

THE NEW JUNKYARD OF CORPORATE FINANCE: THE TREATMENT OF JUNK BONDS IN BANKRUPTCY

RICHARD E. MENDALES*

TABLE OF CONTENTS

INTRODUCTION	1139
I. DEFINITION	1142
II. JUNK BONDS AND THE DEBT/EQUITY PROBLEM IN BANKRUPTCY.....	1144
A. <i>The Nature of the Debt/Equity Problem</i>	1145
B. <i>The Importance of the Debt/Equity Issue in the Bankruptcy Context</i>	1146
1. <i>Bankruptcy Policies</i>	1146
a. <i>Distributions</i>	1146
b. <i>Dealing With Secured Claims</i>	1148
c. <i>Committee Representation</i>	1149
d. <i>Involuntary Bankruptcy Petitions</i>	1149
e. <i>Voting Rights</i>	1150
2. <i>Other Creditors' Rights Policies</i>	1150
a. <i>Creditors' Rights Under Corporate Law</i>	1151
b. <i>Fraudulent Transfer Law</i>	1151
III. THE ROLE OF THE BANKRUPTCY COURT: AUTHORITY TO CLASSIFY "JUNK BONDS"	1152
A. <i>Equitable Subordination Under Bankruptcy Code Section 510(c)</i>	1152
B. <i>Classification Powers of the Bankruptcy Court</i>	1155
C. <i>General Equitable Powers of the Court</i>	1156
D. <i>Effects of Bankruptcy Code Sections 510(a) and (b)</i>	1157
E. <i>Additional Sources of Law</i>	1158
1. <i>Applicability of Tax Doctrines</i>	1159

* Associate Professor of Law, University of Miami School of Law. A.B. 1969, A.M. 1970, University of Chicago; J.D. 1981, Yale Law School. I would like to thank James Mofsky, Elliott Manning, Patrick Gudridge, George Mundstock, William Bratton, Jr., Lynn LoPucki, Catherine McCauliff, John Gaubatz, Susan Block-Lieb, Richard Hyland, Mark Fajer, Lawrence Crocker, Richard Green, and others for their many helpful comments. All errors, of course, are my own.

	2. <i>Limitations of Applying Tax Jurisprudence</i>	1160
IV.	KEY ISSUES IN CHARACTERIZING JUNK BONDS.....	1161
	A. <i>Criteria for Classification</i>	1162
	1. <i>Residual or Creditor-Type Claim?</i>	1162
	2. <i>Fairness to Other Creditors</i>	1163
	B. <i>Should Public and Private Debt Be Treated Differently?</i>	1164
V.	CHARACTERIZING JUNK BONDS BASED ON CIRCUMSTANCES AND FEATURES OF PARTICULAR ISSUES..	1165
	A. <i>Original Issue Junk</i>	1165
	1. <i>Unsubordinated Debt of Low-Rated or Unrated Issuers</i>	1166
	a. <i>Cases in Which Issuer's Debt Is Not Disproportionate to Its Designated Equity Capital</i>	1166
	b. <i>Cases in Which Issuer's Debt Is Unreasonably Large in Proportion to Its Designated Equity</i>	1166
	2. <i>Subordinated Debt</i>	1167
	a. <i>Debt Subordinated With the Consent of Subordinated Creditors</i>	1168
	b. <i>Debt Subordinated Without the Express Consent of Its Holders</i>	1169
	c. <i>"Structurally Subordinated" Debt</i>	1169
	d. <i>Multiple Subordination</i>	1170
	3. <i>Debt With Other Special Characteristics</i>	1171
	a. <i>Excessive Interest Rates</i>	1171
	b. <i>Deferred Interest: Original Issue Discount and Payment in Kind</i>	1172
	c. <i>Variable Interest</i>	1173
	d. <i>Contingent Interest</i>	1173
	e. <i>Availability of Additional Return</i>	1174
	f. <i>Long Maturity Dates</i>	1175
	g. <i>Stretchout Provisions</i>	1175
	h. <i>Convertibility to Equity</i>	1176
	i. <i>Control</i>	1177
	j. <i>Security Interests</i>	1177
	k. <i>Call and Redemption Rights</i>	1178
	l. <i>Substitution for Equity</i>	1179
	m. <i>Sinking Fund Provisions</i>	1180

n.	<i>Presence or Absence of Protective Covenants</i>	1180
o.	<i>Holder's Rights on Issuer's Default</i>	1182
p.	<i>Proportionality to Common Stock Holdings</i>	1183
B.	<i>"Fallen Angels"</i>	1183
C.	<i>Exchange Offer Junk</i>	1184
1.	<i>Debt Received in Exchange for Equity</i>	1185
2.	<i>Debt Received in Exchange for Other Debt</i>	1187
a.	<i>Same-Issuer Debt</i>	1187
b.	<i>Other-Issuer Debt</i>	1187
c.	<i>Debt Received in Exchange for Claims in a Case Under Chapter 11</i>	1187
VI.	OTHER ISSUES JUNK BONDS RAISE IN THE BANKRUPTCY	
	CONTEXT	1189
A.	<i>Original Issue Discount</i>	1189
B.	<i>Fraudulent Transfer Issues</i>	1192
1.	<i>Solvency Questions</i>	1194
2.	<i>Treatment of Payments of Interest and Principal</i>	1195
C.	<i>Preference Issues</i>	1196
D.	<i>Recoveries By the Trustee Under Corporate Law</i>	1196
1.	<i>Management Fiduciary Duties</i>	1196
2.	<i>Dividend Issues</i>	1197
	CONCLUSION	1198

INTRODUCTION

The high degree of leverage introduced into American corporations during the 1980s threatens many with bankruptcy reorganization or liquidation in the near future. One of the important components of this increased leverage is the junk bond phenomenon.

Few widely employed investment instruments have raised so much controversy in recent years as high-yield debt securities, more popularly known as "junk bonds." Junk bonds have been praised for their flexibility and the capital-market access that they provide for their issuers.¹ At the same time, however, they have been condemned for the additional risk that they have allegedly introduced.² For example, the Financial

1. See, e.g., Merton H. Miller, *Leverage*, 46 J. FIN. 479, 480-81 (1991) (Nobel Prize Lecture delivered Dec. 7, 1990, in part defending junk bonds); Hilary Rosenberg, *The Unsinkable Junk Bond*, INSTITUTIONAL INVESTOR 43, 44 (1989).

2. Issuers of junk bonds increase their degree of leverage by the issuance of the bonds. This, in turn, increases the risk that the issuers will not be able to pay their debts as they become due. Junk

Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA),³ forbids thrift institutions and their affiliates from acquiring or even retaining already-acquired junk bonds.⁴ Similarly, the insurance industry is considering severe limitations on insurance companies' ability to invest in such instruments.⁵

The most prominent junk bond purchasers are institutions such as insurance companies and thrifts.⁶ The restrictions on these institutions' ability to purchase and hold junk bonds, combined with a series of defaults on major junk bond issues,⁷ issuers' difficulty in making interest payments on other issues,⁸ and the failure of a preeminent market maker for junk bonds,⁹ have reduced the liquidity of outstanding junk bond issues and made the issuance of new junk bonds far more difficult.¹⁰ Moreover, some prominent junk bond issuers, attempting to reduce the costs and risks large junk bond issues impose, have sought to exchange them

bonds pose risks to purchasers because of the bonds' high default risk. The risks to issuers also impose greater risks on holders of senior securities in the issuers, raising more general questions as to bondholders' rights in the law of corporate governance. See, e.g., William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92 [hereinafter *Corporate Debt Relationships*]; John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495 (1990) [hereinafter *Unstable Coalitions*].

3. Pub. L. No. 101-73, 103 Stat. 183 (codified in scattered sections of 12 U.S.C. (1989)).

4. FIRREA § 222, adding § 28(d) to the Federal Deposit Insurance Act (12 U.S.C. § 1831e(d) (1989)).

5. The National Association of Insurance Commissioners is considering measures that would limit amounts of junk bonds that insurers can hold. Such measures also would require them to maintain higher reserves for their junk bond holdings. Gary Hector, *Junk's Bad Times are Just Starting*, FORTUNE, June 4, 1990, at 81, 84.

6. William W. Barker, *The Federal Reserve and Junk Bond Financing: Anomaly or Inconvenience?*, 19 PAC. L.J. 769, 782 (1988).

7. Almost six percent of outstanding junk bond issuers defaulted in 1989. Industry specialists estimate that the 1990 default rate could exceed 10%. Hector, *supra* note 5, at 82-84. By the middle of 1990, about 8,400 junk bond issues had defaulted, and other issuers were seeking to reduce their obligations by exchange offers for outstanding junk bond issues. See Andrew Laurance Bab, Note, *Debt Tender Offer Techniques and the Problem of Coercion*, 91 COLUM. L. REV. 846, 847-48 (1991).

8. See, e.g., *Junk's House of Cards*, THE ECONOMIST, Feb. 3, 1990, at 83-84.

9. Drexel Burnham Lambert Group Inc. filed a Chapter 11 bankruptcy petition on February 13, 1990. See Kurt Eichenwald, *Drexel, Symbol of Wall St. Era, Is Dismantling; Bankruptcy Filed*, N.Y. TIMES, Feb. 14, 1990, at A1; Floyd Norris, *At the "Junk Bond" Banquet, The Host Is Suddenly Absent*, *id.*

10. See, e.g., Mathew Winkler, *Junk Market's Worst-Ever Shakeout Continues With More Price Drops, Issue-Liquidity Problems*, WALL ST. J., Sept. 15, 1989, at C1. Market liquidity is so low that junk bond issuers increasingly prefer the private placement market to public registration of new issues and offer incentives—such as options—to buyers to acquire significant shares of the issuers' stock. WALL ST. J., May 23, 1990, at C1.

for cash and other securities.¹¹ Nonetheless, companies are still issuing new junk bonds, albeit in sharply reduced volume, and over \$120 billion worth of junk bonds remains outstanding.¹² Their status will affect not only individual purchasers but also major institutional holders, which in some cases are themselves in frail health.¹³ It is therefore important to consider, before the deluge, how to deal with junk bonds in bankruptcy.

"Junk bonds," as used in the popular press, generically describes instruments, issued as corporate debt, that do not receive an investment-grade rating from at least one major rating agency.¹⁴ Generally an instrument's failure to receive such a rating indicates that it represents higher risks, in terms of timely payment of both interest and principal, than does an instrument that is rated. This Article argues that, in some cases, the risks are such that they more closely resemble equity investments than true debt. Consequently, in the bankruptcies of junk bond issuers, bankruptcy law policies should treat junk bond holders as equity investors rather than as creditors. Treatment of this kind will significantly affect junk bond holders as well as holders of senior debt to whom the junk bond issues are subordinated, holders who otherwise would receive "double dividend" payments from junk bond holders.¹⁵ Moreover, treatment of junk bonds as equity will strongly affect other aspects of bankruptcy cases involving junk bond issuers, such as fraudulent transfer litigation arising from failed leveraged buyouts.¹⁶

It is noteworthy that the failure to receive investment-grade ratings results from junk bond characteristics that vary substantially from one security to another.¹⁷ Since junk bonds are not all alike, it would be neither wise nor fair for bankruptcy courts to treat them all similarly.

11. See, e.g., David Gillen, *Bond Prices Finish Dull Session Flat With Dealers Starved for Quality Paper*, THE BOND BUYER, Jan. 30, 1991, at 3 (RJR Nabisco Inc. offered to exchange \$465 cash and 110 shares of its common stock for each \$1,000 face amount of its subordinated debentures due in 2007); Vineeta Anand, *Junk Bond Holders' Plea For Help Clouds Refinancing*, INVESTOR'S DAILY, Jan. 31, 1991, at 8 (junk bond holders ask for federal protection against abusive exchange offers for their securities). For a discussion of the effects of exchange offers on the analysis of junk bond issues, see *infra* Section V.C.

12. See Hector, *supra* note 5, at 81 (though outstanding junk is hard to price because many issues do not regularly trade, total outstanding value is estimated at \$120-160 billion).

13. *Id.*

14. See *infra* note 19.

15. See *infra* Sections II.A.1.a. and V.A.2.

16. See *infra* Section VI.

17. See *infra* Section V.A. for characteristics which appear, in varying mixtures, in different junk bond issues.

Therefore, one of this Article's major goals is to provide a guide for the reader to those junk bonds with characteristics that may warrant special treatment in the event of an issuer's bankruptcy.

Section I defines, for purposes of this Article, the broad class of instruments called "junk bonds." Section II then describes the debt/equity classification problem and why it now assumes importance in the bankruptcy arena. Section III discusses the sources of authority enabling bankruptcy courts to recharacterize junk bonds as equity when appropriate. Section IV analyzes the theoretical bases for categorizing junk bonds. Section V provides a road map through the maze of junk bond features, describing those characteristics whose presence or absence in a particular issue will help determine how bankruptcy should deal with such an issue. Finally, Section VI discusses important related problems in dealing with junk bond issues in bankruptcy, including the ways in which the debt/equity issue may provide a new viewpoint on challenges to leveraged buyouts under fraudulent transfer law.

I. DEFINITION

What are junk bonds? Most generally, junk bonds are securities, denominated as corporate debt,¹⁸ that credit evaluation agencies such as Moody's and Standard & Poor's either have not rated or have rated at less than investment grade.¹⁹ They include both "fallen angels," corpo-

18. Corporate finance terminology customarily has divided debt securities into "bonds," "debentures," and "notes." Bonds are long-term debt secured by property of the issuer and issued subject to covenants contained in an indenture. Debentures are long-term (usually with maturities in excess of ten years) unsecured obligations of the issuer, also subject to an indenture. Notes are shorter-term debt securities, usually unsecured, and usually issued without a formal indenture. See WILLIAM A. KLEIN & JOHN C. COFFEE, *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 216 (4th ed. 1990); HARRY G. HENN & JOHN ALEXANDER, *LAW OF CORPORATIONS* at 385-90 (3d ed. 1983); Frank J. Fabozzi & Harry C. Sauvain, *Corporate Bonds, in HANDBOOK OF FINANCIAL MARKETS: SECURITIES, OPTIONS AND FUTURES* 290, 299 (Frank J. Fabozzi & Frank G. Zarb eds., 2d ed. 1986); Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 249 (1988) [hereinafter *Bondholders and Stockholders*]; The Cooper Cos., Inc., senior extendible notes, 79 MOODY'S BOND SURVEY 4338-39 (1987) (notes with five-year maturity); Seminole Kraft Corp., senior extendible notes, 79 MOODY'S BOND SURVEY 5203-04 (1987) (notes with 12-year maturity). Regardless of where debt securities fall in this traditional classification, all can be, and will be for this Article's purposes, described as "junk bonds" if unrated or rated at less than investment grade.

19. Standard & Poor's ("S & P") and Moody's are the two most prominent credit rating agencies. Such agencies study the quality of debt issues based on the issuer's ability to repay interest and principal. Issuers' ability to pay turns on both the issuer's financial health and the agencies' evaluation of the effectiveness of protective provisions in the contracts creating the debt. For long-term debt, S & P gives its highest rating, "AAA," to those issues whose issuers have the highest ability to

rate bonds initially issued with investment-grade ratings that have lost those ratings because of changed circumstances affecting their issuers,²⁰ and corporate securities originally issued as junk bonds.

Junk bonds have always been with us in one form or another.²¹ In the early 1980s, however, corporate financiers discovered junk bonds as a means of capitalizing business organizations that previously had little access to the securities markets for raising cash.²² Junk bonds issued in the early 1980s for this purpose generally have few of the characteristics that raise questions as to their proper treatment in bankruptcy.²³

Beginning in about 1983, investment bankers discovered²⁴ that junk bonds were enormously useful for financing takeovers and other forms of corporate restructuring.²⁵ At that time, the size of junk bond issues began to grow dramatically, and issuers added features to junk bonds that

pay interest and principal according to the terms of the investment contract; Moody's corresponding rating is "Aaa." S & P's ratings range from this highest level down to "D," which it gives to bonds actually in default. Moody's and S & P consider issues rated from "BBB" (corresponding to Moody's "Baa") through "AAA" to be "investment grade;" these issues possess strong capacity for repayment of interest and principal. The issues that both agencies rate below that level ("BB" and below in the S & P system, and "Ba," and below in the Moody's system), are considered speculative to varying degrees. See Charles G. Phillips, *High-Yield Securities*, in 17TH ANNUAL INSTITUTE ON SECURITIES REGULATION 71, 72 (Stephen J. Friedman et al. eds, 1986); SUBCOMM. ON TELECOMMUNICATIONS, CONSUMER PROTECTION AND FINANCE OF THE HOUSE COMM. ON ENERGY & COMMERCE, 99TH CONG. 1ST SESS., REPORT ON THE ROLE OF HIGH YIELD BONDS IN CAPITAL MARKETS AND CORPORATE TAKEOVERS: PUBLIC POLICY IMPLICATIONS 1-2, 4-7 (Comm. Print 1985) [hereinafter REPORT]; Kenneth Lehn et al., *The Economics of Leveraged Takeovers*, 65 WASH. U. L.Q. 163, 163-64 (1987); Michael D. Floyd, Comment, *Junk Bonds: Do They Have Value?* 35 EMORY L.J. 921, 922-24 (1986).

20. See *infra* Section V.B.

21. Original issue junk bonds (as opposed to down-graded bonds originally issued with investment-grade ratings) were rare, however, prior to 1977. Paul Asquith et al., *Original Issue High Yield Bonds: Aging Analyses of Defaults, Exchanges, and Calls*, 44 J. FIN. 923, 926 (1989); Robert A. Taggart, Jr., *The Growth of the "Junk" Bond Market and Its Role In Financing Takeovers*, in MERGERS AND ACQUISITIONS 5, 8 (Alan J. Auerbach ed., 1988).

22. Out of approximately 23,000 U.S. corporations with annual sales over \$35,000,000, only about 2,000 are able to issue investment-grade debt securities. *Surviving the Drexel Whirlwind*, THE ECONOMIST, March 24, 1990, at 69. See also Taggart, *supra* note 21, at 8.

23. See *infra* Section V.

24. The discovery is normally credited to Drexel Burnham Lambert. See CONNIE BRUCK, THE PREDATORS' BALL: THE INSIDE STORY OF DREXEL BURNHAM AND THE RISE OF THE JUNK BOND RAIDERS 105-265 (rev. ed. 1989).

25. Of the approximately \$187 billion worth of junk bonds issued from 1983 through 1989, roughly 25% was used to finance leveraged buy-out debt. *Of Raiders, Revving-up and Leverage*, in *Survey on Capitalism*, THE ECONOMIST, May 5, 1990, at 12. Critics of the late 1980s corporate takeover wave assert that junk bonds helped make takeovers too easy for would-be acquirors. Evidence suggests that the importance of junk bonds in merger and acquisition activity tends to increase with the size of the deal. Barker, *supra* note 6, at 772-73; REPORT, *supra* note 19, at 3, 23. See also

raise questions as to the bonds' appropriate status in bankruptcy.²⁶

This Article will use the term "junk bonds" in its most general sense: all securities labelled debt that neither major rating agency rated or that both agencies rated at below investment grade. This broad definition permits us to consider virtually all securities popularly included under the "junk bond" label. It should be stressed, however, that many very different kinds of instruments fit under this broad description, and, having assembled them into this broad class, we must subdivide them according to origin, structure, and function, in order to deal with their proper treatment in bankruptcy.

