhus, *supra* note 142 ("'I think we could use more strengths in social networking and online community experience.'" (quoting representative of Angelo Gordon regarding *Star Tribune*)).

### *B. Observations Regarding Loan-to-Own Strategies*

As illustrated by the activity in the newspaper industry, investors may employ debt-based takeovers not only to increase the return on their investment, but also to enhance their existing portfolio by combining companies with similar platforms or quieting the competition.[160] These investors may have the expertise or the resources to improve the target company's performance, thereby saving or perhaps even creating jobs and increasing enterprise value.[161] That value, however, typically is realized only in the future and captured largely or even exclusively by the distressed-debt investors themselves.

One very real problem with debt-based takeovers concerns the treatment of the company's pre-takeover stakeholders.[162] These stakeholders may include creditors junior to the distressed-debt investor, shareholders, or even employees, depending on whether the investor continues the business, consolidates, or sells operations.[163] Although junior

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160. *See supra* Part III.A.

161. *See* GILSON & ALTMAN, *supra* note 50, at 23–26 (discussing cases involving distressed-debt investors and positing that "the investor's ultimate goal is to create value by causing the firm's assets to be managed more productively, whether this involves taking a direct management role in the firm, effecting management change through control of the reorganization process, exercising control over the firm as a significant owner, or acquiring specific assets from the firm and redeploying them."); Kai Li et al., *Hedge Funds in Chapter 11*, J. FIN. (forthcoming) (manuscript at 215–16, 22), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1493966 (empirical study presenting data suggesting, among other things, "efficiency gains brought by hedge funds [and their activity in Chapter 11] rather than value extraction from other claims"); *see also* Eisenberg, *supra* note 55 (discussing potential benefits to hedge fund activity in distressed debt); Thomas More Griffin, *Financing Available in Distressed Markets: Alternatives When Bank or Government Bail Out Funds Are Not Available*, GIBBONS P.C. (Apr. 7, 2009), http://www.gibbonslaw.com/news_publications/articles.php?action=display_publication&publication_id=2732 (explaining the value in certain financing structures involving distressed-debt investors as the distressed company's only or limited financing alternatives).

162. *See, e.g.*, Hotchkiss et al., *supra* note 21, at 11–12 (explaining conflict that typically exists and motivates decision among various stakeholders, and noting that "[s]enior creditors that are first in line may prefer an inefficient liquidation that converts the firm's assets into cash and provides senior debtholders with a safe distribution[; i]n contrast, junior creditors or out-of-the-money shareholders may prefer inefficient continuation because it has a potential upside"); Strom, *supra* note 20 (explaining tactics by investors for gaining control of distressed companies and explaining how strategies like arbitrage may depress value for lower tranches of debt); Tiffany Kary, *Blockbuster Bondholders Bet Company Will Go Out of Business*, BLOOMBERG, May 7, 2010, *available at* http://www.businessweek.com/news/2010-05-07/blockbuster-bondholders-betting-company-will-collapse-update1-.html ("[A]s many as 25 hedge funds have taken positions that would benefit them if junior notes decline in value." (reporting statement of analyst)).

163. *See, e.g.*, MOYER, *supra* note 114, at 352 ("[A strategy post-reorganization control] could drive an investor with sufficient negotiating leverage to insist on a plan that allocates recoveries to other creditors in the form of debt, so that the control investor's class retains the equity."); Strom, *supra* note 20 (noting that distressed-debt investors often seek to terminate pension fund obligations and work to structure post-reorganization mergers and consolidations as exit strategies). For example,

stakeholders and employees often are adversely affected by a restructuring, the risk may increase in the loan-to-own context.

A loan-to-own strategy is successful if the investor accurately predicts and purchases the tranche of debt that constitutes the company's fulcrum security.[164] This requires a difficult, sometimes subjective valuation of the company. Once an investor makes this calculation, it has a vested interest in that valuation being adopted by the company and others in the reorganization. That valuation is the means by which the investor acquires the company's stock and extinguishes the rights of all junior stakeholders.[165]

The question then becomes whether the valuation is a fair representation or a depressed value that benefits the distressed-debt investor.[166] A distressed-debt investor may intentionally or unintentionally depress value. For example, if the investor is encouraging a debt-for-equity exchange, the company's value likely will be determined by expert appraisals. These appraisals often are subject to different methodologies, opinions, and disputes.[167] Alternatively, if the investor is purchasing the company's assets, the investor's credit bid may chill the bidding process.

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many expect consolidation and resulting layoffs in connection with the distressed-debt investor activity in the newspaper industry. *See, e.g.*, Milbourn, *supra* note 134 ("[T]he newspaper landscape is likely to change, with an increase in mergers and consolidations and accompanying layoffs." (quoting industry consultant)); *Judge Oks $139M of Court Sale of Philly Newspapers*, CBSPHILLY.COM (Sept. 30, 2010), http://philadelphia.cbslocal.com/2010/09/30/judge-oks-139m-court-sale-of-philly-news papers/ ("[C]reditors plan to cut costs by 13 percent across the board [and n]ewsroom employees have agreed to 6 percent pay cuts that include two-week furloughs, but will be spared layoffs for at least a year.").

164. *See supra* notes 19–20 and accompanying text; *see also* Hotchkiss et al., *supra* note 21, at 26 (discussing role of fulcrum security in debt-based changes of control); Kai Li et al., *supra* note 161, at 15–16, 22 (same).

165. *See, e.g.*, Tiffany Kary, *Bankruptcy Turnarounds Menaced by Investor Valuation Fights, Lifland Says*, BLOOMBERG, Sept. 20, 2010, *available at* http://www.bloomberg.com/news/2010-09-20/bankruptcy-turnarounds-menaced-by-investor-valuation-fights-lifland-says.html (explaining perils of valuation fights among stakeholders in Chapter 11 and noting that "[c]ompanies trying to rehabilitate themselves through bankruptcy are threatened by valuation fights among late-arriving investors"); *see also* David Gray Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuation*, 41 AM. U. L. REV. 63, 64 (1991) (positing that bankruptcy courts' valuations are based on "subjunctive facts—facts that can be assessed only contingently in the context of a highly hypothetical universe which can never be"); Stuart C. Gilson et al., *Valuation of Bankrupt Firms*, J. CORP. RENEWAL (July 1, 2000), http://www.turnaround.org/Publications/Articles.aspx?objectID=1292 ("Valuation errors in Chapter 11 have significant wealth consequences. Underestimating value benefits claimants and managers who receive shares or stock options in the reorganization."). For an interesting empirical analysis of the role of bankruptcy judges in valuation disputes, see Keith Sharfman, *Judicial Valuation Behavior: Some Evidence from Bankruptcy*, 32 FLA. ST. U. L. REV. 387 (2005).

166. *See, e.g.*, Douglas G. Baird & Donald S. Berstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1952–60 (2004) (explaining various methods of valuation in the Chapter 11 context and subjectivity and uncertainty associated with those methods); *see also* MOYER, *supra* note 114, at 264–66 (discussing challenges in bankruptcy valuations).

167. *See, e.g.*, *id.* at 1953 (noting that resolution of valuation disputes in Chapter 11 often "'splits

In addition, the distressed-debt investor's proposed uses of the company's assets arguably may divert value from junior stakeholders.[168] In the Tribune Co. cases, the plan proposed by the company and the Angelo Gordon group included releases of the company's claims and causes of action against certain parties.[169] Chapter 11 plans frequently provide releases to plan proponents and other parties. Nevertheless, parties opposing the Tribune Co.'s plan argued that the proposed releases undervalue the claims—value that otherwise might have flowed to junior stakeholders.[170]

It is difficult to assess the valuation arguments surrounding debt-based takeovers with any certainty.[171] The resolution may depend on who does the analysis and how it is performed.[172] Given this uncertainty, Part IV proposes a process for providing more information and signaling opportunities to parties involved in these transactions. The proposal seeks to help those closest to, and most affected by, debt-based takeovers make better informed decisions and better protect their interests. It strives to strike an appropriate balance that permits value-enhancing takeovers while protecting the interests of the company's other stakeholders.[173]

## IV. POLICY ANALYSIS AND RECOMMENDATIONS FOR REGULATION OF DEBT-BASED TAKEOVERS

As discussed above, investors use both equity-based and debt-based takeovers to achieve similar objectives.[174] Moreover, as explained in Parts

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the baby' based on the judge's determination of value, which may depart from what either the senior investor or the junior investor thinks the business is worth").

168. *See supra* note 162 and accompanying text.

169. *See supra* Part III.A.

170. *See, e.g.*, Randall Chase, *Tribune Judge Weighs Competing Plans*, ABCNEWS.COM (Nov. 29, 2010), http://abcnews.go.com/Business/wireStory?id=12268396 (explaining the releases of liability contained in the plan of reorganization submitted by Tribune Co. and others and noting that "[c]ritics of Tribune's plan argue that the holders of senior loan debt from the disastrous buyout are getting off too easily").

171. *See supra* notes 161–62 and accompanying text.

172. *See supra* notes 165–66 and accompanying text.

173. That balance in turn serves the dual goals of debtor rehabilitation and creditor return maximization underlying Chapter 11 of the Bankruptcy Code. *See* H.R. REP. NO. 95-595, at 220 (1977) ("The purpose of a business reorganization case [under Chapter 11] . . . is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders."); S. REP. NO. 95-989, at 10 (1978) (same); Toibb v. Radloff, 501 U.S. 157, 163–64 (1991) (same); *see also* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336 (1993) (discussing multiple goals framing provisions of Bankruptcy Code).

174. *See supra* Parts II, III.

II and III, both strategies pose potential risk to the target company and its stakeholders. Yet, applicable regulations treat the two strategies very differently.

This Part synthesizes the discussion in Parts II and III and proposes a regulatory framework for debt-based takeovers. It suggests a disclosure scheme similar to section 13(d) of the Securities Exchange Act for acquisitions of a company's long-term debt.[175] These disclosures would provide the company and its stakeholders with valuable information prior to filing for bankruptcy, which could change or improve a company's restructuring plans and thereby preserve or create more value.[176] They also would complement and enhance the information provided to parties in the bankruptcy context. Notably, the proposal does not include any provision directly governing tender offers or exchanges involving debt securities, as those types of transactions are generally governed in varying degrees by section 14(e) of the Securities Exchange Act, the Trust Indenture Act, and Chapter 11 of the Bankruptcy Code.[177]

The following discussion explains the intricacies of the proposed disclosure rules and their interaction with the Securities Exchange Act, the Trust Indenture Act, and the Bankruptcy Code. It also considers

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175. *See supra* Part II.B.1.