II. JUNK BONDS AND THE DEBT/EQUITY PROBLEM IN BANKRUPTCY

Junk bonds, by the label that the market gives them and by the language of the documents that create them, purport to be debt instruments. Why, then, should a bankruptcy court consider treating them as qualitatively different from other debt? The answer is that, at least for some junk bonds, the "debt" label may not be accurate. Instead, junk bonds with certain characteristics may deserve the label that THE ECONOMIST has applied to junk bonds in general: "a brand of quasi-equity in the sense that, unlike conventional bonds, they are less a bet on interest rates than on a given company's earning power. . ."²⁷

While THE ECONOMIST's characterization of junk bonds in general as "quasi-equity" appears too broad, observers and participants in the junk bond market have noted the often strong resemblance of junk bonds to equity.²⁸ Albert M. Wojnilower, a leading economist and a managing director of the First Boston Corporation, a major investment banking firm, told a 1989 conference sponsored by the Federal Reserve Bank of Boston that ". . . junk bonds . . . are just equity camouflaged to deceive the Internal Revenue Service."²⁹ Similarly, David Schulte, managing

Taggart, *supra* note 21, at 13-15; Floyd, *supra* note 19 at 944-50 (junk bonds raise the number of potential bidders for a corporate target); BRUCK, *supra* note 24, at 95-148.

26. See *infra* Section V.

27. *Junk bonds: Last Resorts*, THE ECONOMIST, Sept. 2, 1989, at 75.

28. As this Article indicates, many characteristics of particular junk bond issues may support their recharacterization as equity, consistent both with the views quoted here and with substantial anecdotal evidence. Systematic empirical studies of the behavior of junk bonds with equity characteristics also are needed to further this analysis. See, e.g., Philip Shuchman, *Theory and Reality in Bankruptcy: The Spherical Chicken*, 41 LAW & CONTEMP. PROBS 66 (1977).

29. Albert M. Wojnilower, *Discussion* [of Richard W. Kopcke & Eric S. Rosengren, *Regulation*

partner of the investment firm of Chilmark Partners, has described junk bonds as "equity with a bow-tie."³⁰ In a study of junk bonds made prior to the 1989 decline of the junk bond market, Richard A. Booth concluded that, in the takeover context, investors found junk bonds appealing because they represented a way to recover distributions that, absent takeover, target companies were not making and that ordinarily would take the form of common stock dividends.³¹ In this view, junk bonds perform a function more normally performed by equity securities.

If at least some junk bonds are "quasi-equity," a court considering their status in an issuer's bankruptcy must determine whether their "debt" label is accurate and fair to third-party creditors. If their equity characteristics outweigh their debt features, and if treating them as debt would be unfair to third-party creditors, a bankruptcy court will need to consider whether junk bond holders' claims should be allowed as debt. If not, the court may decide to reclassify them as equity, or at least equitably to subordinate them to the claims of those competing creditors who otherwise would suffer unfair treatment.³²

A. *The Nature of the Debt/Equity Problem*

In bankruptcy, the distinction between debt and equity long has been important. The Bankruptcy Code itself follows traditional bankruptcy law in making this distinction. It broadly divides securities that a debtor³³ issues into "claims," debt instruments that give their holders creditor status, and "interests," equity securities giving their holders the

of Debt and Equity], in ARE THE DISTINCTIONS BETWEEN DEBT AND EQUITY DISAPPEARING? (hereinafter "DISTINCTIONS") (Proceedings of conference held at Melvin Village, N.H., 10/89, sponsored by Federal Reserve Bank of Boston, R. Kopcke & E. Rosengrin, eds.), 212, 215.

30. Roger Lowenstein, *Rise of a Junk Play: Betting on Equity*, WALL ST. J., June 4, 1990, at C1. See also Lee A. Sheppard, *Should Junk Bond Interest Deductions Be Disallowed?* 34 TAX NOTES 1142, 1143 (1987) ("In moments of weakness. . . investment bankers will admit that junk debt is really disguised equity").

31. Richard A. Booth, *Junk Bonds, The Relevance of Dividends and the Limits of Managerial Discretion*, 1987 COLUM. BUS. L. REV. 553, 556-57 ("Junk bonds are not really riskier bonds, but rather are stock which includes a promise to pay"). See also Harold Bierman, Jr., *Debt, Stock, and Junk Bonds*, 41 TAX NOTES 1237, 1238 (1988) (Junk bonds have significant equity characteristics, especially when the bonds include features such as convertibility); *Bondholders and Stockholders*, *supra* note 18, at 252 (some security analysts see junk bonds "as a type of equity security"); MICHAEL M. LEWIS, *LIAR'S POKER: RISING THROUGH THE WRECKAGE ON WALL STREET* 216-17 (1989) (junk bonds behave more like equity than traditional corporate bonds).

32. See *IT&T v. Holton*, 247 F.2d 178, 184 (4th Cir. 1957); Asa S. Herzog & Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83, 94-95 (1961).

33. Under the Bankruptcy Code, a "debtor" is a person, including a corporation, who has filed

rights of owners of equity in the debtor.³⁴ The Code does not, however, provide any more detailed guidance on how to classify an instrument whose underlying characteristics make the debt/equity choice uncertain. No bankruptcy case has yet addressed the issue of whether publicly held securities sold as debt actually constitute equity. The rights of creditors and equity holders in bankruptcy differ so much, however, that we can expect this issue to emerge in cases concerning securities bearing both debt and equity features, such as junk bonds.

B. The Importance of the Debt/Equity Issue in the Bankruptcy Context

Parties always have been free to characterize their relationships. Following bankruptcy policy, courts normally have enforced the relationships that investors and business organizations enter into according to the terms of the instruments creating the investment relationships.³⁵ Why, then, does it matter that a relationship that a debtor and its investors labelled "debt" may really be equity? Does it, for example, make any difference whether we characterize an instrument labelled "subordinated debt" as debt or equity, as long as the subordination is enforced?

In fact, significant policies in bankruptcy and related bodies of law make the distinction between debt and equity important.

1. Bankruptcy Policies

a. Distributions

One of the strongest policies of bankruptcy law is that, except for secured claims and claims granted special statutory priority, all creditors must be paid on a pro rata basis.³⁶ Furthermore, the bankruptcy estate must pay all creditors fully before making any payment to holders of equity interests.³⁷ This policy is based on a long history. Creditors al-

a bankruptcy petition or against whom creditors have filed an involuntary petition. 11 U.S.C.A. § 101(13) (West Supp. 1991). Unless otherwise noted, this Article uses the term in this sense.

34. 11 U.S.C. § 501(a) (1988).

35. *See, e.g.*, 11 U.S.C. § 510(a) (1988) (bankruptcy courts will normally enforce subordination agreements parties create outside of bankruptcy); *Butner v. United States*, 440 U.S. 48 (1979).

36. *Begier v. IRS*, 110 S. Ct. 2258, 2262-63 (1990) (equality of distribution among creditors is a central Bankruptcy Code policy and requires pro rata distribution of debtor's property among creditors of the same class).

37. 11 U.S.C. §§ 726, 1129(b) (1988); *Sampsel v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941); *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 113-120 (1939).

ways have expected payment ahead of equity holders. Equity holders, for their part, expect to collect after creditors on insolvency. In return, they are entitled to the residual portion of the debtor's profits and property.³⁸ It is only fair to enforce such traditional and legitimate expectations as to how bankruptcy will treat claims against and interests in a debtor.

If a junk bond issue is in fact equity, the use of the "debt" label should not be permitted to distort this process.³⁹ In most bankruptcy cases, whether Chapter 7 or Chapter 11, the property of the estate will not suffice to pay general unsecured creditors in full.⁴⁰ If forced to share simply because equity holders' claims have been labelled "debt,"⁴¹ genuine creditors will receive less than the "fair and equitable"⁴² distribution to which the law entitles them.

The situation becomes more complicated if the junk bond issue in question is contractually subordinated to certain senior debt. Agreements normally accomplish subordination of this type and, on default of the issuer, require that the holders of subordinated securities turn over any payment made to them to the holders of the senior debt, until the latter's claims are paid in full.⁴³ Such "double dividends" substantially increase the proportion of the senior creditors' claims against an insolvent debtor that will be repaid; the subordinated debt normally will enable them to receive proportionately more than other unsecured creditors.

38. See *infra* section V.A.1.

39. See *IT&T v. Holton*, 247 F.2d 178, 184 (4th Cir. 1957) (claim arising from what purported to be a loan, but which was actually "investment of risk capital," should not be allowed to prejudice claims of general creditors).

40. See, e.g., *Herzog & Zweibel*, *supra* note 32, at 85-86.

41. Such sharing not only would be contrary to the normal order of distribution in bankruptcy, but could result in a windfall for junk bond holders resulting from the fact of bankruptcy. For example, the junk bond instruments might not provide default remedies that would, outside of bankruptcy, enable holders to compete with third-party creditors. See *infra* Section V.A.3.n. Yet, if such instruments are neither reclassified nor otherwise subordinated, they will share pro rata with third-party creditors as a result of bankruptcy. Bankruptcy should not, absent special reasons central to the bankruptcy process itself, change nonbankruptcy entitlements in this way. See *Butner v. United States*, 440 U.S. 48 (1979). See generally, Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989); THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986).

42. 11 U.S.C. § 1129(b) (1988); *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. at 115-117 ("fair and equitable" is a term of art requiring absolute priority for creditors over equity holders); *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935).

43. See *Dee Martin Calligar*, *Subordination Agreements*, 70 YALE L.J. 376, 379 (1961).

If the "subordinated debt" is really an equity interest in the issuer, then the senior creditors should not be entitled to receive "double dividend" payments of this kind. Moreover, any distributions that "subordinated debt" holders receive⁴⁴ will be more than they are entitled to. In this situation they should be subordinated to all third-party creditors as well as to the senior debt holders.⁴⁵

b. Dealing With Secured Claims

The Bankruptcy Code respects properly perfected security interests in either personal or real property. When a valid lien secures a creditor's claim, the claim must be paid in full before any of the property's residual value may be applied to the claims of other creditors.⁴⁶ In other words, unsecured creditors' claims are paid last, out of assets remaining in the estate after all secured claims are paid, and after other claims to which the Code gives special priorities⁴⁷ have been satisfied.⁴⁸ Thus, a secured creditor is likely to recover substantially more than an unsecured creditor.

Assets of the issuer usually do not secure junk bonds.⁴⁹ Indeed, because security interests make payment of an underlying debt more certain, rating agencies are less likely to view secured instruments as junk bonds in the first place. Even if rated as junk, courts are unlikely to recharacterize secured bonds as equity.⁵⁰

A junk bond issue could, however, purport to be secured by property of the issuer.⁵¹ A deeply subordinated issue⁵² could, because of its multiple subordination, have prospects of repayment sufficiently speculative to fall into the junk bond category. If the speculative aspects of such an instrument suffice to make it equity, then it is questionable whether the instrument represents the kind of obligation required to support a security interest under the Uniform Commercial Code;⁵³ it is, at least, doubt-

44. Assuming that third-party creditors receive less than 100% of the amounts owed to them.

45. See *infra* section V.A.2.

46. See 11 U.S.C. § 506 (1988).

47. See 11 U.S.C.A. § 507 (1988 & West Supp. 1991) for special priorities the Bankruptcy Code creates.

48. See 11 U.S.C. § 726 (1988).

49. See STANLEY F. REED, LANE & EDSON, P.C., *THE ART OF M & A: A MERGER/ACQUISITION/BUYOUT GUIDE* 159 (1989).

50. See *infra* Section V.A.3.i.

51. See REED, *supra* note 49, at 159.

52. See *infra* Section V.A.2.d.

53. See U.C.C. §§ 1-201(37), 9-203(b) (1991).

ful that a secured equity interest should receive priority over the claims of genuine creditors, secured or unsecured, as the Bankruptcy Code's scheme of distribution requires.⁵⁴

c. Committee Representation

Creditors' committees play a major role in bankruptcy reorganization. The United States Trustee must appoint a committee of unsecured creditors as soon as possible after the debtor files a bankruptcy petition. Furthermore, the United States Trustee may appoint additional committees—for instance, creditors with special interests or equity interest holders—if such appointments are appropriate or if the bankruptcy court so orders.⁵⁵

The Bankruptcy Code charges creditors' committees with representing creditors or interest holders (if the court orders recognition of an equity committee) in negotiating, with the debtor's management, a plan of reorganization.⁵⁶ If, however, a creditors' committee includes holders of a junk bond issue, when that issue in fact constitutes equity, the representation may be inappropriate and may distort the formulation of a plan.⁵⁷

d. Involuntary Bankruptcy Petitions

Another significant policy concern addresses the initiation of a bankruptcy case. Although most U.S. bankruptcy cases are voluntary,⁵⁸ *i.e.*, initiated by the debtor itself, creditors have the right to commence an involuntary case against a debtor if certain conditions are met. This right belongs only to creditors, and not to persons holding equity interests in the debtor.⁵⁹

54. See *Arnold v. Phillips*, 117 F.2d 497, 500, 502-03 (5th Cir. 1941) (deed of trust and pursuant foreclosure sale invalidated because purported debt that deed of trust secured actually constituted equity and therefore could not be secured against bona fide creditors).

55. 11 U.S.C. § 1102 (1988).

56. 11 U.S.C. § 1103 (1988).

57. This does not mean that the issue of categorizing a particular junk bond issue need be litigated at the outset of a bankruptcy case. The bankruptcy court instead could designate a separate committee to represent the holders of junk bonds that are subject to challenge. 11 U.S.C. § 1102(a)(2) (1988). See *supra* text accompanying note 55.

58. See ELIZABETH WARREN & JAY L. WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS*, at 409-10 (2d ed. 1991).

59. See 11 U.S.C. § 303(b) (1988) (to initiate case against a debtor petitioners must hold claims against the debtor).

e. *Voting Rights*

Creditors and equity holders have important and significantly different voting rights in bankruptcy.

In a Chapter 7 case, unsecured creditors holding allowable, liquidated, and undisputed claims are entitled to vote for the election of a permanent trustee for the debtor. Equity holders have no similar role in the trustee's selection.⁶⁰

In Chapter 11 cases, voting rights are substantially more important, and considerably more complex. Each class of creditors and interest holders must vote on a plan of reorganization before the bankruptcy court can confirm it.⁶¹ The requirements for class approval are different for creditors and interest holders. At least half of the members of each creditor class, and holders of at least two-thirds of the amount of that class's allowed claims must vote for the plan in order for the class to approve. Interest-holder acceptance requires that two-thirds of the total allowed interests vote to approve the plan.⁶²

A bankruptcy court considering the claims of junk bond holders, therefore, may not completely avoid voting distortion merely by treating the claims as separate from the claims of other creditor classes. The problem instead results from classifying them as creditors in the first place, when it would be more appropriate to deal with them as equity holders.

2. *Other Creditors' Rights Policies*

In addition to bankruptcy law, other bodies of law give creditors certain rights adjudicated in bankruptcy. These are predominantly state laws. Correct characterization of investment instruments may be important in vindicating the policies of such laws in the bankruptcy context.

60. 11 U.S.C. § 702 (1988). *See In re St. Charles Preservation Investors, Ltd.*, 112 B.R. 469 (D.D.C. 1990), in which the terms of a limited partnership agreement entitled the limited partners to "guaranteed payments" consisting of repayment of their investment and "interest." The bankruptcy court correctly held that, despite the "guaranteed payment" label, the limited partners' interests were equity, and they were therefore not entitled to vote for the Chapter 7 trustee. The district court reversed, primarily on the strength of the label, and without any real analysis of the nature of the limited partners' interests. The court misused the term "security interest" in attempting to describe their interests. The court held that the limited partners had both equity interests and creditors' claims and could vote for the trustee based on the latter.

61. 11 U.S.C. § 1129 (1988).

62. 11 U.S.C. § 1126 (1988).

a. Creditors' Rights Under Corporate Law

One such body of law is corporate law.⁶³ The development of the junk bond market implicates corporate law policies in several ways. Although corporate law traditionally has offered little protection to creditors, it has provided some, notably by restraining distributions to equity holders. A corporation may not, under most state corporation statutes, distribute assets to shareholders: 1) while insolvent; 2) if such distribution would make the corporation insolvent;⁶⁴ or 3) out of the corporation's stated capital.⁶⁵

If a junk bond issue is in fact disguised equity, mere use of the "debt" label should not help the issue evade state-law restraints. In Chapter 7 liquidations, the trustee may recover pre-bankruptcy distributions made in violation of such restraints for the benefit of creditors. In Chapter 11 reorganizations, the debtor-in-possession, or a creditors' committee acting with authorization from the bankruptcy court may make such a recovery.⁶⁶

Moreover, recharacterization of a junk bond issue as equity may entitle its holders to some of the protections that corporate law offers to shareholders, both in and out of bankruptcy.⁶⁷

b. Fraudulent Transfer Law

Fraudulent transfer laws protect creditors both in and out of bankruptcy. Broadly speaking, these laws prevent an insolvent debtor from transferring property otherwise available to satisfy creditors' claims, unless the transfer is made in exchange for property roughly equivalent in value to the transferred property.⁶⁸ The fraudulent transfer laws protect

63. See *infra* Section VI.D.

64. Corporate law normally defines solvency in the equity rather than the bankruptcy sense. A debtor is equity insolvent if it cannot pay its debts as they come due. See BAYLESS MANNING & JAMES J. HANKS, JR., *LEGAL CAPITAL* 63 (3d ed. 1990).

65. See, e.g., DEL. CODE ANN. tit. 8, §§ 154, 170-174, 244 (1983 & Supp. 1990); N.Y. BUS. CORP. LAW §§ 506, 510 (McKinney 1986); REV. MODEL BUSINESS CORP. ACT § 6.40 (1984); MANNING & HANKS, *supra* note 64, at 63-69.

66. See 11 U.S.C. § 544(b) (1988) (giving the trustee power to avoid any of the debtor's pre-bankruptcy transfers that a creditor could avoid under applicable non-bankruptcy law); Arnold v. Phillips, 117 F.2d 497, 502 (5th Cir. 1941).

67. See William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667 [hereinafter *Convertible Bonds*] (fiduciary duties due equity holders may be an important way to protect convertible bond holders against unfair treatment by issuers' management).

68. See *infra* Section VI.B.

creditors only,⁶⁹ and it is therefore important for the enforcement of these laws, both in and out of bankruptcy, to identify legitimate creditors.⁷⁰

Fraudulent transfer issues are especially likely to come up in bankruptcy when the debtor's financial plight results from a failed leveraged buyout (LBO).⁷¹ Junk bonds came to play a particularly important role in LBOs as the LBO movement reached its climax in the late 1980s.⁷² Whether the junk bonds issued in a particular LBO constitute debt or equity thus may be a key issue in the fraudulent transfer litigation likely to follow from the issuer's bankruptcy.⁷³

III. THE ROLE OF THE BANKRUPTCY COURT: AUTHORITY TO CLASSIFY "JUNK BONDS"

Bankruptcy law gives a court substantial authority to recharacterize a junk bond issue if features of the instruments creating it and the circumstances of its issue indicate that the court should treat it as equity rather than debt.