176. *See generally* ROBERT H. MNOOKIN ET AL., BEYOND WINNING: NEGOTIATING TO CREATE VALUE IN DEALS AND DISPUTES (2000) (discussing the disadvantages created by information asymmetries in the negotiation context). Section 1125 of the Bankruptcy Code requires a plan proponent to provide certain information relevant to the plan of reorganization to parties entitled to vote on the plan. 11 U.S.C. § 1125 (2006). This provision was intended to facilitate information sharing between the parties negotiating the plan and stakeholders who were not involved in that process. *See* RICHARD F. BROUDE, REORGANIZATIONS UNDER CHAPTER 11 OF THE BANKRUPTCY CODE § 11.01, at 11–3 (1986) (explaining the legislative history to section 1125 and noting that "it was thought that the failure of the parties intimately involved in the bankruptcy proceeding to supply adequate information to the constituencies which would be called on to vote on a plan was a matter calling for immediate and substantial reform"). As discussed *supra* Part III, information asymmetry may affect leverage among parties at the negotiating table as well. The proposed regulation discussed in Part IV seeks to remedy this inadequacy, which also will benefit the Chapter 11 process and enhance the disclosures required by section 1125.

177. For example, "[s]ection 14(e) and Regulation 14E apply to tender offers for any type of security (including debt). These provisions apply both to registered and unregistered securities (including securities issued by a private company), except exempt securities under the Exchange Act, such as municipal bonds." U.S. Sec. & Exch. Comm'n, Release No. 34-43069, Commission Guidance on Mini-Tender Offers and Limited Partnership Tender Offers, ¶ I.C. (July 31, 2000), *available at* http://www.sec.gov/rules/interp/34-43069.htm. Section 316(b) of the Trust Indenture Act protects a bondholder's right to payment of principal and interest from modification without its consent. *See, e.g.*, George W. Schuster, Jr., *The Trust Indenture Act and International Debt Restructurings*, 14 AM. BANKR. INST. L. REV. 431, 431–32 (2006). Moreover, sections 1125, 1126 and 1129 of the Bankruptcy Code govern the solicitation of votes on, and confirmation of, any plan of reorganization, including those that contemplate a debt-for-equity or other change-of-control transaction. 11 U.S.C. §§ 1125–26, 1129 (2006).

alternatives to, and potential critiques of, the proposal.[178] This Part concludes by highlighting the competing interests and policies at stake and the strong justifications for using disclosure to achieve an appropriate balance.

### *A. Disclosure of Debt Acquisitions*

The Securities Exchange Act requires investors to file a report with the SEC once they acquire, directly or indirectly, five percent or more of the beneficial interests in a company's equity securities.[179] Although there are certain types of debt that constitute "securities" under the Securities Exchange Act,[180] they are not *equity* securities and do not trigger any type of reporting obligation.[181] In addition, certain types of debt are not considered securities at all.[182] Regardless of whether a debt holding constitutes a security, debt purchasers generally have no obligation to report their acquisitions to the debtor company.

The lack of disclosure obligations for debt purchasers provides them with a strategic advantage, particularly if they desire to influence corporate affairs or take over control of the company.[183] These debt purchasers can quietly accumulate large holdings in a company's debt that provide them with substantial advantages in any subsequent restructuring.[184] This lack of disclosure also significantly increases existing information asymmetry in restructuring negotiations.[185] The company or other stakeholders could

178. *See infra* Part IV.D.

179. *See supra* Part II.B.1; *see also* GAUGHAN, *supra* note 71, at 71–73 (explaining requirements of section 13(d)).

180. The definition of "security" under the 1934 Securities Exchange Act includes notes, bonds, and debentures. *See* Securities Exchange Act of 1934, ch. 404, § 3(a)(10), 48 Stat. 881, 883 (codified as amended at 15 U.S.C. § 78c(a)(10) (2006)).

181. Section 13(d) applies only to "equity securities." 15 U.S.C. § 78m(d) (2006); *see also supra* Part II.B.1; Lipson, *supra* note 17, at 1630 ("[Rule 13d-1] does not apply to 'straight' debt securities.").

182. For example, credit facilities and syndicated loans generally are not considered securities under section 3 of the Securities Exchange Act., ch. 404, § 3(a)(10), 48 Stat. 881, 883 (codified as amended at 15 U.S.C. § 78c(a)(10) (2006)).

183. *See supra* Part I.

184. *See supra* Part III.A.

185. *See, e.g.*, Lipson, *supra* note 17, at 1651–53 (discussing the costs of information asymmetry in restructuring negotiations and noting that such "[s]hadow bankruptcy obscures these incentives, and thus makes negotiation more uncertain and expensive"); *see also* Ryan Operations G.P. v. Santiam-Midwest Lumber Co., 81 F.3d 355, 362 (3d Cir. 1996) ("[The] disclosure requirements are crucial to the effective functioning of the federal bankruptcy system. Because creditors and the bankruptcy court rely heavily on the debtor's disclosure statement in determining whether to approve a proposed reorganization plan, the importance of full and honest disclosure cannot be overstated."). "Information asymmetry can occur when one market participant has more or better information than another market

make different or more timely, proactive decisions regarding a financial restructuring if afforded more complete information.

To help mitigate these circumstances, Congress should amend section 13 of the Securities Exchange Act to include reporting obligations for debt purchasers.[186] These reporting obligations should include the following elements:

- A comprehensive definition of "long-term debt" that includes not only debt securities, but also any debt qualifying as "long-term debt obligations" under Generally Accepted Accounting Principles (GAAP) and disclosure requirements for Management's Discussion and Analysis under section 13 of the Securities Exchange Act.[187]
- A reporting requirement for any person that acquires, directly or indirectly, a beneficial ownership interest in a company's long-term debt that constitutes fifteen percent (15%) or more of any single long-term debt obligation or twenty percent (20%) or more of the company's aggregate long-term debt obligations.[188]

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participant." Eleonora Zlotnikova, *The Global Dilemma in Short Selling Regulation: IOSCO's Information Disclosure Proposals and the Potential for Regulatory Arbitrage*, 35 BROOK. J. INT'L L. 965, 977 (2010).

186. The Article refers to these amendments as the proposed regulation. The proposed regulation would apply to all companies required to file quarterly and annual reports with the SEC, and is not dependent on the financial condition of a company. Limiting the disclosure requirements to the distressed context would limit the utility of the proposal because it unnecessarily restricts response time for the company and other stakeholders and the value of signaling. The underlying policy is to acknowledge the similarities between equity and debt in the takeover context and provide similar regulation for both. In these and other respects, the substance of the proposed regulation differs significantly from the positional disclosure suggested by Professor Lipson in the context of "shadow bankruptcy." *See* Lipson, *supra* note 17, at 1614–15, 1669–70 (discussing the unregulated environment that allows private investors to influence distressed companies and the need for additional transparency).

187. *See* 15 U.S.C. § 78m (2006); 17 C.F.R. § 229.303(a)(5)(ii)(A) (2010) (Item 303(a)(5)(ii) of Regulation S-K) ("*Long-Term Debt Obligation* means a payment obligation under long-term borrowings referenced in FASB Statement of Financial Accounting Standards No. 47 *Disclosure of Long-Term Obligations* (March 1981), as may be modified or supplemented.").

188. The term "beneficial ownership" would be defined under Rule 13d-3, which includes ownership by

> any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) [v]oting power which includes the power to vote, or to direct the voting of, such security; and/or, (2) [i]nvestment power which includes the power to dispose, or to direct the disposition of, such security.

17 C.F.R. § 240.13d-3(a)(1)-(2) (2010).

- The required report should include, at a minimum, the beneficial owner's name; the purchaser's name (if different from the beneficial owner); the type of debt purchased; the amount of each type of debt owned by the beneficial owner as of the date of the report; and whether the beneficial owner owns or holds the economic rights, voting rights (as granted by the applicable debt instrument or applicable law), or both with respect to each type of debt.[189]
- The required report should be filed within seven days of the purchase that triggers the reporting obligation, unless at the end of that seven-day period, the beneficial owner no longer owns, directly or indirectly, an interest in the company's long-term debt that constitutes fifteen percent (15%) or more of any single long-term debt obligation or twenty percent (20%) or more of the company's aggregate long-term debt obligations.[190]
- The report should be filed with the SEC and served on the company and any indenture trustee or agent associated with the subject debt instruments.[191]

Although these reporting obligations resemble the requirements for equity securities under section 13(d), there are four important

189. These disclosures would track Items 1, 2, 5 and 6 on Schedule 13G. 17 C.F.R. § 240.13d-1 (2010). They are intended, among other things, to mitigate the practice of empty voting where an investor severs the voting rights from the economic rights associated with the debt instrument or security. The lack of economic consequences to an investor holding only voting rights raises concern regarding motivation and arbitrage plays. *See, e.g.*, Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008); *see also* Lipson, *supra* note 17, at 1648–49; Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 427–29 (2007).

190. The proposed regulation generally is not intended to capture traders who buy and sell the debt quickly. *See* Harner, *supra* note 3, at 112–16 (describing different types of distressed-debt investors and explaining strategies and motivations of traders). Notably, the proposed regulation may apply to investors intending to profit by trading or flipping the debt, but who are holding the debt pending resolution of any restructuring. Nevertheless, disclosures would be required only if the investor accumulated debt above the threshold amounts. In those instances, even if the investor is not vying for control, its significant debt ownership may provide it with significant leverage in any restructuring negotiations. The proposed seven-day grace period strikes an appropriate balance between these competing interests. *Cf.* Wachtell et al., *supra* note 95 (proposing a shorter grace period in the equity-based takeover context).

191. As discussed *infra* Part IV.C, the proposed regulation would continue to apply after any bankruptcy filing. In those cases, filing with the bankruptcy court also may be appropriate and would further serve the goals of addressing information asymmetry and providing signaling in the corporate reorganization context.

differences.[192] First, the type of debt governed by the provision extends beyond the definition of securities.[193] The proposed regulation could be limited to debt securities, but that approach would exclude a large portion of debt typically included in a company's capital structure and limit the utility of the regulation.[194] The broader application is necessary to protect the filing company and the holders of that company's securities. This core purpose underlying the regulation is consistent with the SEC's general mission.[195]

Second, the trigger thresholds differ based on whether the purchaser is accumulating debt within a single tranche or across the company's capital structure. The higher percentage for the latter type of acquisition pattern reflects the fact that, to have meaningful influence within each purchased tranche of debt, the investor must have greater overall ownership.[196]

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192. Given the potential for an investor to acquire both equity and debt in the same company, a joint disclosure form that discloses both types of holdings when an investor's purchases exceed either the equity or the debt threshold might be warranted. *See supra* Part II.B.1.

193. The scope of "long-term debt" for purposes of the proposed disclosures would be broader than the definition of debt securities for other purposes under the securities laws. This broader definition is warranted to prevent manipulation of a company's capital structure to avoid the mandated disclosures. This Article does not propose extending the use of the long-term debt concept beyond this limited purpose.

194. Secondary trading markets exist not only for notes, debts, and debentures, but also for a company's other long-term obligations. *See* Harner, *supra* note 3, at 710–12 (describing types of debt trading on secondary markets).