A. *Equitable Subordination Under Bankruptcy Code Section 510(c)*

One way in which to recharacterize purported debt securities as equity is to label the recharacterization equitable subordination, a classic equitable doctrine adopted in Bankruptcy Code section 510(c). The bankruptcy court has broad discretion to decide whether to subordinate the claims of a creditor or group of creditors to the claims of other creditors in order to achieve equity.⁷⁴ Courts have used equitable subordination

69. See, e.g., UNIFORM FRAUDULENT CONVEYANCE ACT §§ 4-10 (1918); UNIFORM FRAUDULENT TRANSFER ACT §§ 4-5, 7 (1984).

70. Moreover, whether a given transaction is subject to attack under fraudulent transfer law may depend on whether the debtor was solvent at the time of the transfer or was rendered insolvent by it. Whether a debtor is solvent for fraudulent transfer purposes may in turn depend on whether junk bonds the debtor issued are characterized as debt or equity. See *infra* Section VI.B.1.

71. See, e.g., *Kupetz v. Wolf*, 845 F.2d 842 (9th Cir. 1988); *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987); *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488 (N.D. Ill. 1988); *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175 (S.D. Cal. 1985); *In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127, 134-41 (Bankr. D. Mass. 1989); *In re Morse Tool, Inc.*, 108 B.R. 389, 390-92 (Bankr. D. Mass. 1989); *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*, 91 B.R. 430 (Bankr. N.D. Ohio 1988).

72. See *supra* note 25; REED *supra* note 49, at 116-119.

73. See *infra* Section VI.B.

74. 11 U.S.C. § 510(c) (1988); *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941) ("The power of the bankruptcy court to subordinate claims or to adjudicate equities arising

more than any other doctrine to deal with purported debt that has equity characteristics. This application of equitable subordination includes those cases in which "creditors" acquired claims labelled debt in pre-bankruptcy exchanges for equity instruments.⁷⁵

In the absence of a pre-bankruptcy exchange, however, certain characteristics of equitable subordination may make the doctrine inappropriate for use in the recharacterization of most junk bonds. Courts normally use the doctrine to prevent creditor (usually insider) overreaching at the expense of less favorably placed creditors.⁷⁶ Under the doctrine, a court subordinates the claims of the overreaching creditors to the claims of creditors injured by the overreaching. Since equity interests in a debtor are subordinate to all creditors' claims, equitable subordination is at first glance an effective way in which to recharacterize securities bearing the "debt" label as equity.

Bankruptcy courts have applied equitable subordination in three kinds of situations: 1) fraud, illegality, or breach of fiduciary duties; 2) undercapitalization; and 3) situations that would normally justify piercing the corporate veil, *i.e.*, situations in which a corporate entity is an instrumentality or an alter ego of an affiliate.⁷⁷ Junk bond issuers are often undercapitalized. This is a significant factor in the recharacterization of "debt" as equity for tax purposes.⁷⁸ In the tax context, no proof of fraud or illegality is required.⁷⁹

Equitable subordination classically requires three elements: 1) the

out of the relationship between the several creditors is complete."); *Pepper v. Litton*, 308 U.S. 295, 296, 304-07 (1939); *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939); *In re Holiday Mart, Inc.*, 715 F.2d 430, 432-33 (9th Cir. 1983); 3 COLLIER ON BANKRUPTCY ¶ 510.01 (15th ed. 1990); Harry S. Gleick, *Subordination of Claims in Bankruptcy Under the Equitable Power of the Bankruptcy Court*, 16 BUS. LAW. 611, 611-12 (1961).

75. *McConnell v. Estate of Butler*, 402 F.2d 362, 367 (9th Cir. 1968); *Robinson v. Wangemann*, 75 F.2d 756, 758 (5th Cir. 1935).

76. See *Pepper v. Litton*, 308 U.S. 295 (1939); *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939); *In re Multiponics, Inc.*, 622 F.2d 709 (5th Cir. 1980); *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977); *Costello v. Fazio*, 256 F.2d 903 (9th Cir. 1958); Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975).

77. *In re Missionary Baptist Found. of America*, 712 F.2d 206, 212 (5th Cir. 1983).

78. See I.R.C. § 385(b)(3) (1989) (regulations concerning whether an interest in a corporation should be treated as debt or equity for tax purposes may include issuer's debt to equity ratio as factor); William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 507-19 (1971); Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 534-36 (1977).

79. *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219-20 (1941); *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 322-23 (1939); *IT&T v. Holton*, 247 F.2d 178, 183 (4th Cir. 1957).

party to be subordinated has engaged in inequitable conduct; 2) that conduct has injured other creditors or given the party against whom subordination is sought an unfair advantage; and 3) subordination of the claim is consistent with the purposes of the Bankruptcy Code.⁸⁰

While courts normally recharacterize debt as equity within the framework of equitable subordination,⁸¹ the recharacterization of junk bonds does not always comfortably fit within this framework. Mislabelling equity as debt technically meets the requirements for equitable subordination enumerated above: such mislabelling is inequitable and gives an unfair advantage to those holding the mislabelled instruments⁸² and to those holding senior debt who will also receive more than their due share based on subordination agreements.⁸³ Nonetheless, bankruptcy courts, which most often apply the doctrine in cases involving insider misconduct, often limit its application to those cases.⁸⁴ Because junk bond holders are not normally insiders of the issuer, the courts would be reluctant to apply the doctrine to them. Even a large holder of privately placed junk bonds is unlikely to be an insider, as long as the placement is negotiated at arms' length and the buyer does not acquire excessive power, through debt covenants or in the course of a working relationship, over the issuer.⁸⁵

Under certain circumstances involving large, privately placed issues, however, a court may find that a lender is an insider because of a close relationship between borrower and lender. In that case, the use of equi-

80. *In re* Missionary Baptist Found. of America, 712 F.2d at 212. *Accord In re* Multiponics, Inc., 622 F.2d 709, 713 (5th Cir. 1980). *See also In re* Mobile Steel Co., 563 F.2d 692, 700 (5th Cir. 1977).

81. Herzog & Zweibel, *supra* note 32, at 93-98.

82. IT&T v. Holton, 247 F.2d at 184 (it would be "highly inequitable" for a parent to share *pro rata* with its subsidiaries' creditors, when its claim "represents in reality nothing but its investment of risk capital"); Herzog & Zweibel, *supra* note 31, at 93-98.

83. *See supra* Section II.b.1.a.

84. *See* Long Island Lighting Co. v. Bokum Resources Corp., 40 B.R. 274, 296-299 (Bankr. D.N.M. 1983)(bankruptcy court refused to treat purported debt as equity, stressing that "inequitable conduct" was needed for equitable subordination).

85. *See id.* Another line of cases, however, holds that noninsiders' claims may be equitably subordinated, but that subordination requires proof of more "egregious" misconduct on their part than in cases involving insiders: conduct amounting to "fraud, overreaching, or spoliation." *In re* Pacific Express, Inc., 69 B.R. 112, 116 (Bankr. 9th Cir. 1986); *In re* W. T. Grant Co., 4 B.R. 53, 74-75 (Bankr. S.D.N.Y. 1980). Denominating equity interests as debt might well qualify as "overreaching" for purposes of this test, if the instrument so labelled had equity characteristics clearly outweighing its debt features.

table subordination as an appropriate doctrine for reorganization may be quite straightforward.

The fit becomes worse still when the junk bonds in question are publicly held. Junk bonds' registration under the Securities Act of 1933 or state blue sky laws may not be decisive in bankruptcy; issuers may have designed a registered issue for a few large, institutional holders.⁸⁶ When, however, the junk bond holders are truly public, i.e., when the securities are dispersed among a significant number of investors of differing sophistication, equitable subordination becomes much more difficult to use. If other factors that call for recharacterization⁸⁷ still significantly outweigh public holding, the court may need to apply other doctrines to find authority for the recharacterization.

If, however, equitable subordination is available to the court, it may have some advantages over other methods of dealing with equity-like instruments. Equitable subordination is a flexible doctrine that subordinates debt only to the claims of creditors adversely affected by the actions of the creditor against whom subordination is sought.⁸⁸ This means that in the junk bond context, a court could apply equitable subordination to benefit involuntary creditors, tort claimants and the public fisc, for example, while leaving the subordinated debt on the same level as certain other creditors who, while not themselves subject to subordination or reclassification, lent to the debtor knowing of the existence of the junk bonds. Under this theory, because the junk bond issue did not disadvantage these creditors, their claims should not have priority over those of the junk bond holders.⁸⁹ Moreover, subordination (as opposed to recharacterization) would not have some of the other adverse effects described below.⁹⁰

B. Classification Powers of the Bankruptcy Court

The powers of the bankruptcy court to classify the claims and interests

86. See *infra* note 138 and accompanying text.

87. See *infra* Section IV.B.

88. See 11 U.S.C. § 510(c)(1) (1988); *In re Mobile Steel Co.*, 563 F.2d 692, 701 (5th Cir. 1977); *In re Slefco*, 107 B.R. 628, 644 (Bankr. E.D. Ark. 1989); David Gray Carlson, *A Theory of Contractual Debt Subordination and Lien Priority*, 38 VAND. L. REV. 975, 989-90 (1985).

89. See Herzog & Zweibel, *supra* note 32, at 87 (subordinated creditors, despite demotion of their claims below those of other creditors, remain creditors with the other rights of creditors such as voting on plans of reorganization).

90. See *infra* Section VI.

asserted against a debtor,⁹¹ supported by the court's general equity powers,⁹² appear to provide a more satisfactory basis for dealing with the debt/equity problem in bankruptcy. A court using these powers need not deal with the insider status of the holders of the instruments in question, as in the case of equitable subordination. Instead, the court need only decide: 1) that the party advocating reclassification had overcome the normal presumption in favor of the label that the parties to the instrument had attached to it; 2) that the features of the instrument and the circumstances of its issue compel a finding that its "debt" label is inappropriate; and 3) that it would be unfair to the debtors' genuine creditors not to reclassify the instrument as equity.⁹³

To reach such a decision, the court would have to analyze the initial transaction carefully, based on the presence or absence of certain factors, enumerated below,⁹⁴ and on any other features that might be present.⁹⁵ The analysis should not simply compare the features of a particular deal to a laundry list of suspect provisions, but should instead ascertain what kind of instrument the parties intended to create.⁹⁶ If the analysis shows that the parties intended an instrument with the advantages and disadvantages of equity, but with a "debt" label, and that honoring the label rather than the substance would significantly disadvantage genuine creditors, the court should apply the more appropriate "equity" label.⁹⁷

C. *General Equitable Powers of the Court*

Bankruptcy courts are primarily courts of equity.⁹⁸ They derive their equitable powers from their inherent powers as courts,⁹⁹ from particular policies of the bankruptcy laws, and from particular statutory grants in

91. See 11 U.S.C. §§ 502, 1123, 1129 (1988).

92. See 11 U.S.C. §§ 105, 1123(b)(5) (1988).

93. *Arnold v. Phillips*, 117 F.2d 497, 502-03 (5th Cir. 1941) (purported advances to corporation by its dominant shareholder "were capital contributions," even absent "proof of mala fides"). See also *Herzog & Zweibel*, *supra* note 32, at 93 ("capital contribution" bankruptcy cases actually turn on whether a debt exists, not on classic subordination analysis).

94. See *infra* Section V.

95. This Article begins but scarcely ends the inquiry; the creativity of investment bankers knows no limit.

96. See *Slappey Drive Indus. Park v. United States*, 561 F.2d 572, 581-82 (5th Cir. 1977).

97. See *Arnold v. Phillips*, 117 F.2d at 502-03.

98. *United States v. Energy Resources Co.* 110 S. Ct. 2139, 2142 (1990); *Pepper v. Litton*, 308 U.S. 295, 304 (1939); *Local Loan Co. v. Hunt*, 292 U.S. 234, 240-41 (1934).

99. See 28 U.S.C.A. § 1334 (West Supp. 1991); *A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1003 (4th Cir.), *cert. denied*, 479 U.S. 876 (1986).

aid of their jurisdiction.¹⁰⁰ An important aspect of this power is the court's authority to examine agreements between the debtor and certain creditors to prevent unfairness to third-party creditors. A court can invoke its general equitable powers to support the doctrines of equitable subordination and reclassification described above.

Moreover, a court can invoke its general equitable powers to modify the relief described above to fit the equities of particular situations. This modified relief could, for example, deal with certain features of a securities issue as equity rights, while continuing to treat some of the holders' rights as debt. Thus, in a junk bond issue with conversion rights, the court could treat the underlying bond issue as debt, while separating out the conversion rights and treating them as independent options. While tax law has been reluctant to engage in such separation,¹⁰¹ the special equities of bankruptcy—including the more drastic consequences to holders—argue for attempting to do so in a bankruptcy case if feasible and not unfair to third-party creditors.

D. Effects of Bankruptcy Code Sections 510(a) and (b)

Bankruptcy Code section 510(a) provides that a subordination agreement is enforceable in bankruptcy according to its terms to the same extent as it would be under non-bankruptcy law.¹⁰² This codifies pre-Bankruptcy Code doctrine,¹⁰³ and, in the case of a junk bond issue, normally makes it difficult for holders of expressly subordinated debt to escape the consequences of their agreement to subordinate their claims. It is far less clear, however, that this provision should help senior debt holders who attempt to enforce subordination of only impliedly subordinated claims.¹⁰⁴

Code section 510(b) requires the subordination of a claim arising from fraud in connection with the sale of a security to all claims or interests that would be senior to that security.¹⁰⁵ The provision codifies prior case

100. See, e.g., 11 U.S.C. § 105 (1988). See also 11 U.S.C. § 1123(b)(5) (1988) (court may approve any appropriate provision in a reorganization plan consistent with the rest of the Bankruptcy Code).

101. See Willard B. Taylor, *Debt/Equity and Other Tax Distinctions: How Far Can We Go?*, 62 TAXES 848, 857 (1984).

102. 11 U.S.C. § 510(a) (1988).

103. H.R. REP. NO. 595, 95th Cong., 1st Sess. 359 (1977); 3 COLLIER ON BANKRUPTCY ¶ 510.01 (15th ed. 1990). See also Gleick, *supra* note 74.

104. See *infra* Section V.A.2.b.

105. 11 U.S.C. § 510(b) (1988).

law that barred shareholders from bootstrapping themselves into creditors' claims by claiming securities fraud in connection with the acquisition of their shares.

In the junk bond context, this will prevent junk bond holders, whose securities have been subordinated or reclassified as equity, from restoring themselves to general creditor status by claiming damages for securities fraud in the offering materials for the junk bonds that they purchased. This section will not, however, bar them from recouping their losses against persons other than the issuer, through, for example, securities-law actions based on preparation of materially misleading offering materials.¹⁰⁶

E. Additional Sources of Law

To apply the powers discussed above in the debt/equity context, a court must first decide whether securities with primarily equity characteristics actually have been mislabelled as debt. The Bankruptcy Code itself provides no guidance for this task. There are comparatively few recent bankruptcy cases in which courts have dealt with the debt/equity issue. As a result, bankruptcy courts approach the classification problem with a relatively unsophisticated eye. A court deciding whether to reclassify or subordinate securities thus may find it helpful to borrow cautiously from the experience of courts dealing with the issue in other legal contexts.

Tax law provides the most extensive experience of this kind. Although the tax laws have been neither clear nor consistent when faced with debt/equity problems,¹⁰⁷ tax courts and commentators at least have been forced to deal at great length with the classification of financial instruments as debt or equity. This experience can be quite helpful in the absence of a similar wealth of bankruptcy cases and commentary.¹⁰⁸ Tax

106. See, e.g., Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (1988); Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1991).

107. This difficulty in drawing clear debt/equity lines is illustrated by the Treasury's inability to deal with the issue. Though authorized by I.R.C. § 385 to draft appropriate regulations, the Treasury withdrew the only set it proposed, and courts continue to deal with the issue on a case-by-case basis. See Adam O. Emmerich, Comment, *Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation*, 52 U. CHI. L. REV. 118, 118-119, 128-133 (1985); BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 4.04 (5th ed. 1987). See generally William D. Andrews, *The ALI Reporter's Proposals on Corporate Distributions and Corporate Taxation With a Personal Consumption Tax*, 22 SAN DIEGO L. REV. 333 (1985).

108. See, e.g., Herzog & Zweibel, *supra* note 32, at 95 (bankruptcy courts would do better to

law may be helpful in this context not only because it has had to deal with the debt/equity issue in many different situations, but also because of important similarities between tax and bankruptcy jurisprudence.

1. *Applicability of Tax Doctrines*

Tax and bankruptcy law have a great deal in common. In both, courts and administrators have had to consider whether parties have attached accurate labels to their transactions. Both employ equitable concepts to deal with business transactions according to their economic substance, even when the parties seek special treatment by manipulating the form of those deals.¹⁰⁹

The debt/equity issue is very much this kind of issue for both legal disciplines. Bankruptcy courts need to distinguish between debt and equity for the policy reasons described above,¹¹⁰ while the Internal Revenue Service and tax courts need to make the distinction for different, tax-based, policies.¹¹¹ While tax authorities and bankruptcy courts have different reasons for the classification, the distinction is the same, and both disciplines make it by looking through the form of a transaction to its

borrow from tax cases on the debt/equity distinction than to reason from the vague "rules of fair play and good conscience" that many attempt to apply on the issue).

109. *Frank Lyon Co. v. United States*, 435 U.S. 561, 572-81 (1978) (economic substance of a transaction, rather than formal written documents that the parties prepared, should govern its tax treatment); *Gregory v. Helvering*, 293 U.S. 465, 469-70 (1935) (substance of a transaction, rather than its form, should determine its tax treatment); *Slappey Drive Indus. Park v. United States*, 561 F.2d 572, 581 (5th Cir. 1977) (parties' labels for their transactions do not guarantee appropriate tax treatment); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968) (tax treatment of an investment depends on its economic substance rather than the labels the parties place on it); *Plumb*, *supra* note 78, at 405-06; Karen Nelson Moore, *The Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 FLA. L. REV. 659 (1989); Herzog & Zweibel, *supra* note 32, at 94-95; Gleick, *supra* note 74, at 611, 620 (there is little difference between tax and bankruptcy treatment of purported debt of undercapitalized corporations). See also *Pepper v. Litton*, 308 U.S. 295, 304-05 (1939) (bankruptcy courts exercise their equitable powers, *inter alia*, so that "substance will not give way to form"); *Kupetz v. Wolf*, 845 F.2d 842, 846 n.6 (9th Cir. 1988); *In re Carolee's Combine, Inc.*, 3 B.R. 324 (Bankr. N.D. Ga. 1980). But see *In re Pacific Express, Inc.*, 69 B.R. 112, 115 (Bankr. 9th Cir. 1986) (tax authority "irrelevant" to debt/equity classification for bankruptcy purposes); *Long Island Lighting v. Bokum Resources Corp.*, 40 B.R. 274, 296-97 (Bankr. D.N.M. 1983) (although bankruptcy cases evaluate debt/equity status of a claim "for a different purpose and [utilize] different criteria" than tax cases, tax cases defendant cited "deserve discussion").

110. See *supra* Section II.

111. Important tax policies implicated by the debt/equity issue include the fact that the Internal Revenue Code makes interest on debt deductible, while dividends on equity are not deductible. For an extensive (though somewhat dated) description of the different ways in which tax laws treat debt and equity, see *Plumb*, *supra* note 78, at 371-404.

substance. Both thus can use similar analysis to determine whether a relationship that parties have labelled "debt" actually constitutes equity.¹¹² Consequently, there always has been some crossover between bankruptcy and tax jurisprudence, both in case law and in scholarly analysis.¹¹³ In fact, the early development of the debt/equity issue in the tax context relied in part on sources in bankruptcy law and the related law of equity receivership, from which much of bankruptcy reorganization law derives.¹¹⁴

Moreover, applying tax principles where appropriate, rather than developing an independent set of principles for bankruptcy purposes, will simplify business planning and avoid some unnecessary problems. It will enable business planners to structure transactions to satisfy a single set of requirements, instead of forcing them to satisfy independent and possibly inconsistent criteria for tax and bankruptcy purposes.