195. *See* U.S. Sec. & Exch. Comm'n, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, http://www.sec.gov/about/whatwedo.shtml (last modified Feb. 1, 2011) ("The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."). The SEC has expressed support for enhanced disclosures in the U.S. debt markets. *See, e.g.*, The Bond Price Competition Improvement Act of 1999: *Hearing Before the House Subcommittee on Finance & Hazardous Materials*, 106 Cong. 9–11 (1999) (executive summary of statement of Hon. Arthur Levitt, Chairman, Securities and Exchange Comm'n), *available at* http://www.sec.gov/news/testimony/testarchive/1999/tsty0499.htm ("The Commission has long believed that transparency promotes the fairness and efficiency of the U.S. capital markets and fosters investor confidence in those markets. This is as true for debt markets as for equity markets."). Any amendment to section 13(d) of the Securities Exchange Act incorporating the proposed regulation should expressly grant the SEC authority to propose and implement disclosure rules relating to long-term debt obligations given the relevance of trading in the secondary markets for long-term debt to interstate commerce, issuers, and holders of securities. "Congress established the Securities and Exchange Commission in 1934 to enforce the newly-passed securities laws, to promote stability in the markets and, most importantly, to protect investors." U.S. Sec. & Exch. Comm'n, *Creation of the SEC*, http://www.sec.gov/about/whatwedo.shtml (last modified Feb. 20, 2011). Notably, the proposed regulation targets the same concerns as the Securities Exchange Act. *See* H.R. REP. NO. 73-1383, at 11 (1934) ("No investor . . . can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. . . . [T]he hiding and secreting of important information obstructs the operation of the markets as indices of real value.").

196. For example, a class of claims is deemed to vote in favor of a Chapter 11 plan of reorganization only if two-thirds in amount and one-half in number of holders vote in favor of the plan. 11 U.S.C. § 1126 (2006); *see also* Baird & Rasmussen, *supra* note 26, at 691 (positing

Moreover, although neither percentage reflects a true blocking position (typically at least one-third ownership), it suggests a commitment to the investment that may lead to greater future ownership.[197]

Third, the proposed regulation maintains the concepts of direct and indirect purchases and beneficial ownership. As in the equity context, investors can use indirect means, as well as decoupling strategies, to purchase debt.[198] Any regulation thus needs to try to close these gaps and require reporting in all potential acquisition scenarios. For this reason, the report itself mandates a disclosure of the types of interests owned or held by the beneficial owner.

Finally, the proposed regulation incorporates the seven day grace period for filing a report found in section 13(d), but excludes investors who sell or divest a sufficient amount of debt within that seven days.[199] Alternatively, the exclusion could be applicable only if the investor sells or divests all long-term debt holdings on or before the seventh day. The less restrictive approach is proposed to minimize any disruption of trading related to the reporting obligation in secondary debt markets.

### *B. Parameters of Disclosure Obligations*

The proposed disclosure regulation uses only a portion of the federal and state regulations applicable to equity-based takeovers.[200] A more limited approach is warranted given other processes that govern debt exchanges and asset sales and the questionable utility of takeover

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hypothetical with four distressed-debt investors each holding twenty-five percent (25%) of the company's outstanding unsecured debt and explaining that "[s]ection 1129 of the Bankruptcy Code allows any of the three to form a coalition in which they can cramdown a plan on the fourth"); Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 256 (2009) (discussing benefits to private debt versus public debt and noting that "a debt violation in a public bond issue triggers the need to obtain the agreement of two-thirds of the bondholders to waive a violation, which can be both a difficult and a slow process").

197. Nevertheless, in the out-of-court restructuring context, a single bondholder may block modifications to the principal and interest due on the bonds, which may be necessary to facilitate any consensual restructuring. *See supra* note 177 and accompanying text (discussing the Trust Indenture Act).

198. *See supra* notes 187–88 and accompanying text. The language used to describe "beneficial ownership" needs to consider and capture derivative instruments that permit the holder to influence or exercise control. *See, e.g.*, CSX Corp. v. Children's Inv. Fund Mgmt. (UK), 562 F. Supp. 2d 511, 539–40 (S.D.N.Y. 2008) (noting potential limitations of "beneficial ownership" definition in the equity-based takeover context).

199. *See supra* note 189.

200. *See supra* note 177 and accompanying text.

defenses, particularly in the debt context.[201] Moreover, the proposed regulation does not suggest an option for qualifying the purchase as a passive investment. Unlike in the equity context, the rights associated with a debt instrument itself may facilitate the takeover opportunity without the investor necessarily launching a public takeover campaign.[202]

Many of the regulations for tender offers found in section 14 are neither applicable nor necessary in the straight debt context.[203] This section was designed, in part, to protect shareholders from unequal or unfair treatment in a tender offer.[204] The Trust Indenture Act provides similar protection in bond exchanges. Furthermore, most debt-for-equity exchanges and asset sales proceed through the federal bankruptcy process.[205] The Bankruptcy Code generally gives affected stakeholders the opportunity to vote on the proposed plan of reorganization or at least file objections to the plan or any asset sale.[206]

Likewise, shareholders' rights plans, staggered boards, and other state law anti-takeover defenses appear mismatched with, or inapplicable to, debt-based takeovers.[207] For example, a company in financial distress has likely triggered or is about to trigger cross-default provisions in all of its debt instruments, rendering meaningless debt acceleration provisions triggered by changes in control.[208] Similarly, a company that restructures

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201. *See supra* Part II.B.2.

202. For example, Rule 13d-1 explains that a person who is otherwise required to file a report under the rule may file a short-form statement on Schedule 13G if, among other things,

> [s]uch person has acquired such securities in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect, including any transaction subject to Rule 13d-3(b) . . . .

17 C.F.R. § 240.13d-1(b)(1)(i) (2010). Schedule 13G, in turn, requires only minimal disclosures. Moreover, because simply holding a significant position in a distressed company's debt may give the investor leverage in any restructuring, the proposed regulation does not require a specific statement that the investor has purchased the debt in an effort to force a change of control. *See* Item 4, Schedule 13G. The proposed regulation assumes this as a potential consequence of the debt ownership.

203. Nevertheless, section 14(e) does apply to debt securities. *See supra* note 177 and accompanying text. "The net effect is that a tender offer for debt securities need only comply with the anti-fraud rules of section 14(e) and not with the more fulsome registration and disclosure rules of section 14(d)." Lipson, *supra* note 17, at 1631.

204. For example, section 14(d)(7) and Rule 14d-10 require all investors who tender shares to receive the same price and to have an opportunity to withdraw. 15 U.S.C. §§ 78n(d)(5), (7) (2006); 17 C.F.R. § 240.14d-10 (2010).

205. *See supra* note 177 and accompanying text.

206. *Id.*

207. *See supra* Part II.B.2.

208. *See generally* ALLISON TAYLOR & ALICIA SANSONE, THE HANDBOOK OF LOAN SYNDICATION AND TRADING 341–42 (2007) (explaining the meaning and consequences of cross-default and cross-acceleration provisions in debt documents).

under Chapter 11 of the Bankruptcy Code can propose a completely new board of directors under its plan of reorganization, undercutting the utility of staggered boards.[209] Moreover, given the potential value of debt-based takeovers, the proposed regulation does not seek to impose or endorse insurmountable barriers to such takeover activity.[210]

### *C. Application in Bankruptcy*

A debtor in bankruptcy has extensive disclosure obligations.[211] Those obligations generally do not apply, however, to creditors, shareholders, or other parties in interest. Rather, these parties typically are not required to make any disclosures until they file a proof of claim or interest, if required, or otherwise seek to be heard in the bankruptcy case.[212] When disclosure is required, a general statement of the type of claim or interest held by the party often suffices. Consequently, much of the secrecy surrounding debtholders' activities outside of bankruptcy continues even during the bankruptcy case.[213]

The proposed regulation would significantly help the flow of information and communication in Chapter 11 cases. Many investors

209. *See, e.g.*, Hotchkiss et al., *supra* note 21, at 22–26 (discussing management turnover in context of Chapter 11 cases); Kai Li et al., *supra* note 161 (same).

210. *See supra* note 161 and accompanying text.

211. *See supra* note 206 and accompanying text.

212. *See, e.g.*, 11 U.S.C. § 1109 (2006) (describing parties in interest that may be heard on issues raised in Chapter 11 cases); FED. R. BANKR. P. 3001 (listing disclosures required by creditor or equity holder filing a proof of claim or interest in the Chapter 11 case).

213. The lack of transparency surrounding distressed debt investments not only is a problem in out-of-court workouts, but also in Chapter 11 cases. Bankruptcy rule 2019 requires "every entity or committee representing more than one creditor or equity security holder" to disclose certain information to the bankruptcy court. FED. R. BANKR. P. 2019(a). This information concerns the names of the represented creditors or equity holders, the nature and amount of the claims or interests held by those parties and certain other information concerning the relationship among the parties. *Id.* Courts are split regarding the application of rule 2019 to creditors acting collectively through an ad hoc committee or single professional in the case, which typically includes distressed-debt investors. *Compare In re* Phila. Newspapers, LLC, 422 B.R. 553 (Bankr. E.D. Pa. 2010) (Bankruptcy rule 2019 does not apply) *and In re* Premier Int'l Holding, Inc., 423 B.R. 58 (Bankr. D. Del. 2010) (same), *with In re* Wash. Mut. Inc., 419 B.R. 271 (Bankr. D. Del. 2009) (Bankruptcy rule 2019 does apply). Amendments to rule 2019 were proposed to increase the disclosures required by the rule and clarify the scope of its application. *See* Davis Polk & Wardwell, *Insolvency and Restructuring Update: Standing Committee Approves Major Changes to Bankruptcy Disclosure Rule*, DAVIS POLK CLIENT NEWSL. (June 16, 2010), http://www.davispolk.com/files/Publication/ab3987a9-a349-451e-8495-bc7873da2789/Presentation/PublicationAttachment/ed332081-c016-4b89-9071-bcf2f66c6f20/061610_ir_update.pdf. The U.S. Supreme Court approved the proposed amendments on April 26, 2011, and the amendments are expected to take effect on December 1, 2011. *See* Milbank, Tweed, Hadley & McCloy LLP, *U.S. Supreme Court Approves Proposed Amendment Expanding Disclosure Requirements Under Bankruptcy Rule 2019* (May 6, 2011), http://www.milbank.com/NR/rdonlyres/B405D0F7-4F7D-4CFD-A17E-46620A8CC44E/0/Rule2019_FRGClient_Alert_05062011.pdf.

continue or start buying the company's debt after it files a bankruptcy case.[214] The debt may be further discounted at that time, and holders may be more willing to sell to avoid the delay and uncertainty associated with the bankruptcy case. The Securities Exchange Act generally continues to govern Chapter 11 debtors that were subject to the Act prior to the bankruptcy filing.[215] The proposed regulation should be no different, and debt purchasers should remain subject to its provisions throughout the Chapter 11 case.