2. *Limitations of Applying Tax Jurisprudence*

Congress has not generally sought to achieve consistency between tax and bankruptcy law, except when they interact directly, i.e., when tax issues arise as a consequence of bankruptcy, or in the context of bankruptcy cases. The courts never have held tax precedent to be controlling for bankruptcy purposes, even in cases involving common economic issues. Bankruptcy courts have been wary in applying tax principles, but as unconventional financial instruments have increasingly come to their attention, they have found themselves increasingly faced with tax-based arguments. Their reaction to date has not been consistent. One case that dealt with the characterization of original issue discount¹¹⁵ which, like the debt/equity problem, has been extensively covered in tax but not in

112. See Jules S. Cohen, *Shareholder Advances: Capital or Loans?* 52 AM. BANKR. L.J. 259, 264-65 (1978). But see *In re Pacific Express, Inc.*, 69 B.R. at 115; *Long Island Lighting Co. v. Bokum Resources Corp.*, 40 B.R. at 296; *In re Rego Crescent Corp.*, 23 B.R. 958, 962 (Bankr. E.D.N.Y. 1982). These three cases fail to perceive that, although tax and bankruptcy make the debt/equity distinction for different purposes, the distinction they make is the same, and should therefore follow a similar analysis. They also fail to note previous cases in which tax courts relied on bankruptcy authority and vice versa in making the distinction. See *infra* note 114.

113. See, e.g., *Herzog & Zweibel*, *supra* note 31, at 94-95; *Sheppard*, *supra* note 30, at 1146 (arguing for applicability of bankruptcy doctrine in characterizing junk bonds as equity for tax purposes).

114. See *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d 11, 12-13 (2d Cir. 1935) (citing *Hazel Atlas Glass Co. v. Van Dyk & Reeves*, 8 F.2d 716 (2d Cir. 1925) (receivership) and *In re Culbertson's*, 54 F.2d 753, 757 (9th Cir. 1932) (bankruptcy)); *Plumb*, *supra* note 75, at 428-29.

115. See *infra* Section VI.A.

bankruptcy, held that tax law was “instructive, but not controlling” for bankruptcy purposes.¹¹⁶ The bankruptcy court in that case nonetheless relied extensively on tax statutes, their legislative history, Treasury regulations, and tax cases in dealing with original issue discount for bankruptcy purposes. Nonetheless, the court held that, based on its interpretation of a particular Bankruptcy Code provision, it should use different principles in calculating the amount of original issue discount.¹¹⁷ In a related case, a bankruptcy court relied on tax law to actually calculate original issue discount for bankruptcy purposes.¹¹⁸ More recently, a district court, without explanation, applied tax law in holding in a reorganization case that no original issue discount had been created in a pre-bankruptcy exchange offer.¹¹⁹

In determining whether to borrow from tax experience, a bankruptcy court should consider the derivation of tax principle that the court may apply. Is it principally a revenue-related purpose, a quirk in tax law not related to the economic characterization of a transaction, or is it a characterization rule developed as to aid in ascertaining the economic substance of a given transaction? If the latter, borrowing from principles developed in the tax context for use in a bankruptcy case will be entirely appropriate. In the former cases, the borrowing, if at all possible, will have to be done cautiously.

This Article, in developing its analysis of the debt/equity issue for bankruptcy purposes, will borrow from tax jurisprudence where appropriate, according to the principles set forth above.

IV. KEY ISSUES IN CHARACTERIZING JUNK BONDS

Despite the broad use of the “junk bond” label, bonds fail to receive investment-grade ratings, and are thus labelled as “junk,” for a wide variety of reasons. The label itself merely means that “junk” securities are riskier than investment-grade corporate debt. Without more, riskiness is

116. *In re Allegheny Int'l, Inc.*, 100 B.R. 247, 251, 253 (Bankr. W.D. Pa. 1989). See also *In re Chateaugay Corp.*, 109 B.R. 51, 57 (Bankr. S.D.N.Y. 1990) (tax rules for accruing original issue discount “instructive” but not “dispositive”), *aff'd*, 1991 U.S. Dist. LEXIS 10059 (S.D.N.Y. July 23, 1991).

117. *In re Allegheny Int'l, Inc.*, 100 B. R. at 251-55 (interpreting Bankruptcy Code § 502(b)(2) (1988)).

118. *In re Chateaugay Corp.*, 109 B.R. at 57-58.

119. See *In re Pengo Indus., Inc.*, 129 B.R. 104, 108-09 (N.D. Tex. 1991) (applying CIR v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974), without discussing appropriateness of applying tax law in the bankruptcy context).

not sufficient reason to reclassify these securities. The common stock of some issuers may be a safer investment than the debt of others, without changing the characterization of either.¹²⁰ Whether recharacterization is appropriate should depend more on the status of a given instrument within the capital structure of the issuer than on its risk status in the external market. If an issuer sells an instrument and investors buy it with the expectation that it will perform equity-type functions for the issuer and the holders, a bankruptcy court should look to the characteristics of the instrument, and to its place in the capital structure of the issuer, to see whether it has been correctly labelled as debt. The "junk" label should not, by itself, overcome the normal presumption that bankruptcy courts will enforce contracts that are valid under non-bankruptcy law.¹²¹

Whether a challenge to the "debt" label on a particular instrument should overcome that presumption thus depends not on its failure to receive an investment grade rating, but on the reasons for that failure. Such a challenge must rest on particular features of the issue in question, including the circumstances of issue, the contractual features of the investment agreement creating the issue, and other reasons, such as particular characteristics of the issuer.

A. *Criteria for Classification*

1. *Residual or Creditor-Type Claim?*

One of the central bases for characterizing a security as debt or equity is whether it primarily represents a creditor-type claim, or a residual claim on the profits and assets of the corporation.¹²² A debt claim, for payment of interest and principal in preset amounts on certain fixed dates, is paid out of the debtor's available assets. A creditor, in agreeing to such a contract with the debtor, bargains for certainty rather than for an "upside."¹²³ Management has no discretion to vary payments of in-

120. See Emmerich, *supra* note 107, at 122-24.

121. See 11 U.S.C. § 502(a) (1988) (claims in bankruptcy are deemed allowed unless a party in interest objects). See also *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d at 13.

122. See *In re Loewer's Gambrinus Brewery Co.*, 167 F.2d 318, 320 (2d Cir. 1948) (L. Hand, J., concurring) (shareholders and creditors of a corporation take different risks: the former "stand to lose first, but in return they have all the winnings above the creditors' interest, if the venture is successful"); KLEIN & COFFEE, *supra* note 18, at 1.

123. See *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d at 12 (creditor is paid independently of risk of success); *Slappay Drive Indus. Park v. United States*, 561 F.2d 572, 581 (5th Cir. 1977) (because a lender seeks only a fixed interest rate, it will not normally be willing to bear a substantial

terest and principal on such claims. Indeed, any such variation would result in a default. In fact, because the creditors' claims reduce the amount available for distribution to equity holders, to whom management owes its primary duties, creditors try to restrict management's freedom to undertake activities that could increase profits available for distribution to equity.¹²⁴

A residual claim, on the other hand, is highly variable, depends primarily on the profits of the debtor, and is paid after the claims of true creditors have been met.¹²⁵ An equity investor, in establishing a residual claim, primarily bargains for a potential upside rather than for certain return of principal and interest.¹²⁶ Such an upside, contingent on profits derived from the success of the issuer's business, is not paid unless the issuer's management so authorizes.¹²⁷ The more discretion the issuer's management has over distributions, the closer the underlying security approaches the equity paradigm.

2. *Fairness to Other Creditors*

Fairness to third-party creditors is a matter of central concern in the bankruptcy process.¹²⁸ Any "party in interest"—a term that includes all creditors and holders of interests in a debtor—has the right to object to any claim.¹²⁹ A bankruptcy court, in deciding how to treat creditors' claims against the debtor, must consider how its finding will affect all other creditors. This represents one of the few important areas in which

risk of corporate failure); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 91 (1985) (creditors are risk-averse and accept a lower return in exchange for greater certainty, which they receive because stockholders are wiped out first). See also John J. Slain & Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261, 286-87 (1973). One can argue further that the ultimate creditor paradigm, the involuntary creditor, has no intention of making any sort of investment in the debtor, but merely wishes to be repaid on the principal amount of his or her claim as expeditiously as possible.

124. See Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 833-34 (1985).

125. See Lehn, *supra* note 19, at 173.

126. See *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Commissioner v. O.P.P. Holding Corp.*, 76 F.2d at 12.

127. See, e.g., N.Y. BUS. CORP. LAW §§ 506, 510, 513, 516, 719 (McKinneys 1986 & Supp. 1991); DEL. CODE ANN. tit. 8, §§ 170-74 (1983 & Supp. 1990).

128. See *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941); *Pepper v. Litton*, 308 U.S. at 304, 306-309; *In re Loewer's Gambrinus Brewery Co.*, 167 F.2d 318, 319 (2d Cir. 1948). See also THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 21-27 (1986).

129. 11 U.S.C. § 502(a) (1988).

the rationale for recharacterization in bankruptcy potentially diverges from the rationale for recharacterization in the tax context, where the court must consider the interest of only one major third-party creditor—the public fisc. For bankruptcy purposes, a court dealing with the debt/equity issue must determine whether it would be clearly unfair to third-party creditors to let a party holding an instrument labelled “debt,” but whose characteristics are primarily those of an equity security, share with the third-party creditors on an equal basis.¹³⁰

B. Should Public and Private Debt Be Treated Differently?

Junk bonds are issued both publicly and privately, although the proportion of private placement recently has increased because of difficulties with the market for publicly held junk bonds.¹³¹ Even before the recent market difficulties, however, most direct junk bond purchasers were large institutions.¹³²

The debt/equity issue, so far as it has come up in the bankruptcy context, has not arisen with respect to publicly held securities.¹³³ Nonetheless, in one of the few cases on record in which junk holders challenged the form-over-substance treatment of an instrument, arguing that such recharacterization should not apply to publicly traded securities, the court held that the mere fact of public trading should not affect the characterization of purported debt securities for bankruptcy purposes.¹³⁴

This holding appears overbroad. Bankruptcy's inherent equitable considerations require that a court balance the interests of an extensive class of public securities purchasers against those of the debtor and other creditors. Purchasers of publicly traded securities lack the sophistication characteristic of purchasers of privately placed securities, who, with full representation, can negotiate particular provisions in the agreements that govern their investments.¹³⁵ The public trading of a junk bond issue should therefore weigh against recharacterization. It should not, however, weigh so heavily that it irrebuttably precludes recharacterization.

130. *IT&T v. Holton*, 247 F.2d 178, 184 (4th Cir. 1957).

131. Constance Mitchell & Anita Raghauan, *Private Market Attracts Issuers of Junk Bonds*, WALL ST. J., May 23, 1990, at C1.

132. Barker, *supra* note 26, at 782 (90-95% of junk bond purchasers are institutions); Taggart, *supra* note 21, at 11 (Drexel Burnham Lambert estimated that institutions hold 80-90% of junk bonds).

133. *See, e.g., In re Hawaii Corp.*, 694 F.2d 179 (9th Cir. 1982).

134. *In re Allegheny Int'l, Inc.*, 100 B.R. 247, 250 (Bankr. W.D. Pa. 1989).

135. *See Bratton, Convertible Bonds, supra* note 67, at 686 n.71.

If a junk bond issue has pronounced and obvious equity characteristics such as yields linked to contingencies or far above prevailing market rates, these characteristics may justify an inference that the buyers bought the bonds primarily for their equity characteristics.¹³⁶ In cases like this, because unfairness to third party creditors could well outweigh any unfairness to junk bond buyers, recharacterization might be appropriate.

Moreover, the mere fact of registration under the Securities Act of 1933¹³⁷ may not in itself justify the conclusion that a junk bond issue is "publicly traded" for bankruptcy purposes. Large institutional investors often hold registered junk bond offerings, and neither they nor the issuers intend to disperse such offerings among a broader class of security holders. Offering bonds in minimum units of \$1 million or more is but one way issuers evidence their intent that the bonds be so held.¹³⁸

V. CHARACTERIZING JUNK BONDS BASED ON CIRCUMSTANCES AND FEATURES OF PARTICULAR ISSUES

A. *Original Issue Junk*

One of the basic considerations for characterizing a junk bond claim is whether the junk bond issue in question was original issue junk. This label implies two primary characteristics: 1) the issuer sold the issue in question to the holders (whether or not through an underwriter or underwriters) for cash or property,¹³⁹ rather than for other securities of the issuer; and 2) because the issue in question lacked an investment-grade rating when issued, its initial purchasers bought it as junk. The alternative situations—junk bonds issued in exchange for other securities or obligations of the debtor, and obligations that the debtor originally issued as investment-grade debt—introduce additional complications and will be discussed below.

136. See Booth, *supra* note 31, at 558-59 (buyers may be attracted to junk bonds in takeover context because of their equity characteristics).

137. 15 U.S.C. §§ 77a - mm (1988).

138. See Barker, *supra* note 25, at 786-89 (the Pantry Pride offering pursuant to a 1986 takeover was in minimum denominations of \$2.5 million, making it resemble a private placement).

139. Other than previously issued securities of the issuer.

1. *Unsubordinated Debt of Low-Rated or Unrated Issuers*

a. *Cases in Which Issuer's Debt Is Not Disproportionate to Its Designated Equity Capital*

An appropriate place to begin classifying junk bonds is with issues that do not present a significant classification problem. If unrated or low-rated debt securities result from the issuer's lack of a track record or from the riskiness of the issuer's business, rather than from its internal capital structure or from the presence in the issue of any of the particular characteristics discussed below, a court should treat the securities as debt for bankruptcy purposes.¹⁴⁰ Treatment of an instrument of that kind as anything but debt would disregard the normal principle that a financially weak debtor's obligations should not be treated as equity merely because of those very weaknesses.¹⁴¹ To fit in this class, however, an issuer's debt should be unsubordinated, labelled "debt,"¹⁴² proportionate to the portion of the issuer's capitalization the issuer considers equity, should include a full complement of protective covenants, and should lack any of the special characteristics discussed below.¹⁴³

b. *Cases in Which Issuer's Debt Is Unreasonably Large in Proportion to Its Designated Equity*

A junk bond issue must be considered in the context of its issuer's overall capital structure. If the issuer has ample capital that it expressly holds as equity, or if the issuer's equity is at least substantial in proportion to its debt, the issuer's debt is probably exactly what it purports to be.¹⁴⁴ On the other hand, if the issuer has very little capital that it for-

140. A court could view a junk bond with these characteristics as a securitized term loan, i.e., a loan much like a bank loan, which would usually constitute debt, but issued in the form of a tradable security. See Taggart, *supra* note 21, at 10. Taggart, however, generalizes too broadly in asserting that junk bonds can be viewed in this way; bank loans generally do not have other junk bond characteristics, such as subordination and the other features discussed *infra*. See also KLEIN & COFFEE, *supra* note 18, at 220.

141. See, e.g., Plumb, *supra* note 78, at 530-33.

142. The label the parties put on their instrument, while not determinative, is significant; if they do not call it "debt," it is highly unlikely it will be so treated. See Slaphey Drive Indus. Park v. United States, 561 F.2d 572, 582-83 (5th Cir. 1977). But see Koppers Co. v. American Express Co., 689 F. Supp. 1371, 1402-03 (W.D. Pa. 1988) (preferred stock held "sufficiently debt-like" to raise issue under Federal Reserve margin regulations); Caesar's World, Inc. v. Sosnoff, No. CV-1622 WJR, 1987 U.S. Dist. LEXIS 14293, at *2 (C.D. Cal. June 8, 1987) (instrument labeled "preferred stock" held to be debt for Federal Reserve margin requirement purposes).

143. See *infra* Section V.A.3.

144. See Alex E. Weinberg, *Selected Tax Aspects of Leveraged Buyouts Including Management*

mally labels equity, a court must consider that at least part of the issuer's putative debt capitalization actually may be serving as equity.¹⁴⁵ This is particularly true if the issuer recently has replaced a substantial part of its equity capitalization with "debt" securities¹⁴⁶—a circumstance that frequently follows a leveraged buyout.¹⁴⁷

Thus, an issuer's "thin capitalization" is one of the major reasons to scrutinize that part of its capitalization that it labels debt for possible recharacterization as equity. This has long been true both in the bankruptcy¹⁴⁸ and tax contexts.¹⁴⁹

2. Subordinated Debt

One of the most important factors that can prevent a debt-denominated instrument from receiving an investment-grade rating is subordination to other debt.¹⁵⁰ Subordination by its nature makes the

Participation, in LEVERAGED ACQUISITIONS AND BUYOUTS 1987, at 105, 116 (Harvey E. Benjamin and Michael B. Goldberg, Co-Chairmen) (in structuring LBO debt, it may be advisable to divide debt into layers so that if the lowest level is reclassified as equity, it will support the argument that senior levels are true debt for tax purposes).

145. See *IT&T v. Holton*, 247 F.2d at 184; *Herzog & Zweibel*, *supra* note 32, at 94-97.

146. See *Costello v. Fazio*, 256 F.2d 903 (2d Cir. 1958); *IT&T v. Holton*, 247 F.2d at 179, 184.

147. See *Weinberg*, *supra* note 144, at 115.

148. *IT&T v. Holton*, 247 F.2d at 184 ("When the subsidiary is thus launched by the parent with an entirely inadequate capitalization and with congenital insolvency, it would be highly inequitable to allow the parent to share with creditors on the basis of an indebtedness, which represents in reality nothing but its investment of risk capital.").

149. *Herzog & Zweibel*, *supra* note 32, at 96 (insufficient capitalization when "loans" are made to debtor may lead to their recharacterization as capital contributions in debtor's bankruptcy); *Gleick*, *supra* note 74, at 611, 612-13, 620-21 (bankruptcy courts may treat alleged debts as contributions to capital where debtor is undercapitalized); I.R.C. § 385(b)(3) (1988) (debt/equity ratio can be considered in formulating regulations on whether an interest in a corporation is stock or debt); *Slappy Drive Indus. Park v. United States*, 561 F.2d at 582; *Plumb*, *supra* note 78, at 507-19 ("thin capitalization" is a major factor in considering debt/equity status for tax purposes).

150. Subordination, depending upon the parties' agreement, can take various forms. At one extreme is "complete" subordination, which bars any payments to the subordinated creditors, regardless of circumstances, until the debtor fully pays more senior creditors. This type of subordination is rare, and exists primarily in cases in which the subordinated creditors are insiders of the debtor. It is not the usual form of junk-bond subordination. See *Reade H. Ryan, Jr., The Subordinated World of Junk Bonds*, 105 *BANKING L.J.* 4, 5 (1988). The other broad division for subordination has been called "inchoate" subordination in one analysis, see *Calligar*, *supra* note 43, at 377, and "contingent" subordination in a more recent study. *Carlson*, *supra* note 88, at 983. In this type of subordination, the subordinated creditors receive payments from the debtor under the terms of their instrument until an event of default occurs on the senior debt. After the default, the debtor must make all payments otherwise due on subordinated debt to the senior creditors until the default is cured or the debtor fully satisfies the senior creditors' claims. In such cases, the subordinated creditors are normally deemed to hold any post-default payments that they receive

subordinated debt an equity-like cushion for the senior debt to which it is subordinated.¹⁵¹ A bankruptcy court, in considering how to characterize an issue of subordinated debt, must consider whether the fact of subordination, by itself or in combination with other factors, justifies treating the subordinated debt as equity with respect to all other debt.

Tax law has long treated subordination as an important factor in determining whether a "debt" claim actually constitutes equity for tax purposes.¹⁵² Nonetheless, subordination, in and of itself, is a normal practice that provides advantages for debtors, senior creditors and junior creditors.¹⁵³ It should not, therefore, constitute grounds for recharacterization of debt as equity if present in simple form (i.e., absent multiple subordination), and if there are no further equity characteristics present in the instrument.

Subordination, however, can exist under different circumstances, which may have different consequences in characterizing the instrument as debt or equity.

a. Debt Subordinated With the Consent of Subordinated Creditors

Most subordinated debt originates in subordinated form; the subordination occurs with the consent of its holders.¹⁵⁴ This is significant for purposes of this analysis because it indicates that the original parties to the instruments entered their agreement with certain expectations as to the advantages and detriments of the subordination. Buyers of originally subordinated instruments clearly bargain for higher risk than those buying senior debt. The question that must be resolved for purposes of the

(including distributions from the debtor's bankruptcy estate) for the benefit of the senior creditors (who thus receive "double dividends" in the debtor's bankruptcy—their pro rata share of the debtor's estate, plus the share of the subordinated creditors, up to the full amount of the senior creditors' claims against the debtor). *Id.* at 983-86. Since junk bond subordination is of the latter type, this Article shall generally consider subordination to follow this pattern unless otherwise specified.

151. See H.R. REP. NO. 54(1), 101st Cong., 1st Sess. 298 (1989) (certain forms of subordinated debt constitute "capital" that protects depository institutions by providing a "cushion" to absorb losses); Robert W. Johnson, *Subordinated Debentures: Debt That Serves As Equity*, 10 J. FIN. 1, 2, 10 (1955) (subordinated debt functions as equity for purposes of senior lenders); Sheppard, *supra* note 29, at 1146 (investment bankers consider subordinated debt to be "functionally equivalent" to preferred stock).

152. I.R.C. § 385(b)(2) (1988); Plumb, *supra* note 78, at 497-99.

153. See Carlson, *supra* note 88, at 983-86.

154. See, e.g., Calligar, *supra* note 43; REED, *supra* note 49, at 157, 161, 185-95.

debt/equity issue, however, is whether they are bargaining for so much risk that the court should consider that they actually have taken an equity position in the issuer. Of course, this risk relates to the rest of the issuer's capital structure, and particularly to the risk that the issuer's trade and involuntary creditors take.

b. Debt Subordinated Without the Express Consent of Its Holders

A more difficult issue arises when the issuer subordinates debt without the express consent of its holders. Normally, issuers offer such debt to the public, not with clauses deliberately subordinating its holders' claims to those of other debt holders, but merely without covenants barring the issuer from incurring new senior debt.¹⁵⁵ The issuer in fact may subsequently incur purportedly senior debt. In a subsequent bankruptcy case, the court must decide whether the instruments creating the purportedly junior debt implied the subordination. Given the severe consequences of subordination, even absent possible recharacterization, equitable considerations suggest that the court should respect subordination of this kind only if the parties clearly so intended at the time they created the junior debt.¹⁵⁶ Furthermore, courts should not weigh such implied subordination in the same way as express subordination in considering whether debt actually constitutes disguised equity.

c. "Structurally Subordinated" Debt

Debt may be subordinated de facto as well as by express subordination agreements. The most common method for such subordination is the security agreement, which in effect subordinates unsecured creditors to secured creditors with respect to specific assets of the debtor.¹⁵⁷ Security interests on substantially all of the issuer's property may as effectively subordinate unsecured creditors' claims as if they had entered express subordination agreements with the secured creditors.

A second kind of structural subordination may arise from the formal structure of a corporate group. In such a group, creditors of a parent corporation have no direct claim to the assets of a subsidiary. Their claim instead is limited to the subsidiary's stock that the parent owns.

155. Junk bond indentures often restrict the issuer's right to issue new debt senior to the debt the indentures create. See REED, *supra* note 49, at 161. The absence of such restrictions therefore creates some doubt that the parties drafting the indenture really intended it to create debt.

156. See Herzog & Zweibel, *supra* note 32, at 92.

157. See REED, *supra* note 49, at 117-18, 121-22.

Because stockholders' interests are subordinate to the claims of the subsidiary's creditors, the parent's creditors' claims are structurally subordinate to those of the subsidiary's creditors.¹⁵⁸ When a parent corporation holds little or no property except its stock in subsidiaries, and when the parent issues substantial unsecured debt—a frequent situation in LBO financing—the parent's unsecured creditors are effectively subordinated to the creditors of the operating subsidiaries.¹⁵⁹

d. Multiple Subordination

Highly leveraged debtors may create hierarchies of debt subordination. A creditor may be multiply subordinated as the result of subordination to more than one senior creditor at the same level, or subordination to one or more senior creditors who in turn are subordinated to other creditors.¹⁶⁰ The latter type of multiple subordination especially will increase the uncertainty of payment to creditors at the deeper levels of subordination, making their claims look far more like equity interests.¹⁶¹

Multiple subordination may be express or based on one or more layers of structural subordination—a frequent circumstance in large LBOs.¹⁶² If, for example, there are three layers of debt—bank debt secured by substantially all the debtor's property, “mezzanine” unsecured debt,¹⁶³ and junk bond debt subordinated to the “mezzanine” debt—the lowest layer will be multiply subordinated even in the unlikely case that it is not expressly subordinated to the bank debt. The same is true when structural subordination occurs based on the corporate structure of a group of corporate affiliates. Structural subordination may add several layers to a hierarchy of subordinated securities.

The ultimate case of multiple subordination is global subordination:

158. *Id.* at 193-95.

159. *See, e.g.*, The Cooper Companies, Inc., Senior Extendible Notes due 1/1/93, 79 MOODY'S BOND SURVEY 4338-39 (1987).

160. *See REED supra* note 49, at 157 (junk debt may include both senior subordinated debt and junior subordinated debt, the latter being subordinated to the former).

161. *See Johnson, supra* note 151, at 15 (junior subordinated debt resembles preferred stock); Weinberg, *supra* note 144, at 116.

162. *See Weinberg, supra* note 144, at 116 (multiple levels of debt are normally needed for large LBO's).

163. *See BRUCK, supra* note 24, at 98-99. When there are multiple levels of subordinated debt, mezzanine debt may consist of senior subordinated debt. *See REED, supra* note 49, at 118. The term “mezzanine debt,” Wall Street argot rather than a technical term, also has been used to designate all debt junior to senior secured debt in the LBO context. Its intermediate status, when so used, is between such senior debt and preferred or common stock. *See Sheppard, supra* note 30, at 1143.

the subordination of a claim to all other claims against the debtor. Because universal subordination is a major characteristic of equity, a claim of this type is almost certainly equity rather than debt.¹⁶⁴ While such recharacterization will not make any real difference in determining the relative priorities between holders of globally subordinated claims and other claim holders, it may significantly affect the validity of interest payments on such claims, voting rights in a reorganization case, and fraudulent transfer issues.¹⁶⁵

3. *Debt With Other Special Characteristics*

a. *Excessive Interest Rates*

High interest rates are the most important single characteristic of junk bonds; the most frequently used alternative term for these instruments is, after all, "high-yield bonds."¹⁶⁶ While high yield is not necessarily a sufficient reason to recharacterize a security as equity, the yield may be so high that it actually represents a residual claim on corporate profits, rather than a creditor-type claim on which unconditional payment reasonably can be expected.¹⁶⁷ Because an extremely high yield is one of the most important and obvious features of a junk bond, the yield should be one of the most decisive factors in deciding whether to recharacterize a particular security. A yield that far exceeds prevailing market rates for corporate bonds with the lowest investment grade ratings¹⁶⁸ could readily justify recharacterization, particularly if combined with some of the other factors enumerated here. The ease with which even an unsophisticated observer can ascertain that a given interest rate greatly exceeds rates available on conventional debt makes action of this kind more fair to investors than reclassification based on less readily ascertainable factors.

164. See *Scriptomatic, Inc. v. United States*, 555 F.2d 364, 370 (3d Cir. 1977).

165. See *infra* Section VI.B.

166. See, e.g., Asquith, *supra* note 21, at 923 and *passim*; Taggart, *supra* note 21, at 5; BRUCK, *supra* note 24, at 39 and *passim*.

167. See *Scriptomatic, Inc. v. United States*, 555 F.2d at 370 n.7; Plumb, *supra* note 78, at 439-440; Weinberg, *supra* note 144, at 116 (interest rate should not be so high as to indicate that a commercial lender would be unlikely to approve such a loan, or that interest payments could not be met given management earnings projections).

168. While courts faced with this question will decide on a case-by-case basis whether to reclassify a given junk bond, a yield 30% higher than the current rate for BBB-rated securities of comparable maturity should justify careful scrutiny of the instrument in question.

b. Deferred Interest: Original Issue Discount and Payment in Kind

Junk bonds may offer their high yields on a deferred basis. This may be done in several ways: 1) by offering the bonds at an original issue discount (OID)¹⁶⁹ rather than by regular interest payments commencing at a normal period after the initial offering; 2) by commencing of interest payments more than a year after the initial offering, resulting in a hybrid of OID and subsequent interest payments;¹⁷⁰ and 3) by paying interest in kind rather than in cash ("paid-in-kind" or "PIK" in Wall Street jargon). Issuers usually pay PIK interest in the form of other securities.¹⁷¹ These include "mini-bonds"—further promises to pay the holder at a later date—and common or preferred shares in the issuer.¹⁷² In either case, PIK interest represents a combination of present and deferred income, and the underlying securities therefore compensate their holders similarly to those in category (2).

While the use of discount, as opposed to periodic interest payments, should not in itself require recharacterization of discounted securities as equity,¹⁷³ the use of discount in combination with a long maturity date generally increases risk,¹⁷⁴ and makes final payment heavily contingent on issuer performance. In fact, the issuer's inability to meet current payments is the most likely reason for the interest-payment deferral.¹⁷⁵ Such absence of liquidity leads to further concern that defaults may occur when deferred obligations finally do mature.¹⁷⁶ Therefore, courts

169. When firms issue debt securities at a discount, the discount is described as original issue discount or "OID." If original issue discount makes up the entire compensation to purchasers of the securities—if, in other words, the issuer will not make periodic interest payments—the securities also may be described as "zero coupon" debt. See *In re Chateaugay Corp.*, 109 B.R. 51, 55 (Bankr. S.D.N.Y. 1990); BRUCK, *supra* note 24, at 267-68.

170. See Sheppard, *supra* note 30, at 1144.

171. See *Junk's House of Cards*, THE ECONOMIST, Feb. 3, 1990, at 83-84.

172. Major issuers of PIK bonds include Greyhound Lines, RJR Nabisco (pursuant to its LBO), Community Newspapers, and MCorp. Roger Lowenstein, *Rise of a Junk Play*, WALL ST. J., June 4, 1990, at C2.

173. It would be unreasonable, after all, to view Treasury bills, sold at a discount, as anything but pure debt.

174. Note, for example, the higher variability of the value of "stripped" securities, which separate principal from interest obligations. See, e.g., Taylor, *supra* note 101, at 850-52.

175. Professor Louis Lowenstein has characterized zero coupon junk bonds, particularly in the LBO context, as "superjunk," because an issuer bases its use of OID in this context on its inability to make interest payments *ab initio*. Louis Lowenstein, *Introduction and Foreword: Lessons for Wall Street from Main Street*, 15 J. CORP. L. 161, 164-65 (1990).

176. Lowenstein, *supra* note 172, at C2; *Junk's House of Cards*, *supra* note 171, at 83.

generally should weigh the debtors' use of discount, particularly over a long period, in favor of equity characterization.

c. Variable Interest

Interest may be variable as well as fixed. Given the economic climate of the last decade, during which prevailing interest rates have varied significantly, an increasing number of financial instruments have been issued with variable interest rates.¹⁷⁷

Instruments issued with interest rates that vary based upon purely external factors—such as prime rates set by certain major financial institutions on given dates—should not therefore be subject to recharacterization as equity, even though the variability may increase the risk of issuer default in periods of rising interest rates. Variability of this kind makes the instruments more attractive to risk-averse investors, by addressing the concern that the instrument's secondary-market value will decline in a climate of rising interest rates.¹⁷⁸ In so doing, externally adjusted rates address a debt-oriented concern, rather than the profit-oriented concern of equity-flavored instruments.

On the other hand, if issuer management has discretion to adjust interest rates, or if interest rates are adjusted based on circumstances internal to the issuer, the variability takes on a contingent quality and raises the issues discussed below.¹⁷⁹

d. Contingent Interest

One of the chief features of ordinary debt is that it carries an absolute promise to pay interest on certain dates.¹⁸⁰ Making interest payments contingent on certain future events therefore tends to make an instrument with such features bear less resemblance to paradigmatic debt. The nature of the contingencies will help determine whether the instrument is so far from the debt paradigm that a court should recharacterize it as equity.

177. See Fabozzi & Sauvain, *supra* note 18, at 317-18.

178. *Id.*

179. See *infra* Sections V.A.3.d and V.A.3.e. The indenture may, however, limit managerial discretion by giving debt-holders the right to force the issuer to redeem their bonds after the issuer changes the interest rate. See, e.g., proposed issue of senior extendible notes by Seminole Kraft Corp., 79 MOODY'S BOND SURVEY 5203-04 (1987). Such limitation would reduce the impact of issuer discretion, strengthening the argument for characterizing such instruments as debt.

180. See *supra* notes 122-27 and accompanying text; Plumb, *supra* note 78, at 404, 430-31.

Contingencies are least troublesome when fixed in the original junk bond indenture, and when based on factors external to the issuer, such as prevailing interest rates and market conditions. They raise more serious questions when based on factors over which the issuer has control, depending on the degree of such control. The issuer's payment status on senior debt, for example, involves less issuer control than does its overall debt/equity ratio at various time intervals. As the issuer's control over the contingencies increases, and as the contingencies become more directly related to the profitability of the issuer's business, the equity flavor of the instrument increases.¹⁸¹ Equity characteristics begin to predominate as the issuer's management acquires discretion over the payment of the issuer's obligations on a debt instrument; at that point, the payments begin to look more like dividends than payment of interest and principal.¹⁸²

e. Availability of Additional Return

Similarly, the amount of interest and repaid principal is normally a sum certain on pure debt instruments. If purported debt instruments make additional return available under certain circumstances, they may begin to assume equity characteristics in important ways; indeed, one of equity's chief advantages over debt is the availability of an "upside" to its holders.¹⁸³

The least controversial type of additional return takes the form of interest penalties. If the rate of interest is subject to increase on the issuer's default or other noncompliance with indenture terms, the increase actually serves to protect the debt characteristic of certainty of payment. Such provisions, therefore, should not add significant equity flavor to a junk bond issue.

At the other extreme are provisions that make additional interest payable based on the issuer's profits. This kind of participation in profits is, as noted above, a strong equity characteristic.¹⁸⁴ While the addition of such participation to an otherwise fixed interest rate in itself will not be

181. See *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 698 (3d Cir. 1968); *Talbot Mills v. Commissioner*, 146 F.2d 809, 811-12 (1st Cir. 1944), *aff'd sub nom. John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946); Johnson, *supra* note 151, at 13.

182. See *Wetterau Grocer Co. v. Commissioner*, 179 F.2d 158, 160 (8th Cir. 1950) (payment of interest at directors' discretion, subject to corporation's earnings, was more characteristic of dividends than of interest); Plumb, *supra* note 78, at 430-32.

183. See *supra* notes 125-27 and accompanying text.

184. *Id.*

decisive for purposes of recharacterization, a court needs to consider the participation in the context of the terms of the instrument. If, for example, the underlying interest rate is unrealistically low for an instrument of its risk level, then the buyer of such an instrument will look more toward participation than a fixed rate of return, and the instrument will take on a stronger equity flavor. Provisions of this kind could, *inter alia*, act as a substitute for more conventional features such as convertibility. Moreover, a court must consider these features in the presence or absence of the other characteristics described in this section. For instance, a long-lived instrument in which profit participation compensates for abnormally low interest rates, combined with other features such as management discretion, may come very close to being a pure equity instrument.

f. Long Maturity Dates

The longer the span between issue and final principal repayment, the more uncertain the final repayment and the more the underlying issue resembles equity.¹⁸⁵ Maturity, as a factor in the debt/equity equation, covers a spectrum running from the ultimate paradigm of debt, the demand note,¹⁸⁶ to instruments that give the holder no right to principal repayment at any time, thus conforming to an ultimate paradigm of equity investment.

Long maturity dates normally should not force recharacterization in and of themselves, although an "unreasonably long" term in relation to the business of the issuer might have that effect.¹⁸⁷ It is more likely that the combination of long maturity, high risk, and other factors such as deferred interest and convertibility will indicate that the instrument is really equity.

g. Stretchout Provisions

Stretchout provisions enable the issuer to delay otherwise-required principal and interest payments.¹⁸⁸ They are of potentially significant

185. See *Slappy Drive Indus. Park v. United States*, 561 F.2d 573, 581 (5th Cir. 1977) (because a lender stands to gain only a fixed interest rate, it would not be likely to take risk associated with committing its funds "for a prolonged period").

186. A demand note is payable at any time on the creditor's demand. Commercial bankers holding senior debt generally prefer that the debtors repay the loans in five years or fewer. See Sheppard, *supra* note 30, at 1143.

187. See Plumb, *supra* note 78, at 415-20.

188. See Larry Light et al., *Yesterday's Bad Deals Are Today's New Business*, BUSINESS WEEK, Dec. 11, 1989, at 96.

value to an issuer uncertain of the prospects for its business or of its ability to sell key assets to service its debt. By thus asserting issuer control, stretchout provisions diminish holders' rights to payments on dates certain, increase the contingency of payments on issuer discretion and performance, and thereby tend to weigh in favor of equity characterization. Tax jurisprudence has endorsed this view,¹⁸⁹ and no good reasons suggest drawing different conclusions in the bankruptcy context.

h. Convertibility to Equity

(I) At Instance of Holders

Long before the emergence of a distinct market for junk bonds, and at least as early as the late nineteenth century,¹⁹⁰ corporate debtors issued instruments whose features included convertibility to equity shares at prices fixed in advance.¹⁹¹ This kind of convertibility in itself made instruments of this kind debt/equity hybrids, raising questions as to whether, for corporate law purposes, such instruments constituted debt or equity.¹⁹² Policy considerations under bankruptcy law are significantly different, but convertibility at the holder's instance is nonetheless a factor courts should weigh in the overall determination of whether the securities bearing the feature constitute equity for bankruptcy purposes.