### *D. Potential Critiques*

The primary focus of the proposed regulation is more disclosure. Admittedly, disclosure alone will not completely mitigate the risks associated with debt-based takeovers.[216] Investors will still be able to accumulate significant holdings of debt, which provide them a seat at the negotiating table and an opportunity to influence the outcome of those negotiations. Similarly, the proposed regulation does not give other stakeholders a seat at the table or any type of leverage over the process. Rather, it provides notice to the company and its stakeholders, allowing them to consider not only alternative restructuring options, but also ways to get other parties to the table or otherwise temper the potential influence of the distressed-debt investor.[217]

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214. *See generally* Harner, *supra* note 3 (explaining the timing and discounts relevant to distressed debt investing decisions and providing four case studies to illustrate strategies).

215. For a discussion of SEC reporting obligations relating to bankruptcy filings, see David J. Barton, *SEC Disclosure, Filing Requirements for Public Companies in Chapter 11*, J. CORP. RENEWAL (Jan. 23, 2009), http://www.turnaround.org/Publications/Articles.aspx?objectID=10450.

216. *See, e.g.*, D. Daniel Sokol, *Competition Policy and Comparative Corporate Governance of State-Owned Enterprises*, 2009 BYU L. REV. 1713, 1743 (discussing role of disclosure in mitigating risks); Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 369–73 (2006) (same and discussing several studies suggesting value to mandatory disclosure schemes); Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123 (2004) (noting debate concerning value of disclosure schemes and transparency); *see also* Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1032 (2000) ("While there is an obvious information asymmetry between issuers and investors, '[o]ne must be careful to avoid the fallacy that if some information is good, more must be better.'"); Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1 (discussing challenges to effective disclosure in increasingly complex financial markets).

217. *See* Troy A. Paredes, *Blinded By the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 431–32 (2003) ("People rarely want information for its own sake. Rather, people want information because it is empowering. Information enables those who have it to make informed decisions and to better protect their interests, whatever they may be. The federal securities laws are no different."); *see also* David W. Case, *Corporate Environmental Reporting as Informational Regulation: A Law and Economics Perspective*, 76 U. COLO. L. REV. 379,

Similar to the original purpose of the Williams Act, the proposed disclosures are designed to promote investor protections. They are not intended to prohibit or impede debt-based takeovers.[218] Debt-based takeovers may in certain cases present the best price and utilty for the target company. Nevertheless, in other cases, they may undercut the value and sustainability of the company. Although investors dealing in the secondary debt markets may appreciate the risks associated with loan-to-own investment techniques and may price that risk into the transaction, other stakeholders (including a company's shareholders and public bondholders) may not have the relevant information and may not otherwise be able to protect their interests without it.[219]

For these reasons, the proposed disclosures are targeted and carefully crafted to balance the competing interests.[220] A regulation that intruded further into the debt markets and attempted to govern the process or substance of debt-based control contests could actually make it more difficult for the distressed company to access additional liquidity or finance potential restructuring alternatives. Such a broad-based regulation could kill the business that it is trying so hard to protect.

Though the proposed disclosures are purposefully targeted, some investors will nonetheless contend that they are far too intrusive. Distressed-debt investors typically are very protective of information concerning their holdings, arguing that such information reveals proprietary investment strategies.[221] Notably, the proposed regulation does not require a disclosure of the price at which the investor purchased the

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431–32 (2005) (explaining in the environmental context how disclosure and transparency lead to "better-informed decision-making").

218. *See supra* notes 95–96 and accompanying text.

219. Investors also may argue that the proposed disclosures increase the costs of transactions and in turn will increase the cost of financing. That could in fact be the case, but any such increase should be minimal given the relative ease with which investors can electronically report the transactions they already monitor. In addition, that consideration should be offset by the enhanced protection for the investor community more generally.

220. *See* Masulis & Thomas, *supra* note 196, at 256–57 (explaining competitive disadvantage to mandatory disclosures in certain contexts); Zlotnikova, *supra* note 185, at 987–88 (explaining costs to mandatory disclosure rules and noting that "when establishing disclosure and reporting regimes, regulators should be clear about the objectives of such regulations").

221. *See, e.g.*, Eric B. Fisher & Peter D. Morgenstern, *Hedge Funds in Bankruptcy Court: Rule 2019 and the Disclosure of Sensitive Claim Information*, FIN. & BANKING COMM. (Am. Bankr. Inst., Alexandria, Va.), *available at* http://www.abiworld.org/committees/newsletters/financebank/vol4num2/2.pdf (discussing potential concerns with increased mandatory disclosures in the bankruptcy context); Houman B. Shadab, *The Challenge of Hedge Fund Regulation*, REGULATION (CATO Inst., Wash., D.C.), Spring 2010, at 36, *available at* http://www.cato.org/pubs/regulation/regv30n1/v30n1-1.pdf (discussing concerns with general disclosures of investors equity positions and related information).

debt or any information about its other investments or portfolio companies.[222] The required report mandates disclosure of only limited information that is necessary to protect the interests of the company and its stakeholders. Anything less would reduce the value of the report significantly and only alert the company to a potential problem without providing it with any information to formulate an appropriate response.[223]

Finally, investors and commentators may suggest that this problem is best addressed by private contract.[224] In theory, parties could negotiate these types of disclosure provisions as part of the original debt documents. In practice, however, it is very unlikely that the company would have sufficient leverage to prevail in that negotiation.[225] Lenders and indenture trustees would have little incentive to agree to any provision that restricted their ability to sell their claims and likely would resist any such provision. Companies also would likely wait until a refinancing or forbearance negotiation to request the provision, thereby exacerbating the leverage problem. Although seeking these disclosures through private negotiation could work theoretically, that approach simply will not be feasible in most cases.[226]

In fact, the proposed disclosures may facilitate more informed and complete contracting regarding the terms and consequences of transactions involving the company's debt. The disclosures would provide the company and its stakeholders with information concerning the company's

222. *See supra* Part IV.A.