(II) At Instance of Issuers

Debt securities convertible to equity at the instance of the issuer are significantly different from securities convertible at the instance of the holder. Courts should treat debt convertible to equity at the issuer's option as equity even absent other equity characteristics;¹⁹³ the issuer's option effectively gives it control of whether to pay on the securities, and

189. Plumb, *supra* note 78, at 417-418.

190. See *Sutliff v. Cleveland & Mahoning M.R.R.*, 24 Ohio St. 147 (1873); *John Hancock Mut. Life Ins. Co. v. Worcester, N. & R. R.R.*, 149 Mass. 214, 215 (1889) (convertible bonds issued 1874 pursuant to 1873 New Hampshire statute); *Day v. Worcester, N. & R. R.R.*, 23 N.E. 824 (Mass. 1890) (convertible bonds issued 1874 pursuant to 1873 New Hampshire statute); *Pratt v. American Bell Tel. Co.*, 5 N.E. 307-308 (Mass. 1886) (convertible notes issued 1882); *Parkinson v. West End St. Ry.*, 53 N.E. 891 (Mass. 1899); Bratton, *Convertible Bonds*, *supra* note 67, at 682-83.

191. See William A. Klein, *The Convertible Bond: A Peculiar Package*, 123 U. PA. L. REV. 547 (1975).

192. See Bratton, *Convertible Bonds*, *supra* note 67, at 682-83; Klein, *supra* note 191, at 559-60, 562, 567, 570 (issuers have tended to view traditional, i.e., non-junk, convertible bonds as deferred equity financing).

193. See *Covey Inv. Co. v. United States*, 377 F.2d 403, 405 (10th Cir. 1967) (where issuer had option to convert notes to common stock, notes were equity for tax purposes).

deprives holders of the basic hallmarks of debt: rights to payment of interest and principal. This analysis also applies to securities, nominally convertible to equity at the holder's option, whose economic terms make conversion *de facto* mandatory.¹⁹⁴ Therefore, convertibility should at least attach to such securities a rebuttable presumption that they are disguised equity.

(III) At Instance of Third Parties

Certain debt may also be convertible to equity at the instances of third parties such as affiliates of the issuer or senior lenders. Courts should consider the identity of such parties and their relationship to the issuer in determining the impact of such convertibility on the status of the debt subject to conversion. Convertibility at the instance of an issuer's parent, for example, could be considered analogous to convertibility at the issuer's option, while convertibility at the instance of a senior lender might more closely resemble conventional subordination.

i. Control

Control over an issuer's management, an important equity characteristic,¹⁹⁵ is typically not a junk bond feature, except as a default right. This absence should not, in and of itself, be treated as a factor for debt characterization, however, since absence of control except on default is a common feature of preferred stock, the equity status of which is normally subject to little question. The presence of unusual control rights¹⁹⁶ in a junk bond issue, however, would weigh strongly in favor of equity characterization.

j. Security Interests

The presence of a security interest in certain collateral is normally strong evidence that the instrument in question is debt.¹⁹⁷ Nonetheless, deep subordination of secured debt¹⁹⁸ may make the security illusory.

194. See Taylor, *supra* note 101, at 857 (where issuer had right to call convertible notes at substantially less than par value, there was "very high probability" of conversion, resulting in IRS ruling that notes constituted equity).

195. See Plumb, *supra* note 78, at 447-50.

196. For instance, a right to vote for one or more directors when the issuer is not in default, or more than conventional debtholders' rights on default.

197. See Plumb, *supra* note 78, at 466-70.

198. Subordination of debentures will not itself prevent the parties from securing such debentures. *Midwest Sav. Ass'n v. National W. Life Ins. Co.*, 758 F. Supp. 1282, 1287 (D. Minn. 1991).

Moreover, if the circumstances under which the parties created the instrument indicate that they really intended to give the "lender" an equity-type interest, a security interest alone will not transform that interest into debt.¹⁹⁹

In this context, it is worth noting that firms have been known to use security interests to make certain the payment of dividends and liquidation preferences on preferred stock. Although security interests of this kind would be ineffective as against genuine creditors of the issuer, they could protect their holders against other shareholder classes, and their mere presence has not necessarily led courts to reclassify such instruments as debt.²⁰⁰ Therefore, the presence of a security interest should not, without more, preclude reclassification of a purported debt instrument as equity, if its other characteristics strongly indicate that the parties intended that the secured party have an equity-type interest.

k. Call and Redemption Rights

Call and redemption rights permit the termination of bond contracts before the normal maturity dates of the issues in question. Call rights are present in most junk bond issues.²⁰¹ They permit an issuer to terminate its obligation on a bond issue, prior to its normal maturity date, by paying all principal and interest due at the time of the call, often with a slight additional amount added as a premium.²⁰² A bondholder with redemption rights²⁰³ can force the issuer to pay off all interest and principal

199. *IT&T v. Holton*, 247 F.2d 178, 184 (4th Cir. 1957)(mortgage indebtedness subordinated to claims of general creditors on finding by court that it was "not a loan in any true sense at all," but an "investment of risk capital," i.e., an equity-type interest).

200. *See Warren v. King*, 108 U.S. 389 (1883)(nature of preferred stock held not altered by provision creating lien on corporation's property to secure its dividends and liquidation preference); *Toledo, St. L. & K. C. R.R. v. Continental Trust Co.*, 95 F. 497 (6th Cir. 1899) (provision in preferred stock agreement making it a lien on the corporation's property held valid). *See also Arnold v. Phillips*, 117 F.2d 497, 502-03 (5th Cir. 1941) (mortgage on corporation's property purporting to secure equity interest held ineffective "as against creditors"); *Dayton & Mich. R.R. v. Commissioner*, 112 F.2d 627 (4th Cir. 1940) (preferred stock held equity for tax purposes despite mortgage securing dividends thereon).

201. *Asquith*, *supra* note 21, at 936.

202. *See HENN & ALEXANDER*, *supra* note 18, at 393-94; *Bratton, Convertible Bonds*, *supra* note 67, at 678.

203. An issuer redeems a bond by paying its principal before the bond's stated maturity date. *See* 6A WILLIAM MEADE FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 2731 (rev. perm. ed. 1989). A call right, as noted above, is the issuer's right to redeem at or after a given date without penalty beyond that stated in the bond indenture itself. The indenture also may give the holder the power to compel the issuer to redeem the bond at a date prior to its stated

at the holder's option.²⁰⁴ By shortening the life-span of an issue, both call and redemption rights tend to support debt characterization; they bring the issue closer to the ultimate paradigm of the demand note.

Call rights also serve to limit equity-like features such as conversion rights by giving the issuer the right to force the use or loss of such rights at the time most favorable to the issuer.²⁰⁵ In the junk bond context, they not only serve the classic purpose of limiting the value of conversion privileges,²⁰⁶ but they also give the issuer the right to terminate payment of high interest rates as soon as the issuer is able to obtain financing at lower rates. Consequently, they serve to limit the rights of holders to any residual income of the issuer, thus reducing the weight of one of the most important equity characteristics that junk bond issues may have.

Call rights themselves, however, may have little effectiveness if the issuer lacks the wherewithal to exercise them. If, at the time of issue, the issuer's ability to exercise call rights is unclear in the short run, their mere existence should not weigh heavily toward debt characterization.

It should also be noted that call and redemption rights often appear in preferred stock issues, and do not force recharacterization of such issues as debt.²⁰⁷ Call and redemption rights are thus factors a court should weigh on the side of debt characterization; they are not in themselves decisive.

1. Substitution for Equity

Junk bonds often directly or indirectly replace securities that issuers formally labelled equity. In LBOs in particular, firms raise capital through junk bonds to pay off the shareholders they buy out.²⁰⁸ Junk bonds' replacement of equity securities invites even closer scrutiny as to

maturity. This Article uses the term "redemption right" to distinguish this right in a bondholder from the issuer's call right.

204. The right to compel redemption, often described as a "put," can be a useful supplement to bond covenants in protecting the bondholder by giving the bondholder the right to have his or her bonds redeemed if the issuer fails to comply with certain conditions of creditworthiness. The bondholder may, for example, have the right to compel redemption if the issuer terminates certain contracts with third parties, or if a specified third party ceases to be a major shareholder in the issuer. See, e.g., *Seminole Kraft Corp.*, senior extendible notes due Sept. 15, 1999, 79 MOODY'S BOND SURVEY 5203-04 (1987).

205. See Bratton, *Convertible Bonds*, *supra* note 67, at 678-80.

206. *Id.*

207. See Plumb, *supra* note 78, at 451.

208. See Booth, *supra* note 31, at 556-57; Weinberg, *supra* note 144, at 112-13.

whether they should be treated as equity.²⁰⁹

The other most frequent instance in which junk bonds replace equity securities occurs when they are issued pursuant to an exchange offer for the latter. This situation will be discussed separately below.²¹⁰

m. Sinking Fund Provisions

Sinking fund provisions allow the debtor to set aside certain amounts, in advance of actual payment dates, for the payment of debt obligations.²¹¹ Because sinking funds serve to make the eventual payment of such obligations more certain,²¹² their presence tends to support debt characterization.²¹³ Nonetheless, a bankruptcy court should not rely on the mere existence of a sinking fund to treat as debt an instrument that otherwise strongly resembles equity.²¹⁴ In such cases, the court should use the sinking fund accounts to satisfy higher priority claims until the latter claims are paid in full.²¹⁵

n. Presence or Absence of Protective Covenants

Since courts historically have based protection of bondholders' rights more upon their contracts with the issuer than upon inherent duties that the debtors' management owes to bondholders,²¹⁶ the bondholders rely heavily on protective covenants in the instruments creating the debt.²¹⁷ Covenants of this kind have become highly standardized.²¹⁸ The most

209. See *Costello v. Fazio*, 256 F.2d 903 (2d Cir. 1958); *IT&T v. Holton*, 247 F.2d 178, 179, 184 (4th Cir. 1957); *Wetterau Grocer Co. v. Comm'r*, 179 F.2d at 160 (payments on "notes" issued in exchange for preferred stock held dividends rather than interest for tax purposes); *Talbot Mills v. Comm'r*, 146 F.2d at 810-12.

210. See *infra* section V.C.

211. See HENN & ALEXANDER, *supra* note 18, at 394 n.29.

212. See FLETCHER, *supra* note 203, at § 2732.

213. See Plumb, *supra* note 78, at 466-70.

214. See *In re Hawkeye Oil Co.*, 19 F.2d 151, 152 (D. Del. 1927) (bankruptcy court characterized securities as equity despite sinking fund support for payments to their holders); *United States & Mexican Oil Co. v. Keystone Auto Gas & Serv. Co.*, 19 F.2d 624, 625-26 (W.D. Pa. 1924) (certificates supported by deposits designated as "sinking fund" or "bond fund" treated as equity in bankruptcy of issuer).

215. *United States & Mexican Oil Co.*, 19 F.2d at 626.

216. See Bratton, *Convertible Bonds*, *supra* note 67, at 668-69, 685-88.

217. See Lehn, *supra* note 19, at 173, 177; Bratton, *Corporate Debt Relationships*, *supra* note 2, at 117, 139-42; REED *supra* note 49, at 144-50.

218. See Bratton, *Convertible Bonds*, *supra* note 67, at 686-91; Bratton, *Corporate Debt Relationships*, *supra* note 2, at 105 n.42, 117; REED *supra* note 49, at 158-62; AMERICAN BAR FOUNDATION, CORPORATE DEBT FINANCING PROJECT, COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS: (1965); MODEL DEBENTURE INDENTURE PROVISIONS: ALL REGISTERED ISSUES:

important covenants for our purposes reinforce debt characteristics by preventing corporate management from demoting the securities that they protect to more subordinated status, and by generally making payment of the instruments that they protect more certain.

Covenants of this kind include negative pledge clauses, which limit the issuer's rights to grant liens on its property,²¹⁹ and which thereby protect debt holders from structural subordination to additional secured creditors.²²⁰ Closely related to negative pledge clauses are covenants that limit the issuer's rights to engage in sale and leaseback transactions, which encumber property in ways that are often hard to distinguish from secured loans.²²¹

Other important covenants limit the issuer's right to incur additional debt, including debt senior to that which the covenants in question protect, and debt of equal seniority with the protected debt. Such protection may be absolute, i.e., barring the issuer from issuing any debt in a given class, or may require that the issuer meet certain tests, such as possession of specified amounts of tangible net worth in proportion to permitted, newly issued additional debt.²²²

Covenants also protect debt by limiting the issuer's ability to make distributions to lower-ranking security holders. The most important distributions of this kind are dividends paid to stockholders and repurchase by the corporation of its own stock. As with limitations on incurring new debt, limitations of this kind can absolutely prohibit the distributions in question, or can condition the distributions on issuer compliance with certain financial prerequisites that assure that the issuer will have assets sufficient to pay the protected debt even after it makes distributions to junior security holders.²²³

The absence of key protective covenants, noteworthy in many junk bond indentures,²²⁴ not only indicates that the junk bonds in question lack important debt characteristics, but also makes the holders more sub-

AND CERTAIN NEGOTIABLE PROVISIONS WHICH MAY BE INCLUDED IN A PARTICULAR INCORPORATING INDENTURE (1971) [hereinafter ABF COMMENTARIES].

219. See, e.g., ABF COMMENTARIES, *supra* note 218, at 349-367.

220. See *supra* Section V.A.2.c.

221. See, e.g., ABF COMMENTARIES, *supra* note 218, at 432-449.

222. *Id.* at 368-400.

223. *Id.* at 401-21.

224. See, e.g., REPORT, *supra* note 19, at 24 (Metromedia replaced much of the bank financing for its LBO with junk bonds, reducing its interest rates as well as freeing it from important restrictive covenants).

ject to the discretion of the issuer's management. The absence of covenants may therefore indicate that the parties to the instrument intended to create an equity rather than a debt relationship.

o. Holders' Rights on Issuer's Default

Why and when bondholders²²⁵ may declare a bond issuer in default, and the bondholders' rights upon the declaration of default, are important in protecting their interests against the issuer.²²⁶ The unconditional nature of a debt obligation requires that, at the very least, bondholders be able to declare a default upon any issuer failure to pay interest or principal, and in the event that the issuer defaults on any of its other obligations.

The bondholders' ability to call a default on the issuer's breach of important protective covenants further reinforces the debt-like nature of an instrument,²²⁷ since absence of such a right could largely vitiate such covenants. "Hair-trigger" provisions may also support debt characterization for an instrument. These provisions enable bondholders to call a default before an actual cessation of payments, based on the issuer's failure to comply with certain minimum requirements as to its financial condition, or based on some harm that threatens the issuer's ability to continue payment.²²⁸ Hair-trigger provisions enable debt holders to maximize chances of recovering all that the issuer owes them by letting holders assert their rights while the issuer still has assets against which they can realize their claims. Provisions of this type also give debt holders greater bargaining power against the issuer's management, particularly in workout situations.

The absence of such provisions, particularly the right to call defaults on the issuer's breach of its payment obligations, may indicate that the parties intended an equity rather than a debt relationship. The absence or attenuation of key rights on default, particularly the right to accelerate the entire indebtedness protected by the default provisions,²²⁹ make default provisions useless and therefore may suggest that the parties intended an equity relationship.

225. Under usual circumstances, a corporate bond-issue trustee acts for the bondholders.

226. See REED, *supra* note 49, at 150-52; see also, WILLIAM SHAKESPEARE, JULIUS CAESAR act I, sc. ii ("[De]fault, dear Brutus, is not in our stars but in ourselves").

227. See *supra* Section V.A.3.n.

228. See, e.g., ABF COMMENTARIES, *supra* note 218 at 212-16.

229. See *id.* at 217-19.

p. Proportionality to Common Stock Holdings

In the tax context, the issuance of "debt" to shareholders of the issuer, in proportion to their shareholdings, is considered a strong indication that the "debt" may actually represent equity interests.²³⁰ This is also a strong indication of equity status in the bankruptcy context;²³¹ but because junk bonds normally represent an effort to raise capital from sources other than the common stockholders of the issuer, the proportionality issue is unlikely to arise for most junk bond issues.

B. "Fallen Angels"

"Fallen angels" were among the original junk bonds.²³² They are debt securities, originally issued with investment-grade ratings, that the rating agencies downgraded for any of a number of reasons.²³³ The reasons may have nothing to do with the characteristics of the security, but instead simply may reflect changes in the credit characteristics of the issuer. On the other hand, downgrading may reflect the rating agencies' realization of flaws inherent in the instrument downgraded. The agencies also might recognize, in light of changing circumstances such as an LBO or leveraged recapitalization, that a particular instrument has weaker credit characteristics not just because of increased leverage on the part of its issuer, but because of features of the instrument such as a lack of protective covenants.²³⁴

230. See *Slappey Drive Indus. Park v. United States*, 561 F.2d at 583-84; *Fin Hay Realty Co. v. United States*, 398 F.2d at 696-98; *Plumb*, *supra* note 78, at 470-73.

231. See *L & M Realty Corp. v. Leo*, 249 F.2d 668, 670 (4th Cir. 1957) (the fact that a corporation allegedly owed debt to its shareholders in rough proportion to their interests in the corporation was a factor in court's holding that the alleged debt was equity interest subordinated to claims of third-party creditors in the corporation's bankruptcy); *In re Loewer's Gambrinus Brewery Co.*, 167 F.2d 318, 319 (stockholders' loans to their corporation, made in proportion to their equity holdings, subordinated to claims of third-party creditors).

232. Before a distinct market for junk bonds developed, major issuers such as Chrysler and Ford had their debt down-graded from time to time into the high-yield range, largely because adverse changes in their business made rating agencies consider their debt to be high risk. Only in 1977, however, did Lehman Brothers begin underwriting corporate debt deliberately issued with high-risk, high-yield characteristics. A market for these securities really began to develop somewhat later, when Drexel Burnham Lambert perceived strong demand for them and saw them as a means of developing its own business. REPORT, *supra* note 2, at 5-6. See also Paul C. Judge, *S. & P. Cuts Ratings of Detroit's Big 3*, N.Y. TIMES, Feb. 7, 1991, at D1 (Standard & Poor's downgrades Chrysler senior debt to junk bond level); Taggart, *supra* note 21, at 8; Floyd, *supra* note 19, at 923-24; BRUCK, *supra* note 24, at 27-28 ("fallen angels" were among the original junk bonds).

233. See, e.g., BRUCK, *supra* note 24, at 27-28. See also LEWIS, *supra* note 31, at 212-13.

234. See, e.g., Bratton, *Corporate Debt Relationships*, *supra* note 2, at 139-42 (Increased trust

Generally, if issuers initially sold bonds with investment-grade ratings under normal market conditions, there should be a strong presumption in favor of treating them as debt. For a publicly held issue, this should be an almost irrebuttable presumption, since investors in public, rated debt rely heavily on the rating and on the characteristics of the debt in deciding to invest.²³⁵ They invest in these instruments to receive a fixed rate of return at a given—and limited—level of risk, not to participate in the profits of a particular issuer. Such investors rely primarily on rating-agency research and are not well positioned to make their own investigations into the factors that, under changing circumstances, may later lead to the agencies' downgrading their securities into the junk bond category.²³⁶

C. *Exchange Offer Junk*

During the late 1980s, junk bonds often were not issued directly for cash, but instead were issued in exchange for other securities. Exchange offers for outstanding securities have become important for issuers attempting to reduce painfully heavy levels of debt, including extreme situations in which the issuer needed the exchanges to stave off defaults.²³⁷ Exchanges of this kind have become frequent enough that some major equity speculators have bought junk bonds as equity investments, with the expectation that issuers will exchange the junk bonds for equity instruments with normal features of common stock such as voting rights. In evaluating junk bond issues for possible acquisition, these speculators value the issues as they would value expressly denominated equity securities.²³⁸

Firms making exchange offers for distressed junk bonds may offer preferred or common stock in exchange for the junk bonds in question.²³⁹ They may also, however, seek to exchange other junk bonds, sometimes

during post-World War II era led to the gradual dropping of protective covenants such as restrictions on new debt, until the beginning of a new era of corporate financial restructuring in the 1980s).

235. See, e.g., McDaniel, *supra* note 18, at 238-45.

236. See, e.g., John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 745-47 (1984); Coffee, *Unstable Coalitions*, *supra* note 2, at 1510 n.51.

237. See, e.g., Asquith, *supra* note 21, at 924-25, 933-36 (distressed issuers of high-yield bonds often use exchange offers to forestall defaults); BRUCK, *supra* note 24, at 75-77, 124. See also Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 232-33, 236, 246-48 (1987).

238. Roger Lowenstein, *Rise of a Junk Play: Betting on Equity*, WALL ST. J., June 4, 1990, at C1.

239. See Roe, *supra* note 237, at 236, 241; BRUCK, *supra* note 24, at 75.

in combination with cash and/or preferred or common stock, for the distressed issue.²⁴⁰ The junk bonds that investors receive in exchange for a distressed issue usually have features that significantly differ from the bonds that they surrender. The issuer and the holders expect that these features will make it easier for the issuer to meet terms of the junk bonds. Changed features may include lower interest rates; deferred interest;²⁴¹ new convertibility into other securities of the issuer, or convertibility at more favorable rates of exchange;²⁴² removal of protective covenants, such as limits on the creation of new liens on the issuer's property and of new issuer debt senior to the instruments in question;²⁴³ limitation of holders' default remedies, and removal of conditions whose violation would enable holders of the instrument to invoke default remedies.²⁴⁴

Issuers generally attempt to induce holders to engage in these exchanges by threatening to file bankruptcy petitions if the exchange offers fail.²⁴⁵ In some cases, issuers offer positive incentives such as partial payment in cash.

While distressed-issuer exchanges are the most common exchange offers, there are several other types. Each exchange has special characteristics that must be considered in order to properly determine how to deal with the junk bonds received pursuant to the exchange under bankruptcy law.

1. *Debt Received in Exchange for Equity*

There are special considerations for debt that holders have received in exchange for other securities. Apart from theoretical considerations, a special body of legal doctrine applies to such debt, particularly under *Robinson v. Wangemann*²⁴⁶ and its progeny. The *Robinson* doctrine provides that, in bankruptcy, debt received in exchange for equity is subordinated to all other debt of the issuer.

In *Robinson*, Arthur Wangemann was a large shareholder and president of the Wangemann-Reichardt Company. In October, 1922, he exchanged an equity interest in the corporation for debt by selling the

240. See *In re Chateaugay Corp.*, 109 B.R. at 52; Asquith, *supra* note 21, at 933.

241. See *supra* Section V.A.3.b.

242. See *supra* Section V.A.3.h.

243. See *supra* Section V.A.3.n.

244. See *Roe*, *supra* note 237, at 241, 247-48; BRUCK, *supra* note 24, at 38, 74-77. See also *supra* Section V.A.3.o.

245. See BRUCK, *supra* note 24, at 75-79.

246. 75 F.2d 756 (2d Cir. 1935).

corporation 500 of its own shares and taking its note for \$55,000 in return. The corporate board duly authorized the exchange, which it made at a time when the corporation was solvent. The note was due January 1, 1923, but the corporation issued renewal notes instead of paying in full as of that date. The corporation filed for bankruptcy several years later, while at least \$32,000 in principal and an unspecified amount of interest on the debt were still outstanding. The Fifth Circuit reversed the district court's allowance of the claim of Wangemann's heir for this amount. In so holding, the court noted that both the solvency of the corporation at the time of the initial exchange, and the good faith of the parties, were immaterial to the claim;²⁴⁷ the doctrine thus does not rely on fraudulent transfer law.²⁴⁸ Rather, it is based on the premise that a corporation may not distribute assets to its shareholders at a time when any of its debts are unpaid. When a corporation makes a distribution of this kind in the form of a debt instrument—a promise to pay—such a promise necessarily includes the condition that no payment may be made until the corporation pays third-party creditors in full.²⁴⁹

The *Robinson* doctrine, though followed in other circuits and never overruled,²⁵⁰ has not been raised by trustees in bankruptcy in certain recent cases involving debt securities received in exchange for equity.²⁵¹ These omissions appear to be based on inadvertence rather than desuetude, since other recent cases follow the doctrine.²⁵²

One must also consider the particular characteristics of the exchanged securities. Certain preferred stock issues may themselves approach the debt/equity line.²⁵³ While most "preferred stock" securities are pre-

247. *Id.* at 757.

248. *See infra* Section VI.B.

249. 75 F.2d at 757-58. *See also* *McConnell v. Estate of Butler*, 402 F.2d 362, 366-67 (9th Cir. 1968) (whether payment can be made on debentures received in exchange for equity must be determined as of time payments are to be made, rather than at time of original exchange).

250. *See, e.g.*, *FDIC v. Bank of America Nat'l Trust & Sav. Ass'n*, 701 F.2d 831, 838 (9th Cir.) (*Robinson* and its progeny followed in bank receivership), *cert. denied*, 464 U.S. 935 (1983); *In re Hawaii Corp.*, 694 F.2d 179, 181 (9th Cir. 1982) (*Robinson* followed in subordinating debt received in exchange for equity); *McConnell v. Estate of Butler*, 402 F.2d 362, 366 (9th Cir. 1968) (*Robinson* followed in subordinating debentures received in exchange for equity); *In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127, 136, 140 (Bankr. D. Mass. 1989) (corporate debt incurred in exchange for redemption of stock by insiders avoided on fraudulent transfer theory, with court noting that such debt could also be subordinated under *Robinson*).

251. *See, e.g.*, *In re Allegheny Int'l, Inc.*, 100 B.R. 247 (Bankr. W.D. Pa. 1989).

252. *See supra* note 250.

253. *See* *Plumb, supra* note 78, at 450-57.

sumptively equity,²⁵⁴ this may not always be true. Therefore, if a court can fairly characterize exchanged securities as debt rather than equity, it should not apply the *Robinson* doctrine. Instead, the court should apply the analysis normally used for debt received in exchange for other debt.²⁵⁵

2. *Debt Received in Exchange for Other Debt*

a. *Same-Issuer Debt*

Where holders receive debt securities in exchange for other securities of the issuer, one must first consider the characteristics of the original securities. If the original securities had primarily equity characteristics, then the analysis will be substantially the same as that applied in cases in which holders receive debt securities in exchange for equity securities of the issuer.

If, however, the original securities clearly were debt, then the analysis should turn to the characteristics of the new securities. That the holders took the new securities in exchange for debt will not prevent them from being equity. After all, one of the chief purposes of exchange offers is to lighten burdens on the issuer, and equity-type securities are less burdensome to a distressed issuer than pure debt. Exchange offers frequently offer equity instruments in exchange for debt that has proven too burdensome;²⁵⁶ once such an exchange is made prior to bankruptcy, a bankruptcy court will give full effect to the exchange, treating the exchanging holders as having purely equity interests in the debtor.

b. *Other-Issuer Debt*

Normally, courts should treat securities holders receive in exchange for the securities of other issuers as if they had been issued for cash. Special considerations may apply, however, if the issuers are affiliated, and particularly if both are parties in the same or related bankruptcy cases.

c. *Debt Received in Exchange for Claims in a Case Under Chapter 11*

One feature of the current bankruptcy climate is that debtors increas-

254. *Id.*

255. *See infra* Section V.C.2.

256. *See* BRUCK, *supra* note 24, at 75-77.

ingly will file for bankruptcy more than once.²⁵⁷ This does not necessarily mean that the subsequent petitions are vexatious or filed in bad faith. Many of the repeat filings are by debtors who confirmed plans of reorganization in one bankruptcy case, and then, for a variety of reasons, had to file new bankruptcy petitions for the reorganized entities.²⁵⁸ Moreover, distressed debtors are increasingly turning to "prepackaged Chapter 11" bankruptcy cases in place of more traditional debt-security exchange offers.²⁵⁹ A debtor in this position is comparable to, and faces the same risks as, one who has attempted to restructure debt through an exchange offer.

The risks to a reorganized company tend to be high, and, despite complete good faith of the parties in formulating and conforming to the plan of reorganization, the reorganized corporation may itself have to file for bankruptcy. The bankruptcy court considering such a secondary bankruptcy case should, among other things, consider the status of the securities issued pursuant to the first plan of reorganization.

257. Although the Bankruptcy Code bars an individual debtor from receiving a discharge in a case commenced fewer than six years after a prior discharge, 11 U.S.C. § 727(a)(8) and (9) (1988), nothing in the Code prevents a corporate debtor from commencing a new bankruptcy case following the confirmation of a Chapter 11 plan. See 11 U.S.C. §§ 109, 301 (1988). There is, however, a judicially created doctrine that a court may dismiss a bankruptcy case if the bankruptcy petition is filed in "bad faith." See *In re Kerr*, 908 F.2d 400, 404 (8th Cir. 1990); *In re Coastal Cable T.V., Inc.*, 709 F.2d 762, 764-65 (1st Cir. 1983); *In re Lindbergh Plaza Assoc.*, 115 B.R. 202, 206 (Bankr. E.D. Mo. 1990); *In re Tinti Constr. Co.*, 29 B.R. 971, 974-75 (Bankr. E.D. Wis. 1983); Edith H. Jones, *The "Good Faith" Requirement in Bankruptcy*, 1988 ANNUAL SURVEY OF BANKRUPTCY LAW 45; Robert L. Ordín, *The Good Faith Principle in the Bankruptcy Code: A Case Study*, 38 BUS. LAW. 1795 (1983).

258. See, e.g., *In re Braniff Airlines*, 118 B.R. 819 (Bankr. M.D. Fla. 1990).

259. In a prepackaged Chapter 11, the debtor and its principal creditors work out an agreement for re-adjustment of the debtor's obligations before the debtor files its bankruptcy petition. The workout takes the form of a Chapter 11 bankruptcy reorganization plan, including the debtor's issue of new securities in substitution for its pre-plan obligations. The debtor submits the plan for approval by its creditors and interest holders simultaneously with the filing of the bankruptcy petition. Prepackaged plans of this kind, if practicable, offer greater certainty than non-bankruptcy workouts, and are less expensive to all parties than full-scale Chapter 11 reorganizations. See 11 U.S.C. §§ 1121(a), 1123, 1125, 1126 (1988); Richard L. Epling, *Exchange Offers, Defaults, and Insolvency: A Short Primer*, 8 BANKR. DEVELOPMENTS J. 15, 34-42 (1991); Claudia MacLachlan, *Prepackaged Bankruptcy Stumbles*, NAT'L L.J., Jan. 28, 1991, at 1; Diana B. Henriques, *Troubled Times on Wall Street: Future Buzzwords Rise From Ashes of the '80's*, N.Y. TIMES, Jan. 2, 1991, at D1; Paul Richter, *Corporations Learn to Tilt Bankruptcy In Their Favor*, L.A. TIMES, Dec. 7, 1990, at A1. From the first quarter of 1990 through the first quarter of 1991, at least six major corporations—Southland, Kroy, Arizona Biltmore Hotel, 14 Wall Street Associates, La Salle Energy, Circle Express, and Angelo Energy—filed and confirmed prepackaged Chapter 11 cases. 21 Bankr. Ct. Dec. (CRR) #17, at A1 and A4 (April 18, 1991).

The best analysis of such securities indicates that the court should treat them as if their issue, although in exchange for old securities of the debtor in the first reorganization case, were an initial public offering. The reorganized entity is completely new and it issues securities on the premise that, with plan confirmation having discharged its former obligations, it is viable as reorganized.²⁶⁰ Therefore, only the inherent characteristics of the reorganization securities themselves need be considered if it is necessary to examine their status in a subsequent bankruptcy case.

VI. OTHER ISSUES JUNK BONDS RAISE IN THE BANKRUPTCY CONTEXT

The debt/equity issue, while central to the treatment of junk bonds in bankruptcy, is not the only issue they raise. It does, however, substantially affect the resolution of other issues raised concerning junk bond treatment in bankruptcy.

A. *Original Issue Discount*

Even if a court does not recharacterize a junk bond issue as equity, substantial questions may arise as to the amount of claims based on such an issue that the court can allow in bankruptcy. The most important such question arises from the use of original issue discount (OID).

Claims for unmatured interest are not normally allowable in bankruptcy,²⁶¹ but the Bankruptcy Code does not provide guidance as to how courts should compute such unmatured interest when firms use original issue discount rather than periodic interest to compensate holders of debt instruments for the use of their funds.²⁶²

260. See 11 U.S.C. § 1129(a)(11) (1988) (confirmation of plan requires court finding that liquidation or further reorganization is unlikely to be needed, unless proposed by the plan); 11 U.S.C. §§ 1141(c) and (d) (1988) (with certain exceptions, confirmation of plan discharges debtor from pre-bankruptcy claims and interests, and property the plan disposed of is free of all pre-bankruptcy claims and interests).

261. 11 U.S.C. § 502(b)(2) (1988). The one exception to this rule is that interest may continue to accrue against any amount by which a claim is oversecured. 11 U.S.C. § 506(b) (1988). See also *United States v. Ron Pair Enters.* (*In re Ron Pair Enters.*), 489 U.S. 235 (1989).

262. Bankruptcy Code § 502(b)(2) (1988) merely provides that a claim is not allowable to the extent that "such claim is for unmatured interest." Neither Code § 502 nor the Code's general definitional section, § 101, define "interest" or "unmatured interest." The legislative history of the provision, of little more help, expressly notes that OID not accrued as of the date of a bankruptcy petition constitutes "unmatured interest" and therefore must be disallowed, but gives no guidance as to how to compute the interest other than a statement that it has to be "prorated." S. REP. NO. 989, 95th Cong., 2d Sess. 62 (1978). See *infra* notes 265-75 and accompanying text.

Recent cases have dealt with the OID issue at the bankruptcy court level;²⁶³ their inconsistency shows the need for a standard rule. The problems concern not whether unaccrued OID is allowable in bankruptcy—the legislative history of Bankruptcy Code section 502(b)(2) makes clear that it is not,²⁶⁴ and the courts, in the few cases decided on the issue, have consistently so held²⁶⁵—rather what the initial discount was (a problem when the holders received the discounted obligations in exchange for other obligations or securities of the debtor), and what method the courts should use in computing interest accrued between the time of issue and the filing of the bankruptcy petition.

In *In re Allegheny International, Inc.*,²⁶⁶ the court had to compute OID on junk bonds that the debtor issued, almost four years before its bankruptcy, in exchange for an issue of preferred stock.²⁶⁷ Faced with a complete lack of guidance from the Bankruptcy Code and its legislative history, the bankruptcy court declined to follow tax law.²⁶⁸ The court valued the junk bonds in question, computing their issue price for OID purposes, based on their market value on the first day of their issue; the tax rule would have valued them based on the market value of the securities exchanged for them.²⁶⁹ The court offered no bankruptcy-based reason for its rule. In computing the accrual of interest from this initial value to the date of bankruptcy, the court similarly declined to follow tax law,²⁷⁰ and computed accrual on a straight-line basis,²⁷¹ rather than applying the constant-interest method²⁷² that tax and financial accounting

263. *In re Public Service Co.*, No. 88-00043, 20 Bankr. Ct. Dec. (CRR) 850 (Bankr. D.N.H. April 13, 1990); *In re Allegheny Int'l, Inc.*, 100 B.R. 247 (Bankr. W.D. Pa. 1989); *In re Chateaugay Corp.*, 109 B.R. 51 (Bankr S.D.N.Y. 1990), *aff'd*, 1991 U.S. Dist. LEXIS 10059 (S.D.N.Y. July 23, 1991).

264. See *supra* note 262.

265. *In re Public Service Co.*, 20 Bankr. Ct. Dec. (CRR) at 850-52; *In re Chateaugay Corp.*, 109 B.R. at 54-57; *In re Allegheny Int'l*, 100 B.R. at 249-252, 255.

266. 100 B.R. 247 (Bankr. W.D. Pa. 1989).

267. No one seems to have raised the issue of subordination or reclassification under *Robinson v. Wangemann* and its progeny. See *supra* notes 246-55 and accompanying text.

268. I.R.C. § 1232(b)(1) (1984) and associated Treasury Regulation § 1.1232-3(b)(2)(iii)(c) (1984) (as of the time of the exchange offer), corresponding to current § 1272 and associated regs.

269. *In re Allegheny Int'l, Inc.*, 100 B.R. at 252-54.

270. I.R.C. § 1232 (1984) (as of the time of the exchange offer), corresponding to current § 1272.

271. Straight-line accrual computes interest by subtracting the initial value of the securities in question from the maturity value, dividing the difference by the number of months from issue date to maturity, and multiplying the quotient thus obtained by the number of months from issue to bankruptcy. See *In re Allegheny Int'l, Inc.*, 100 B.R. at 254.

272. The constant interest method finds overall interest owed in the same way as the straight-line method, *viz.*, by subtracting the initial value of the securities from their value at maturity. The

principles required. While the court justified its refusal to follow tax law based on the legislative history's statement that OID accrual should be computed by proration,²⁷³ there is no logical reason why proration must be on a straight-line, rather than a constant-interest, basis.

In *In re Chateaugay Corp.*,²⁷⁴ on the other hand, the bankruptcy court followed tax principles. The holders had received the securities in question pursuant to the debtor's exchange offer. Debt securities were exchanged for new debt-denominated securities with different interest rates, maturity dates, and sinking fund requirements, plus common stock of the issuer.²⁷⁵ Although the bankruptcy court declined to follow *Allegheny*, it did compare the legislative history of Bankruptcy Code section 502(b)(2) with that of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),²⁷⁶ concluding that TEFRA was not only not inconsistent with the Bankruptcy Code provision, but it also offered a good interpretation of "proration" for purposes of complying with Bankruptcy Code section 502(b)(2)'s legislative history. Accordingly, the *Chateaugay* court held that the proper initial valuation of the new securities received under the exchange offer should be the market value of the old securities exchanged therefore, and that accrual of interest on the new securities should be computed under the constant interest method.²⁷⁷

The *Chateaugay* approach clearly is more sensible than that taken in *Allegheny*. The constant-interest method measures interest costs to the issuer more accurately than the straight-line method, as the Senate Finance Committee noted in its report on TEFRA.²⁷⁸ In addition, it makes sense to follow a single rule, consistent with the principles of financial accounting, rather than to permit bankruptcy courts to choose methods of computation essentially *ex aequo et bono*, until courts of appeals can decide the question—at which time there may not only be dif-

accrual, however, is computed differently—as compound interest—by finding an interest rate for the first year of accrual, accruing imputed interest for a first year, and then applying the same interest rate successively for each year until maturity to the initial principal amount plus the imputed interest for each preceding year. The amount accrued at the date of bankruptcy is total accrued interest up to that date. It will be a lower number than that found by the straight-line method, and thereby will increase the amount of nonallowable, unmaturing interest on a given claim. See *In re Chateaugay Corp.*, 109 B.R. 51, 57-58 (Bankr. S.D.N.Y. 1990).

273. 100 B.R. at 254.

274. 109 B.R. 51 (Bankr. S.D.N.Y. 1990).

275. *Id.* at 52, 56.