223. *See supra* notes 10–11 and accompanying text.

224. *See* Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 191–92 (2005) (explaining debate regarding the privatization of debtor-creditor laws); Susan Block-Lieb, *The Politics of Privatizing Business Bankruptcy Law*, 74 AM. BANKR. L.J. 77 (2000) (same); Bainbridge, *supra* note 216 (discussing privatization issues in corporate law context); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 197–98 (2006) (same). Moreover, the SEC is better suited than states or exchanges to oversee the proposed regulation, particularly in light of its relation to the market value of securities. *See* John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 534 (2001) (discussing general proposals to privatize securities regulation).

225. Several commentators have observed the increasing control of creditors over distressed companies in both out-of-court and in-court restructurings. This increased control often is achieved through covenants negotiated in debt instruments prior to any sign of financial trouble. *See, e.g.*, Ayotte & Morrison, *supra* note 31 (empirical study documenting increasing creditor control and leverage over debtors); Douglas Baird & Robert Rasmussen, *Chapter 11 at Twilight, Reply*, 56 STAN. L. REV. 673, 675 (2003) ("Even in the cases most resembling the traditional reorganization, creditor control is the dominant theme. Indeed, if the experience of large businesses leaving Chapter 11 in 2002 is any guide, those at the helm do the bidding of the creditors throughout the case."); *see also supra* note 31 and accompanying text.

226. *See supra* note 31 and accompanying text; *see also* DAVID A. SKEEL, JR., DEBT'S DOMINION (2001) (discussing dynamics in U.S. corporate restructurings).

capital structure in a timely manner, which would permit contracting to mitigate or account for potential change of control events.[227] The proposed disclosures thus actually complement objectives that parties may seek through private contracting.

### *E. Potential Value to Proposed Disclosures*

The proposed disclosures strike an appropriate balance between the proprietary interests of debtholders on the one hand and the management and investment interests of the company and its other stakeholders on the other.[228] Under the existing scheme, debtholders are permitted to purchase potential future control of the company without providing any information regarding their existence or intentions to those affected most by any control contest.[229] Moreover, this lack of disclosure significantly undercuts the potential value of takeover activity by limiting any signaling effect and intensifying information asymmetry in these transactions. Informing management and other stakeholders of the presence of a potentially controlling debtholder prevents a *fait accompli* and gives those parties an opportunity to preserve and potentially enhance value.[230]

That opportunity is particularly meaningful with respect to distressed companies.[231] As explained above, the identification of the fulcrum security turns on the valuation of the company—a valuation that may vary depending on assumptions, methodology, and future business models.[232] Consequently, a debtholder vying for control of a company has the ability to depress value through its valuations (or chill the bidding process in the sale context), thereby extinguishing the rights of not only shareholders, but

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227. Admittedly, the company's management may be prevented by cognitive biases—such as overconfidence or framing biases—from taking appropriate action, even with relevant and timely information. Accordingly, the proposed disclosures are specifically designed to alert other stakeholders to the information so that they may discuss the matters with management or take other appropriate action. In this respect, the re-emergence of proxy activity by shareholders could facilitate important, protective uses of information provided by the proposed disclosures.

228. *See supra* Part IV.A; *see also* 1 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 1.2[3], at 27 (4th ed. 2002) ("The focus on disclosure was based on the conclusion that sunlight is the best disinfectant.").

229. *See supra* Parts I, III.

230. Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 786 (2001) (discussing role of disclosure in market performance); David A. Westbrook, *Telling All: The Sarbanes-Oxley Act and the Ideal of Transparency*, 2004 MICH. ST. L. REV. 441, 453 (observing that mandatory disclosures "increase transparency and thereby increase informational efficiency of markets").

231. *See supra* notes 164–67 and accompanying text.

232. *Id.*

also any junior creditors in the company's capital structure.[233] Providing some information to the company and its stakeholders earlier in the process may allow operational or managerial changes that preclude a depressed valuation or encourage other stakeholders to engage in any control or auction contests. The proposed regulation creates a more level playing field that potentially benefits and protects more parties, except for those who would rather play without any rules.

## CONCLUSION

A distressed company's debt offers a unique takeover opportunity for investors, particularly when contrasted with the more public face of equity-based takeovers. An investor purchasing distressed debt can amass a substantial portion—either a controlling or blocking share—of the debt constituting the company's fulcrum security and potentially turn that debt into ownership and control of the company itself. Still, just as in the equity-based takeover context, debt-based takeovers may enhance enterprise value by, for example, disciplining management or providing much-needed liquidity to implement a company's restructuring plan. Debt-based takeovers also, however, expose an already vulnerable company and its other stakeholders to value-raiding. Let's not indulge some investors in what F. Ross James observed in the movie *Barbarians at the Gate*: "[They seek] to earn money the old-fashioned way. They steal it."[234]

233. *See supra* Part III.B.
234. BARBARIANS AT THE GATE (Ray Stark 1993).