276. Pub. L. No. 97-248, 96 Stat. 324 (1982).

277. See *supra* note 275, at 57-58.

278. S. REP. NO. 494, 97th Cong., 2d Sess. 210, 212 (1982).

ferent tax and bankruptcy rules, but different bankruptcy rules in each circuit.

B. *Fraudulent Transfer Issues*

Fraudulent transfer law is an ancient body of law²⁷⁹ that has become an integral part of the bankruptcy process.²⁸⁰ It protects creditors—represented in bankruptcy by the trustee in bankruptcy, or the debtor-in-possession in Chapter 11 reorganizations—by enabling them to avoid certain pre-bankruptcy transfers by a debtor that deplete the debtor's estate of property, which, absent the transfers, would have been available to satisfy the creditors' claims.

The application of fraudulent transfer law to large corporate transactions, and particularly to LBOs,²⁸¹ has aroused considerable controversy in recent years.²⁸² The use of junk bonds materially affects the applica-

279. Fraudulent transfer law dates back at least as far as Roman law; it was mentioned as early as 65 B.C. in an early letter of Cicero, and was generally stated in the Institutes of Justinian, 4,6,6 (ca. 533 A.D.). See, e.g., Max Radin, *Fraudulent Conveyances at Roman Law*, 18 VA. L. REV. 109 (1931). Modern Anglo-American fraudulent transfer law is traditionally traced from the statute of 13 Eliz., ch. 5 (1570), though in fact English fraudulent conveyance law substantially predates this statute. See, e.g., 50 Edw. III, ch. 6 (1376). While some states, such as Illinois, still follow variants of the statute of 13 Eliz., a majority of states now follow modern statutes. For purposes of this discussion, modern statutes include 11 U.S.C. § 548 (1988), the 1984 UNIFORM FRAUDULENT TRANSFER ACT (UFTA), and the 1917 UNIFORM FRAUDULENT CONVEYANCE ACT (UFCA).

280. Professor Clark has argued, with considerable force, that fraudulent transfer law can be seen as a paradigm for much of what bankruptcy law seeks to accomplish in rectifying certain creditors' inequitable pre-bankruptcy conduct. See Clark, *supra* note 78, at 517-62 (norms of fraudulent transfer law can be seen to justify most powers of the trustee in bankruptcy, including equitable subordination). The Bankruptcy Code has its own specific fraudulent transfer section, 11 U.S.C. § 548 (1988). The trustee in bankruptcy (or debtor-in-possession in a Chapter 11 case) also can apply applicable state fraudulent transfer law to challenge a transfer under 11 U.S.C. § 544(b) (1988).

281. The analysis here applied to LBOs applies equally to similar transactions, also common during the late 1980s, called leveraged recapitalizations. In a leveraged recapitalization, a corporation exchanges a large proportion of its equity capitalization for debt by borrowing large sums and paying most of the amounts borrowed as dividends to its shareholders. Thus, as in an LBO, large amounts are paid to stockholders and the corporation is left with a far higher proportion of debt than before the transaction; but, unlike an LBO, the corporation is left with the same shares outstanding, and largely the same stockholders, now left holding "stubs" worth far less than their shares prior to the dividend payment. Junk bonds are, as in LBOs, an important means employed for such borrowing. See Harvey L. Pitt et al., *Tender Offers: Offensive and Defensive Tactics and the Business Judgment Rule*, in 1 CONTESTS FOR CORPORATE CONTROL 7, 196-203 (Co-Chairman Dennis J. Block & Harvey L. Pitt, PLI Corp. Law & Practice, Course Handbook Series No. 730, 1991).

282. See, e.g., *Kupetz v. Wolf*, 845 F.2d 842 (9th Cir. 1988); *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987); *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488, 496, 499-504 (N.D. Ill. 1988); *Credit Managers Ass'n v. Federal Co.*,

tion of fraudulent transfer law to transactions such as LBOs, and raises certain fraudulent transfer issues in and of itself.

Modern fraudulent transfer law has established two broad categories of transfers avoidable as "fraudulent:" those transfers the debtor makes with actual intent to hinder, delay, or defraud creditors,²⁸³ and those that are "constructively fraudulent." While one should not exclude the possibility of invalidating a large corporate transaction such as an LBO based on actual intent,²⁸⁴ most challenges to such transactions are based on claims that they are constructively fraudulent.

A successful challenge to a transfer on grounds of constructive fraud must establish two basic elements: 1) the transferor received less than reasonably equivalent value in exchange for the transfer;²⁸⁵ and 2) the transfer was made while the transferor was insolvent, or rendered the transferor insolvent;²⁸⁶ or the transfer left the transferor with insufficient capital for its business or for a transaction in which it was engaged;²⁸⁷ or the transferor made the transfer at a time when it intended to incur, or believed that it would incur, debts beyond its ability to pay as they came due.²⁸⁸

The first element of a constructively fraudulent transfer has raised some debate in the LBO context. In an LBO, the acquiring entity, whose shareholders often include key members of the target corporation's management, borrows a large percentage of the funds it uses to buy the target's shares.²⁸⁹ The purchaser encumbers the target's assets to secure the

629 F. Supp. 175 (C.D. Cal. 1985); *In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127, 134-41 (Bankr. D. Mass. 1989); *In re Morse Tool, Inc.*, 108 B.R. 389, 390-91 (Bankr. D. Mass. 1989); *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*, 91 B.R. 430 (Bankr. N.D. Ohio 1988); Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985); David Gray Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73 (1985); Kathryn V. Smyser, *Going Private and Going Under: Leveraged Buyouts and the Fraudulent Conveyance Problem*, 63 IND. L.J. 781 (1988); Kevin J. Liss, Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491 (1987); Mary Goulet, *The Rights of Debtholders When a Leveraged Corporation Fails*, 15 J. CORP. L. 257 (1990).

283. 11 U.S.C. § 548(a)(1) (1988); UFTA § 4(a)(1); UFCA § 7.

284. See *United States v. Tabor Court Realty*, 803 F.2d at 1304-1305 (LBO transactions held fraudulent by actual intent).

285. 11 U.S.C. § 548(a)(2)(A) (1988); UFTA §§ 4(a)(2) and 5(a). The UFCA uses the term "fair consideration" instead of "reasonably equivalent value," but the two concepts are quite similar. The only difference is that "fair consideration" requires not only an equivalent value, but also that the transfer be made in "good faith." UFCA §§ 3-6.

286. 11 U.S.C. § 548(a)(2)(B)(i) (1988); UFTA § 5(a); UFCA § 4.

287. 11 U.S.C. § 548(a)(2)(B)(ii) (1988); UFTA § 4(a)(2)(i); UFCA § 5.

288. 11 U.S.C. § 548(a)(2)(B)(iii) (1988); UFTA § 4(a)(2)(ii); UFCA § 6.

289. See *United States v. Tabor Court Realty*, 803 F.2d 1288, 1292 (3d Cir. 1986), *cert. denied*,

senior debt used for this purpose. The target will normally assume the entire acquisition debt. In larger LBOs, such debt will have several different strata of seniority, ranging from secured debt at the top to one or more layers of junk bonds at the bottom.²⁹⁰ These junk bonds will tend to be deeply subordinated, both structurally and by subordination agreements the parties execute as part of the financing for the overall transaction.

Under the first element for finding a transaction constructively fraudulent, the issue is whether the target receives reasonably equivalent value in exchange for the liens it grants and the obligations it incurs pursuant to the LBO. If the borrowing and payment of shareholders are treated as part of a single transaction, creditor advances do not constitute reasonably equivalent value because they do not benefit the target, but rather its former shareholders.²⁹¹

While the existence or nonexistence of reasonably equivalent value in LBOs remains controversial, a challenge to a transaction as constructively fraudulent also must prove the second element.²⁹² It is with respect to this element that recharacterization of junk bonds emerges as a potential defense against fraudulent transfer actions in the LBO context.

1. Solvency Questions

Statutes that make the insolvency of the debtor an element of a constructively fraudulent transfer generally follow the "bankruptcy" definition of insolvency: a debtor is insolvent for fraudulent transfer purposes if the sum of the debtor's obligations exceeds the value of the debtor's assets.²⁹³ If the debtor is a junk bond issuer, the status of its junk bonds as debt or equity will materially affect its solvency under this definition. If the bonds are debt, even though subordinated, the debtor's obligations

483 U.S. 1005 (1987); REED, *supra* note 49, at 106 (purchasers' equity in LBOs is often less than 5% of the target's value).

290. REED, *supra* note 49, at 117-19.

291. See *United States v. Tabor Court Realty*, 803 F.2d at 1302 (affirming district court in collapsing secured borrowing and payment of stockholders into one transaction, and finding lack of fair consideration); *In re Ohio Corrugating Co.*, 91 B.R. 430 (Bankr. D. Ohio 1986). *But see In re Greenbrook Carpet Co.*, 722 F.2d 659 (11th Cir. 1984) (court declined to view borrowing and payment to shareholders as parts of a single transaction).

292. See, e.g., *Telefest, Inc. v. VU-TV, Inc.*, 591 F.2d 1368 (D.N.J. 1984) (fraudulent transfer challenge dismissed for failure to prove debtor's insolvency).

293. 11 U.S.C. §§ 101(31) and 548(a)(2)(B)(i) (1988); UFTA §§ 2 and 5(a); UFCA §§ 2 and 4. UFTA § 2(b) also establishes a presumption that a debtor is insolvent for fraudulent transfer purposes if it is equity insolvent, i.e., if it is generally not paying its debts as they come due.

to pay on them will be included among the obligations weighed against the issuer's assets in determining whether it is bankruptcy insolvent;²⁹⁴ if equity, they should not be so included.

The effect of recharacterization on the solvency question means that it not only places a sword in the hands of a trustee in bankruptcy, but a potential shield in the hands of LBO lenders and former shareholders who tendered their shares pursuant to an LBO. In a suit to avoid LBO payments and lien creation, defendants of this kind could assert that the junk bonds created pursuant to the LBO were actually equity. This recharacterization would reduce the amount of debt to be weighed against the value of the debtor's assets, and thereby would increase the chances that the debtor was neither insolvent at the time of the LBO, nor thereby rendered insolvent.²⁹⁵ Moreover, a court that recharacterizes one or more junk bond issues of a post-LBO as equity is less likely to find the existence of one of the alternatives to insolvency as a fraudulent transfer element—that it had unreasonably small capital for its business, or that it expected to incur debt beyond its ability to repay.

2. *Treatment of Payments of Interest and Principal*

If a junk bond issue is actually disguised equity, payments denominated as interest thereon may actually constitute dividends.²⁹⁶ In addition to having corporate-law implications,²⁹⁷ this characterization may subject such payments to scrutiny under the fraudulent transfer laws. Normally, the law considers payments on an antecedent debt to be made in exchange for reasonably equivalent value.²⁹⁸ If, however, the payments are distributions on an equity investment, reasonably equivalent value is not normally present.²⁹⁹

294. See *In re Ultime Corp.*, 207 F.2d 427, 428-29 (2d Cir. 1953) (voluntary subordination of certain claims did not reduce total debt of corporation for solvency purposes); Herzog & Zweibel, *supra* note 32, at 87.

295. See generally, REED, *supra* note 49, at 169.

296. See, e.g., Sheppard, *supra* note 30, at 1146.

297. See *infra* Section VI.D.

298. 11 U.S.C. § 548(d)(2)(a) (1988); UFTA § 3(a); UFCA § 3(a); *Mayo v. Pioneer Bank & Trust Co.*, 270 F.2d 823, 830-31 (5th Cir. 1959), *cert. denied*, 362 U.S. 962 (1960); *Cohen v. Sutherland*, 257 F.2d 737, 742 (2d Cir. 1958); *Inland Sec. Co. v. Estate of Kirshner*, 382 F. Supp. 338, 347 (W.D. Mo. 1974).

299. See *In re Roco Corp.*, 701 F.2d 978, 982 (1st Cir. 1983); *In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127, 136 (Bankr. D. Mass. 1989).

C. Preference Issues

A closely related issue concerns the attacks on preferences under the Bankruptcy Code.³⁰⁰ The preference provisions of Code section 547 promote equality of distribution of the debtor's assets among its creditors³⁰¹ by giving the trustee in bankruptcy³⁰² the power to avoid payments the debtor makes to a creditor, on an antecedent debt, if the debtor makes those payments during the 90 days before bankruptcy,³⁰³ while the debtor was insolvent,³⁰⁴ and if they enabled the creditor to receive more than it would have received in a liquidation of the debtor had the payment not been made.

For preference purposes, the debtor is presumed to have been insolvent during the 90 days prior to the filing of the bankruptcy petition.³⁰⁵ This presumption is rebuttable, and no such presumption applies to the period from 90 days to one year before bankruptcy during which insider preferences are avoidable. Thus, for purposes of proving that the debtor was not insolvent during the preference period, recharacterization of junk bonds as equity may offer a preference defense much like that described above for fraudulent transfer actions.

D. Recoveries By the Trustee Under Corporate Law

The trustee in bankruptcy possibly may recover on behalf of creditors under sources of law other than traditional debtor-creditor law. Corporate law may provide one such source of recovery to supplement recoveries under fraudulent transfer law.³⁰⁶

1. Management Fiduciary Duties

Under standard principles of corporate law, management owes fiduci-

300. 11 U.S.C. § 547 (1988).

301. *Begier v. I.R.S.*, 110 S. Ct. 2258, 2263 (1990) (Bankruptcy Code § 547(b) promotes equality among creditors by preventing debtor from favoring one creditor over another shortly before bankruptcy).

302. Or the debtor-in-possession in a Chapter 11 reorganization case.

303. One year before bankruptcy if the creditor was an "insider" of the debtor. 11 U.S.C. § 547(b)(4)(B) (1988).

304. 11 U.S.C. § 547(b)(3) (1988). Insolvency for preference purposes is defined as it is for fraudulent transfers, as "balance-sheet," or bankruptcy insolvency, under 11 U.S.C. § 101(31). *In re Taxman Clothing Co.*, 905 F.2d 166, 168 (7th Cir. 1990).

305. 11 U.S.C. § 547(f) (1988).

306. *See* *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488, 507-12 (N.D. Ill. 1988) (debtor-in-possession stated causes of action against debtor's former directors for breach of fiduciary duty and violation of Illinois Business Corporations Act by improper distributions).

ary duties to stockholders. It owes these duties to corporate creditors only if the corporation is insolvent.³⁰⁷ Junk bonds, as hybrid instruments, raise questions as to whether corporate management owes fiduciary duties to their holders, and as to the extent of such duties.³⁰⁸ If management breached these duties, creditors—and the trustee in bankruptcy, standing in their shoes—may recover for the breach.³⁰⁹

2. Dividend Issues

If junk bonds are in fact equity, then state corporate statutes that regulate equity distributions, dividends and redemption of shares, may limit distributions made on such issues.³¹⁰ Under the corporate law of most states, insolvent firms may make no such distributions.³¹¹ Improper distributions may be recovered from the directors who authorized them,³¹² and, under more limited circumstances,³¹³ from those who received them.³¹⁴

Distributions of interest and principal on a junk bond issue may thus be subject to recovery as improper dividends if the issue is recharacter-

307. See Bratton, *Convertible Bonds*, *supra* note 64, at 667, 667-68, 733; Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 *BUS. LAW* 413, 442-450 (1986) (advocating creation of general fiduciary duties to bondholders); 3A WILLIAM MEADE FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 1175 (rev. perm. ed. 1986) (under one theory, corporate officers are trustees for creditors of an insolvent corporation).

308. See Bratton, *Convertible Bonds*, *supra* note 64, at 732 (fiduciary duties could be imputed to convertible bondholders based on characterizing their conversion privileges as an equity interest).

309. See *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. at 507-510 (debtor-in-possession stated claim against debtor's former directors for breach of fiduciary duties).

310. *Arnold v. Phillips*, 117 F.2d 497, 502-03 (5th Cir. 1941) (since purported debt actually constituted equity, pre-bankruptcy interest payments thereon "were dividends").

311. See, e.g., N.Y. *BUS. CORP. LAW* § 510(a) (McKinney 1986).

312. See, e.g., N.Y. *BUS. CORP. LAW* § 719(a)(1) (McKinney 1986); *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. at 510-12 (debtor-in-possession stated claim against debtor's former directors for improper distributions to shareholders under Illinois Business Corporation Act); *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 583-85 (M.D. Pa. 1983) (creditors entitled to recover from directors and controlling shareholders authorizing improper distribution to shareholders under Pennsylvania corporate law), *aff'd sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

313. Recovery from shareholders receiving an illegal distribution (as opposed to recovery from directors authorizing the distribution) normally requires that the corporation have been insolvent at the time of the distribution, or that the shareholders had knowledge that the distribution was illegal. See, e.g., N.Y. *BUS. CORP. LAW* § 719(d)(1) (McKinney 1986).

314. See *Reilly v. Segert*, 201 N.E.2d 444 (Ill. 1964); N.Y. *BUS. CORP. LAW* § 719(d)(1) (McKinney 1986), *REV. MODEL BUSINESS CORP. ACT* § 8.42(b)(2); HENN & ALEXANDER, *supra* note 18, at 903-04.

ized as equity.³¹⁵ Recoveries of this kind would involve different parties than in the case of the fraudulent transfer theory noted above, since authorizing directors as well as actual recipients of the distributions could be subject to liability and since the elements of proof also would differ.³¹⁶

CONCLUSION

In the wake of the recent junk bond explosion of the 1980s, the bankruptcy courts have begun dealing with resultant junk bond problems. They should realize that, despite the broad use of the "junk bond" label, there are many different kinds of junk bonds, and that a court dealing with the bankruptcy of a junk bond issuer must determine the status of each of the issuer's securities based on the issue's own inherent characteristics.

A bankruptcy court dealing with a junk bond issue should presume that the bond indenture should be enforced in bankruptcy as the parties intended. Nonetheless, if the characteristics of an issue are predominantly those of an equity instrument, it would be unfair to the debtor's genuine creditors for a court not to consider recharacterizing the issue as equity for bankruptcy purposes. In deciding whether to do so, the court should take into account the normal equitable principles of bankruptcy law, and, where specific bankruptcy authority is unavailable, should refer carefully to the courts' more extensive experience with tax law rather than building a new legal edifice from first principles.

This Article has made a broad survey of the issues that junk bonds raise in the bankruptcy context. Its coverage has necessarily been less than comprehensive, since it intends primarily to begin discussion of these issues rather than to deal with them definitively. This Article seeks to establish a framework for further discussion of these questions and of related questions that may arise, such as securities law issues that result from the bankruptcy of junk bond issuers. Further exploration of this

315. *See* *Arnold v. Phillips*, 117 F.2d 497, 502-03 (5th Cir. 1941).

316. Instead of proving that the transferor was bankruptcy-insolvent or undercapitalized, and made a transfer for less than reasonably equivalent value, the plaintiff would have to prove that defendants were directors and voted for distributions in violation of state dividend or share redemption law (or were shareholders and received such improper distributions with knowledge of the impropriety). This proof generally involves equity insolvency rather than bankruptcy insolvency. In many states, even if the corporation is not insolvent, an improper distribution can be based on proof that it exceeds the corporation's balance-sheet surplus. *See, e.g.*, N.Y. BUS. CORP. LAW §§ 102 (a)(8), 510, 719(a) (McKinney 1986).

field will become increasingly important as the junk bond issuers of the 1980s find their way to the bankruptcy courts of the 1990s.

